Chapter XI

Taxation

J. van Hoorn, Jr. and L. Hart Wright*

INTRODUCTION

This study on the foreign and United States tax implications encountered by American industry in rendering services, or disposing of products, in the European Common Market is designed for the benefit of those who have little or no understanding of the subject matter. While this analysis constitutes the most comprehensive published integrated study of the subject, it falls far short of answering every question with which a specialist in foreign tax affairs must ultimately come to grips. After all, the economies of the six nations which make up that market are almost as sophisticated as that in the States, and this means that their tax structures will be almost equally complicated. While those nations do not publish rulings and regulations in a degree comparable to the Federal practice, and thus do provide less raw interpretative data, nevertheless, one cannot expect in a few hundred pages to develop in meaningful sequence all of the known variations in their tax patterns, particularly if room is required to accommodate integration of relevant American tax principles and costs. The aim here does not go beyond providing detailed orientation to a degree that

*Most of the basic data concerning foreign taxes was prepared in the form of a rough draft by Mr. J. van Hoorn, Jr., in cooperation with the International Bureau of Fiscal Documentation (Herengracht 196, Amsterdam) of which he is the managing director. Mr. van Hoorn also serves as a tax consultant and is co-author of a three volume treatise in Dutch on the principles of taxation, "Het Belastingrecht Zijn Grondslagen En Ontwikkeling," (L. J. Veen's Uitgeversmij. N.V., Amsterdam, 1954, 2d ed.). In addition to authorship of other tax articles, he is director of the tax volumes in the twelve volume series, "Recueils Pratiques du Droit des Affaires dans les Pays du Marché Commun."

Revision of this Chapter into a final manuscript and original development of the materials dealing with American tax implications were the responsibilities of Professor Wright (Professor of Law, University of Michigan; formerly Professor of Tax Law, Advanced Training Center, Internal Revenue Service (1954-1956); Consultant to the Commissioner of Internal Revenue (1956, 1959-1960); author, "Basic Income Tax Law For Internal Revenue Agents and Office Auditors," Internal Revenue Service (1957); and author of various tax articles.)
one may formulate tentative plans and identify those questions which must then be referred to the specialist. To this end, the study is divided into six PARTS, the sequence being geared generally to the evolutionary stages through which an American business might logically expand its foreign operations.

PART I contains a country-by-country survey of the tax systems employed by the Common Market countries; it provides background essential to a true understanding of the tax differentials later dramatized by functionalized comparisons in PARTS II, III, and V. The discussion in PART I of each country’s tax structure has been arranged according to a more or less common pattern. Consideration of a particular country’s income and enterprise taxes is followed by an analysis of its property and turnover taxes. With respect to income taxes, immediately following a description of the overall tax pattern and the rate structure applicable to individuals and corporations, the focus shifts to the prevailing notion of gross income including the treatment of capital gains. An analysis of deductions and certain special problems follows. Included in the latter are accounting problems, the matter of taxable years, and differences in tax treatment where an American company establishes a foreign subsidiary, as distinguished from a permanent establishment in the nature of a branch.

The truly functionalized comparative study, including integration of American tax principles and costs, begins in PART II with an analysis of the overall tax effects encountered by an American company when it first seeks to enter the Common Market through development of direct exports to customers situated there. The first prime concern in that setting involves the extent to which promotional and sales activity can be carried on in the Common Market itself without subjecting any part of the export profits to their income taxes. Compared also are the turnover taxes which would be imposed by each member nation, including some indication of the way these may multiply, depending on the manner in which the sale is handled. Integration of these into the American tax pattern is followed by a consideration of the circumstances in which exports can be immunized from the manufacturers’ excise tax. The direct export story then concludes with an analysis of the considerations which affect the competitive tax position of American exporters when compared to other exporters as well as with producers in the Common Market itself.

For a variety of reasons, an American exporter may conclude
that those products destined for foreign markets should actually be manufactured abroad, in whole or in part. Execution of a licensing and "know-how" agreement between the American company and an established European firm may be preferred by the less venturesome as against establishment abroad of an American owned manufacturing facility. A complementary motive may be to assure a ready outlet for certain components which will continue to be manufactured at home. In any event, second only to the development of direct export trade—where also little capital, if any, is ventured abroad—direct licensing arrangements enjoy the least complicated foreign tax effects. Accordingly, it seemed appropriate that the fairly simple comparative foreign income and turnover tax effects, including integration of American tax costs, should also be dealt with in PART II, immediately following analysis of the export situation.

Put off for discussion in PART III are the more sophisticated sales and licensing arrangements, involving use of the same organizational devices which might house a manufacturing facility, specifically a foreign permanent establishment in the nature of a branch or a foreign subsidiary. In order to facilitate comparison of the foreign tax effect on these in each of the member nations, the discussion in PART III proceeds first, in Sections B and C, on the assumption that a facility is to be established to serve only one member nation. Comparison is made in Section B of the total direct tax load (income, enterprise, and property taxes) which each country would impose if it were chosen as the locale. Integration in Section C of the American tax costs also provides the occasion for a basic analysis of the reasons why, and instances where, there are differences in the overall or combined tax costs of doing business through a foreign branch as distinguished from a subsidiary. Emergence of a differential which generally favors the subsidiary arrangement is traced, leading, inter alia, to a more or less complete discussion of the provisions regarding the deduction and credit for foreign taxes allowed by the United States in the setting of a single-tier foreign facility. Discussion of the limitations of the credit will serve, illustratively, to explain—in terms of preferred tax locales—why a country like Belgium, which relies primarily on an income tax, enjoys a relative advantage over a country like Germany which looks also to annual net wealth taxes on corporations as well as on individuals for a significant part of its direct tax revenue.
The foreign and American tax ramifications of the next stage in the life line of an expanding Common Market facility, i.e., the circumstance where it begins to engage in direct exports to customers in other member nations, is taken up in Section D of PART III. An analysis of the bilateral income tax treaties among nations of the Common Market is followed in that Section by an indication of the arrangements which serve to whittle down the likelihood of multiple turnover taxes. The Section concludes by supplying the reasons behind an admonition bearing on the tax considerations which should be taken into account in choosing a locale for that facility which will export into other member nations.

The succeeding Section E examines the further foreign and American tax ramifications which will arise if the operating facility in one member nation intensifies its development of markets in other member nations by establishing therein its own branch or a sub-subsidiary. Discussion of the extent to which there will be two foreign income taxes on the second facility's profits—the likelihood depending on the organizational nature of the facility and the choice of locale, is followed by an examination of the way the American credit for foreign taxes would respond to such a two-tier arrangement.

Compared with the foregoing, in the following Section F, are the tax implications which would be associated with the American parent company's own establishment of "sister" branches or subsidiaries.

Widespread and expanding operations of that type logically focus attention, in Section G, on the tax advantages which could be achieved if a foreign holding or "base" company were superimposed on the operating facilities, provided, of course, a favorable tax climate for the holding company could be found. The importance of this latter condition is highlighted by comparing, as possible locales, certain Common Market countries with certain so-called "tax havens" located adjacent to that market, the indication being that the Netherlands and in a lesser degree, Luxembourg, provide a tax regime as favorable as any.

PART III then concludes with an indication of the tax implications encountered where a foreign facility in the Common Market exports directly to customers outside the Community.

It seemed unwise to interrupt PART III's evolving and integrated tax story of an expanding and ever more penetrating foreign operation with diversions into certain American tax matters which,
together, might be subsumed under a tax accounting label. Accordingly, the methodology and timing aspect, as they relate to conversion of foreign profits into American dollars, are covered in PART IV in the setting of blocked as well as unblocked foreign currencies. Also dealt with there is the conversion problem as it relates to the American credit for foreign taxes.

Even the most simple penetration of a foreign market, a direct export arrangement, may lead an American company to assign certain American employees abroad as promotional representatives. The likelihood is even greater if a permanent establishment or subsidiary is created in the Common Market. The function of PART V is to compare the foreign tax loads which would be imposed on such persons, indicating at the same time the way in which American tax law responds to the situation. Foreigners employed by the Common Market facility, as well as Americans stationed there, may be expected to make brief business visits to the States—combined perhaps with a vacation. Other Americans, normally stationed in the States, may also make brief business trips abroad. The ensuing tax complications and the degree to which the interested nations have avoided double taxation in these circumstances, are also subjects of discussion in PART V.

Whereas the first five PARTS are concerned with the tax pattern existing in July 1960,\(^1\) PART VI attempts to survey changes which might be expected in the future with respect to Common Market taxes and such American tax principles as affect companies interested in the market outlet provided by the European Economic Community.

Mr. van Hoorn would like to acknowledge the contribution of his assistants, Messrs. W. H. J. Charbon, J. P. C. Huiskamp, and D. A. van Waardenburg, as well as aid received from correspondents who checked his findings, as follows:

—Belgium: Me. Paul Sibille, Brussels (Attorney at law at the Court of Appeal, and director of the "Ecole Supérieure de Sciences Fiscales");
—France: Jean H. Rothstein, H.E.C., Paris (tax consultant, national reporter to the 12 volume "Recueils Pratiques du Droit des Affaires dans les pays du Marché Commun," and author of various publications on international tax law);
—Germany: Dr. Albert J. Radler, Dipl. Kfm., Munich

\(^1\) After the original manuscript was prepared, PART III was revised to accommodate certain changes made in August 1960 by Congress.
AMERICAN ENTERPRISE IN THE COMMON MARKET

(>Assistant in the Institute of International Tax Law at the University of Munich); and

—Italy: Dr. Giancarlo Croxatto, Genoa (Assistant, University of Genoa; co-author of various publications in the field of international tax law, national reporter to the 12 volume, "Recueils Pratiques du Droit des Affaires dans pays du Marché Commun").

—Acknowledgment is also made to R. Mees & Zonnen, Rotterdam, for permission to use in Part III, infra, certain formulae which first appeared in a publication prepared for that firm by International Bureau of Fiscal Documentation, Company Taxation in Western Europe (1959).

Professor Wright would like to acknowledge the research assistance provided by Mrs. Elizabeth H. G. Brown, Research Associate, University of Michigan Law School, and by Mr. Robert Wartell, his research assistant.
PART I. THE TAX SYSTEMS OF COMMON MARKET COUNTRIES

(A Country By Country Survey)

SECTION A. BELGIUM

SUBSECTION I. INCOME TAXES

(a) In general.—Unlike the single federal income tax utilized by the United States, the Belgian national government employs a series of different income taxes. Income of individuals and juridical entities is first divided by reference to its type into three primary categories, each of which is subjected to a different tax. A fourth tax, applicable only to individuals, is superimposed on these separately scheduled assessments; it is applied to the aggregate income from the three primary sources. A fifth tax, enacted during the critical days of the 1930’s and known as the Contribution Nationale de Crise, is imposed on selected items of income belonging to two of the three primary categories, as well as on distributed profits of some juridical entities.

The first of the prime categories comprises income from all real property situated in Belgium. Whereas gross income for American tax purposes would normally include the actual income from such property, only an estimated amount has been included in Belgium. This estimate, made according to a Land Register (cadastre), is often much less than the actual income. Once made by reference to average net yield, the estimate thereafter remains constant for a period of 20 years. The contemplated periodic revision of the estimates has not been undertaken in recent years, though a new estimate—expected to be much closer to actual income—is under consideration.\(^1\) This “income” is subject to a modest flat rate national tax (Contribution Foncière); to this is added the progressive rate of the national crisis tax and substantial local surcharges.

Another, but different, flat rate tax (Taxe Mobilière) applies to actual income from investments in personal property, though here

\(^1\) This method has the advantage that the tax will be the same, irrespective of whether the property is used by the taxpayer himself or leased.
variations in the flat rate do exist, depending on whether the income item is a dividend, interest, royalty, etc. It applies also to income from real property situated abroad. Where such an investment is made by a silent partner of a partnership or of a Belgian private company, the income is subject also to the national crisis tax and at progressive rates. Foreign partnership or private company income is subject to ¼rd of the ordinary rates of this latter tax.2

A graduated tax, known as the Taxe Professionnelle, is applied to the third basic type of income, i.e., to that derived from the conduct of a trade or business, including also professions, vocations, or an employment. Corporations with outstanding shares may avoid the greater part of this progressive tax by distributing their profits. But in such case, a flat rate tax under the selective Contribution Nationale de Crise is assessed against the corporation by reference to the amount of the gross dividend. At that same point the shareholder would be assessed under the basic, separately scheduled and previously described, flat rate Taxe Mobilière.

A final type of tax (Impôt Complémentaire Personnel) is applicable only to individuals. It is designed to apply a graduated rate to the individual’s aggregate income from the three basic sources first mentioned (real property, personal property, and business or employment activity).

A more detailed analysis of the cumulative effect of these various taxes follows.

(b) Taxes on estimated income from realty.—Apart from the progressive tax on an individual’s aggregate income from all sources, at least three different taxes are applied to administratively determined advance estimates of “imputed” income derived by juridical entities or individuals from ownership of real property. The first, a national 6% flat rate, is complemented by the graduated national crisis tax, the progressive rates of which range from 2 to 15%. Local units then surcharge the national flat rate imposition, and these surcharges are said to approximate an average rate of about 36%.3 Table I A indicates the cumulative effect of the three rates.

One procedure, very similar to that followed by American states in imposing real property taxes, has served in practice to cushion what might seem to be a rather high cumulative rate pattern. The

2 For the tax treatment of foreign income, see sub-topic (j), infra.
3 This average differs from that given in a Belgian official publication, where a figure of 30% is used.
### Table 1 A

**REAL PROPERTY RATE SCHEDULE**

<table>
<thead>
<tr>
<th>Estimated Income</th>
<th>Belgian Francs</th>
<th>Dollars</th>
<th>% re Flat Rate Tax</th>
<th>% re the National Crisis Tax</th>
<th>Additional Tax (Local Gov't)</th>
<th>Average %</th>
<th>Total %</th>
</tr>
</thead>
<tbody>
<tr>
<td>From 0 to 2,999</td>
<td>From 0 to 59</td>
<td>6</td>
<td>2</td>
<td>36</td>
<td>44</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3,000 to 9,999</td>
<td>60 to 199</td>
<td>6</td>
<td>3</td>
<td>36</td>
<td>45</td>
<td></td>
<td></td>
</tr>
<tr>
<td>10,000 to 24,999</td>
<td>200 to 499</td>
<td>6</td>
<td>4</td>
<td>36</td>
<td>46</td>
<td></td>
<td></td>
</tr>
<tr>
<td>25,000 to 49,999</td>
<td>500 to 999</td>
<td>6</td>
<td>6</td>
<td>36</td>
<td>48</td>
<td></td>
<td></td>
</tr>
<tr>
<td>50,000 to 99,999</td>
<td>1,000 to 1,999</td>
<td>6</td>
<td>8</td>
<td>36</td>
<td>50</td>
<td></td>
<td></td>
</tr>
<tr>
<td>100,000 to 149,999</td>
<td>2,000 to 2,999</td>
<td>6</td>
<td>10</td>
<td>36</td>
<td>52</td>
<td></td>
<td></td>
</tr>
<tr>
<td>150,000 to 199,999</td>
<td>3,000 to 3,999</td>
<td>6</td>
<td>12.5</td>
<td>36</td>
<td>54.5</td>
<td></td>
<td></td>
</tr>
<tr>
<td>200,000 and over</td>
<td>4,000 and over</td>
<td>6</td>
<td>15</td>
<td>36</td>
<td>57</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Administratively determined amount of estimated income from each piece of real property remains unchanged for long periods of time. Because the economic criteria used in fixing the present effective base pre-dates the Second World War, the amount of estimated income assigned to any given piece of real property is not nearly as high as the present *true* annual use value. The *effective* base, according to one authority, constitutes not more than one-fifth of the true amount. This compensating factor is offset in part, but only in the case of real property used in connection with industrial activity, in that the base otherwise determined is increased by one-half.

Accordingly, if the *true* annual use value of a small factory building and the tract of land on which it is situated approximates $6,000 (B.Frs. 300,000), the taxable estimated income is not likely to exceed $1,800 ($6,000 × \(\frac{1}{6}\) × 1½) for which the typical stated cumulative average rate is 50% or $900, which means an effective rate of 15%.

(c) *Taxes on income from investments in personalty.*—The Taxe Mobilière, generally collected on a withholding basis, incorporates different flat rates for various types of income derived from investments in personal property. Dividends received from companies, the capital of which is divided into shares, are taxed at 30% while debenture interest and royalties are taxed at 18% though this latter rate is reduced approximately to 12.2% if the debtor, rather than the creditor, actually bears *and* pays the tax.4

---

4 Profits distributed to a silent partner of a partnership are taxed at 25% under the Taxe Mobilière and at 2% to 15% under the national crisis tax.
Assessment of this tax against stockholders with respect to dividends is complemented by a flat rate national crisis tax, assessed against the corporation, on the same gross dividend. Moreover, if the shareholder is an individual, the dividend will be aggregated with his other income in fixing the base against which a third tax, the progressive Impôt Complémentaire Personnel, is applied. These two additional taxes are considered in more detail below.

The Taxe Mobilière is also applicable to income from foreign real property, but, as is true in the case of income from foreign personality, the rate is reduced to a flat 12%.

(d) Taxes on retained income from trade or business activity.—The Taxe Professionnelle applies a graduated rate to income derived from a profession, employment, or from trade-or-business activity carried on by corporations, partnerships, or individuals. It differs from the American federal income tax in two major respects. First, income from investments in personal property, such as stocks or bonds, as well as any imputed income derived from real property is beyond the reach of this particular tax. Second, in the case of corporations and partnerships, this exaction is only applied to undistributed profits. The type of taxes applied to distributed profits depends, as is later noted, upon the character of the distributing juridical entity. Because these latter taxes do serve as a substitute for the Taxe Professionnelle in the case of distributed profits, a credit arrangement has been worked out to accommodate those situations where retained profits which have been subjected to the Taxe Professionnelle are distributed in a later year, at which time they become subject to the other taxes.

The progressive rate schedule of the basic tax applicable to undistributed business profits of juridical entities appears in Table I B.

<table>
<thead>
<tr>
<th>On That Part of Taxable Income:</th>
<th>Belgian Francs</th>
<th>U.S. Dollars</th>
<th>Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>From 0 to 150,000</td>
<td>From $ 0 to $ 3,000</td>
<td>25.0%</td>
<td></td>
</tr>
<tr>
<td>From 150,000 to 500,000</td>
<td>From 3,000 to 10,000</td>
<td>30.0%</td>
<td></td>
</tr>
<tr>
<td>From 500,000 to 1,000,000</td>
<td>From 10,000 to 20,000</td>
<td>35.0%</td>
<td></td>
</tr>
<tr>
<td>From 1,000,000 to 10,000,000</td>
<td>From 20,000 to 200,000</td>
<td>37.5%</td>
<td></td>
</tr>
<tr>
<td>From 10,000,000 and over</td>
<td>From 200,000 and over</td>
<td>40.0%</td>
<td></td>
</tr>
</tbody>
</table>

In appraising this schedule, account should be taken of two additional factors. First, the Taxe Professionnelle is actually levied on the income of businesses and liberal professions in the year
following the year in which the income was derived, and in principle the amount, as distinguished from the rate, of tax is increased by 20%. But this increase may be avoided en toto if the ultimate tax was accurately estimated and paid in advance, i.e., before the 15th day following the first half of the taxpayer's taxable year (accounting year). Again, the increase will amount only to 10% if an accurate estimate was made and paid before the 15th day following the close of the taxpayer's taxable year. Absent advance payment, or where the amount paid in advance is less than the tax ultimately due, the amount which has not been paid in advance is increased by 20%. In effect, the portion of the income not reflected in the estimates would, if otherwise subject to the 40% rate, suffer a 48% rate.

Second, unlike the American income tax, on the final due date in the year succeeding the taxable year, the professional tax becomes a deduction in computing the taxable profits of that same succeeding year. The effect of this feature can be illustrated by reference to that part of any yearly profits subjected to the stated 40% ceiling rate. In the first year in which an enterprise operates, that ceiling rate would, of course, be the effective rate on income falling in the top bracket. In the second year, the stated 40% rate on such income would become an effective 24% rate, and in the succeeding years, the stated 40% rate would be tantamount to a shifting effective rate ranging between 30% and 28%.

The quite different rate schedule, applicable under the Taxe Professionnelle to the net business or employment income of an individual, is presented in Table I C.

**Table I C**

<table>
<thead>
<tr>
<th>Net Income After Itemized or Standard Deductions</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Frances</strong></td>
</tr>
<tr>
<td><strong>From</strong></td>
</tr>
<tr>
<td>0</td>
</tr>
<tr>
<td>150,000</td>
</tr>
<tr>
<td>250,000</td>
</tr>
<tr>
<td>500,000</td>
</tr>
<tr>
<td>1,000,000 and over</td>
</tr>
</tbody>
</table>

The remuneration of corporate directors who are members of the board of control and do not have a regular job with the company is subject to the normal rates with a 20% surcharge.
This surcharge is independent of, and its application will precede, the quite different and previously discussed additional tax of 20% which is applied against the amount ultimately due if the latter was not paid in advance either through withholding or estimated payments. Illustratively, if a corporate director's basic rate under the regular income tax is 30%, the special surcharge added with reference to remuneration received as a director will increase the rate to 36% (20% \times 30\% = 6\%), and this will be increased again by another 20%, bringing the rate to 43.2% (20% \times 36\% = 7.2\%), if not paid in advance.

Generally, the tax on salaries and wages (including those paid to company directors) is withheld at the source, the exception being the tax payable by managers (working partners) of the so-called sociétés de personnes (partnerships, limited partnerships, and closely held corporations).

(e) Taxes on distributed profits of an enterprise.—As previously noted, the Taxe Professionnelle applies only to undistributed business profits. Selection of the particular taxes which apply to distributed profits turns on the character of the distributing juridical entity.

Entities, the capital of which is divided into shares, pay a flat national crisis tax of 20% on gross dividends. Viewed separately, this would mean that a corporation would need a profit of $120 in order to distribute a $100 gross dividend. However, since the $20 is not itself distributed, the corporation will also be burdened with the Taxe Professionnelle, which at the maximum 40% rate, would give rise to an additional tax of $8 on the $20 of retained earnings. The overall maximum effect is that a corporation must enjoy a profit of $128 in order to pay a $100 dividend. The two taxes just described will then be complemented by the previously discussed personal property income tax (Taxe Mobilière), assessed on a withholding basis, against the shareholder, the rate being a flat 30% against the gross dividend of $100. Apart then from the yet separate progressive tax on an individual's aggregate income from all sources, that part of a corporation's profits which is distributed will suffer a maximum tax of approximately 45\% \left(\frac{20 + 8 + 30}{128}\right).

Where the capital of a jointly conducted enterprise is not divided

^ It must be understood that this is the maximum possible effect. As the share of current profits which are distributed increases, the likelihood that the enterprise will reach the stated rate of 40% under the Taxe Professionnelle decreases. Moreover, that part of the Taxe Professionnelle attributed to retained profits used to pay the national crisis tax will become a deduction in computing a later Taxe Professionnelle. This would whittle the true effective cost to a figure below $8.
into shares, any portion of the profits distributed to *active* partners is subject to two different progressive taxes. The first involves the progressive rates under the Taxe Professionnelle applicable to individuals, the second being the complementary personal tax which applies a graduated rate to an individual's aggregate income from all sources. Distributions to *silent* partners of such an enterprise are subject, on the other hand, to three different taxes, the personal property income tax (Taxe Mobilière) at a flat 25% rate, a graduated national crisis tax ranging from 2 to 15%, and the regular progressive income tax applicable to an individual's aggregate income. However, the first two of these taxes constitute deductions in arriving at the tax base of the third.

*(f) Complementary progressive tax on individual's aggregate income.*—In addition to the three separate taxes on income from personal property, real property, and business, individuals pay a graduated tax with respect to the aggregate income from all of these sources. However, the three separately scheduled taxes as well as any overall complementary progressive tax paid during the period are deducted from gross income in arriving at the tax base against which the overall progressive tax is applied. These deductions, together with certain deductible personal items to be discussed later, are important in appraising the actual impact of the graduated rates in Table I D.

### Table I D

**TAXABLE INCOME**

<table>
<thead>
<tr>
<th></th>
<th>Francs</th>
<th>Dollars</th>
<th>Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>First</td>
<td>50,000</td>
<td>$1,000</td>
<td>0.5%</td>
</tr>
<tr>
<td>Next</td>
<td>50,000</td>
<td>1,000</td>
<td>3%</td>
</tr>
<tr>
<td>Next</td>
<td>50,000</td>
<td>1,000</td>
<td>5%</td>
</tr>
<tr>
<td>Next</td>
<td>50,000</td>
<td>1,000</td>
<td>10%</td>
</tr>
<tr>
<td>Next</td>
<td>50,000</td>
<td>1,000</td>
<td>14%</td>
</tr>
<tr>
<td>Next</td>
<td>50,000</td>
<td>1,000</td>
<td>20%</td>
</tr>
<tr>
<td>Next</td>
<td>300,000</td>
<td>6,000</td>
<td>24%</td>
</tr>
<tr>
<td>Next</td>
<td>200,000</td>
<td>4,000</td>
<td>26%</td>
</tr>
<tr>
<td>Next</td>
<td>200,000</td>
<td>4,000</td>
<td>28%</td>
</tr>
<tr>
<td>Balance</td>
<td></td>
<td></td>
<td>30%</td>
</tr>
</tbody>
</table>

*(g) The Belgian concept of gross income.*—The types of income embraced by the various basic taxes have been previously described. Since most of the previously mentioned income taxes relate to narrowly defined items, the practical meaning of gross
income need be considered only in the setting of the more far ranging progressive tax on business income and the complementary progressive tax on an individual's aggregate income. Compared to American standards, the most unique principle relates to the treatment of capital gains and income which is not ordinary business income.

Generally speaking, such gains do not constitute a part of gross income. The range of this immunizing principle is limited, however, by the fact that any gain realized from the sale of specific business assets is considered a business profit and is taxed under the applicable rate schedules as such. There is some recognition that such gains are illusory to the extent they are products of a piecemeal inflation which started in Belgium following World War I. The formula used in determining the amount of gain allows the vendor first to increase the historical cost basis by a coefficient, the amount of which depends on the year in which the asset was acquired. From the sum thus determined, depreciation previously allowed for tax purposes is deducted in arriving at the net basis. Table I E presents a schedule of the coefficients.

With reference to the Taxe Professionnelle, as well as the complementary progressive tax on income derived by individuals from

<table>
<thead>
<tr>
<th>Date of Acquisition</th>
<th>Coefficient</th>
</tr>
</thead>
<tbody>
<tr>
<td>1918 and before</td>
<td>16.33</td>
</tr>
<tr>
<td>1919</td>
<td>11.49</td>
</tr>
<tr>
<td>1920</td>
<td>6.15</td>
</tr>
<tr>
<td>1921</td>
<td>6.30</td>
</tr>
<tr>
<td>1922</td>
<td>6.43</td>
</tr>
<tr>
<td>1923</td>
<td>4.37</td>
</tr>
<tr>
<td>1924</td>
<td>3.89</td>
</tr>
<tr>
<td>1925</td>
<td>4.02</td>
</tr>
<tr>
<td>1926</td>
<td>2.72</td>
</tr>
<tr>
<td>1927 to 1934 inclusive</td>
<td>2.35</td>
</tr>
<tr>
<td>1935</td>
<td>1.86</td>
</tr>
<tr>
<td>1936 to 1943 inclusive</td>
<td>1.70</td>
</tr>
<tr>
<td>1944 to 1948 inclusive</td>
<td>1.14</td>
</tr>
<tr>
<td>1949</td>
<td>1.10</td>
</tr>
<tr>
<td>1950 et seq.</td>
<td>1.0</td>
</tr>
</tbody>
</table>

*These coefficients apply only to industrial or commercial buildings and equipment, as well as to securities held for more than five years.
all sources (Impôt Complémentaire Personnel), a further immunity has been granted, but only temporarily—i.e., during the calendar years 1959 to 1963 or counterpart fiscal years, if the realized gain from the disposition is reinvested within a certain period. Satisfaction of the prescribed standard leaves only \( \frac{3}{8} \)th of the gain subject to tax. And none of the gain will be recognized if the reinvestment is made in certain districts which have suffered particularly serious economic dislocations.

The fact that gain realized on the disposition of business assets is generally includible for tax purposes also has significance in the instance where a proprietorship is converted into a limited liability company. The gain, determined by subtracting the net basis just described from the fair market value of the shares received, will be taxed unless the owner himself ceases all trade. In the latter event, only the profit stemming from the transfer of goodwill (clientele) is reached.

With reference to a business's income, it will be recalled that only income from actual business activity is subject to the professional tax. Dividends received by enterprises (other than those which operate in the financial field as such) are subject to the personal property income tax (Taxe Mobilière) but are excluded \(^7\) from both retained or distributed income of the enterprise for the purpose of computing its other taxes. In other words, dividends received by an enterprise are taxed under a complementary progressive tax only to its shareholders. The same applies to other investment income as well as to royalties (except where the enterprise mainly or exclusively exploits patent rights) and to income from immovable property (again, except in the case of a building society or the like) the estimated amount of which is subject to previously described special taxes. Finally, it bears repeating in connection with the professional tax that only retained profits are taken into account.

\((h)\) The Belgian concept of "taxable" income.—Deductions which may be taken from gross income in arriving at the tax base are primarily important only in connection with the tax on business or employment income, and with respect to the complementary tax paid by individuals on their aggregate incomes. While the special tax on income from personal property is also geared to a concept of net income, the fact is that expenses in such settings—illustratively

\(^7\) This method is similar to the dividends received deduction allowed in the United States, only the percentage is 100 instead of 85.
with respect to dividends—are not frequently incurred. But where expenses are suffered in acquiring such income, e.g., banker’s fees, they may be deducted. On the other hand, the special tax on “estimated” income from real property is not geared to actual income, gross or net. As a consequence, actual expenses may not be deducted from the tax base fixed by the administrative authorities.

The net income concept employed by the special tax on business income is quite similar to that used in the United States. Permissible deductions include wages, salaries, rent paid for the use of personal property, interest—including any reasonable amount which a subsidiary pays a parent in connection with a loan, indirect taxes, such as those on sales, and depreciation.

The provisions regarding depreciation are not, however, quite so favorable as they are in the United States. Accelerated depreciation methods which are available in America are not generally allowed, though in particular cases, for example in the case of ships, the useful life over which the property may be written off is relatively short. Depreciation is generally based on the straight line method as applied to historical cost, though other methods may be used as long as they follow the diminishing value of the asset. Depreciation on the basis of replacement value is not allowed except that the historical cost of certain assets has been hiked by a formula in that instance where the asset was acquired before World War II and was still in use thereafter.

For the calendar years 1950 and 1960, and counterpart fiscal years, a type of investment allowance has been created with respect to the Taxe Professionnelle, but not for purposes of the complementary graduated tax on individuals. This allowance, applicable only to certain investments, amounts to 30%, and is to be spread evenly over a 3-year period.

The treatment of closing inventories corresponds roughly to practices followed in the United States. Normally closing inventories must be valued at cost or market, whichever is lower. However, in identifying the goods on hand, neither LIFO nor the base stock method may be used.

The most striking departure from American practices involves the provision which permits taxes on business income to be deducted in the year finally due in computing the business income of that year. The degree to which this practice reduces the impact of a theoretical rate structure has been previously considered.
In the case of individuals on salary or wages and others engaged in the exercise of a liberal profession, a standard deduction, set at \( \frac{1}{4} \) of the gross income, is allowed to accommodate their *business* expenses. However, the standard deduction includes a ceiling. It may not exceed B. Fr. 60,000 ($1,200) plus deductible taxes.\(^8\) To avoid this ceiling, a taxpayer is required to itemize his deductions and must be prepared to submit appropriate evidence that they do in fact exceed the standard allotment. Though this tax (*Taxe Professionnelle*) is imposed on business income, certain personal deductions as well as credits for dependents are allowed. These are identical to those applicable in the case of the complementary tax on an individual's aggregate income.

The personal deductions common to both taxes involve premiums paid for life insurance and old age pensions. And, in both cases, a credit against taxes payable on the first B. Fr. 250,000 ($5,000) may be taken with respect to dependents. These credits range from 5% of the tax in the case of one dependent to 100% in the case of 8 dependents.\(^9\)

Since the complementary tax on an individual's aggregate income is intended to reach only his aggregate *net* income, deductions allowed with respect to the other three separately scheduled basic taxes are in effect also allowed. In addition, a deduction may be taken against his gross income for the amount of those separately scheduled taxes as well as for the aggregate income tax paid in that year. A deduction is also allowed for interest paid on non-business loans and for alimony. Finally, 15% of business or employment income, otherwise subject to the *Taxe Professionnelle*, may be deducted, to a maximum of B. Frs. 30,000 ($6,000).

(i) *Payment and the taxable year.*—All of the previously described taxes are assessed on a yearly basis. Only in the case of the tax on business income may losses of one year be carried forward to offset gains of a later year. This carryover, limited to 5 years, is not complemented by provisions regarding carrybacks.

The taxes on estimated income from real property and on actual income from personal property (*Contribution Foncière* and *Taxe Mobilière*) are paid in the year in which the income is realized. For example, the income tax against a stockholder, deducted at the

\(^8\) In the case of company directors, the standard deduction equals 5% of their gross income plus deductible taxes.

\(^9\) 10% for 2 dependents, 20% for 3 dependents, 30% for 4 dependents, 50% for 5 dependents, 70% for 6 dependents, 90% for 7 dependents.
source on the distribution of a dividend, is the tax for the year in which the dividend is received. The tax on business income (Taxe Professionnelle), on the other hand, is not due in a final sense until the year immediately following the taxable year. However, as previously noted, unless payment is made in advance, the taxpayer will suffer a substantial increase in the effective rate. For example, in early 1960 a corporation must estimate its profits for that year and also anticipate the amount which will be distributed. Assuming a calendar year taxpayer, the tax on the anticipated undistributed profits must be paid before July 15 of 1960; otherwise the first of the previously described increases in the tax will take effect. It is important to understand that the advances are truly pre-payments. For example, when it is said that the Taxe Professionnelle is a deduction in computing the profits for a given year, the deduction in our example would take place in the succeeding year, 1961, when the tax is finally due, not in the year in which payment was made on account. The tax administration recognizes, as an extra-statutory concession, that taxes paid may be deducted even if the taxpayer has not yet received an assessment.

The relevance of residency, and the comparative cost of retaining and accumulating income.—Only in the case of the tax on income from real property situated in Belgium (and the national crisis tax applicable thereto) is the reach of the tax law the same with regard to residents and non-residents. Residents and entities domiciled in Belgium are reached by the other taxes without regard to the place from which the income originated. But where the income originated and was taxed abroad, a reduced rate is applied. On business income of this type, the rate under the Taxe Professionnelle is 1/6th of that normally applied. And where a corporation distributes such foreign earned income, its own national crisis tax is only 1/6th of the normal 20% rate. Also, instead of the regular 30% rate applied to the recipient shareholder, a flat 12% is assessed on dividends distributed out of such foreign income. Again, the graduated rate of the national crisis tax normally applicable to silent partners with regard to such distributed profits is reduced to 1/6rd of the normal rate.

The place from which income originated is also important in the case of non-residents and corporations domiciled outside of Belgium. As is generally true of other countries in such circumstances, the increase, 10% of the amount otherwise payable, is hiked to 20% if payment is delayed beyond the 15th day following the close of the taxable year.
Belgium asserts its jurisdiction only with reference to income which has its source there.

But assuming for the moment that Belgium is the source of income derived from business activity, the particular business form in which that operation is conducted can also make a great deal of difference in the way in which three significant taxes are applied. Assume, for example, that an American enterprise also plans to operate a facility in Belgium. If that facility is housed in a subsidiary corporation domestic to Belgium the business profits—so long as they are retained—will be subject only to the graduated Taxe Professionnelle, the stated rates ranging from 25% to 40%.

However, because the amount of such tax due in one year is deducted in computing the business profits of that year, any profit which falls in the stated 40% rate will not, following the first year, be taxed at an effective rate in excess of 30%.

A corporation which desires to use its profits for expansion may capitalize those earnings by distributing stock dividends. These are not considered taxable income in Belgium. However, the capitalization will be more expensive than leaving the profits in the form of surplus, for certain registration duties and fees are encountered.

On the other hand, where profits of a subsidiary are distributed in cash, the effective combined ceiling rates of the various taxes will be one third higher, i.e., will be 45.3% determined as indicated in Table I F.

<table>
<thead>
<tr>
<th>TOTAL TAXES ON DISTRIBUTED PROFITS OF SUBSIDIARY</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stated rate of national crisis tax against subsidiary; payable from undistributed profits, and applied to gross dividend.</td>
</tr>
<tr>
<td>Stated ceiling rate of Taxe Professionnelle, applied against that part of undistributed profits used to pay national crisis tax.</td>
</tr>
<tr>
<td>Stated flat rate of Taxe Mobiliere, against the shareholder on w/h basis rel gross dividend.</td>
</tr>
<tr>
<td>Effective combined ceiling rate of all taxes.</td>
</tr>
<tr>
<td>20%</td>
</tr>
</tbody>
</table>

11 Of course, the tax on any estimated income from real estate will be applied whether or not profits are distributed and without regard to the form of the enterprise.

12 It should be noted that Belgium does not have any penalty taxes on accumulated profits.

13 These should generally be issued in a later year than that in which the profits have been made.
If profits are to be distributed instead of being ploughed back for expansion purposes, there will be some tax saving to the subsidiary as well as to the parent if the investment is represented in part by loans reflected in a bond issue to the parent. Interest, but not beyond a reasonable amount, constitutes a deductible expense to the subsidiary, and the tax to the parent on interest is 18% (12.2% if the subsidiary bears and pays the tax), contrasted with the 30% tax on dividends.

If the facility is operated as a branch of the American parent, rather than through a subsidiary, the very form of the operation rules out "dividends" as such. The parent will own the profits of the branch as they come into being. Thus the national crisis tax and the Taxe Mobilière, which normally apply to dividends, are rendered inapplicable. The foregoing is another way of saying that in this setting the question of whether profits are retained or distributed is immaterial. The Taxe Professionnelle reaches the entire profit in either case. But instead of the graduated rate applicable to local corporations, in this instance Belgian law applies a stated flat rate of 40%. But again, the fact that the professional tax due in one year is deducted in computing the business profits of that year means that, in the second and succeeding years, the effective rate will not exceed 30%.

Nonresident individuals suffer the progressive tax on aggregate income only where they hold a dwelling house situated in Belgium or exploit a permanent establishment located there, and then only to the extent income is derived from these sources.

(k) Disposition of an enterprise.—As in the United States, the Belgian tax provisions relating to the disposition of an enterprise are rather complex. Accordingly, only a general comment can be made here. If a corporation disposes of its assets, any realized gain to it is, in principle, taxable income. However, the bases of the assets are multiplied by a coefficient before determining the amount of its gain. If the proceeds are then distributed to the stockholders (or to silent partners in the case of the sociétés de personnes), the distributed amount will be subjected to three taxes (national crisis tax, personal property income tax, and the complementary progressive tax) to the extent the stockholder's basis (the capital originally paid in), multiplied by a coefficient, is exceeded by the distribution. However, the impact of the first two of these is cushioned by what is tantamount to a credit equal to that tax paid by the enterprise on that business income which in turn is being distributed.
TAXATION

SUBSECTION 2. OTHER SIGNIFICANT TAXES

(a) Belgian taxes on capital and property.—Belgium does not utilize a property tax as such. But if real estate is transferred for consideration in money or money's worth, a so-called registration duty is payable. The rate normally depends on the character of the person to whom the transfer is made and on the nature of the real estate transferred. The normal rate of 11% of the selling price or value is whittled down, in the case of sales to charitable institutions, to 6% and in some cases to 1.5%. The rate is also 6% with reference to sales of small lots and modest dwelling houses.

Incorporation of assets or subsequent increases in paid-in capital also give rise to fairly significant registration duties, the rate being 1.6% in the case of Belgian companies. Nonresident companies which have a "permanent establishment" in Belgium must also be registered there and must pay .1% on total paid-in capital with a ceiling, however, of 1,000,000 Belgian francs ($20,000) and a minimum of 18,000 francs ($360). With reference to its real estate, a registration duty of 1.6% is levied.

Belgium also employs a gift tax, but, unlike the arrangement in the United States, the complexion of the tax is similar to that of the Belgian inheritance tax. The latter is levied not on the estate as such, but on each individual acquisition by heirs or legatees. In the case of both taxes, the rates depend on the relationship between the donor (deceased) and the donee (heirs or legatees) as well as on the value of the acquisition. Both taxes are generally imposed only where the donor (deceased) is domiciled in, or is a resident of, Belgium. However, real estate constitutes an exception to this rule; donative or testamentary transfers of such are reached if the property is situated in Belgium.

(b) Taxes on turnover.—Income taxes are supplemented in a most significant way by turnover taxes on transfers of unfinished as well as finished products and on licensing, royalty, and many service contracts.

The general turnover tax (Taxe de Transmission), normally carrying a rate—except for luxury items—of 5%, is a multiple stage arrangement in that it applies to each transfer which may take place in the course of developing a finished product, the only important exemption relating to a transfer to the ultimate individual consumer. The importance of this exemption is not to be discounted, for the product at that point will have reached its maximum value,
Since the tax on each successive vendor, in the chain of those who contribute to the finished product, includes the value on which his predecessor had paid as well as the value added, goods which are converted by one taxpayer from the basic raw material into the finished product will normally suffer less tax cost than will goods which have to go through several hands.\(^{14}\)

In the case of imports, the tax is first assessed at the point of importation.\(^{15}\) However, presumably for the purpose of facilitating exports, an exporter may acquire unfinished goods free of the tax and may also export the finished product free of the tax.

The other turnover taxes are complementary to the Taxe de Transmission (luxury tax and similar taxes), and include taxes on the rendition of services, royalties, transport, etc.

\((c)\) Other miscellaneous levies.—Among other miscellaneous taxes are (1) stamp duties which are levied on instruments and documents, (2) excises imposed on the production or importation of certain commodities such as beer, wine, and tobacco, and (3) amounts levied annually by reference to the horse-power of passenger or freight motorcars.

**Section B. France**

**Subsection 1. Income Taxes**

\((a)\) In general.—Since 1948, the over-all income tax arrangement regarding individuals has differed from that applicable to corporations, though in the case of profits derived from industry and commerce a more or less common tax base has been used.

Until 1959, individuals were subjected to two different income taxes. The first, a proportional income tax (Taxe Proportionnelle), was geared to a system of separate schedules which differed in that each reached a different type of income. Though the tax was separately applied to each of the various sources, after 1948 a more or less common rate had been used. The second tax (Surtaxe Progressive) was a surtax levied on the individual's aggregate income from all sources and at progressive rates.

For this dualistic individual income tax system, a reform in December 1959 substituted a single general tax on income. Gen-

\(^{14}\) On 31 goods, there is a special non-multiple tax. This contractual transmission tax is designed to avoid differences which would otherwise arise depending on the number of hands through which they pass.

\(^{15}\) Details regarding the application of turnover taxes to imports are more fully considered in Section A of PART II, *infra*. 
erally speaking, this new tax is assessed according to those rules which had governed the old progressive surtax. For budgetary and psychological reasons, the old proportional tax with its separate schedules was not abolished outright. In other words, the reform is to be implemented in stages. At the moment, the proportional tax temporarily survives under the name of "Taxe Complémentaire," but at a considerably reduced rate. The rates of the old progressive surtax, operating now under its new name (Impôt sur le Revenu des Personnes Physiques), were increased. Also special measures were taken to see that income previously exempt from the old proportional tax (e.g., wages and salaries) will now be fully taxed.

On the corporate side, generally speaking, there is only one income tax (Impôt sur les Sociétés), and it is imposed at a flat rate. Partnerships (sociétés en nom collectif) may also elect this treatment instead of one which would subject the individual partners to individual income taxes on their respective distributive shares.

A third arrangement (versement forfaitaire), applicable to every business enterprise, is intimately related to the income tax scheme. Before the recent reform, instead of requiring that wages and salaries be included in one of the proportional tax schedules filed by employees, employers themselves suffered an assessment geared to three different rates, the choice depending on the total amount of annual remuneration paid a given employee. This arrangement survived the reform. Moreover, as before, employees will continue to include wages and salaries for purposes of the separate progressive surtax.

Employers will pay the versement forfaitaire at the rates as shown in Table I G.

<table>
<thead>
<tr>
<th>Remuneration</th>
<th>New Francs</th>
<th>Dollars</th>
<th>Rate Applicable to the Portion Indicated</th>
</tr>
</thead>
<tbody>
<tr>
<td>0 to 30,000</td>
<td>$0 to 6,000</td>
<td>5%</td>
<td></td>
</tr>
<tr>
<td>30,000 to 60,000</td>
<td>6,000 to 12,000</td>
<td>10%</td>
<td></td>
</tr>
<tr>
<td>Excess over 60,000</td>
<td>Excess over 12,000</td>
<td>16%</td>
<td></td>
</tr>
</tbody>
</table>

In any case where an employer does not suffer the versement forfaitaire, e.g., with reference to wages paid French employees by foreign employers, the employee himself pays this tax.
The question of whether a company director's remuneration is assessed against him or is instead assessed as a charge against the employer-company by reference to the above described rates of the versement forfaitaire, turns on whether his duties go beyond those normally performed by directors and are such as to give rise to the additional relationship of employer and employee. In this connection, managing directors are generally considered employees. In the case of private companies (sociétés à responsabilité limitée), special rules exist.

By statute all dividends are subject to a 24% withholding tax which normally serves as a credit against the recipient's general income tax. A bilateral treaty with the United States reduces the rate to 15% in the case of dividends paid residents or entities in the United States, and when the recipient is an American parent of a French subsidiary, this will normally constitute the final levy against the parent.

A statutory withholding pattern similar to that above applies to interest paid foreigners, except that the withholding rate on interest from French industrial bonds is only 12%.

(b) The progressive surtax on an individual's income.—The income tax, levied on an individual's aggregate income from all sources (including wages or salaries subject to the versement forfaitaire), conforms to the graduated rates as in Table I H.

Table I H

<table>
<thead>
<tr>
<th>Aggregate Taxable Income</th>
<th>Rate Applicable to the Portion Indicated</th>
</tr>
</thead>
<tbody>
<tr>
<td>New Francs</td>
<td>Dollars</td>
</tr>
<tr>
<td>0 to 2,200</td>
<td>$0 to 440.</td>
</tr>
<tr>
<td>2,200 to 3,500</td>
<td>440. to 700.</td>
</tr>
<tr>
<td>3,500 to 6,000</td>
<td>700. to 1,200.</td>
</tr>
<tr>
<td>6,000 to 9,000</td>
<td>1,200 to 1,800.</td>
</tr>
<tr>
<td>9,000 to 15,000</td>
<td>1,800 to 3,000.</td>
</tr>
<tr>
<td>15,000 to 30,000</td>
<td>3,000 to 6,000.</td>
</tr>
<tr>
<td>30,000 to 60,000</td>
<td>6,000 to 12,000.</td>
</tr>
<tr>
<td>Excess over 60,000</td>
<td>Excess over 12,000.</td>
</tr>
</tbody>
</table>

a For salaries and wages etc. subject to the versement forfaitaire, rates are 0%; 10%; 15%; 20%; 30%; 40%; 50%; 60%, respectively.

b An additional surcharge of 10% of the tax otherwise computed is applied if taxable income exceeds 6,000 N.F. or $1,200.

The effect of the foregoing rate schedule is cushioned by an arrangement which is applicable to married persons or those with
dependent children and is similar to the “split-income” arrange-
ment allowed under American law. In the case of a married couple
without dependent children, the figures for a given income bracket
are doubled though the rate remains constant. One dependent child
counts just one-half as much as a spouse. Whereas the coefficient
for a married couple is 2, it is 2½ for a married couple with one
child and would, by way of further example, be 3 if they had two
children. Accordingly, the graduated scale reflected in the schedule
set forth in Table I H would be modified in the case of a married
couple with one dependent child, the coefficient being 2½, as shown
in Table I I.

### Table I I

<table>
<thead>
<tr>
<th>Aggregate Taxable Income</th>
<th>Rate Applicable to the Portion Indicated *</th>
</tr>
</thead>
<tbody>
<tr>
<td>New Francs Dollars</td>
<td></td>
</tr>
<tr>
<td>0 to 5,500</td>
<td>$0 to 1,100</td>
</tr>
<tr>
<td>5,500 to 8,750</td>
<td>1,100 to 1,750</td>
</tr>
<tr>
<td>8,750 to 15,000</td>
<td>1,750 to 3,000</td>
</tr>
<tr>
<td>15,000 to 22,500</td>
<td>3,000 to 4,500</td>
</tr>
<tr>
<td>22,500 to 37,500</td>
<td>4,500 to 7,500</td>
</tr>
<tr>
<td>37,500 to 75,000</td>
<td>7,500 to 15,000</td>
</tr>
<tr>
<td>75,000 to 150,000</td>
<td>15,000 to 30,000</td>
</tr>
<tr>
<td>Excess over 150,000</td>
<td>Excess over 30,000</td>
</tr>
</tbody>
</table>

* See footnotes a and b re previous schedule.

(c) The complementary tax on individuals.—While this
modern flat rate version of the old proportional tax is deemed to
be only a temporary levy for the years 1959 and 1960, it may
remain in force for a longer period. Though it reaches the majority
of income items, salaries, wages, pensions, and the like are ex-
cluded. The rate is 9% for 1959, and 8% for 1960. Certain types
of income enjoy a basic exemption of $600 (3,000 new Francs)
or $880 (4,400 new Francs).

The impact of this tax is reduced by an arrangement which
permits the amount of tax in one year to be deducted from the
taxpayer’s income of the following year in computing his general
income tax.

(d) Cumulative effect of complementary and progressive
income tax on individuals.—The cumulative effect of the two income
taxes applicable to individuals can be best illustrated, as in Table
I J, by the case of a married couple (neither of whom is on salary
or wages) who have one dependent child, their taxable income (appropriate deductions have been taken) being 37,500 N.F. ($7,500).

**Table I J**

<table>
<thead>
<tr>
<th>Taxable Income</th>
<th>New Francs</th>
<th>New Dollars</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. The 8% complementary tax</td>
<td>37,500</td>
<td>$7,500</td>
</tr>
<tr>
<td>2. Amount subject to general tax</td>
<td>34,500</td>
<td>6,900</td>
</tr>
<tr>
<td>3. General tax Computation</td>
<td></td>
<td></td>
</tr>
<tr>
<td>5% on 5,500 N.F.</td>
<td>275 N.F.</td>
<td></td>
</tr>
<tr>
<td>15% on next 3,250 N.F.</td>
<td>487.50 N.F.</td>
<td></td>
</tr>
<tr>
<td>20% on next 6,250 N.F.</td>
<td>1,250 N.F.</td>
<td></td>
</tr>
<tr>
<td>25% on next 7,500 N.F.</td>
<td>1,875 N.F.</td>
<td></td>
</tr>
<tr>
<td>35% on next 12,000 N.F.</td>
<td>4,200 N.F.</td>
<td></td>
</tr>
<tr>
<td>34,500 N.F.</td>
<td>8,087.50</td>
<td></td>
</tr>
<tr>
<td>10% surcharge</td>
<td>808.75</td>
<td></td>
</tr>
<tr>
<td>4. Total tax (effective rate of about 32%)a</td>
<td>8,896.25</td>
<td>1,779</td>
</tr>
</tbody>
</table>

*a The effective rate of 32% relates to taxable income; because of certain standard deductions, it will actually be lower.

(e) Corporation income tax.—The French corporate income tax (Impôt sur les Sociétés) reaches the aggregate net income in a manner similar to that of the United States corporate tax. The two most notable distinctions between the two systems involves, first, the rate structure; France applies a flat 50%. Second, it reaches only income derived from French sources.

Another major distinction involves the treatment of dividends received by one corporation from another in which the former holds shares. In evaluating this arrangement, it must be remembered that the distributing corporation’s own profits will be subject to the flat 50% corporate income tax. Then when it declares a dividend from that profit which is left after taxes, it must withhold a tax which represents an assessment against the recipient corporation, the amount normally being 24% of the gross dividend. Even so, the dividend is includible in the gross income of the recipient corporation for the purposes of computing its regular 50% corporate tax though at that point it enjoys a credit for the 24% previously
TAXATION

withheld. When the recipient corporation itself declares a dividend to its shareholders, it too must withhold a 24% tax. And those shareholders, if individuals, will also suffer the previously described income tax on individuals, the 24% withholding tax being treated as a credit.

In one circumstance, the multiple impact suffered under the regular corporate tax as a result of inter-company arrangements is largely eliminated. That circumstance involves the case where the recipient corporation is French and owns at least 20% of the share capital of the original distributing corporation. The recipient corporation will first receive a dividend-received deduction, much on the order of that allowed in the United States, in computing its own regular corporate tax. Limitation of the deduction to 75%, instead of allowing a full 100%, represents an attempt on a standard basis to accommodate the fact that a part of the recipient corporation's general expenses will have been attributable to dividends received. Secondly, while the 24% dividend tax must be withheld by the recipient corporation when it declares a dividend, this withholding principle is not applied to the extent its declaration is out of dividends which it earlier received from the original distributing corporation.

(f) The French concept of gross income.—With regard to business income derived by individuals or corporations, the concept of gross income is similar to that in vogue in the United States, the three prime differences being noted below.

The first difference relates to capital gains which are not taxed in France unless (a) they are regularly and professionally made by the taxpayer or (b) they involve business property. But even in the circumstance related in (b), the gain will not be recognized if it is reinvested within a specified period.

Where the gain is reached, ordinary rates are applied except where the gain is realized in connection with the termination of the business through liquidation or merger. In the latter event, lower rates are applied.

If a given capital gain would fall into the taxable category, the taxpayer may use a system of coefficients to upgrade the historical cost which would otherwise be used in computing his gain, the aim being to neutralize in some measure the effect of changes which have taken place over the years in the value of the franc. The schedule

16 Pursuant to the reform of 1959, the tax authorities may grant the same privilege to corporations which own less than 20% of the participating rights.
of coefficients with datelines representing possible points of purchase appears in Table I K.

Table I K

<table>
<thead>
<tr>
<th>Year</th>
<th>Coefficient</th>
<th>Year</th>
<th>Coefficient</th>
</tr>
</thead>
<tbody>
<tr>
<td>1914 and prior years</td>
<td>204.1</td>
<td>1937</td>
<td>36.1</td>
</tr>
<tr>
<td>1915</td>
<td>142.9</td>
<td>1938</td>
<td>31.9</td>
</tr>
<tr>
<td>1916</td>
<td>108.9</td>
<td>1939</td>
<td>30.7</td>
</tr>
<tr>
<td>1917</td>
<td>74.9</td>
<td>1940</td>
<td>24.6</td>
</tr>
<tr>
<td>1918</td>
<td>61.2</td>
<td>1941</td>
<td>22.5</td>
</tr>
<tr>
<td>1919</td>
<td>59.1</td>
<td>1942</td>
<td>20.4</td>
</tr>
<tr>
<td>1920</td>
<td>40.8</td>
<td>1943</td>
<td>14.9</td>
</tr>
<tr>
<td>1921</td>
<td>61.2</td>
<td>1944</td>
<td>13.7</td>
</tr>
<tr>
<td>1922</td>
<td>65.9</td>
<td>1945</td>
<td>6.8</td>
</tr>
<tr>
<td>1923</td>
<td>51</td>
<td>1946</td>
<td>4.3</td>
</tr>
<tr>
<td>1924</td>
<td>43.5</td>
<td>1947</td>
<td>3.4</td>
</tr>
<tr>
<td>1925</td>
<td>38.7</td>
<td>1948</td>
<td>1.9</td>
</tr>
<tr>
<td>1926</td>
<td>29.8</td>
<td>1949</td>
<td>1.6</td>
</tr>
<tr>
<td>1927</td>
<td>32.7</td>
<td>1950</td>
<td>1.4</td>
</tr>
<tr>
<td>1928</td>
<td>32.7</td>
<td>1951</td>
<td>1.05</td>
</tr>
<tr>
<td>1929</td>
<td>33.3</td>
<td>1952</td>
<td>1.05</td>
</tr>
<tr>
<td>1930</td>
<td>37.5</td>
<td>1953</td>
<td>1.10</td>
</tr>
<tr>
<td>1931</td>
<td>40.8</td>
<td>1954</td>
<td>1.15</td>
</tr>
<tr>
<td>1932</td>
<td>47.7</td>
<td>1955</td>
<td>1.15</td>
</tr>
<tr>
<td>1933</td>
<td>52.4</td>
<td>1956</td>
<td>1.10</td>
</tr>
<tr>
<td>1934</td>
<td>54.4</td>
<td>1957</td>
<td>1.05</td>
</tr>
<tr>
<td>1935</td>
<td>61.2</td>
<td>1958</td>
<td>1</td>
</tr>
<tr>
<td>1936</td>
<td>51</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

(*Fixed by Decree No. 59-289 of 14th February, 1959.)

That portion of any gain which is immunized from the regular corporate income tax only because of the impact of the above coefficients, i.e., because of revaluations in the currency, must be reflected on a balance sheet as a special revaluation reserve and presently suffers a special 3% tax. The ordinary withholding tax applies, however, if that reserve is distributed, though in some cases the withholding rate is reduced to 12%.

A second major difference between French and United States concepts of gross income arises in the circumstance where a branch is shifted into a subsidiary. In France, one-half of any difference which exists between the book value and the current fair market value of the branch’s assets is subjected to the ordinary corporate tax rates, provided the branch existed for less than 5 years. For older branches, only 10% of the gain is reached.\(^\text{17}\)

\(^{17}\) The rate is only 6.6% in the case of private enterprises.
A third prime difference between the two systems with regard to the meaning of gross income involves private enterprises with relatively small turnover. In France, these may be taxed on the basis of a *presumptive* profit.

\( g \) *The French concept of “taxable” income.*—In a business setting, the deductions which may be taken from gross income under French law, in arriving at taxable income, are similar to those allowed in Belgium and the United States. In other words, the aim is to reach only net income and is accomplished through allowance of deductions for those expenses incurred in properly carrying on the enterprise, provided, of course, that the expenditure did not involve an increase in inventory or capital equipment. For example, interest on loans is deductible, even if paid by a subsidiary to a parent, provided the loan relates to the commercial aspects of the enterprise and the interest is fair and reasonable.\(^{18}\) Again, in principle the indirect taxes suffered by an enterprise are deductible in computing taxable income.

The annual French “amortization” (amortissement) deduction, designed to take account of normal wear and tear arising out of use of buildings, equipment, etc., differs in one major respect from the American depreciation allowance. Because of marked changes which have taken place in the actual value of the franc, France has found it necessary to make *standard* modifications in the historical cost against which depreciation would otherwise be computed. The procedure involves use of the coefficients previously described in connection with the discussion of capital gains. After applying the appropriate coefficient for the year of purchase to historical cost, previous depreciation—computed on the basis of historical cost for purposes of the current computation—is multiplied by the coefficients appropriate for the years of earlier write-offs. Following subtraction of the re-valued earlier depreciation from the re-valued historical cost, the normal rules regarding depreciation are applied, i.e., the balance is spread over the remaining useful life of the property. As in the States, determination of “useful life” ultimately depends on the way the taxpayer will use the property; extraordinary usage, for example, will be taken into account in making the determination. Certain general rate patterns have also been issued by the government to accommodate typical cases, and in some instances, for example with reference to hotels, quite detailed schedules have been promulgated. Until the recent tax reform, only the

\(^{18}\) However, interest paid to a parent or other shareholders is only deductible to the extent the loan does not exceed 50% of the subsidiary’s capital.
straight line method was permitted, except in the instance where some additional depreciation was allowed to facilitate modernization of equipment. Now, however, the declining balance method may also be used with reference to a majority of investments.

Inventory is valued at cost or market whichever is less. It is not possible, however, to use the LIFO inventory method.

In the case of individuals, certain standard deductions may be taken in lieu of itemizing business expenses. The standardized figure for those working for salary or wages is 10% of the salary or wage; for commercial travelers, such as a salesman, the figure is 37%. In computing the general income tax, the taxpayer may also deduct his flat rate complementary tax, if any, and any versement forfaitaire which he may have suffered as an employer of domestics. Other items of an equally personal sort which are deductible include a limited amount of life insurance premiums on policies contracted before 1959, charitable contributions with a ceiling of .5% of taxable income, and alimony paid pursuant to the French civil law.

In addition to the foregoing deductions (including the standard business expense deduction), an abatement of 20% is allowed for salary and wage earners.

(h) Payment and the taxable year.—While the calendar year is usually the taxable year, an enterprise may elect a different fiscal year comprising not more than 12 months. However, losses of one year may generally be carried forward for a period up to 5 years.

While the tax due in one year relates to the income of the preceding fiscal year, in most cases a system of pre-payment exists.

Generally, a choice does not exist as to the matter of accounting methods. Special rules and regulations govern the matter of timing as it relates to different types of items, but in general the accrual basis constitutes the proper accounting method.

(i) The relevance of residency as it affects individuals.—As to resident-individuals, France asserts a less sweeping jurisdiction in assessing its flat rate complementary tax than it does with reference to the general income tax. Applicability of the former tax rests, in general, on a principle of territoriality, the tax applying only to that part of a resident's income which has its source in France. The only major exceptions relate to dividends and interest which, absent treaty provisions, are included regardless of source.
The general income tax, on the other hand, quite generally reaches all of a resident's income, without regard to source. A combination of these divergent general jurisdictional principles means, except for dividends and interest, that the foreign "sourced" income of residents suffers a smaller total tax than does domestic income. 19

Nonresidents enjoy an even more favorable status. Since they suffer either tax only with reference to income which has its source in France, the residency of an individual under French law may assume considerable importance. Normally a foreigner residing in France will not be treated as a resident unless he has transferred his sphere of interest to France or remains there for at least 5 years. Until one or the other of these tests is satisfied, the foreigner will suffer tax only on his French income, though in the absence of such he will be taxed on an amount five times the rental value of his dwelling. When one of the alternative tests for residency is finally satisfied, the foreigner may still be immune from the general income tax with reference to non-French income if he is able to demonstrate that he is properly taxed on such by the country of which he is a citizen.

(j) The relevance of residency as it affects corporations.

—In general, the corporate tax follows the principle of territoriality with reference to domestic as well as foreign corporations. Thus both are taxable generally only on profits deemed to have a source in France. In the case of a foreign corporation, this includes income arising from a complete cycle of economic transactions in France as well as those earned there by a foreign-owned permanent establishment. 20

Since even a French corporation will suffer the regular corporate tax on its foreign income in only rare circumstances, the most important difference between French and foreign corporations relates to the separate 24% tax which it must withhold as a charge against stockholders on gross dividends. The French corporation must withhold this tax without regard to the geographical source from which it derived the income from which the dividend was paid. The non-French corporation, on the other hand, must withhold the 24% tax only on that part of the dividend which corresponds to its French business.

19 Accordingly, there is less pressure in France for unilateral tax relief in the case of foreign income than would otherwise be the case.

20 Pursuant to a bilateral tax treaty with the United States, the industrial and commercial profits earned by an American corporation will be taxed in France only if it has a "permanent establishment" there.
Section B of PART III, infra, indicates two modifications of the foregoing pattern as it affects American residents and entities. First, the withheld dividend tax, payable illustratively on dividends distributed by a French subsidiary to an American parent, is reduced by a bilateral tax treaty to 15%. Second, while the French subsidiary will also have previously paid its own 50% corporate tax, the latter is the only income tax suffered if an American company conducts its affairs in France through a permanent establishment in the nature of a branch located there. In that event, the base would consist of income properly attributable to the permanent establishment, as is more fully explained in PART III, infra.

(k) The comparative cost of retaining and distributing corporate profits.—In Belgium, it will be recalled, distributed profits encountered a different corporate tax pattern than undistributed profits. This is not so in France. Distributed and undistributed profits are taxed alike. France does not even employ the type of additional penalty tax which may be encountered in America with regard to unreasonable accumulations. In this connection, a flat unavoidable temporary levy of 2% on reserves—an outgrowth of the extraordinary expenses incurred in Algeria—was terminated at the close of 1958.

While the corporate tax itself remains the same, whether or not profits are distributed, it must be remembered that the corporation, upon distribution, will be required to withhold, as a charge against stockholders, the 24% tax on dividends, a figure which is reduced to 15% in the case of payments to American residents or corporations.

A French corporation which decides to retain certain earnings may capitalize them, without prejudice to the stockholders, by distributing a stock dividend. Only if the recipient stockholder later receives a liquidating dividend will his earlier receipt of the stock dividend have any tax significance to him. For tax purposes, the nominal (par) value of his original shares will have been spread in proper proportion to include also the dividend shares. Illustratively, if his original shares carried a par value of $100, receipt of a 100% stock dividend would lead, for tax purposes, to a new allocation of a $50 par value to each of his original and dividend shares. And only that amount could be recaptured tax free at the point of liquidation.

(l) Disposition of an incorporated enterprise.—If a corporation sells its assets as a preliminary step to liquidation, that part
of the gain, if any, attributable to capital assets will be taxed at the special rates previously indicated, i.e., at 10% on gain from any such assets held for over 5 years and at 50% on one-half of the gain realized from any such assets held for a lesser period. Then on distributing the after-tax balance, the corporation must withhold the 24% dividend tax.

A merger out of which stockholders derive new shares of stock is not treated as a liquidation; gains which would have otherwise been taxed on liquidation enjoy an immunity in the case of merger, the distinction resting on the fact that here there is a continuity of interest on the part of all concerned. The constituent corporation which is absorbed in the merger will, however, file a separate corporate tax return covering the ordinary profits of the partial year concluded by the merger.

SUBSECTION 2. OTHER FRENCH TAXES

(a) Taxes on capital and property.—France does not impose taxes on capital or property simply because of its ownership. However, fairly significant amounts may be exacted when property is transferred. If the transfer is for money or money's worth and the deed must be registered, a registration duty must be paid. This registration fee, upon the sale of real property, is apart from a low tax and must be paid at the rate of 16.6%. However, the rate is only 2.2% when real property is brought into a corporation. On the establishment of a corporation a different fee of 1.6% is levied on the share capital.

(b) French turnover taxes.—An unusual type of turnover tax is actually more important to the French government than the income tax. The former tax differs markedly from the turnover taxes of other member nations. Most countries impose a tax on each transfer, measured by the delivery price. As a consequence, an integrated company may have a real advantage over a non-integrated company. In France, however, the net effect is to tax only that value which each successive entrepreneur adds to the product, thus depriving integrated companies of the advantage they enjoy in other countries. While the French tax base is smaller than that of other countries, it will also later be noted that the rate in France is somewhat higher.

In effect, the technique by which only the added value is reached involves two separate steps. First, the full effective rate is applied against each vendor on the delivery of goods, the amount of the tax being separately reflected by him on the invoice which is delivered
to the buyer. Before paying the tax, as a second step, the vendor deducts the amount of turnover taxes reflected on invoices which he received covering his purchase of components, services, and equipment (including such things as machinery and industrial buildings). The practical effect, if the rates are always the same, is that the manufacturer, e.g., will usually pay a tax on the difference between his selling price and the lesser sum which he paid for raw materials, etc.

The turnover tax is also applied at the point goods are imported. However, at the point of export, any tax paid at import or with respect to intermediate domestic transfers is wholly refunded.

The normal French rate is stated to be 20%, but since the base against which it is applied includes the tax itself, the normal effective rate which is reflected on an invoice is 25%. Transfers of certain types of goods call for special rates, some higher and some lower than the normal rate. The stated rate for services is 8.5%, the effective rate being 9.23%.

While these rates are higher than those of most member nations, thus neutralizing in one degree or another the use by the French of a smaller base, account must also be taken of two other considerations in reckoning the total impact of its turnover taxes. One of these involves the immunity of the retailer's mark-up from this tax. In other words, retail vendors—normally the last in a chain of successive vendors—are exempt from the added value turnover tax. Indeed, in some significant circumstances, wholesalers are also exempt. However, the exemption of retailers is itself in part neutralized by local turnover taxes levied on the entire retail sales price at a stated rate of 2.75%, the effective rate being 2.83%. The difference between the tax load borne by retailers and that borne by others is not as great as one might suppose. The tax on the retailer covers the entire price, not just the value added. In other words, he is not permitted to deduct earlier turnover taxes paid by those from whom he acquired his merchandise.

*(c) Miscellaneous taxes.*—French business is subject to a number of taxes in addition to income, conveyancing, and turnover taxes. One involves the previously described "versement forfaitaire" which is assessed against employers with respect to salaries and wages paid employees. Another is closely akin to a

---

21 The rate will not always be the same, particularly with reference to services.

22 This same rate normally applies to royalties. However, under certain bilateral tax treaties, including one with the United States, royalties derived by nonresident inventors are usually exempt. See PART II, infra.
business license tax (contribution des patentes), the amount being dependent upon four factors: (a) the scale of the business; (b) the location or municipality in which the business is located; (c) the rental value; and (d) the number of employees.

Special duties are also levied on certain types of consumers' goods, such as wine, meat, coffee, and tea. On the other hand, controlled monopolies have taken over the sale of certain other products, such as tobacco, explosives, and matches.

Motor vehicles are also subject to a special tax, one which differs from that levied on freight carriers. The latter also enjoy freedom from the turnover tax.

SECTION C. FEDERAL REPUBLIC OF GERMANY

SUBSECTION I. INCOME AND NET WEALTH TAXES

(a) In general.—The basic pattern of income taxation in Germany, as it affects individuals, differs substantially from the previously described Belgian system. Whereas the latter country generally exacts two different income taxes from individuals, Germany imposes only one (Einkommensteuer), with progression in the rate structure rising to a ceiling of 53%. A limited exception to this unified arrangement involves a separate substitute withholding tax on income from certain kinds of bonds. Though that substitute exaction may be a final levy, under certain conditions a taxpayer is permitted to aggregate this type of bond income with other types of income in computing the more general income tax, the amount previously withheld being treated in such case as a credit. Other withholding taxes, such as those on wages and dividends, are generally treated as integral parts of, and serve as credits against, the general income tax.

Germany's corporate income tax differs from the previously described counterpart found in France. It will be recalled that the latter does not discriminate at the corporate level between distributed and undistributed earnings; its flat rate tax is imposed uniformly, for the year income is earned, without regard to dividend policy. Germany, like Belgium, does discriminate at the corporate level. While the former imposes only one corporate income tax, the rate on distributed profits is much lower than the rate on those corporate profits which are not currently deflected to stockholders.

23 The important churches are permitted to levy a church tax as a surcharge on the income tax, but in an amount not exceeding 8% of the income tax.
However, as later explained, the impact of this differential on certain smaller corporations which must look to internal financing for expansion has been whittled down through application of a special rate structure. In either case, however, distributed profits will suffer another tax in the hands of shareholders, as in Belgium and France.

Corporations as well as individuals are also subject to a flat rate tax on net wealth (Vermögensteuer) though only individuals may deduct this tax in computing the general income tax base. In addition, enterprises, whether owned by a corporation or individuals, suffer a municipal enterprise tax (Gewerbesteuer), which uses income as one of the factors in fixing the amount of the exaction. The amount of this tax constitutes a deduction for both individuals and corporations in determining that income subject to the general income tax.

(b) Income, enterprise, and net wealth taxes on individuals.
—The income tax on individuals caters to married persons and, up to a point, progressively also to those with children.

The split-income system which is normally utilized by married persons in the United States is also available in Germany. The tax on a married couple is twice the amount which would otherwise be due on one-half of the combined income of the two spouses. Where the two spouses earn different amounts, the effect is to spread their incomes equally between the two, confining the income to lower rate brackets.

Taxpayers who file a separate return enjoy a personal allowance of $400 (DM 1,680); husbands and wives who file a joint return have two such allowances. There is also a modest allowance for old age; single taxpayers over 50 years of age may deduct $200 (DM 840) from gross income; those over 70 enjoy an additional allowance of $85 (DM 360), this amount being doubled in the case of married persons.

Allowances for children, accommodated through deductions from gross income, are progressive in amount up through the third child, at which point they level off—as follows:

<table>
<thead>
<tr>
<th></th>
<th>Dollars</th>
<th>DM</th>
</tr>
</thead>
<tbody>
<tr>
<td>First child</td>
<td>$215.</td>
<td>900.</td>
</tr>
<tr>
<td>Second child</td>
<td>400.</td>
<td>1,680.</td>
</tr>
<tr>
<td>Third child, and each added child</td>
<td>429.</td>
<td>1,810.</td>
</tr>
</tbody>
</table>

The significance of the personal allowances and the right of married persons to split their incomes on filing a joint return can
be illustrated by the case of a male taxpayer whose total earned income, all being derived from employment, is $9,524 (DM 40,000). As a single person, he would pay $3,060 (DM 12,843), the effective rate being 32% compared with an effective rate of 25% if, as a married taxpayer, he filed a joint return, and with 22% for married taxpayers with two dependent children. Those who reside in Berlin would also enjoy a 20% tax reduction.

Individuals also suffer a flat 1% deductible tax on net wealth. This means that a taxpayer whose income is derived from a stock portfolio will suffer larger cumulative taxes than will a taxpayer who does not own property but derives from employment a like amount of income. The difference can be illustrated by the previously mentioned single taxpayer whose total net income equalled $9,524 (DM 40,000). Whereas his effective rate was 32% when all of such income was derived from employment and subject only to the income tax, the cumulative effective rate of both taxes would be 39% if one-half of his income had been derived from stocks valued at $119,047 (DM 500,000).

The net wealth tax, like the general income tax, applies whether the individual is a property-owning employee or is engaged in the operation of a business. However, the businessman also incurs a three-factor municipal enterprise or trading tax, the rates of which vary among municipalities. The basic rate is progressive up to 5% on profits and is .2% on net worth and wages. Surcharges with respect to profits and net worth reach a maximum of twice the basic charge, increasing the tax to 15% on profits and .6% on property. Surcharges with respect to the tax on wages may, on the other hand, increase that basic levy tenfold. This three-factor tax is deductible, however, in computing taxable income for purposes of the general income tax, and may be treated as a debt in calculating the net amount of property owned. Inter alia, the foregoing principle means that the trade tax which is paid is deductible in computing that portion of the trade tax which turns on profit, for that net income which is used in computing the general income tax is also the income which is used in computing the trade or enterprise tax.

(c) Income, net wealth, and enterprise taxes on juridical entities.—The corporate income tax (C.I.T. Körperschaftsteuer) reaches the aggregate net income of all juridical entities (Aktiengesellschaft, Gesellschaft mit beschränkter Haftung, etc.), the prime rate being a flat 51%. However, this is reduced to 15% with respect to that portion of the income which is currently distrib-
Except in one instance, however, distributed profits are further subject to a 25% withholding tax against stockholders who apply it as a credit against their own general income tax. The one exception is intended to avoid multiplication of the tax load in the case of certain inter-corporate dividends. If the distributee is another German corporation which has shares outstanding and which owns 25% or more of the stock interest of the distributing corporation, the latter is not required to withhold the dividend tax. Nor will the recipient corporation be required to include the dividend in its own gross income, provided that dividend is immediately distributed to its own stockholders. In such case, it will, however, withhold the 25% dividend tax. Moreover, if it retains the dividend, it must pay a special tax of 36% (51% less 15%). This special levy was designed to prevent avoidance of the 51% rate where profits of a subsidiary are not effectively distributed to the ultimate equity owners, i.e., stockholders of the parent. Absent this special arrangement, it was thought that subsidiaries might avoid the 51% tax by distributing dividends to a parent which, instead of distributing the profit to its own shareholders, might then loan the funds back to the subsidiary.

Because of the marked differential between the normal corporate rates on distributed and undistributed profits, a special cushion has been designed to facilitate internal financing by small corporations which have a net worth not exceeding $1,185,000 (DM 5,000,000), provided their shares are in registered form and are owned, to the extent of 76% or more, by individuals. In such case, a progressive rate—the maximum charge being 49% on a profit of $11,850 (DM 50,000), is applied to the undistributed profit. But the tax on distributed profits of such a corporation is 26.5% instead of the normal 15%.

Juridical entities also pay the flat 1% tax on net wealth as well as the special municipal enterprise tax on their profits and net wealth. The basic rates and surcharges of the latter are similar to those described above in the setting of individuals. Also, as in the case of individuals, there is a 20% rate reduction in taxes for enterprises in West Berlin.

(d) Combined impact of corporate and individual direct taxes.—In calculating the cumulative effect of direct taxes imposed,

---

24 The 15% rate is applied to the so-called “berücksichtigungsfähige Ausschüttungen.” Literally translated, this means “distributions that may be taken into account.” In effect, the low rate will apply only to those distributions which are made pursuant to a resolution adopted at a shareholders’ meeting.

25 Applicable only to distributions by German corporations.
TAXATION

for example, on a manufacturing corporation and its stockholders, account must always be taken of three taxes on the corporation (general income tax, trade or enterprise tax, and net wealth tax) and, if any profits are distributed, of two taxes on the individual stockholders (income and net wealth taxes). It does not follow, however, that a constant percentage of corporate profits will always be absorbed by these five taxes. Because the normal corporate rate of 51% differs from the reduced 15% corporate rate on those profits actually distributed, there will be differences in the total tax load depending on whether all, part, or none of the corporate profits, after taxes, are distributed. Moreover, if it is contemplated that all of the profits, after taxes, of various corporations will be currently distributed, there will still be differences in the degree to which those profits are absorbed by direct taxes. In the first place, the ratio between corporate net wealth taxes and corporate profits will not be the same for all industries. Nor, with reference to the net wealth tax on stockholders, will the ratio between stock values and dividends be constant. Again, the ratio of the corporate trade or enterprise tax to corporate profits will vary among municipalities because of differences in rates applied to the three base factors; variation with reference to this tax will also exist among corporations within a municipality because of differences in ratio between two of the contributing factors (net wealth and wages) and corporate profits. Finally, with reference to the general income tax itself, there is a difference in the rate structure for those small corporations which pay 26.5% on distributed profits and others which pay 15%, just as there are differences in the progressive rate applicable to stockholders who enjoy varying amounts of income.

Only if one indulges in certain assumptions is it possible even to measure the cumulative effect of the 3 direct corporate taxes. For example, if it be assumed (1) that all corporate profits (after corporate taxes) are currently to be distributed, (2) that the corporation’s profits before taxes bear a 10% ratio to its net wealth which, in turn, is subject to the non-deductible net wealth tax, (3) that the normal corporate income tax rate structure (51% with a reduced rate of 15% on distributed profits) is to be applied, and (4) that the municipal trade tax is levied at more or less maximum rates on profits and net wealth (15% and .6% respectively), it is possible, through application of a complicated formula, to predict that direct corporate taxes will absorb 53.04% of the company’s profits, leaving 46.96% of such profits for distribution. In the foregoing circumstance, of the total corporate tax of 53%, approxi-
mately 18.2% is attributable to the municipal enterprise tax, 10% to the net wealth tax, and 24.8% to the corporate income tax. That the corporate income tax absorbed almost 25% of the profits, as computed before taxes, may come as something of a surprise in view of the assumption that all profits, after taxes, were distributed and that one rate on distributed profits was only 15%. However, the latter rate is applicable only to that portion of corporate profits actually deflected to stockholders; in effect the 51% rate is applied to that portion of the profits absorbed by the tax collector.

Using the same assumptions, except that now 40% of the profits after direct taxes will be distributed, the tax collector would absorb through direct corporate taxes almost 65% of the corporate profits as contrasted with almost 70% if none of the profits were to be distributed.

The minimum separate impact of a distribution on stockholders can be illustrated by returning to the case where all of the after-tax corporate profits (47% of pre-tax profits) were distributed. If the stock yields only 4% on its value, the 1% tax on the shareholder’s net wealth will absorb 25% of the dividend. And if it be further assumed that the taxpayer is single, and that he derives all of his modest income (26 ($2,380 or DM 10,000) from dividends, his personal exemption and deductions will convert the first bracket income tax rate of 20% into an effective rate of 10.74% of the dividend. Thus in this case, corporate and individual direct taxes would have the following cumulative effect:

<table>
<thead>
<tr>
<th>Corporate profits</th>
<th>$100.00</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less corporate taxes</td>
<td>53.00</td>
</tr>
<tr>
<td>Dividend</td>
<td>$ 47.00</td>
</tr>
<tr>
<td>Less individual direct taxes:</td>
<td></td>
</tr>
<tr>
<td>Net Wealth Tax</td>
<td>11.75</td>
</tr>
<tr>
<td>Income Tax</td>
<td>5.05</td>
</tr>
<tr>
<td>Church Tax</td>
<td>40.80</td>
</tr>
<tr>
<td>% of Corporate profits after all direct taxes</td>
<td>$ 29.80.00</td>
</tr>
</tbody>
</table>

(e) German concept of gross income.—As a general proposition, the gross income of an individual includes all of his profits, with certain exceptions the most important of which relates to

---

The standard deduction for expenses has been taken into account (DM 150). The property tax is deductible as a personal expenditure.
capital gains. While these are generally excludable, the immunity does not extend to three frequently recurring situations. Profits derived from sales of property used in an enterprise, such as office equipment or obsolete machinery but not land, is considered a business profit and must be included. Speculative gains, if they equal $238 (DM 1,000) or more a year, are also includible. A gain is deemed speculative if it is realized from the sale of immovables held for less than 2 years or from movables held less than three 27 months. Finally, profit in excess of a certain amount, derived from the sale of certain corporate shares, will be taxed, though at special rates, even though such shares do not constitute a part of the normal trading assets of the taxpayer. This principle is applied in the instance where the taxpayer actually or constructively owned a "considerable interest" in the corporation. The taxpayer will be treated as though he owned such an interest if, immediately before the sale or within the 5 preceding years, he, his wife, fiancee, or certain relatives owned more than 25% of the nominal paid in capital. The special rates are fixed by the tax authorities and range from 10% to 30%. Usually a rate equal to one-half of the rate applied to the taxpayer's total income will be used. While profits of this type are taxed only if they exceed a certain amount, that minimum standard varies and depends on the portion of the enterprise's capital which is sold.

With one prime exception, all profits realized by a corporation are taxable, including capital gains. The one exception relates to the previously discussed immunity extended to inter-corporate dividends where a recipient German corporation holds at least 25% of the shares in a distributing German corporation. However, as previously noted, the recipient corporation will be required to pay a 36% tax if it does not make a current distribution of the dividend to its own shareholders. A corporation may also transfer a branch to a subsidiary without recognition of gain, if any, provided the subsidiary continues to reflect the assets at the value at which they were carried on the parent's balance sheet.28

With certain modifications, the income factor of the municipal enterprise tax is also calculated according to the profits concept of the general income tax. The modifications relate to deductions as well as inclusions. For example, interest paid on long-term debts

27 A tax reform bill will extend this period to six months.
28 Whether this applies to a foreign corporation with a German branch has not been settled. The statute is not wholly clear on this point, and there are no interpretative decisions.
and salaries paid to shareholder-managers who own a significant interest (25% or more) must be restored to income. On the other hand, income from foreign permanent establishments may be excluded. In keeping with the philosophy of the first of the foregoing modifications, involving restoration to income of interest paid on long-term debt, it should also be noted that the long-term debt itself is treated as a part of the company's net worth for purposes of the separate net wealth factor.

(f) German concept of "taxable" income.—In the case of an individual, deductions from gross income include personal as well as business expenses.

Personal or non-business expenses (Sonderausgaben) which may be itemized, apart from the previously described basic exemptions allowed for the taxpayer and his dependents, are of three types. First, the entire net wealth and church taxes paid by an individual, as well as interest on personal loans, may be deducted. Second, up to a certain maximum amount, deductions may be taken for premiums for social security as well as life, health, and accident insurance, and subject to a separate maximum limitation—amounts contributed to charity and the like. In lieu of itemizing these first two types of personal expenses, the taxpayer may take a standard personal deduction. If his total income is derived wholly or partly from employment or consists of periodic payments, the standard minimum is $150 (DM 636); in other cases it is $48 (DM 200).

Finally, so-called extraordinary charges associated with illness, death, etc., are separately deductible to the extent they exceed a minimum amount. Even extra expenses for a housekeeper may be fitted into this category under certain conditions. The minimum amount which a taxpayer must absorb without benefit of a deduction varies, depending upon the taxpayer's income and family status.

Itemization of an individual's business expenses can also be avoided by his election to take certain standard business deductions. For wage and salary earners, a minimum amount of $135 (DM 564) is allowed. With respect to income from capital, the standard deduction is $35 (DM 150) or twice that amount for a married couple, and for periodic payments the standard is $48 (DM 200).

The categories of business expenses which may be itemized are quite similar to those in the United States, and include wages, salaries (but not remuneration paid directors 29), rents, depreci-

29 In German law, the term, "directors," may refer to "Vorstandsmitglieder" (managing directors) or to "Aufsichtsratsmitglieder" (members of the board of directors). Only the latter group is meant here.
TAXATION

TAXATION

ation, interest (including reasonable interest charges paid to a parent company or other shareholder), excise duties, turnover taxes, and the enterprise tax. The net wealth tax is deductible, however, only by *individuals* and as a personal item; it is *not* deductible by corporations.

Enterprises may compute depreciation by straight-line, accelerated, or other methods, depending on which is the more suitable, but subject to certain legal limitations. Beginning with 1958, a deduction under the accelerated method cannot exceed 25%\(^30\) of the base nor can it be more than 250% of that which would be allowed under the straight-line method. Perhaps because of its rapidly expanding economy, Germany does not presently complement its regular depreciation allowances with additional first-year incentive allowances.

Inventory valuation must generally conform to the so-called "Niederstwertprinzip," i.e., cost or market whichever is lower. Although it was thought that the law permitted taxpayers to reflect inventory at cost even though the replacement market price was lower, court decisions have reached a contrary result. In any event, generally speaking, valuation of assets for tax purposes must conform to those valuations reflected on balance sheets for commercial purposes.

Also with reference to the matter of inventory, the Supreme Tax Court has determined that the taxing statute does not permit the use of LIFO or the base stock method. This limitation may not be particularly important in the German setting, for there has been little inflation in recent years. Nevertheless Section 51 of the taxing statute authorizes the Minister of Finance to promulgate regulations, with the approval of Parliament, allowing the creation of replacement reserves. Such a reserve is authorized only where there has been a price increase of 10% or more in the taxpayer's replacement market during the year. Moreover, within a period of six years the reserve must be restored to profit.

*(g)* *Payment and the taxable year.*—The tax must generally be computed by reference to a period of 12 months, and most taxpayers use the calendar year. However, in order to accommodate cases of fluctuating income, commercial losses of one year may be carried forward, if need be, into each of the 5 succeeding taxable years—offsetting the income of those years. Carrybacks are not permitted.

\(^{30}\) A tax reform bill will limit this to 20%.
Most businesses are required to reflect their incomes according to an accrual method of accounting.

Much of one's tax is paid currently, either through withholding or quarterly estimated payments. In general there are two types of withholding. The first relates to the 30% withholding rate (Kapitalertragsteuer) applied to interest on certain bonds, a levy not ordinarily applied to nonresidents. The taxpayer may elect to treat the amount withheld here as a final payment, in which case the interest itself is excluded from his aggregate income in applying the progressive rates of the general income tax. The other withholding taxes on income, such as that applicable to wages (Lohnsteuer) or to income derived from other forms of capital (Kapitalertragsteuer) are thought of as integral parts of the general income tax itself, serving as credits. This is particularly important with reference to the withholding tax on dividends, for a flat 25% is withheld. In the case of nonresidents, however, this latter figure is usually the final levy.

While the withheld wage tax is generally treated as a credit, in one instance it too may constitute the final levy. This will be so where the taxpayer (1) derives compensation (or a pension) from only one employment, (2) the amount is not in excess of $5,700 (DM 24,000), and (3) his income from sources other than employment does not exceed $190 (DM 800).

A special director's tax (Aufsichtsratsteuer), applicable only to nonresident members of a company's board of control, is also handled on a withholding basis. Resident directors, however, handle their fees under the general income tax; indeed, such fees are not even subject to the general withholding tax on wages.

(h) The relevance of residency.—The tax base of a resident of Germany includes income derived from without as well as that derived from within the country, without regard to his nationality. However, a unilateral provision, much like an arrangement in force in the United States, serves to avoid double taxation. Foreign income taxes paid on amounts derived from without Germany may be taken as a credit against the German tax.

Nonresidents are subject to taxation only with reference to income derived from German sources. Aside from this jurisdictional limitation, the principles which govern the calculation of a resident's gross income generally apply to a nonresident. A variation

31 However, there may be adjustments at the end of the year. The arrangement is called Lohnsteuerjahresausgleich, for it involves annual averaging of the wage tax.
exists, however, with respect to one of the three exceptional cases where capital gains suffer tax incidence. In the case of a nonresident, so-called speculative capital gains are taxed only where derived from the sale of land.

Except in two primary instances, a minimum 25% tax rate applies to nonresidents. This minimum is not applicable to wage earners who are taxed by reference to the normal tables. Also, in lieu of the regular minimum, nonresident corporate directors pay a flat 30% tax on their remuneration as a final levy.

(i) The comparative costs of retaining and distributing corporate profits.—Sub-topic (a), supra, points up the difference which exists in the rates applied to distributed as distinguished from undistributed profits. In effect, this difference (15% on distributed profits compared with 51% on undistributed profits) constitutes a penalty tax on the use of undistributed profits for purposes of expansion.

There is only a slight variation on the foregoing theme in the instance where a German facility is owned directly or indirectly by an American corporation. If the facility is operated as a branch, a progressive rate, ranging up to 49%, is applied without regard to whether the profits are transferred to the United States. If all of the profits are to be distributed, it may be less expensive, taxwise, to operate through a subsidiary. In that event the subsidiary will pay at the 15% rate (as distinguished from the 51% if the profits are retained) and will withhold a dividend tax which is limited by a tax treaty to 15%.32 These two levies will not, however, represent exactly 30% of the subsidiary's profits. In the first place, that portion of the subsidiary's profits which is absorbed by the corporate levy will be taxed at the rate of 51%, for to that extent the profit is not actually distributed to stockholders. Secondly, the 15% dividend tax is applied, not to the subsidiary's total profit, but only to that part (subsidiary's profit after taxes) of the profit actually distributed to stockholders. There is one other basic tax difference between operation through a branch and through a subsidiary. Even if a branch could be financed through loans from the American parent, any so-called interest would not be deductible by the branch. A subsidiary, however, may obtain such a deduction in computing its taxable income for income tax purposes, but not for purposes of the municipal enterprise tax.

32 A change in the existing Germany–U.S. treaty is being negotiated, the German aim being to restore the withholding tax on intercorporate dividends to 25%.
(j) Disposition of an enterprise.—Where a corporation disposes of its business, the income tax will be applied to the difference between the adjusted basis and the selling price of the assets. And upon liquidation of the corporation a shareholder will suffer a tax on his realized gain if he has a significant interest (25% or more) in the corporation or, in the case of residents, if his gain fits into the so-called speculative category (holding period 3 months or less).

While the foregoing suggests that a disposition of an enterprise is generally a tax reckoning event, under certain conditions it is possible to effect a merger of corporate enterprises without immediate income tax cost but in effect, of course, tax incidence is only postponed until a later tax reckoning event—such as a liquidation.

SUBSECTION 2. OTHER GERMAN TAXES

(a) German taxes on capital and property.—In the case of resident corporations and individuals, the previously described net wealth or property tax (Vermögensteuer) is applied to property wherever situated. Nonresidents are reached only with respect to property situated within Germany. While the rate is normally 1%, a minimum base of $23,810 (DM 100,000) is assumed for a corporation and $4,762 (DM 20,000) is assumed for a private company (Gesellschaft mit beschränkter Haftung). All enterprises also pay the previously described enterprise or trade tax. There is also a very modest land tax (Grundsteuer) running from .5% to 1% of the rental value of the property. To this, surcharges may be added.

A registration duty (Grunderwerbsteuer) is also payable upon the transfer of real estate for money's worth—the normal rate being 7%. While this registration duty is avoided in the case of a gift, such a transfer will be subject to a gift tax which is integrated with the German death duty (Erbschaftsteuer)—common principles being applicable to inter vivos and testamentary transfers. The rate is progressive, running up to 60% on gifts in excess of $2,380,000 (DM 10,000,000) where the donor and donee are strangers.

(b) Turnover taxes and excise duties.—Revenue from the German income tax is supplemented substantially by a multiple stage turnover tax which is applied to the rendition of services as well as to each transfer of goods in the course of developing a finished product. While every turnover is taxed, the normal rate of 4% is reduced to 1% in the instance where one entrepreneur transfers an item to another entrepreneur without changing its nature.
Laying aside the matter of tariffs, imports might be said to enjoy a tax advantage, for a flat 4% tax is applied at the point of importation regardless of the number of stages through which the imported product may have previously gone. In certain cases, however, this rate may be increased up to a ceiling of 6%.

Export transactions enjoy even more favorable treatment. In order to make German products more competitive in the world market, these have been exempt. In fact, at the point of exportation, refund may be obtained—according to certain fixed standards—of any turnover taxes paid on prior transfers. The formula which governs such refunds is not, however, always generally thought to be sufficiently generous to accommodate the entire actual amount of turnover taxes previously paid.

While the turnover tax rate for luxury goods is the same as for other goods, special excise duties do exist with reference to a number of products, e.g., tea, beer, coffee, sugar, tobacco, playing cards, etc. On the other hand, some products, such as bread, are immune from the turnover tax.

(c) Registration duty on capital contributions.—When new capital is contributed to a corporation or is devoted to a branch of a foreign corporation, a registration duty (Gesellschaftsteuer) of 2.5% must be paid. On issuance of bonds, a similar 2.5% levy (Wertpapiersteuer) is imposed.

(d) Miscellaneous.—Other taxes utilized by Germany include those on motor vehicles (differentials frequently being geared to cylinder volume or weight) and testamentary transfers. The latter is geared to a progressive rate schedule which looks to the value transferred as well as the character of the relationship between the decedent and the beneficiary. It applies if a resident-beneficiary receives property from a nonresident as well as where the decedent was a resident. If neither party is a resident, it applies if the property is situated in Germany.

Section D. Italy

Subsection 1. Income Taxes

(a) In general.—The Italian income tax system is quite similar to that of Belgium in that it consists of a series of different income taxes. Income of individuals and juridical entities is first divided by reference to its type into four prime categories, each of

---

33 This matter, as it relates to exports from the United States to Germany, is more fully covered in Part II, infra.
which is subjected to a different tax rate. The four separately scheduled assessments relate, respectively, to (1) estimated income from rural property, (2) income from the active conduct of an agriculture or farm enterprise, (3) estimated income from urban property, and (4) income from labor, from movable capital (including interest but not dividends), and from industrial and commercial activity.

Superimposed on these separately scheduled assessments is a fifth tax, applicable only to individuals, covering aggregate income. A sixth tax, applicable only to corporations, is more closely akin to an excess profits and property tax than to an income tax.

On behalf of municipalities, a family tax is also imposed on the aggregate income of all members of a family. Municipalities, provinces, Chambers of Commerce, and certain others may also levy surcharges on other taxes, and these will differ from place to place.

A more detailed analysis of the cumulative effect of these various taxes follows.

(b) Separately scheduled taxes on income from rural property.—The first separately scheduled tax relating to rural property (Imposta sui Terreni) is applied to imputed income, determined by reference to values reflected in a land register, rather than to actual income. Because the base itself is quite unrealistic, the land register not having been brought up to date after a substantial monetary devaluation, the rate applied to the base is very high. The basic rate of 10% is multiplied by a coefficient of 12; surcharges by various units may increase the resulting rate to 146.7% of imputed (not actual) income.

Assuming the owner does not use the property in the active conduct of farming or, alternatively, in industrial or commercial operations, his actual income from the property, as distinguished from the imputed income, will not be assessed under any of the other separately scheduled assessments, though it will be subject to the complementary personal tax on aggregate income or to the corporate excess profits tax, as the case may be. On the other hand, if the owner uses the property in connection with industrial or commercial activities, the imputed income is not subject to the first separately scheduled assessment but the actual amount will be subject to the fourth separately scheduled tax on industrial and commercial activity, as described below in sub-topic (d).

A second and quite distinct tax on rural property actually relates
to income from the active conduct of farming operations (Imposta sul Reddito Agrario). While the basic rate is 10% multiplied by a coefficient of 12, surcharges by various units may increase the total to 300% of imputed (not actual) income. If the land is rented instead of being actively used by the owner, neither party will pay this tax. The owner will pay the previously described tax on imputed income from rural property not actively used by him, and the lessee will pay the fourth separately scheduled assessment on income from industrial and commercial activity, described—as noted above—in subtopic (d) below.

(c) Separately scheduled tax on income from urban property.—The separately scheduled tax relating to urban property (Imposta sui Fabbricati) is applied to the actual income therefrom, though imputed income is sometimes used as an audit yardstick. Surcharges added to a basic rate of 5% can run the total to as high as 31% of the actual income.

This tax does not apply to income from urban property occupied by an enterprise engaged in industrial activity, the building being used to house machinery and the like. In that circumstance, but only that circumstance, the income will be reached by the fourth separately scheduled tax relating to industrial activity. In all cases, however, the complementary personal tax on aggregate income or the corporate excess profits tax will be applied.

(d) Separately scheduled tax on income from certain capital, labor, and industrial or commercial activity.—The separately scheduled tax on income from capital and/or labor (Imposta sui Redditi di Ricchezza Mobile), generally known as R.M., is further divided into four basic classes.

Class A includes only that income which is derived from capital, i.e., interest and the like, but excluding dividends. Surcharges increase the basic rate of 23% to 26.32%.

Class B includes income from a combination of capital and labor, usually relating to commercial and industrial profits. In the case of individuals and partnerships, the first $387 (240,000 Lire) of this income is exempt; from $387 to $1548 (960,000 Lire), the federal rate is 9%; on income from $1548 to $6840 an 18% rate is applied; any excess over $6840 suffers a 20% rate. A flat rate of 18% is applied to the first $6840 realized by corporations; any excess is subject to a 20% rate. However, both corporations and

---

84 The 26.32% rate is temporarily reduced by one-half with respect to interest paid by corporations.
individuals suffer additional local taxes and surcharges, the effect being to increase the top rate of 20% to 31.23%.

Class C-1 covers only income from liberal professions. Again, the first $387 (240,000 Lire) is exempt. Income in excess of that, up to $1548 (960,000 Lire), suffers a 4% rate. The top federal marginal rate of 8% on the balance is further increased by additional local taxes and surcharges, rising to 13.95%.

Class C-2 covers income from employment in other than a liberal profession. While the exemption and basic rate structure applicable to the latter is carried over to this fourth class, additional local taxes and surcharges here increase the top 8% rate only to 9.15%. The employer is responsible to withhold this tax.

(e) The complementary progressive tax on an individual's aggregate income.—In computing an individual's aggregate income for the purpose of determining the complementary progressive tax, a general personal allowance of $387 (240,000 Lire) is first deducted from gross income. Another deduction of $81 (50,000 Lire) is allowed for each dependent. Life insurance premiums as well as the previously described separately scheduled taxes may also be deducted from gross income. In the end, the progressive complementary tax will not actually be charged unless the individual's aggregate income, before the foregoing allowances, exceeds $1161 (720,000 Lire).

The progressive scale on the amount actually subject to tax begins with a basic rate of 2% (increased by surcharges, etc., to 2.24%) on taxable amounts up to $387 (240,000 Lire), and extends upward to 50% (increased by surcharges, etc., to 54%) on taxable amounts in excess of $806,452 (500 million Lire). Progression is not nearly as intense as in America for moderate incomes. For example, the marginal basic rate (before surcharges) for $25,000 (15½ million Lire) is approximately 10%, and for $50,000 (31 million Lire) it approximates 14%.

(f) The complementary tax on corporate excess profits and capital.—The corporate tax which complements the separately scheduled assessments is not a typical income tax nor are the rates progressive. It is more closely akin to a combined capital and excess profits tax. First, a rate of .75% is imposed on capital and reserves. Coupled with this is a 15% tax on those profits which exceed 6% of the capital and reserves. In computing these profits, the previously described separately scheduled assessment (R.M.) on business income is deductible.
In the case of foreign corporations, the capital levy only reaches investments in Italy.

(g) Cumulative effect of taxes imposed on distributed business income of corporations.—While income derived by a corporation from the conduct of business suffers a separately scheduled corporate assessment as well as the complementary tax imposed on corporate enterprises, dividends received by individual shareholders are not subject to another separately scheduled assessment. They are subject, however, to the complementary progressive tax imposed on individuals. The same immunity from a second separately scheduled assessment applies if the shareholder is a corporation; but the dividend will be included in the recipient corporation’s profits for the purpose of computing its complementary excess profits tax, if any. American parent companies would not even pay this tax, however, with respect to dividends received from an Italian subsidiary.

If it be assumed that the distributing corporation’s taxable profits equalled 10% of its capital and reserves, its tax load would be computed as in Table I L.

<table>
<thead>
<tr>
<th>Table I L</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>Separately scheduled assessment</th>
</tr>
</thead>
<tbody>
<tr>
<td>—Effective rate under Category 3 (R.M.)</td>
</tr>
<tr>
<td>Capital tax</td>
</tr>
<tr>
<td>—Effective rate on capital</td>
</tr>
<tr>
<td>—Ratio of capital to profits</td>
</tr>
<tr>
<td>—Effective rate on taxable profits</td>
</tr>
<tr>
<td>Excess profits tax</td>
</tr>
<tr>
<td>—15% of 1/10 of profits; effective rate</td>
</tr>
<tr>
<td>Total effective corporate rate</td>
</tr>
</tbody>
</table>

Since an individual does not suffer a separately scheduled tax on dividends, the tax impact on him, as distinguished from the corporation, depends on the moderately progressive rates of the complementary tax on his aggregate income. Subjection of dividends to but one tax in the hands of individuals has the net effect, if the corporate tax is ignored, of creating a substantial tax differential between dividend income and other forms of income. The differ-

---

35 It will be recalled that this rate applies only to income in excess of $6480; lower incomes are subject to a basic rate of 18%, increased by surcharges to 27.85%.
ence is particularly striking in the case of low and moderate incomes. The substantial character of the differential in these settings arises out of the fact that the effective rate of the additional separately scheduled assessments on other types of income, e.g., employment income, begins with a higher rate and rises more quickly than the progressive rates of the complementary tax on aggregate income. Illustratively, the cumulative effect of both taxes on employment income of $2,640 (1½ million Lire) earned by a single taxpayer is 7.22% contrasted with an effective single tax rate of 2.89% for a like amount of dividend income. A married taxpayer with two children, on like amounts of income, would suffer a total effective rate of 6.80% on employment income and only 2.47% on dividend income.

(h) *Italian concept of gross income.*—The gross income concept is roughly similar to that in the United States with two prime exceptions. First, income from rural property is always based on an estimate as is other income in the absence of adequate records. Second, capital gains are not always included in the tax base. For example, an investment purchase of one house followed shortly thereafter by a sale will not lead to inclusion of any of the realized gain. But the converse will be true if the taxpayer regularly speculates, i.e., regularly buys and sells houses, securities, etc., and in such case the ordinary rates are applied. This speculative element is always implied in the case where an enterprise sells fixed business assets. With respect to those entities taxed on the basis of their balance sheets, capital gains may be taxed before they are realized, i.e., earlier—when and if entered in their accounting records.

(i) *Italian concept of “taxable” income.*—Permissible deductions from gross income in arriving at taxable income are similar to those in the United States. Special comment need be made only with reference to the deductions for taxes, interest, and depreciation, together with the treatment of inventory.

In computing taxable income for purposes of the corporate or individual complementary taxes, deduction may be taken for the separately scheduled assessments (including the R.M. tax) as well as indirect taxes incurred in the production of income.

Interest actually paid on loans associated with the production of income is quite generally deductible, even where paid to a parent company, provided the charge does not exceed a reasonable amount.
Depreciation is generally computed by the straight line method, suggested rates having been worked out by the Finance Department, in consultation with industry and commerce, for various types of items. Accelerated depreciation may also be used in connection with construction of new plants or modernization of old plants. Indeed, allowances in addition to normal depreciation may be taken in the first four years up to a total of 40% of cost, but not exceeding 15% in any one year.

Inventories are valued at cost or market, whichever is lower. Identification may be made according to LIFO as well as other methods.

(j) Payment and the taxable year.—While income is calculated on a yearly basis, Italy now allows operating losses to be carried forward, if need be, into the five succeeding years. Carrybacks are not permitted.

Income is generally reported according to the calendar year, though entities which report their income on the basis of balance sheets use their respective accounting years.

The tax is levied in two installments, a provisional levy designed to facilitate current reporting, and then a definitive levy. The provisional levy uses the past experience of the taxpayer as a yardstick. For example, in the case of individuals and partnerships, the provisional tax for 1961 is determined by reference to that income which was produced in 1959 and declared in March, 1960. The definitive tax is then assessed on the actual income of 1961, as declared in 1962. Corporations which are taxed on the basis of their balance sheets, according to their accounting year, use more recent past experience in computing the provisional tax. The provisional tax for 1961 is determined by reference to income produced in 1960 and declared in 1961. But again the definitive tax for 1961 will be that year’s actual income, as declared in 1962.

(k) The relevance of residency.—The principle of territoriality governs the basic separately scheduled taxes (income from rural and urban property, from farming, and the R.M. tax). These reach only income derived from sources in Italy, the residence of the taxpayer being irrelevant. However, in the case of an Italian business enterprise, for the purposes of these basic taxes the entire income will be deemed to have its source in Italy, except to the extent it is earned by a foreign permanent establishment which has its own administration and accounting system. Income earned by
a permanent establishment located in Italy is deemed, of course, to have its source there.

A slightly different theory of jurisdiction governs the complementary progressive tax on individuals and the excess profits tax on corporations. Resident citizens of Italy are subject to the former tax with respect to their entire income, regardless of origin. Resident aliens, on the other hand, initially suffer this tax only with respect to income having its source in Italy, but income from foreign sources will be reached when remitted.

The excess profits tax on corporations, like the complementary progressive tax on individuals, reaches the entire income of Italian corporations without regard to the place of origin. On the other hand, foreign corporations and other entities with a permanent establishment in Italy are subject to this tax only with respect to their income from the establishment.

(1) The cost of retaining versus the cost of distributing profits to an American enterprise.—Because of the cumulative effect of two principles, Italian direct taxes will generally be the same whether an American enterprise conducts its affairs in Italy through a branch (permanent establishment) or through an Italian subsidiary. The first contributing principle is to the effect that the corporate tax in Italy is unaffected by the question of whether or not profits are distributed. The second involves the fact that, by treaty, American corporations are free from direct taxes with respect to any dividends received from an Italian subsidiary. Accordingly, with reference to Italian direct taxes, the form in which the American enterprise conducts its affairs in Italy, and the question of whether it plans to have the foreign facility retain or distribute profits, are not material considerations. Because of the neutral position reflected by the Italian tax system toward these matters, Italy does not need, nor does it have, a penalty tax on unreasonable accumulation of profits.

If the foreign facility is housed in a subsidiary corporation, its retained profits can be capitalized without direct tax costs through the issuance of stock dividends. Such shares would not be deemed income even under Italian national law. Nor would there be a direct tax on such shares at the point of disposition or liquidation, for Italy does not reach such capital gains. However, capitaliza-

36 This relates only to the shareholder. A corporation would be taxable according to the ordinary rates if it realized a capital gain in the course of winding up its affairs.
tion would lead to certain indirect tax costs in the forms of registration fees and stamp duties.

(m) Disposition of an enterprise.—Disposition and liquidation of a corporate enterprise can give rise to three different gains. Realized gain by the corporation, on the sale of fixed assets will normally be deemed taxable speculative gain. Any hidden reserves must also be restored to profit in computing the corporation's income. Finally, the shareholders, on relinquishing their shares, will be deemed to realize taxable income but only if the gain fits in the previously described speculative category, i.e., was enjoyed by a taxpayer who frequently buys and sells securities. Also only in this latter case would a merger result in any tax on shareholders.

Death of an individual who owns all or a part of an enterprise (proprietorship or partnership) does not serve to terminate the enterprise and will not be deemed a taxable disposition where the business is carried on by his surviving heirs or partner.

SUBSECTION 2. OTHER SIGNIFICANT TAXES

(a) Taxes on capital and capital transfers.—There are only two taxes in Italy which resemble a property tax, and these have a limited sweep. The most general of them relates to the complementary tax on corporations. It will be recalled that one of the factors associated with that tax involves a .75% flat rate tax on the corporation's capital and reserves.

The second and a more limited type of property tax involves a flat rate .05% annual levy on industrial bonds issued by Italian corporations.

While Italy does not have a general property tax, documents which must be registered, and these include those involving the transfer of property for money's worth, are subject to registration duties or fees. The general rate is 4%.

Italy also employs a gift tax, using rates identical to those associated with succession duties which are applicable to inheritances. Testamentary transfers are also subject, however, to an estate tax. In terms of jurisdiction, the gift tax is imposed on all gifts made within Italy, and this includes all of those which are registered in that country. Succession duties and the estate tax, on the other hand, are imposed only on property situated within Italy at the time of the decedent's death, his domicile, residence, and nationality being irrelevant.
(b) Turnover taxes and excise duties.—Italy relies upon indirect taxes to a much greater degree than most western countries. And the Imposta Generale Sull'entrata (gross receipts tax) is the most important of its indirect taxes. The normal rate is 3.3% though retail sales are fully exempt. Since some tax is imposed on each transfer of goods (except at retail) and rendition of services for money's worth, the effect is to increase the total tax load by reference to the number of enterprises through which goods pass in the course of developing and disposing of a finished product. In many of the cases where this cumulative principle would provide integrated companies with a substantial competitive advantage, Italy, like Belgium, has selected one common type transfer as the point of impact for a single turnover tax.

To whittle down at least some of the tax advantage which imports might otherwise enjoy (laying aside the matter of tariffs), the turnover tax is first imposed at the point of importation.37 On the other hand, to neutralize the effect of the tax on export trade, exports are freed from the tax. In fact, turnover taxes previously charged in connection with the development of the exported item are refunded.

In addition to the foregoing general turnover tax, special excise duties have been placed on certain consumers' goods, such as liquor, sugar, tobacco, and mineral oils. Moreover, the state has monopolized the tobacco and salt industries.

(c) Other miscellaneous taxes.—Miscellaneous revenue measures include fees for the registration of all types of legal documents and stamp duties on the instruments themselves. There is also a motor vehicle tax, imposed on the basis of horsepower or deadweight.

Most important to local units is the Imposta di Famiglia. This tax is levied on the total income of a family, the progressive rates ranging from 2 to 12% (16% with surcharges).

SECTION E. LUXEMBOURG

SUBSECTION I. INCOME, NET WEALTH, AND ENTERPRISE TAXES

(a) In general.—During World War II, Germany converted Luxembourg into a province, and the latter's tax system

37 This matter, insofar as it relates to exports from the United States to Italy, is covered more fully in PART II, infra.
was redesigned so as to conform closely to that prevailing in Germany. While Luxembourg made some post-war changes, the two systems are still quite similar today, the most striking difference being that Luxembourg does not discriminate between distributed and undistributed profits in determining a corporation's income tax.

Generally speaking, individuals are only subject to one national income tax, the progressive rates of which are applied to aggregate income and, in the case of single persons, reach a maximum effective rate of 54%. The remuneration of a corporate director (member of board in control) is also subject, however, to a second special tax. In addition, individuals pay a general property tax, the rate being .5% of net wealth. Finally, businessmen suffer a three-factor municipal enterprise tax, geared to profits, net wealth, and payroll. This assessment is deductible in computing taxable income for federal purposes as well as in computing the profit factor associated with this same tax.

Corporations are also subject to a national income tax. With the exception of small enterprises, however, a flat rate is used. This is complemented also by a flat rate tax on net wealth and by the deductible three-factor municipal enterprise tax.

While corporate dividends are also generally subject to the national income tax, an effort has been made to reduce the degree of multiple taxation of corporate earnings by freeing inter-corporate dividends from tax in those instances where the receiving corporation holds a substantial interest in the distributing company.

(b) Income, enterprise, and net wealth taxes on individuals.

—The general progressive income tax on individuals (Impôt sur le Revenu des Personnes Physiques) reaches all types of ordinary income except for a limited exclusion in cases where a total of $60 (L. Fr. 3,000) or less is derived from incidental services. While remuneration received for performing the role of corporate director is subject to a separate flat rate 20% withholding tax, in effect, the net amount of remuneration received—i.e., the remuneration less the withheld 20% tax—is also separately subject to the progressive rates of the general income tax or, in the case of a nonresident director, to a flat 8% general income tax, provided the remuneration does not exceed $1,060 (L. Fr. 53,000). In effect, while a

38 Not all municipalities use the third factor, payroll, though a number of the important ones do. The basic rate is .2% and surcharges increase this to an average total of 1.2%.
39 Ibid.
director's remuneration is subject to both taxes, the special flat 20% tax itself is deductible from gross income in computing the taxable base of the general income tax. If all of a resident director's gross remuneration would fit, say, into the 40% bracket of the general progressive tax, the privilege of treating the additional flat 20% as a deduction from gross income has the effect of reducing the added impact of the special tax to 12%. This effect is to be contrasted with that which stems from other withholding taxes which are integral parts of, and serve as credits against, the general income tax itself.

Built into the tables reflecting progression in the rate structure are allowances for married men and additional amounts for those with children. The table of effective rates, appearing in Table I M, indicates the significance of those allowances and the degree of progression.

**Table I M**

<table>
<thead>
<tr>
<th>Income</th>
<th>Single Taxpayer</th>
<th>Married Taxpayer</th>
<th>Married and 1 Child</th>
<th>Married and 2 Children</th>
<th>Married and 4 Children</th>
<th>Married and 5 Children</th>
</tr>
</thead>
<tbody>
<tr>
<td>$720</td>
<td>.56%</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Fr. 36,000</td>
<td>.56%</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Fr. 50,000</td>
<td>6.00%</td>
<td>2.00%</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Fr. 100,000</td>
<td>14.73%</td>
<td>8.76%</td>
<td>6.57%</td>
<td>4.33%</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Fr. 200,000</td>
<td>24.08%</td>
<td>15.32%</td>
<td>12.60%</td>
<td>10.12%</td>
<td>5.96%</td>
<td>4.10%</td>
</tr>
<tr>
<td>Fr. 300,000</td>
<td>30.01%</td>
<td>19.81%</td>
<td>17.36%</td>
<td>14.88%</td>
<td>10.74%</td>
<td>8.81%</td>
</tr>
<tr>
<td>Fr. 400,000</td>
<td>34.33%</td>
<td>24.45%</td>
<td>22.22%</td>
<td>19.95%</td>
<td>16.03%</td>
<td>14.21%</td>
</tr>
<tr>
<td>Fr. 500,000</td>
<td>37.71%</td>
<td>28.43%</td>
<td>26.45%</td>
<td>24.44%</td>
<td>20.89%</td>
<td>19.24%</td>
</tr>
<tr>
<td>Fr. 750,000</td>
<td>43.94%</td>
<td>36.05%</td>
<td>34.53%</td>
<td>32.99%</td>
<td>30.24%</td>
<td>28.92%</td>
</tr>
<tr>
<td>Fr. 1,000,000</td>
<td>47.71%</td>
<td>40.82%</td>
<td>39.68%</td>
<td>38.52%</td>
<td>36.45%</td>
<td>35.47%</td>
</tr>
<tr>
<td>Fr. 1,250,000</td>
<td>49.51%</td>
<td>44.06%</td>
<td>43.23%</td>
<td>42.22%</td>
<td>40.56%</td>
<td>39.79%</td>
</tr>
<tr>
<td>Fr. 1,500,000</td>
<td>50.42%</td>
<td>46.48%</td>
<td>45.72%</td>
<td>44.95%</td>
<td>43.57%</td>
<td>42.92%</td>
</tr>
<tr>
<td>Fr. 1,750,000</td>
<td>50.94%</td>
<td>48.27%</td>
<td>47.62%</td>
<td>46.96%</td>
<td>45.77%</td>
<td>45.22%</td>
</tr>
</tbody>
</table>

Individuals also pay a flat .5% tax on net wealth (Impôt sur la Fortune). The consequent extent to which the national direct tax load on income from capital exceeds that on earned income
(e.g., from employment) can be illustrated by a case where a taxpayer derives his entire income from capital which yields 10% on its market value. In this circumstance, absent other considerations, the .5% tax on net wealth would be equivalent to an additional 5% tax on the income therefrom.

In addition to the two foregoing taxes, those engaged in the conduct of a business are also subject to a three-factor municipal enterprise tax (Gewerbesteuer). Basic rates of 4% on profits in excess of $4,000 (L. Fr. 200,000) for individual proprietors, and in excess of $1,600 (L. Fr. 80,000) for companies, have been surcharged in varying amounts, increasing the municipal tax on profits to between 5.5% and 8.4% and the tax on net wealth to between .28% and .42%. However, the ultimate impact of this tax is reduced by the fact that it is deductible in computing the base of the national income tax and may also be a debt in determining one's net wealth.

(c) Income, net wealth, and enterprise taxes on corporations.—All juridical entities (e.g., société anonyme and the société à responsabilité limitée) are subject to a national income tax (Impôt sur le Revenu des Collectivités) on aggregate income, the normal rate being 40%. Progressive rates are applied, however, to enterprises with small incomes. Because the applicable rate in the progressive schedule is applied to the small company's entire income, not just to that portion falling within a given bracket, it was necessary to add a marginal relief schedule in order to even out rate changes. The basic progressive rates, and the marginal relief provisions, follow.

<table>
<thead>
<tr>
<th>Corporation's Total Profit</th>
<th>Basic Rate</th>
<th>Marginal Relief: Tax Shall Not Exceed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Profit</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. $8,000 (Fr. 400,000)</td>
<td>20%</td>
<td>$1,600 (Fr. 80,000) plus 50% of profit over $8,000 (Fr. 400,000)</td>
</tr>
<tr>
<td>2. In excess of $8,000 (Fr. 400,000) but under $20,000 (Fr. 1,000,000)</td>
<td>30%</td>
<td>$6,000 (Fr. 300,000) plus 72% of profit over $20,000 (Fr. 1,000,000)</td>
</tr>
<tr>
<td>3. Over $20,000 (Fr. 1,000,000)</td>
<td>40%</td>
<td></td>
</tr>
</tbody>
</table>

The basic rates of the three-factor municipal enterprise tax (4% on profits and .2% on net wealth) and the varying surcharges

---

40 Ibid.
41 Ibid.
are the same for corporations as individuals. Since corporations, like individuals, may deduct this tax in computing the general income tax base, the prime difference between the two relates to the fact that only individuals enjoy an exemption for the first $10,000 (L. Fr. 500,000) in computing the net wealth factor.

Also in the case of corporations and private companies (société à responsabilité limitée), for purposes of the net wealth tax, minimum property holdings are assumed, the respective assumed amounts being $10,000 (L. Fr. 500,000) and $4,000 (L. Fr. 200,000).

(d) Combined impact of corporate and individual direct taxes.—As noted earlier in the setting of Germany, certain variables affect the degree to which corporate earnings will be absorbed by direct taxes on corporations and their stockholders. The progressive character of the income tax’s rate structure, as applied to individuals (and small corporations), is one such variable. Differences in the amount of surcharges added by various municipalities to the basic rates of the municipal enterprise tax is another. Further variables, associated with net wealth taxes on corporations and individuals, include the relationships of corporate net wealth to corporate earnings and of stock values to dividends. These will vary from industry to industry and among corporations within an industry.

The cumulative effect of direct taxes on distributed corporate earnings can be measured, however, and compared to the tax load on an individual’s earned income, by making certain assumptions. Those indulged in here are similar to those made in discussing the tax loads of other countries and include an individual with modest income ($2,380 or L. Fr. 119,000), municipal enterprise tax rates of .4% on net wealth and 8% on profits, and a corporation which earns 10% on its net wealth while its stock yields 4% on its market value.

Under the foregoing circumstances, the corporation would have to earn approximately $4,925 (L. Fr. 246,203) in order to pay a dividend of $2,380 (L. Fr. 119,000), the effective total rate of the three taxes (income, net wealth, and enterprise) on its earnings being 51.67%.

An unmarried individual whose entire income was derived from a dividend of $2,380 (L. Fr. 119,000) on stock worth $59,500 (L. Fr. 2,975,000) would pay a property tax of $287.50 (L. Fr. 14,375), an amount equal to 12% of his dividend, and an income tax
of $379.10 (L. Fr. 18,955), 42 this being 15.9% of his dividend. But when his personal tax load is treated as a percentage of the original corporate earnings, rather than a percentage of his dividend, the following cumulative effect emerges.

<table>
<thead>
<tr>
<th>Total corporate direct taxes</th>
<th>$2,545.</th>
<th>(Fr. 127,203)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Individual direct taxes</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Property tax</td>
<td>288.</td>
<td>(Fr. 14,375)</td>
</tr>
<tr>
<td>Income tax</td>
<td>379.</td>
<td>(Fr. 18,955)</td>
</tr>
<tr>
<td><strong>Total direct tax load</strong></td>
<td>$3,212.</td>
<td>(Fr. 160,533)</td>
</tr>
<tr>
<td>Original corporate earnings</td>
<td>$4,925</td>
<td>(Fr. 246,203)</td>
</tr>
</tbody>
</table>

The cumulative effect of direct taxes on this type of capital may be compared with an individual who earns $2,380 (L. Fr. 119,000) from employment. His total tax of $345 (L. Fr. 17,237) 43 would be only 14% of his income.

(e) The Luxembourg concept of gross income.—In practice, gross income, as such, is not actually computed. The aggregate income against which the rates are applied actually consists of the net incomes from each of the various sources.

In the case of individuals, exclusion of capital gains is much more significant than the one other common tax free benefit, specifically, an amount not in excess of $60 (L. Fr. 3,000) derived from incidental services. The immunity accorded capital gains, such as those derived from the sale of stock or a home, is lost, however, if the transaction is deemed speculative in character. And that characterization is applied, except for certain exceptions relating to shares in Luxembourg corporations and indebtedness running against residents, whenever movables are held less than 1 year or, in the case of immovables, less than 2 years. Also included in the taxable category are profits derived from the sale of assets used in the taxpayer’s business, such as office equipment. In fact, even the conversion of a proprietorship into a limited liability company is deemed a taxable event except where the realized gain is less than $2,000 (L. Fr. 100,000). Finally, as is true in Germany and the Netherlands, gains derived by an investor from the sale of domestic

42 The standard deduction for personal expenses ($80) was taken into account.
43 The standard deductions for personal expenses and business costs were taken into account, being, respectively, $80 and $120.
or foreign corporate stock will be taxed if the individual holds a "considerable interest" in the corporation. Such an interest will be deemed to exist if the taxpayer or certain related parties owned more than 25% of the nominal paid-in capital either at the moment of sale or at any point during the preceding 5 years. But even in such cases, small profits are ignored; the gain will not be taxed if not more than 1% of the corporation's capital stock is sold and the amount of the resulting gain falls below a certain figure. Even where capital gains are taxed, in the case of individuals, a special rate is applied, ranging from 12% to 27%. Normally a rate equal to one-half of that applied to the taxpayer's ordinary income will be used.

There are two significant instances where corporations depart from the profit concept applicable to individual businessmen. First, corporations reflect all of their capital gains just as they reflect income from regular business activity. Second, the so-called Schachtelprivileg permits dividends received by a corporation to be excluded if the recipient holds at least 25% of the stock in a domestic distributing corporation.

The profit concept utilized by the various municipal enterprise taxes is quite similar to that associated with the national income tax. The prime differences, in the case of the enterprise tax, relate (1) to the non-deductibility of interest on long-term indebtedness and of salaries paid to corporate managers who have substantial stock interests (25% or more), and (2) to the permitted exclusion of income from foreign permanent establishments.

(f) The Luxembourg concept of "taxable" income.—In computing the income tax base, individuals are allowed to deduct certain personal expenses, such as interest. Also up to a certain amount, individuals may deduct premiums paid on life, health, and certain other types of insurance. Finally, deduction is allowed for certain extraordinary personal expenses (illness, death, etc.) in excess of a minimum amount which depends upon the taxpayer's income and family status. Instead of itemizing the personal expenses, the taxpayer may elect to take a standard deduction of $80 (L. Fr. 4,000) plus the allowance for extraordinary charges. Also in lieu of itemizing business expenses, wage and salary earners may take a second standard deduction of $120 (L. Fr. 6,000).

Deductible business expenses are very similar to those in the United States, and include wages, salaries, rent, interest—including
reasonable amounts paid to a parent company or other shareholder, excise duties, enterprise taxes, and depreciation.

Prime differences between the two systems in the business expense area relate to the non-deductibility under Luxembourg law of director's fees and property taxes (on net wealth) and to certain differences in the treatment of depreciation and inventories.

While depreciation is usually computed by the straight line method, in some cases the declining balance method is permitted.

As previously noted, upon the sale of business assets, the difference between book value and the selling price is generally taxed. To compensate for earlier inflation, however, it has been necessary to adjust the basis by reference to a system of coefficients. Table I N sets forth the table of coefficients which apply both to historic cost and to its adjustment for depreciation previously taken.

<table>
<thead>
<tr>
<th>Accounting year closed in</th>
<th>Coefficients</th>
<th>Accounting year closed in</th>
<th>Coefficients</th>
</tr>
</thead>
<tbody>
<tr>
<td>1918 or previous years</td>
<td>26.57</td>
<td>1937</td>
<td>3.86</td>
</tr>
<tr>
<td>1919</td>
<td>12.09</td>
<td>1938</td>
<td>3.75</td>
</tr>
<tr>
<td>1920</td>
<td>6.47</td>
<td>1939</td>
<td>3.77</td>
</tr>
<tr>
<td>1921</td>
<td>6.63</td>
<td>1940</td>
<td>3.46</td>
</tr>
<tr>
<td>1922</td>
<td>7.11</td>
<td>1941-1944</td>
<td>2.23</td>
</tr>
<tr>
<td>1923</td>
<td>6.01</td>
<td>1945</td>
<td>1.78</td>
</tr>
<tr>
<td>1924</td>
<td>5.35</td>
<td>1946</td>
<td>1.42</td>
</tr>
<tr>
<td>1925</td>
<td>5.11</td>
<td>1947</td>
<td>1.36</td>
</tr>
<tr>
<td>1926</td>
<td>4.31</td>
<td>1948</td>
<td>1.28</td>
</tr>
<tr>
<td>1927</td>
<td>3.42</td>
<td>1949</td>
<td>1.21</td>
</tr>
<tr>
<td>1928</td>
<td>3.28</td>
<td>1950</td>
<td>1.17</td>
</tr>
<tr>
<td>1929</td>
<td>3.05</td>
<td>1951</td>
<td>1.08</td>
</tr>
<tr>
<td>1930</td>
<td>3.05</td>
<td>1952</td>
<td>1.06</td>
</tr>
<tr>
<td>1931</td>
<td>3.35</td>
<td>1953</td>
<td>1.06</td>
</tr>
<tr>
<td>1932</td>
<td>3.86</td>
<td>1954</td>
<td>1.05</td>
</tr>
<tr>
<td>1933</td>
<td>3.87</td>
<td>1955</td>
<td>1.05</td>
</tr>
<tr>
<td>1934</td>
<td>4.02</td>
<td>1956</td>
<td>1.05</td>
</tr>
<tr>
<td>1935</td>
<td>4.10</td>
<td>1957 and succeeding years</td>
<td>1.00</td>
</tr>
<tr>
<td>1936</td>
<td>4.08</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Apart from regular depreciation, a special additional allowance was authorized for investments in new plant and equipment during
the years 1959 and 1960. A total additional allowance equal to 20% of cost, up to a maximum deduction of $100,000 (L. Fr. 5,000,000), could be spread over a minimum 4-year period.

While inventories must generally be reflected on the basis of historic cost, the listed selling price of an entire stock may be used if it is lower than cost. Generally, too, goods on hand will be identified by reference to FIFO, though LIFO is an available alternative.

(g) Payment and the taxable year.—While income must generally be determined by reference to the calendar year and the accrual method, businesses may select a fiscal year coinciding with their accounting year. Provision has also been made for a two-year carry-forward, but no carry-back, in the case of operating losses.

Two devices are used to keep payments on a current basis. A system of quarterly provisional payments, which serve as credits against the later definitive assessment, is complemented by provisional withholdings in the case of certain types of income. Tax is usually withheld on interest at the rate of 5%, on dividends (Impôt sur les Revenus des Capitaux) at the rate of 15%, and on wages (Impôt sur les Salaires) according to a progressive table which takes account of personal allowances and the two standard deductions ($80 or L. Fr. 4,000 for personal expenses and $120 or L. Fr. 6,000 for business expenses). The regular withheld wage tax is treated as a final levy only where the taxpayer has but one source of employment or pension income which does not exceed $2,800 (L. Fr. 140,000) and then only if his income from other sources does not exceed $100 (L. Fr. 5,000).

(h) The relevance of residency.—Residents of Luxembourg, corporate or individual—and in the latter case without regard to nationality, are liable for income tax on income from without as well as that from within the country. The only unilateral provision dealing with double taxation involves allowance of the foreign tax as a deduction in computing the income tax base. Peculiar to the Luxembourg system is the notion that certain persons will be treated as residents for tax purposes though they do not live within the country. This category includes owners, managers, and deputy managers of corporations resident in Luxembourg. It also includes any director who is also actively associated with a management function.

Nonresidents are only taxable on that income which is deemed to have its source in Luxembourg. This includes income derived
from domestic agricultural enterprises, from non-agricultural permanent establishments or through a representative, from renting domestic property, from the independent exercise of a profession or other employment within Luxembourg, and income derived from movable capital, such as shares and debentures of Luxembourg corporations and indebtedness against other residents—including also profit from the sale of shares where (a) the vendor owned a “considerable interest” in the corporation or (b) the profit fits into the so-called speculative category. The nonresident is also reached with reference to any income mentioned in § 22 of the Income Tax Act insofar as tax is withheld at the source or where speculative gain is derived from the sale of land.

Subject to the foregoing jurisdictional differences, those principles which determine a resident’s income also apply to nonresidents. Illustrative are the previously mentioned special rules relating to capital gains. Nonresidents who are other than wage earners are subject, however, to a minimum income tax of 12%. This is also the percentage withheld on royalties. Nonresident directors’ fees are subject to the special 20% director’s tax as well as the regular income tax. Accordingly, to the withheld 20% special tax, Luxembourg has added an additional 8%, the total amount withheld being 28%.

With reference to the net wealth tax, nonresidents pay only on that property situated in Luxembourg, such as immovables or assets associated with a permanent establishment located there.

(i) The comparative costs of retaining and distributing profits.—In contrast to the situation in Germany, a corporation’s own taxes will be the same whether it retains its profits for expansion or distributes them to stockholders. Luxembourg does not even have a penalty tax, like that in the United States, relating to unreasonable accumulation of profits. Since that part of the profits which are distributed will normally be taxed to the stockholders, it is less expensive to expand out of profits than to have those shareholders contribute additional capital from dividends which they have received. For example, where a parent company in the United States holds the shares, the subsidiary’s use of its own profits for expansion will serve to avoid the 15% withholding tax (Impôt sur les Revenus des Capitaux) imposed by Luxembourg on dividends distributed to an American parent company. Where the subsidiary’s profits are ploughed back in this fashion, the total tax load imposed
by Luxembourg will equal that which would be imposed had the expanding facility been operated as a branch of the American corporation. The Luxembourg tax load will be different, however, at that point when profits are no longer needed for expansion and are to be extracted by the parent. Profits of the branch will be taxed only once, in the year earned. A subsidiary will have suffered a like tax, and, in addition, dividends distributed to the parent will suffer a second tax, 15% of the dividend being withheld. This disadvantage of the subsidiary arrangement can be partially offset if the parent company’s original capital contribution consisted, in part, of loans. The subsidiary could deduct the annual interest payments in computing its income tax base, but not its municipal enterprise tax base. A branch, of course, could not enjoy such a deduction under either tax.

(j) Disposal of an enterprise.—Disposition by a corporation of its assets is a taxable event, the difference between its adjusted basis and the amount realized being includible in gross income. Upon liquidation of the corporation and distribution of the proceeds, any gain enjoyed by a shareholder, measured by the difference between the adjusted basis of his shares and the amount realized, will be taxable if he has a “considerable interest” (25% or more) in the corporation or, in the case of residents, if his gain fits into the so-called speculative category. Corporate shareholders must also include such gains in their income.

Normally, a merger is also deemed a taxable event, the amount realized by the corporations again being the difference between the adjusted bases and fair market value of their assets. But under certain conditions, if it can be guaranteed that this differential will suffer a tax later on, the gain realized at the point of amalgamation will not be recognized for tax purposes.

SUBSECTION 2. OTHER LUXEMBOURG TAXES

(a) Turnover taxes and excise duties.—The general turnover tax is a multiple stage arrangement in the sense that it is applied to each transfer of goods which may take place in the course of developing a finished product. To reduce the impact on middlemen, i.e., on entrepreneurs who deliver merchandise to another entrepreneur without changing its basic nature, the normal rate of 2% is reduced to .5%. Retail sales to consumers, however, bear the regular rate. Indeed, big retail stores which enjoy a 75% retail
turnover pay 2½%, provided their previous year's turnover reached $800,000.

The turnover tax applies pretty much across the board. Services bear the same rate as goods. But certain goods, e.g., a common necessity like bread, are taxed at a reduced rate of 1%. While transfers of luxuries normally suffer only the regular 2% rate, separate excise duties are imposed on certain products such as beer, tobacco, etc.

Tax equality between domestic and foreign products is achieved in some degree by imposing the regular rate on imports at the point of importation. To make domestic products more competitive on the world market, export transactions themselves are free of the tax. But no attempt is generally made to refund turnover taxes previously paid in connection with earlier stages of production or distribution. Metallic products, such as wagons and machinery, are exceptions; a refund of .5% is allowed.

(b) Registration and stamp duties.—A number of transactions are subject to a registration duty (Droit d’Enregistrement). These include the issuance of corporate bonds, shares, and the sale or donation of real estate. While a flat 6% is applied to sales of real estate, donations suffer a progressive duty, running from 1.5% to 12%.

Companies also pay an annual tax on their share capital and indebtedness (Droit d’Abonnement). A number of documents also suffer special stamp duties.

(c) Miscellaneous taxes.—Three of the most important miscellaneous taxes involve levies on motor vehicles, measured by weight or horsepower, succession duties, and a communal land tax.

The death duty (Droit de Succession) is imposed upon the heirs of a person deceased in Luxembourg, and is measured by the net value received. Progressive rates, dependent upon the relationship between the parties and the amount acquired, run from 0 to 15%. Where the decedent is a nonresident, a different tax (Droit de Mutation par Décès) with about the same rate schedule is imposed; it reaches the gross value of his real estate in Luxembourg.

The communal land tax (Impôt Foncier) is measured by the

---

44 This matter, insofar as it relates to exports from the United States to Luxembourg, is more fully considered in PART II, infra.

45 Registration duties and the like are more fully considered in Section G, PART III, infra, in connection with the consideration of Luxembourg as the site for a holding company.
value of real estate, and carries basic rates which vary from .5% to 1%. Local surcharges on this rate also vary.

Section F. Netherlands

Subsection 1. Income and Net Wealth Taxes

(a) In general.—Contrary to the case in Belgium and France, individuals in the Netherlands are generally subject to but one income tax, the progressive rates of which are applied to aggregate income and reach a maximum effective rate of approximately 70% for single persons. Only the remuneration received by a member of a corporate board of directors is subject to a special income tax, and it is in addition to the regular tax. Except in the case of this tax, amounts which are withheld in connection with the system of current payment are generally integrated with the regular income tax, serving as credits.

Because earned income was not given preferential treatment in the income tax legislation itself, the Netherlands have for years imposed a separate flat rate property tax. It differs from that traditionally used by local units in the United States in that the base consists only of net wealth, rather than the gross value of items in which the taxpayer has an equity.

Corporations are subject to what is generally a flat rate income tax, though slightly more modest rates are applied in the case of those with little income. While dividends are also generally taxable in full, extreme multiple taxation is avoided by immunizing one type of inter-corporate dividend, specifically one received by a corporation which has substantial interest in the distributing company.

(b) Income and net wealth taxes on individuals.—The general progressive income tax on individuals (Inkomstenbelasting) reaches all types of ordinary income. While any remuneration of a corporate director is also subject to an additional flat 30% withheld tax on amounts in excess of $263 (Fl. 1,000) plus another 20% on amounts in excess of $1,315 (Fl. 5,000), only the net, after that special tax has been withheld, is actually included in the general income tax base. This reduces, of course, the actual degree to which the special director’s tax is an additional burden. For example, if the gross remuneration would have otherwise fitted into

“The word “director” (commissaris) is used here to refer to any member of the board in control (commissarissenbelasting), not to the single so-called managing director (directeur).
the 40% bracket of the general income tax, allowance of what is tantamount to a deduction for the special director’s tax is equal to a reduction of the latter’s 30% rate to 18%.

Personal allowances for married persons and those with dependent children are built into the general progressive rate schedules which, in the case of single persons, reach a maximum effective rate of 70.5% on that part of one’s taxable income in excess of approximately $20,000 (Fl. 76,000). Table I O provides some idea of the impact of the tax and the degree of progression.

**Table I O**

<table>
<thead>
<tr>
<th>Total Income</th>
<th>Approximate Effective Rate on Total Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dollars</td>
<td>I</td>
</tr>
<tr>
<td>$</td>
<td>Fl.</td>
</tr>
<tr>
<td>394</td>
<td>fl.</td>
</tr>
<tr>
<td>526</td>
<td></td>
</tr>
<tr>
<td>656</td>
<td></td>
</tr>
<tr>
<td>789</td>
<td></td>
</tr>
<tr>
<td>1,578</td>
<td></td>
</tr>
<tr>
<td>2,367</td>
<td></td>
</tr>
<tr>
<td>3,156</td>
<td></td>
</tr>
<tr>
<td>3,949</td>
<td></td>
</tr>
<tr>
<td>5,260</td>
<td></td>
</tr>
<tr>
<td>6,575</td>
<td></td>
</tr>
<tr>
<td>7,898</td>
<td></td>
</tr>
<tr>
<td>10,520</td>
<td></td>
</tr>
<tr>
<td>13,150</td>
<td></td>
</tr>
<tr>
<td>19,725</td>
<td></td>
</tr>
<tr>
<td>26,300</td>
<td></td>
</tr>
</tbody>
</table>

While a separate net wealth tax has usually been imposed at a normal rate of .5%, this has been temporarily increased to .6% for 1959 and 1960. Exemptions serve to immunize the following amounts:

- Single taxpayer $5,921 (Fl. 22,500)
- Married taxpayers 7,895 (Fl. 30,000)
- Additional amount for each dependent child 1,974 (Fl. 7,500)

Laying aside the matter of exemptions for the moment, if it be assumed that the taxpayer’s capital yields only 4% on its market value, the .6% tax on net wealth would be equivalent to 15% of net income. And this entire amount constitutes an additional burden, for in contrast to certain other Common Market countries, the net wealth tax is not deductible in determining the regular income tax.
There is then a significant difference between the tax loads borne by earned and unearned income in the Netherlands.

(c) Income tax on juridical entities.—The corporate income tax (Vennootschapsbelasting) is also applied to aggregate income, the usual rate being 47%. A lower rate is applied only where the total income is less than $13,150 (Fl. 50,000) in which case the first $10,510 (Fl. 40,000) is taxed at 44% with the remaining $2,640 (Fl. 10,000), if any, being taxed at 59%.

While dividends are generally includable in gross income, an exception is made in that case where inter-corporate dividends are received by a corporation which owns at least 25% of the distributing company's shares. This immunity is extended even to dividends received from foreign corporations (in contrast to the practice in Germany and Luxembourg), provided the distributing foreign corporation was itself subject to a foreign income tax. An investment company (holder of a so-called investment fund) is entitled to this privilege even though it holds less than a 25% interest, provided the company meets certain conditions. The Minister of Finance is authorized to grant the same privilege to other corporations which have small holdings, and usually does if the distributing corporation is engaged in a line of business related to that of the corporate stockholder and the particular stockholder-corporate relationship is deemed to be in the public interest.

(d) Combined impact of corporate and individual direct taxes.—While certain variables affect the degree to which corporate earnings will be absorbed by direct taxes on corporations and their stockholders, the number of such variables is not as great in the Netherlands as in certain other countries. This is due to the fact that a multiple-factor separate enterprise tax does not exist in the Netherlands nor is its net wealth tax applicable to corporations. Consequently, variables in the ratio of corporate assets to corporate earnings are not material. The prime variables involve a stockholder's particular income tax bracket and—in taking account of the personal net wealth tax—the changing ratios between the market value of his stock and its yield, as well as the relative significance of the exemptions to his total portfolio.

In order to neutralize these variables, Table I P assumes that the stockholder's shares yield 4% on market value and that his entire income is derived from these shares. Column 7 reflects the combined impact of corporate and personal taxes, and may be com-
pared with column 8 which reflects the percentage which would be absorbed by direct taxes if income equal to that earned by the corporation had been earned by a single individual through employment.

**Table I**

<table>
<thead>
<tr>
<th>Company's Net Income</th>
<th>Corporation Income Tax</th>
<th>Dividend</th>
<th>Personal Income Tax</th>
<th>Property Tax</th>
<th>Total Tax</th>
<th>Total Tax % of Col. 1 Were Employment Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>$1,000</td>
<td>$470</td>
<td>$530</td>
<td>$19</td>
<td>44</td>
<td>533</td>
<td>53.30%</td>
</tr>
<tr>
<td>2,000</td>
<td>940</td>
<td>1,060</td>
<td>110</td>
<td>123</td>
<td>1,173</td>
<td>58.65%</td>
</tr>
<tr>
<td>10,000</td>
<td>4,700</td>
<td>5,300</td>
<td>1,726</td>
<td>759</td>
<td>7,185</td>
<td>71.85%</td>
</tr>
<tr>
<td>20,000</td>
<td>9,400</td>
<td>10,600</td>
<td>4,900</td>
<td>1,554</td>
<td>15,854</td>
<td>79.27%</td>
</tr>
<tr>
<td>50,000</td>
<td>23,500</td>
<td>26,500</td>
<td>15,822</td>
<td>3,939</td>
<td>43,261</td>
<td>86.52%</td>
</tr>
<tr>
<td>100,000</td>
<td>47,000</td>
<td>50,000</td>
<td>34,521</td>
<td>7,914</td>
<td>89,435</td>
<td>89.44%</td>
</tr>
<tr>
<td>1,000,000</td>
<td>470,000</td>
<td>530,000</td>
<td>370,806</td>
<td>79,464</td>
<td>920,270</td>
<td>92.03%</td>
</tr>
</tbody>
</table>

(In the above example deductions for old age premium have been taken into account. $1. = fl. 3.8)

(e) The Netherlands concept of gross income.—In practice, gross income, as such, is not determined. The tax base is calculated by aggregating the net incomes from each of the various sources, and from this amount certain allowable personal expenses and losses are deductible.

The previously described immunity for certain inter-corporate dividends constitutes the most significant exclusion for corporations. The latter do not enjoy, on the other hand, the most fundamental exclusion allowed individuals, that relating to capital gains. Even the gain technically realized by a corporation on shifting the assets of a branch into a newly created subsidiary is normally taxed. In contrast, the immunity extended to individuals embraces even speculative capital gains, though gains of two other types are includable.

First, it was easy to jump from the notion, that all profits made by a business— including, e.g., even interest and dividends—ought to be included, to the conclusion that profits from the sale of fixed business assets were also includable. By statute, however, gain realized on the sale of immovables belonging to an agricultural enterprise are not taxed provided such sales do not constitute a part of the enterprise’s regular business activity.

The second major type of taxable capital gain is intimately related to the first. It involves gain derived from the sale of corporate shares by an individual investor who owns a considerable interest
in the corporation, domestic or foreign. Sale of shares in that circum­
cumstance has a practical resemblance in some degree to sale of business assets. Accordingly, the profit is taxable if at the moment of the sale or during the preceding five years the stockholder or related parties owned more than 25% of the nominal paid in capital. Such profit is not aggregated, however, with his other income; nor are the regular progressive rates applied. Instead, a separate tax is imposed, with rates ranging from 20% to 40%, depending upon the size of the taxpayer's other income.

(f) The Netherlands concept of "taxable" income.—Business expenses incurred by individuals serve as deductions in arriving at the tax base. Itemization of these may be avoided by wage and salary earners (including also those in the so-called liberal professions) through election to take a flat standard business deduction of $26 (Fl. 100). If it can be demonstrated that the actual expenses did at least exceed that amount, the standard jumps to 5% of taxable income but in any case not in excess of $158 (Fl. 600). Business deductions by wage or salary earners in excess of that amount are dependent upon itemization. In any event, certain personal expenses may also be deducted, including life annuity premiums to a maximum amount of $947 (Fl. 3,600), charitable contributions the maximum deduction for which depends upon the size of the individual's income, and finally so-called extraordinary charges (illness, death, etc.) in excess of a minimum amount. As previously noted, additional personal allowances peculiar to married persons and those with dependent children are reflected in the rate tables, an extract from which appears in sub-topic (b), supra.

Business deductions enjoyed by individuals or corporations engaged in the active conduct of an enterprise are quite similar to those in the United States, and include wages, salaries, rent, interest—including reasonable amounts paid to a parent company or other shareholders, losses, charitable contributions up to a certain percentage of income, turnover taxes, and excise duties, but not income or property taxes. Particularly favorable arrangements for depreciation and the treatment of inventory deserve added comment.

Basic depreciation allowances are determined on the basis of historic cost, and, peculiar to the Netherlands, the first period may begin with execution of a purchase contract. Taxpayers are given considerable leeway in fixing the rate of depreciation, pro-
vided a consistent and sound policy is followed. Frequently the matter is handled through agreement with the tax inspector. Both fixed and variable rates, geared either to original cost or the adjusted basis (cost less depreciation previously taken), and dependent, for example, upon intensity of use, have been authorized.

Provision has also been made for accelerated depreciation and a special investment allowance. Originally, accelerated depreciation took the form of an initial deduction of \( \frac{1}{2} \)rd of the cost price in the year an item was ordered or bought. However, the Minister of Finance has regularly used a complementary power to require that this initial allowance be spread over a longer period. In most cases he presently requires a four-year spread, not more than \( \frac{7}{12} \)th of the cost price being deductible in the first year. Accelerated depreciation in the case of buildings is restricted to 6% a year, and may not be applied at all to office furniture or passenger cars.

A so-called investment allowance is quite distinct from the accelerated depreciation provision. The latter, but not the former, serves to reduce the book value of an asset. This incentive allowance, serving in effect to exempt rather than postpone the tax on income, was intended to promote industrial activity and incidentally compensate for some decline in the purchasing power of money. In this latter connection, the Netherlands does not utilize the system of coefficients used elsewhere.

The constantly changing provisions regarding the investment allowance now authorize a deduction, spread over two years, of 10% of historic cost.

As in the case of basic depreciation, taxpayers have considerable leeway in their treatment of inventories provided the method chosen is consistently followed and sound in terms of business practice. Valuation may be at cost, market, or at cost or market, whichever is lower. LIFO or the base stock method may be used as well as FIFO.

\( g \) Payment and the taxable year.—A system of current payment is accomplished through withholding taxes and provisional payments. The withholding tax on dividends (Dividendbelasting) is at the rate of 15%; withholding on wages (Loonbelasting) is geared to progressive tables which take account of deductible social security contributions. These two withholding taxes, like provisional payments and in contrast to the withheld tax on corporate directors' remuneration, generally serve as credits against the later definitive income tax assessment. The withholding tax on wages is itself the
final levy, however, where income from employment (including pensions) does not exceed $1,815 (Fl. 6,900) and income from other sources is not in excess of $53 (Fl. 200).

While the calendar year normally serves as the taxable year, businesses may elect a fiscal year corresponding to their regular accounting year. The provisions regarding net losses are also quite favorable. Generally they may be carried back one year and carried forward 6 years, if need be. Moreover, losses incurred by new business during the first six years of operation may be carried forward indefinitely.

In terms of accounting methods, only very small businesses may use the cash basis; others must use the accrual method. The existence of effective accounting records has assumed special tax significance in that only then may certain privileges be availed of, such as those regarding investment allowances and the unlimited carry forward permitted new enterprises.

(h) The relevance of residency.—The basic jurisdictional principle regarding residents (corporate or individual, and without regard to nationality) calls for inclusion in gross income of income derived from without as well as that derived from within the country. But this notion has been restricted in sweep, except for interest, dividends, and royalties, by unilateral provisions designed to avoid double taxation. Roughly speaking, these serve to exempt foreign income arising from personal labor performed abroad or that derived from commercial and industrial activities performed by a foreign permanent establishment, provided the income was subject to tax in the foreign country. That the foreign income did not actually suffer a foreign tax is not decisive; it may have been sufficiently low to be covered by exemptions. The pivotal question is whether it was subject to a foreign tax. Exempt income will be aggregated, however, with a taxpayer’s domestic income in determining the place his domestic income fits into the progressive rate brackets. Corporations will suffer very little from this requirement, for, practically speaking, a flat corporate rate is used in the Netherlands.

In contrast to the sweeping basic premise regarding residents, a nonresident is generally subject to the Netherlands income tax only with reference to income deemed to have its source there.

In the case of a business, this embraces profits derived from an agricultural enterprise in the Netherlands, or those from a non-

47 This amount will probably be increased to $1,961 (Fl. 7450).
agricultural enterprise if derived through a permanent establishment or regular representative located there. Included also in this latter category is any profit from the sale of shares in a Dutch corporation, provided the shareholder had a so-called “considerable interest” therein.

With reference to personal services, a nonresident must include income from employment in the Netherlands, including that derived from service as a manager or as one of the directors of a Dutch corporation and any periodic payments received from a Dutch governmental unit or from the State Civil Pension Fund. Income from the independent exercise of a liberal profession will be reached, however, only if carried on through a permanent establishment located there.

A nonresident’s investment income will also be reached to the extent it consists of (1) interest on debts secured by a mortgage on Netherlands realty, (2) a share in the profits of a business or profession which has its seat in the Netherlands, and (3) dividends and interest from a Dutch corporation but only if the nonresident has a so-called “considerable interest” and the securities or obligations do not constitute a part of the nonresident’s business property. While securities and obligations owned by a nonresident corporation will always be deemed to be a part of that corporation’s business property, any immunity thereby achieved will be lost if in fact the securities and obligations belong to a Netherlands permanent establishment of the foreign corporation. Even where this is not the case, a nonresident corporation will always suffer a flat 15% withholding tax (Dividendbelasting) on dividends received, except where provision is made otherwise by treaty.

Except for the above differences relating to source, the question of whether a particular gain is income is determined for a nonresident in accordance with the same principles which govern residents. Illustrative are the various principles relating to capital gains.

The jurisdictional standards relating to the separate net wealth tax on individuals have a practical effect similar to that associated with the income tax. The initial premise is that the net wealth tax applies to all of a resident’s property, without regard to location. But again, unilateral provisions and double taxation treaties restrict that general principle so that in many cases only property deemed situated in the Netherlands is reached. While, as expected, nonresidents suffer this tax with respect to real estate situated in the
Netherlands and businesses carried on there, the securities which they hold in Dutch corporations are free of the tax.

(i) The cost of retaining versus the cost of distributing profits to an American enterprise.—Because of the cumulative effect of two circumstances, direct taxes imposed by the Netherlands will be the same whether an American enterprise operates its facility there as a branch (permanent establishment) or through a foreign subsidiary. First, in contrast to the arrangement in Belgium, a corporation's own direct taxes in the Netherlands will remain the same whether or not its profits are distributed. The Netherlands does not even impose a penalty tax on so-called unreasonable accumulations of earnings and profits. Second, dividends paid to an American parent by a Netherlands subsidiary are freed from the withholding tax otherwise applied in the Netherlands to dividends received by certain nonresidents, such as parent corporations domiciled in Belgium, Germany, and Luxembourg.

The primary exception to the rule, that the Netherlands will impose the same total direct taxes on branch and subsidiary operations, involves the circumstance where the American parent's investment is represented in part by loans to a subsidiary (other than loans secured by immovable property). Advances to a branch operation will not be treated, of course, as loans. But a subsidiary will be allowed to deduct interest paid, up to a reasonable amount, as an expense. The interest received by the parent company—wherever situated—will not, on the other hand, be subjected to a Netherlands tax.

If a subsidiary desires to retain its profits to facilitate expansion, the profit can be capitalized through issuance of a stock dividend. Dividends of this sort, received by parent companies in America, France, Italy, or the Netherlands, will not be subjected to tax. But if any part of such dividend is paid to individual stockholders in the Netherlands, a tax will be imposed by reference to the nominal or par value of the dividend shares. And if such a dividend is paid to parent companies in Belgium, Germany, or Luxembourg, the same rate as that applicable to ordinary dividends will be assessed, 15%.

(j) Disposition of an enterprise.—A sale by a corporation of all of its assets is a taxable event, gain, if any, being the difference between the adjusted basis of the assets and the amount realized. And if the corporation is then liquidated, the stockholders will be
deemed to have received a taxable dividend to the extent the amount received exceeds the paid-in capital.

Generally, too, a merger involves a taxable transaction to the corporation, gain again being the difference between the adjusted basis of the corporate assets and their real value. Only if a guarantee is made that the tax will be paid later on (e.g., where the newly formed corporation is actually to be liquidated) will gain not be recognized at the point of the merger.

**SUBSECTION 2. OTHER NETHERLANDS TAXES**

(a) *Turnover taxes and excise duties.*—The Netherlands employ multiple stage turnover taxes, the normal rate of 5% being exacted on each transfer of goods which may take place in the course of developing a finished product. Generally speaking, this means that an integrated company which converts basic raw materials into a finished product has an advantage over those which depend upon suppliers to do part of the processing. One transfer, however, is exempt—that from a retailer to an individual consumer. Transfers directly from a manufacturer to a consumer do not enjoy this exemption; a reduced rate of 4% is applied, however, on the premise that this rate will produce the same amount of tax as that which would have been produced by a 5% tax if the goods had been transferred to a retailer. This premise assumes that the circumvented transfer to a retailer would have been at a smaller price, allowing room for a 20% retail mark-up. On the other hand, it ignores the fact that there is also a .75% tax on transfers by one dealer of finished goods (e.g., a wholesaler) to another dealer.

Because the turnover tax was designed to be an *internal consumption* tax, the regular 5% rate, and sometimes an even higher rate, is imposed at the point of importation. Export transactions, on the other hand, are exempt, and this exemption is coupled with a refund of tax levied at earlier stages, the amount of the refund normally being a percentage fixed by Royal Decree. The effect of this overall pattern is to deprive imports of any advantage over domestically produced items, and to make the latter, if exported, competitive on the world market.

A number of basic necessities, such as bread, milk, etc., are immune from the turnover tax. On the other hand, at the manufacturing level, certain luxury and semi-luxury goods suffer a turnover tax.
tax in excess of the normal rate. Moreover, special excise duties are levied on the production or import of such products as beer, wine, tobacco, etc. Finally, services, including those rendered by a business representative, are taxed at 4%.

(b) Land tax and registration duty on transfers of realty. —The previously described net wealth tax on individuals was an indirect device designed to give preferential treatment to earned income, such as that from employment. In contrast to its base—the net value of one's equity, a separate land tax is imposed on the rental value of all improved and unimproved real estate situated in the Netherlands. The rental values utilized fall far short of the current market, however, for they are still based on estimates made in the 19th century.

In addition to the foregoing, there is a registration duty on transfers of real estate for money or money's worth, the rate being 5%. While donative transfers are free of this exaction, they are subject to the gift tax described below.

(c) Succession duty and gift tax. —The succession duty is not levied on the estate as such, but on individual acquisitions by heirs and legatees of those who die domiciled in the Netherlands. The rate is progressive depending on the relationship of the parties as well as on the value acquired.

A nonresident decedent's property situated in the Netherlands is free of the succession duty except with respect to real estate on which a flat 6% rate is levied.

Provisions covering the succession duty also include a gift tax on inter vivos transfers. The structure and rates of this tax correspond to those associated with the succession duty.

(d) Miscellaneous taxes.—Other taxes include one imposed annually on motor vehicles, the assessment being based on weight, and stamp duties levied on diverse types of instruments and documents.
PART II. OVERALL TAX EFFECTS RE DIRECT EXPORTS AND SIMPLE LICENSING ARRANGEMENTS

SECTION A. INTRODUCTION

Many American manufacturers first introduced their products to foreign countries through sales to New York purchasing offices of foreign import companies. Thereafter, direct orders from overseas were received from others who had seen the product in foreign markets. Further exploitation may then have been attempted through arrangements entered into with foreign independent commission agents or brokers. As a substitute for the latter, or to complement their activities, promotional representatives may have been sent from the United States to one or more countries, and these may or may not have opened display offices.

The discussion which follows deals first with the overall tax effects of these simple export arrangements. Comparative tax effects in the Common Market countries will be integrated with the domestic tax implications. Put off for discussion in PART III, however, are the more sophisticated sales arrangements, involving use of a foreign sales office with general contracting powers or creation of a foreign sales subsidiary.

Eventually, and for a variety of reasons, an American exporter may conclude that those products destined for foreign markets should actually be manufactured abroad, in whole or in part. The prime motive may run all the way from avoidance of freight costs to avoidance of customs duties and minimization of foreign turnover taxes—all of which would affect prices. An alternative to construction of its own facilities in a member nation is the opportunity to conclude a licensing arrangement with an established European firm. Such an arrangement might actually be entered into for the purpose of stimulating export sales, rather than as a complete substitute for them. The aim, for example, may be to provide a better and more certain outlet for special parts or components to be manufactured in, and exported from, the United States, the ultimate product to be finished by the licensee.

Again, inadequacy of capital or an unwillingness to risk available
capital in a foreign country may be the prime motive for entering into a royalty-producing licensing arrangement instead of constructing a foreign facility. It might be further contemplated that the American company, in consideration of additional periodic payments, would keep the licensee abreast of any newly acquired technical knowledge and methods, instructing the licensee's employees in such "know-how" to the extent necessary.

Discussion of licensing arrangements in this PART will be limited, as in the case of exports, to simple arrangements, involving taxpayers who seek to avoid significant activity on foreign soil. PART III, infra, will take account of the more complex and sometimes more advantageous tax effects which follow when a license and "know-how" agreement are complemented by creation of a foreign subsidiary.

SECTION B. COMPARISON OF FOREIGN TAXES ON DIRECT EXPORTS

(a) Foreign income taxes.—Unilateral statutory provisions preceded bilateral conventions in fixing the extent to which European income taxes would reach profits made by a nonresident, such as an American enterprise, on exports into Common Market countries. The statutes of three member nations (Germany, Luxembourg, and the Netherlands) specifically provide that such profits are reached by their respective income taxes only if made through a "permanent establishment" located there. While the domestic laws of the other three members have been construed with more or less similar effect, treaties with a like thrust—between the United States and five of the members—actually do more than codify in permanent form this established principle. The treaties serve the additional function of establishing bilaterally acceptable standards with respect to the meaning of "permanent establishment" in, inter alia, export settings.

On the one hand, the definitional aspects of the term, "permanent establishment," had already been resolved in some measure in most countries. That expression was thought in general to relate to a fixed place utilized by the nonresident in carrying out his profitable activities. But not all subscribed to so limited a view. Moreover,

1 A tax treaty has not yet been concluded with the sixth country, Luxembourg.
2 For instance, according to the national laws of Italy and France, the standard was satisfied whenever a nonresident person regularly or habitually performed activities which constituted a complete cycle of business.
there were important "grey" areas, just as there are instances where one cannot be sure under American law whether a given nonresident will be deemed to be "engaged in a trade or business in the United States." Though the language in the treaties does not provide a ready answer to all export situations, the provisions do constitute an improved point of departure in resolving definitional difficulties.

According to all five treaties, the mere fact that an American enterprise handles its European sales through a bona fide independent commission agent or broker, acting in his regular capacity as such, will not, standing alone, lead to the taxation of its export profits. Indeed, all five recognize that an American enterprise's own employed representative in the Common Market will not himself be deemed a permanent establishment, though engaged in sales promotion work, provided he (1) does not have, nor habitually exercises, "general authority to negotiate and conclude contracts on behalf of" the American enterprise, and (2) does not have "control over a stock of merchandise from which he regularly fills orders on behalf of such enterprise."

Four of the treaties do not specifically deal with the case where a mere sales promotion representative also has a small stock to accommodate emergency cases or for display purposes. Such a person would not be "regularly" filling orders; nor would he necessarily have, or be "habitually" exercising, general authority to negotiate and conclude contracts on behalf of the American enterprise. These considerations were sufficiently impressive to lead the American government to publish an interpretation favorable in the reverse setting to some nonresidents who send promotional representatives to the United States.8 Foreign governments, however,

8 United States regulations pertaining to its treaty with Belgium are perhaps the most informative with respect to the American interpretation of treaties falling in this group. T.D. 6160, Section 504.104(b)(8)(ii) provides: "If the enterprise has an agent in the United States who has power to contract on its behalf, but only at fixed prices and under conditions determined by the enterprise, it does not thereby necessarily have a permanent establishment in the United States. The mere fact that an agent of a Belgian enterprise—assuming he has no general authority to negotiate and conclude contracts on behalf of his principal—maintains samples, or occasionally fills orders from incidental stocks of goods maintained, in the United States does not of itself mean that the enterprise has a permanent establishment in the United States. The mere fact that salesmen, employees of a Belgian enterprise, promote the sale of their employer's products in the United States or that a Belgian enterprise transacts business in the United States by means of mail order activities does not mean that the enterprise has a permanent establishment in the United States." Section 504.105(b) adds: "Similarly, if during the taxable year, the enterprise were to secure orders in the United States for such merchandise through its sales agents whose sole function in the United States is sales promotion, the orders being transmitted to Belgium for acceptance, then the profits arising from such sales would not be includible in gross income and would be
seldom publish general interpretations. At an extreme point, it must also be remembered that three of the above mentioned four treaties do go on specifically to state that a "warehouse" does constitute a permanent establishment, and the other would probably subsume that characterization under the shotgun expression, "or other fixed place of business." Thus, in the case of a stock of goods kept on hand for emergencies, at some point one will encounter the supplementary question: How large a stock can be on hand, and how frequently can resort be made to it, before the storage arrangement will be characterized as a warehouse? In this setting, not much comfort can be derived from the further fact that two treaties (Germany and Italy) specifically exclude the "casual and temporary use of mere storage facilities" from the definition of a permanent establishment.

The fifth treaty, one with Germany, stands alone in specifically mentioning the matter of displays. But there, displays are first conjunctively associated with a sales office in a proscription to the effect that a "permanent display and sales office" will be deemed a permanent establishment. It then goes on to say that a warehouse maintained "for convenience of delivery and not for purposes of display shall not of itself constitute a permanent establishment." 4

In the case of most countries, one may be more secure in relying on information obtained from tax authorities in the country concerned or, in the case of emergency stocks, arrange to have such exports remain under customs seal in that country. While published rules do not exist even with reference to the immunity of this practice, it is not believed that such stocks would be deemed a permanent establishment. Moreover, with reference to all exported items, this arrangement provides added advantages in connection with the matter of turnover taxes, a matter discussed under the next sub-topic.

Finally reference should be made to PART III, infra, for con-

exempt from United States tax." United States regulations relating to the treaty with the Netherlands also adopt a liberal interpretation for the benefit of foreigners, providing as follows: "The mere fact that an agent (assuming he has no general authority to contract on behalf of his employer or principal) maintains samples or occasionally fills orders from incidental stocks of goods maintained in the United States will not constitute a permanent establishment within the United States." T.D. 5778, § 7.853(a). Regulations relating to the treaty with France are somewhat similar: "However, the mere fact that a commission agent or broker through whom a French enterprise carries on business in the United States maintains a small stock of goods in the United States from which occasional orders are filled shall not be construed as meaning that such enterprise has a permanent establishment in the United States." T.D. 5499, § 7.413(a).

4 Art. II(1) (c).
sideration of the way income taxes are affected by various organizational arrangements, should an American enterprise desire to create a permanent establishment in a member nation in connection with export operations.

(b) Comparative effect of Common Market turnover taxes and excises on direct American exports into a member nation.—The turnover tax patterns in the Common Market countries are so complicated and varied as to preclude doing anything more here than provide a general comparative orientation of the way in which they might affect direct American exports.

The country-by-country survey in PART I indicated that each Common Market nation exempts its own exports from its turnover tax. Each does, however, impose its tax on imports. Otherwise imported items would not suffer the same tax burden as domestically produced items designed for consumption within the country. In keeping with the logic of this theme, a particular import may enjoy an exemption or suffer luxury or semi-luxury rates if domestically produced competitive items are so treated. The classification of luxury items varies, of course, from country to country.

In comparing the turnover taxes of member nations, it will be recalled that in four countries (France, Germany, Luxembourg, and the Netherlands), the effective rates of the local turnover tax are slightly higher than the stated rates, for the tax is imposed on a sales price which includes the tax itself. The cumulative character of turnover taxes in all countries but France has also given rise to further differentials regarding the turnover tax on imports. A single transfer rate, if imposed on certain imported items, would not be sufficient to equalize the tax burden with that borne by domestically produced equivalents which have gone through more than one taxable transfer in the course of development. To compensate for the difference, four countries (Belgium, Germany, Italy, and the Netherlands) may impose on certain imports a rate which is greater than that imposed on a single transfer of a domestically produced item. Since the difficulty stems from the multiple stage character of turnover taxes, the amount of increase is frequently lower for various raw materials than for finished or semi-finished products. These increased rates are usually imposed irrespective of the country of origin, the one exception relating to an immunity from such increase of items imported into Belgium from Luxembourg.

Luxembourg may also apply increased rates, but rules pertaining to such have not yet been issued.
Table II A reflects the normal stated and effective rates, the stated and effective rates for luxuries, and the maximum by which these rates might be increased on certain imports over that rate borne by a single transfer of domestically produced equivalents.

**Table II A**

<table>
<thead>
<tr>
<th>Country</th>
<th>Normal Stated Rate</th>
<th>Normal Effective Rate</th>
<th>Luxury Stated Rate</th>
<th>Luxury Effective Rate</th>
<th>Max. Amt. by Which Other Rates May Be Increased</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belgium</td>
<td>5%</td>
<td>5%</td>
<td>11 or 13%</td>
<td>11 or 13%</td>
<td>10%*</td>
</tr>
<tr>
<td>France</td>
<td>20%</td>
<td>25%</td>
<td>25%</td>
<td>33.33%</td>
<td>—</td>
</tr>
<tr>
<td>Germany</td>
<td>4%</td>
<td>4.17%</td>
<td>4%</td>
<td>4.17%</td>
<td>2%</td>
</tr>
<tr>
<td>Italy</td>
<td>3.3%</td>
<td>3.3%</td>
<td>8.3%</td>
<td>8.3%</td>
<td>—</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>2%</td>
<td>2.04%</td>
<td>2%</td>
<td>2.04%</td>
<td>—</td>
</tr>
<tr>
<td>Netherlands</td>
<td>5%</td>
<td>5.26%</td>
<td>18–20%</td>
<td>22–25%</td>
<td>7%</td>
</tr>
</tbody>
</table>

The foregoing rates are normally imposed on the same value as that used for the purpose of customs' duties adjusted for certain matters, the most important of which is usually the amount of import taxes themselves.

An American enterprise which makes direct exports to customers in member nations should take account of the possibility that turnover taxes might be levied more than once before his product reaches the ultimate consumer.

The first such possibility may be affected by the way in which he designs the sale. Except in Belgium and Italy, one turnover tax may be levied by reference to the act of import and another on the delivery to the customer if the sale, as defined under the member nation's law, is deemed to take place there. For example, delivery under reservation of title until payment is effected may give rise to such multiple taxation. Again, in the Netherlands, title to goods shipped from New York via public transport is normally deemed to pass upon delivery to the customer, not upon delivery to the transport agency. In that country, however, multiple taxation can be avoided in two instances. First, tax free delivery in a sea-port is permitted, but only in the case of staple commodities. Second, with respect to other goods, multiple turnover taxation can be avoided by keeping the goods under customs bond until delivery can be effected. The double tax problem is much less acute in Germany;


*The stated rate for cars is 7%, yielding an effective rate of 7.5%.*

*In practice, the increase does not exceed 6%.*
actual delivery, as such, is less significant there in determining passage of title. For example, title to goods shipped from New York via public transport, if addressed to the purchaser, is deemed to pass upon delivery to the transport agency.

In those circumstances where multiple turnover taxes are applied, first on import and then again on actual delivery, the same rates are usually applied to the two events except in the case of the Netherlands where the wholesaler’s rate of .75% is imposed on one of the two events. Indeed, a second tax will not be imposed there if the delivery is to a person who buys the goods for his private consumption. In the event both circumstances are taxed in France, a credit in the amount of the first tax will be allowed against the second tax, for in effect France quite generally taxes only the value added, not the value transferred.

The discussion above involved the possibility of multiple turnover taxation in effecting delivery to an American enterprise’s own customer. In analyzing its competitive position, the American enterprise must also take account of the fact that its own customer will also suffer a turnover tax, though perhaps at a different rate, if it holds the goods for re-sale, for that tax will affect the ultimate price paid by the consumer. Table II B compares the rates which would normally be applied to an importer’s re-sale.

<table>
<thead>
<tr>
<th>Country</th>
<th>Rate If Re-sale Is to Person Who Buys Other Than for His Private Consumption</th>
<th>Rate If Re-sale Is to a Person Who Buys for His Private Consumption</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belgium</td>
<td>5%</td>
<td>0</td>
</tr>
<tr>
<td></td>
<td>20%</td>
<td>20%</td>
</tr>
<tr>
<td></td>
<td>(There is a credit for tax previously paid)</td>
<td>(Credit is also allowed here for tax previously paid)</td>
</tr>
<tr>
<td>France</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Germany</td>
<td>1%</td>
<td>4%</td>
</tr>
<tr>
<td></td>
<td>(Wholesaler’s rate)</td>
<td></td>
</tr>
<tr>
<td>Italy</td>
<td>3.3%</td>
<td>0</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>.5%</td>
<td>2%</td>
</tr>
<tr>
<td></td>
<td>(Wholesaler’s rate)</td>
<td></td>
</tr>
<tr>
<td>Netherlands</td>
<td>.75%</td>
<td>0</td>
</tr>
<tr>
<td></td>
<td>(Wholesaler’s rate)</td>
<td></td>
</tr>
</tbody>
</table>
In Germany and the Netherlands, the foregoing tax can be avoided in the case of staple commodities which enjoy immunity at the point of delivery in sea-ports and for the first delivery outside these sea-ports. In Belgium and Italy, multiple taxation can be mitigated for a number of different items with respect to which one tax, though usually higher than normal, covers all stages from the manufacturer or importer to the consumer.

As indicated in the country-by-country survey in PART I, each member nation imposes certain excise duties, usually at very high rates, on specific goods, as distinguished from turnover taxes which, in general, apply to transfers of all goods. It is not possible within the confines of this study to list all of the goods subject to such excises nor all of the rates which are constantly changing. Examples include alcoholic beverages, sugar, tobacco, and mineral oils. Italy, more than others, impose excises on a very long list, and these are equally applicable to imports.

Section C. American Taxes Re Exports Direct To Foreign Customers

(a) Introduction.—The effect of the federal income tax on export profits derived by an American enterprise from direct sales to foreign customers turns on two questions. The first involves the extent to which such profits are includible in gross income. The second relates to the other side of the ledger: To what extent is a deduction or credit allowed for any foreign taxes paid with respect to such transactions?

The separate discussion below of these two questions indicates that the American income tax affects a simple export arrangement in a manner quite similar to that associated with domestic sales. A third sub-topic goes on to examine the overall competitive tax position of an American exporter, due account being given to the tax patterns of the more significant federal excise taxes.

(b) Gross income as affected by export profits from sales direct to foreign customers.—Congress has acknowledged that profit from a foreign sale of personal property produced in the United States is derived partly from sources within, and partly from sources without, the United States. But this is primarily significant only to nonresident aliens and foreign corporations. Beginning with the first income tax act passed pursuant to the Sixteenth

*I.R.C., § 863(b).*
Amendment, Congress has required *domestic* corporations to include in their gross all income without regard to the source from which it was derived.\(^\text{10}\)

This assertion of world-wide jurisdiction, applicable also to individual citizens and residents, was sustained by the Supreme Court in the face of contentions of unconstitutional discrimination by reference to the fact that nonresident aliens and foreign corporations were required *only* to include that income which was derived from sources *within* the United States.\(^\text{11}\)

As a result of that determination, a domestic corporation's gross income from direct exports will not be affected by the question of whether title and the risk of ownership changes in the United States or in Europe. Its entire profit will be includible in either event. As a practical matter, however, this need mean only that the *manufacturing* profit will be within the reach of the Internal Revenue Service. All or a portion of the remaining profit associated with the distribution process—getting the product into the hands of the *ultimate* foreign consumer—may be free of the American income tax and be subject only to what may be smaller direct taxes of a foreign country, thus reducing the total amount of direct taxes which the whole process must absorb.

The extent to which the distribution profit will be immune from the federal tax depends on the choice of media through which distribution is to be handled. Illustratively, sales to an unrelated *foreign* incorporated wholesale export house with a purchasing office in New York, or to a foreign import house with a purchasing office in a Common Market country, would confine the American vendor to the manufacturing profit. Even if both wholesalers consummated their purchases in the United States, the distribution profit could be placed beyond the range of the federal treasury. Since a foreign corporation's profit is includible in American gross income only to the extent it is derived from sources within the United States, the two wholesalers could avail themselves of the further statutory provision which treats profit derived from the purchase of personal property within, and its sale without, the United States as derived *entirely* from sources without this country.\(^\text{12}\) It would be essential

\(^{10}\) Rev. Act of 1913, § 8(a), now I.R.C., § 61.


\(^{12}\) I.R.C., § 862(a) (6).
to immunity, of course, that the wholesalers' dispositions take place outside this country.\(^\text{13}\)

A somewhat similar effect would be accomplished, but by virtue of different principles, if the sale to the ultimate foreign consumer is effected by the American vendor through a foreign independent commission agent, as distinguished from a foreign merchant. While the American vendor's gross would be fully includible in its gross income, the sales commission would be deductible as a selling expense.\(^\text{14}\) And this is so though the foreign agent's distributing commission is free of American tax, suffering instead the direct taxes of the appropriate foreign country.

For at least a period of time, it is even possible for the American manufacturer to immunize the distribution profit without dividing it with strangers. It could create its own foreign subsidiary. The tax advantages associated with this more dramatic penetration into a foreign country are considered, however, in PART III infra. With reference to the American manufacturer who is not yet quite ready to become so involved in foreign soil, it is important to note here, however, that the prime tax advantages associated with a foreign sales subsidiary are not available to an ordinary\(^\text{15}\) domestic subsidiary which might be created to handle direct export sales. This latter arrangement would serve only to divide between two domestic corporations that gross income which would otherwise be enjoyed by the parent. The one advantage in this relates to the possibility of creating a second exemption from surtax, the subsidiary's first $25,000 of taxable income being subjected only to the normal tax rate of 30%.\(^\text{16}\) Assuming the parent company is in the 52% bracket, the consequent 22% yearly saving on the first $25,000 ($5,500) will be more than offset, however, by the tax on inter-corporate dividends\(^\text{17}\) if the subsidiary's pre-tax sales profit approximates $135,000 or more. At that point, its after-tax income of approximately

\(^{12}\) For federal purposes, generally the place where the benefits and burdens of ownership pass fixes the place of sale. I.T. Regs., § 1.861-6; U.S. v. Balanovski, (2d Cir. 1956) 236 F. (2d) 298, cert. den., 352 U.S. 968, 77 S. Ct. 357 (1957); Commissioner v. East Coast Oil Co., S.A., (5th Cir. 1936) 85 F. (2d) 322, cert. den., 299 U.S. 608, 57 S. Ct. 234 (1936).

\(^{13}\) I.R.C., § 162.

\(^{14}\) The relevance of the proposed Foreign Investment Incentive Tax Bill of 1960 (the so-called Boggs Bill) is mentioned in PART VI, infra.

\(^{15}\) I.R.C., § 111. Even this advantage might be lost under some circumstances, by reference to I.R.C., §§ 1551, 269, or 61. E.g., see James Realty Co. v. United States, (D.C. Minn. 1959) 59-2 USTC para. 9660; Aldon Homes, Inc., 33 T.C. No. 65 (1939).

\(^{16}\) I.R.C., § 11. Even this advantage might be lost under some circumstances, by reference to I.R.C., §§ 1551, 269, or 61. E.g., see James Realty Co. v. United States, (D.C. Minn. 1959) 59-2 USTC para. 9660; Aldon Homes, Inc., 33 T.C. No. 65 (1939).

\(^{17}\) Inter-corporate dividends are deductible by the recipient only to the extent of 85%. I.R.C., § 243.
$70,000 \textsuperscript{18} would suffer an inter-corporate dividend tax equal to the earlier saving. This tax on inter-corporate dividends can be avoided only if the parent files a consolidated return which carries with it loss of the added exemption otherwise enjoyed by the subsidiary and an additional 2\% charge on the total income derived from domestic as well as export sales.

To avoid the difficulties just mentioned, a parent company might seek to confine the domestic subsidiary's profits by setting unrealistic limitations on its sales commissions or by charging unrealistically high prices for items purchased by the subsidiary for re-sale. Obviously the Internal Revenue Service does not, and cannot, officially approve such practices whatever a given revenue agent may allow in a specific case. The Code contemplates that transactions between parent and subsidiary will conform to commercial practices followed by those who bargain at arm's length.\textsuperscript{19}

(c) **Deductions or credits for foreign taxes re exports direct to foreign customers.**—Congress began in 1913 to take account of all foreign taxes paid by an incorporated American enterprise, the arrangement coinciding with that traditionally associated with state and local taxes.\textsuperscript{20} A deduction from gross income was allowed in arriving at the net to which the American rates were to be applied. In that day, income taxes imposed by states were more or less \textit{de minimus}.\textsuperscript{21} World War I costs, however, led foreign countries almost immediately to increase substantially their income and excess profits taxes. Congressional accommodation of those charges only by way of a deduction meant that the federal government absorbed only that percentage of the foreign tax equal to a domestic taxpayer's American rate. The enterprise itself had to absorb the balance. In 1918, for the asserted purpose of reducing the "very severe burden" which followed the double taxation of foreign earned income, Congress created a credit, allowing American enterprises to elect to offset the domestic tax itself with any foreign "\textit{income, war profits, or excess profits taxes}" imposed on income

\textsuperscript{18}On a gross income of $135,000, the subsidiary would pay 30\% on the first $25,000 ($7,500) and 52\% on $110,000 ($57,200), a total tax of $64,700 leaving $70,300 available for dividends.

\textsuperscript{19}I.R.C., § 482.


\textsuperscript{21}The first state income tax was not passed in the United States until 1911, and by 1919 the total yield in all states approximated only $50,000,000. Hellerstein, State and Local Taxation 7 (1953).
derived "from sources within such [foreign] country." 22 Of course, provision was made to prevent an electing taxpayer from doubling up by deducting from gross income any tax for which the credit arrangement had been elected. 23 While the privilege to elect a credit was later extended to other types of taxes, this was so only where the other tax was imposed in lieu of an income, war profits, or excess profits tax otherwise generally imposed. 24

Since an American enterprise engaged only in direct exports to customers in the Common Market is not likely to incur foreign taxes of a type which satisfy the credit provision, the refinements limiting the credit are considered in PART III, infra. That such taxes are not likely to be encountered in the circumstance under consideration stems from the fact, as noted in Section B supra, that the United States has a bilateral tax treaty with all member nations except Luxembourg. And these conventions free "industrial and/or commercial profits" of American enterprises from foreign income taxes except in the instance where a "permanent establishment" is maintained abroad.

Under this standard, an American enterprise engaged only in direct export sales could retain immunity even if the sales arrangement called for the burdens and benefits of ownership to pass in Europe, rather than in the United States. As a business matter, however, this may be neither practicable nor desirable. Moreover, as noted in Section B, supra, the effect may be to multiply the number of times the foreign country's turnover tax will be applied, once at the point of import and again on delivery. While such taxes would be deductible in computing gross income for American purposes, the credit provision would not apply 25 with the consequence that the manufacturer's competitive position might be prejudiced.

Providing for the benefits and burdens of ownership to pass in the United States may in one circumstance, on the other hand, entrap an American company into double taxation of its export profits. Suppose that the American company, while operating under this arrangement, sends a promotional representative to a Common Market country intending to so limit his function as to preclude the foreign government from asserting that a permanent establishment

22 H. Rep. No. 767, 65th Cong., 2d Sess. 11 (1918); Rev. Act of 1918, §§ 222(a) (1) and 238(a) (1), now, as modified, I.R.C., § 901 et seq. (Italics added.)

23 Rev. Act of 1918, §§ 214(a) (3) and 234(a) (3), now I.R.C., § 164(b) (6).


25 E.g., Eitingon-Schild Co., Inc. and Subsidiaries, 21 B.T.A. 1163 (1951). Inapplicability of the credit provision to turnover taxes is more fully discussed in Section D, infra, in the setting of royalties received from licensing arrangements.
has been created there. Later, to accommodate business requirements, the promotional representative informally assumes added responsibilities to a point where the foreign government, while acknowledging that the matter falls into the "grey" area, asserts, nevertheless, that a permanent establishment has been created. It might go on to assert that profits from the export sales are attributable to that establishment even though the benefits and burdens of ownership passed in the United States. The United States, on the other hand, might deny that a permanent establishment was created and deny that any credit is allowable against the American tax for the asserted foreign income tax. As a general proposition, bilateral tax treaties require the United States to grant a credit only to the extent provided for in the Internal Revenue Code. 26 And in an equally general sense, credit for foreign income taxes is allowed only where the taxpayer derived income from a foreign source. 27 The American government might contend that passage of the benefits and burdens of ownership in the United States meant that the export profit had its source in this country, 28 rendering inapplicable the credit arrangement. While diplomatic channels might be available in any effort to conform the foreign country's interpretation of the so-called "grey area," this type of remedy may be small comfort to a taxpayer whose foreign activities—as viewed by the foreign government—have slipped just over the "permanent establishment" line.

(d) Comparing the competitive tax positions of American exporters with that of other exporters, and with producers in a Common Market country.—The foregoing discussion indicates that an American enterprise may export items direct to customers in a member nation without incurring any income tax liability under the latter's laws, provided only that sales are not handled through its own "permanent establishment" located there. The shape of the internal laws of the member nations is such that the same result would generally follow even in the absence of bilateral tax treaties with the United States. 29 It follows from this that competitive enterprises in other exporting countries can also avoid Common

26 The usual practice in the treaties is first to freeze the American credit provisions as they existed at the time the treaty goes into effect. It is then provided that this shall not restrict allowance of any credit otherwise allowed by the national laws of the contrasting states. See, e.g., the treaty with Belgium, Articles XII and XX.
27 I.R.C., § 904. This is discussed more fully in PART III.
28 See note 13, supra.
29 However, see note 2, supra.
Market income taxes even though the exporting country does not have bilateral tax treaties with the member nations. On this score, the only difference between the position of such an exporting enterprise and one in America relates to slight variations which may exist between the way "permanent establishment" is defined under the national laws of member nations and the way it is defined in the American bilateral tax treaties. Generally, however, these differences are not likely to have great practical significance. For example, where the transactions are handled through an importer, both exporters may want to deal only with an independent firm in order to avoid any contention that they maintain a taxable permanent establishment in the member nation.

Nor, with respect to Common Market turnover taxes—standing alone, will the competitive tax position of American exporters differ from that of other outsiders who export into the Common Market. Turnover taxes of member nations do not generally differ by reference to the origin of imported items. It is the relationship of the outsiders' domestic income tax systems to their own respective turnover tax systems that controls the competitive tax position inter se. Where the former taxes are high, the latter will be relatively lower, and vice versa. Accordingly, an exporter in an outside country with relatively low income taxes and relatively high turnover taxes which are refunded at export will enjoy a competitive tax advantage over another outsider from a country with an opposite tax pattern, and vice versa. As between outsiders from different countries, Common Market taxes will have a neutral effect; neither outsider will be subject to the income taxes of member nations and both will suffer the same Common Market turnover taxes.

The same domestic relationships generally control the competitive tax positions of exporters from outside the Common Market with those from within with respect to exports to other member nations. Finally, an outside exporter in a country with a relative low income tax and relatively high turnover taxes which are refunded at export will enjoy a competitive tax advantage over a local producer in a given member nation which, relatively speaking, has an opposite tax pattern. Both will suffer approximately the same turnover taxes—hypothetically the low one imposed by the member nation, and by hypothesis the local producer is subject to the greater income tax.

30 Cf., e.g., note 2, supra, with the discussion of the treaty provisions in Section B.
The foregoing problem is not peculiar to comparisons between outside exporters and producers within the Common Market. It exists within the Common Market itself. Indeed, from the beginning of "Benelux" and the Coal and Steel Community, tax experts have worked diligently, without much practical success, to resolve the difficulties growing out of the differentials.

While American industry is burdened with a relatively high income tax and with some non-refundable indirect taxes, at least with reference to certain rather widely applied excises it does enjoy a position generally comparable to competitors situated in countries which immunize exports from turnover taxes and refund those previously paid. In this connection, the United States imposes a manufacturers' excise tax on the sale of a variety of items, including, e.g., automobiles, appliances, refrigerators, musical instruments, phonographs, records, radios, television sets, photographic apparatus, light bulbs, pens and mechanical pencils, lighters, and business machines. The most typical rate is 10%. Until 1958, the practice followed under the then existing law with regard to these items allowed a manufacturer to make a tax-free sale, regardless of the number of subsequent intermediate purchasers, as long as he had advance knowledge that the article was destined for exportation before any other use was to be made of it. In one sense, however, the tax was only suspended; the manufacturer had to obtain proof within 6 months of his shipment or sale (whichever was earlier) that the item had actually been exported. Many manufacturers were concerned with problems associated with proof of eventual exportation in that instance where several intermediate purchasers were involved. Accordingly, beginning with the revision in 1958, manufacturers have been permitted in the export setting to make tax-free sales only where the sale itself was "for export, or for resale by the purchaser to a second purchaser for export . . ." prior to any other use. This was coupled with another provision bearing on the instance where tax had to be charged because there would be more than one intermediate purchaser; a refund, the benefit of which would actually be enjoyed ultimately by the exporter, could be obtained in that instance, provided the necessary

---

31 I.R.C., Chapter 32, § 4061 et seq.
32 Tobacco products are dealt with separately in I.R.C., § 5704(b).
34 This goes back to an interpretation under the old code (I.R.C. (1939), § 2705) in Treas. Reg. 46 (1940), § 316.25.
36 I.R.C., § 4221(a) (2).
One of these conditions traces back to an interpretative position taken by the government under earlier law, to the effect that sales could be made tax free or refund obtained only if the manufacturer had advance notice that the product he was selling was ultimately destined for export prior to any other use. Others thought it served a useful purpose. For example, automobile manufacturers urged that only through this advance notice requirement would they be in a position to see that an exported automobile was properly equipped for driving in the foreign country. In the end, the limitation in question survived the revision of 1958 as to a host of articles, though not all. The rule continues to apply, e.g., in the case of automobiles, refrigeration equipment, appliances, radio and television sets, and phonographs.

In spite of the relatively favorable treatment of exports under the manufacturers' excise tax, the over-all competitive tax position of American exporters will be less favorable than that of an exporter from a low income tax country unless the latter's turnover tax provides an inadequate rebate system for exports. Because items competitive with American products might come from any one of a hundred countries, it is not possible to lay down fixed rules. At the moment, the American exporter can do little more than determine whether his product would be competitive price-wise under the existing price structure within a given member nation. No advantage would be derived from shipping goods to one country for re-shipment to a member nation. While the first country's turnover taxes could be avoided, the turnover taxes of the country of destination would apply just as in the case of direct exports to that country.

Section D. Foreign and Domestic Taxes Re Simple Licensing Arrangements

(a) Introductory note.—For any one of the reasons indicated in the Introduction to this PART, an American enterprise may eventually choose to have its product manufactured, in whole or in part, in one or more of the Common Market countries. Simple licensing arrangements and "know-how" agreements with estab-

---

37 I.R.C., § 6416.
41 The limitation survives as to manufacturers' excises imposed by I.R.C., §§ 4061(a), 4111, 4121, 4141, and 4201. See H. Rep. No. 2596, 85th Cong., 2d Sess. 5, 8 (1958).
lished foreign firms, the over-all tax effects of which are considered below, may be entered into as a substitute for establishment by the American company of its own facility abroad. Later, in PART III, account will be taken of the additional over-all tax advantages which may follow when such arrangements are complemented for one or more reasons by creation of a foreign subsidiary.

(b) Comparison of foreign income taxes on royalties from licenses.—If the American enterprise licenses its patent to an independent European firm, the latter may treat royalties paid as a business expense fully deductible from gross income in computing its own income tax. For purposes of the German enterprise or business tax, however, only one-half the amount is deductible. Again, with reference to the income tax properly so-called, in the case of dependent corporate licensees (a subsidiary or majority-owned company), such royalties are deductible only to the extent they are fair in amount and do not represent a "hidden" distribution of profits.

In the absence of a bilateral tax treaty, all member nations except the Netherlands would compensate themselves for the loss of revenue flowing from the deduction by treating royalties paid to nonresidents as taxable income to them. The Netherlands does not impose a tax on royalties paid a nonresident except where the latter has a Dutch permanent establishment. With respect to the other member nations, again in the absence of a treaty, in all but one a special income tax rate would actually be applied, and then—except in Germany—only to the net royalty which remains after payment of a turnover tax the rates of which are discussed in the next sub-topic. The special income tax rates which would be applied to the net amount follows:

<table>
<thead>
<tr>
<th>Country</th>
<th>Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belgium</td>
<td>18%</td>
</tr>
<tr>
<td>France</td>
<td>24%</td>
</tr>
<tr>
<td>Germany</td>
<td>25%</td>
</tr>
<tr>
<td>Italy</td>
<td>23.62% on 3/8 of the gross amount</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>12%</td>
</tr>
</tbody>
</table>

The United States has concluded tax treaties with all member nations except Luxembourg. These, like similar treaties between other countries, generally exempt from the income tax otherwise imposed by the licensee's country any royalties paid to a nonresident American licensor in consideration, for example, of "the right to use copyrights, patents, secret processes and formulae, trademarks,
and other analogous rights." 42 In effect then, the American enterprise’s royalties would generally be subject to a member nation’s special rates only where the licensee is a Luxembourg firm.

The immunity otherwise enjoyed is subject, however, to an important limitation, i.e., that the American firm does not maintain a permanent establishment in the member nation in question. The consequence which would follow from maintenance of such an establishment is still open to dispute. One possibility is that the royalty will be subject to the special rates set forth above. The other is that the royalties will be deemed to be a part of the income of the permanent establishment and taxed according to the rates applicable to its income. The difficulty arises from the fact that all five treaties literally exempt only those American firms “not having a permanent establishment” in the member nation. Discussions are still being carried on with the aim of identifying which result should follow under various circumstances. At the moment there seems to be a tendency to treat such royalties as part of a permanent establishment’s income only if conclusion of the licensing agreement can properly be considered a part of the permanent establishment’s business activities.

A somewhat different interpretative difficulty which may arise involves possible differences between royalties properly so-called and additional payments for providing continuous technical assistance. At some point, the technical assistance to be rendered may include an element of service, as distinguished from an act of communicating in a practical way the nature of the “right” granted— for the use of which “right” the consideration is aptly characterized as royalty. The foreign income tax problem will not be complicated, of course, where the additional service, if any, is performed within the United States. In such case, compensation for the service would have its source in the United States. But a problem may arise where instruction, etc., is to take place abroad. Even in this case, however, it must be remembered that normally the treaties do immunize payments for the right to use secret processes and formulae as well as more concrete intangibles such as a patent. And meaningful communication of the “right” is indispensable, i.e., part and parcel, to its use. Sterile written instructions may well fall far short of communicating the exact nature of the right granted. In the reverse

42 All of the treaties except that with Germany use language almost identical to that quoted. Two of the treaties project the immunity only to one other case; those with Belgium and France go on to provide that the term royalties shall be deemed to include rentals in respect to motion picture films. The other three also include rentals and like payments for the use of industrial, commercial, and scientific equipment,
situation, where an American company was the licensee and was to be given instruction in the United States with reference to the foreign licensor's "know-how," the line of reasoning just indicated led the Internal Revenue Service to react as follows:

The essence of the contract is the making available to the domestic corporation the technical knowledge, methods, experience, that is, the "know-how" of the foreign corporation. While manufacturing "know-how" is of a nonpatentable nature, it is something that its possessor can grant to another for a consideration. The right to use such "know-how" is not materially different from the right to use trade-marks, secret processes and formulae, and, if the right thereto is granted as part of a licensing agreement, it becomes, in effect, an integral part of the bundle of rights acquired under such agreement.

The payments made under the contract are applicable both to the specific rights therein granted, that is, the right to use the "know-how," and to services performed abroad in instructing and training the employees or technicians of the domestic corporation. Such payments should therefore be allocated between the license to use the "know-how" and the personal services. Since the personal services have only nominal value apart from the license to use such "know-how," all but a nominal sum should be allocated to the license.\(^43\)

As indicated in the next sub-topic, one Common Market country has indicated, at least for purposes of its turnover tax, that consideration paid for those practical steps essential to a meaningful communication and practical utilization of the right granted will be deemed royalty. Notice was given, however, that accessory operations going beyond that line would not be so classified.\(^44\)

(c) Comparison of foreign turnover taxes on royalties from licenses.—All Common Market countries treat the benefit rendered by the licensor as a service to the licensee, with the consequence that the gross amount of the royalty is subjected to a turnover tax. The rates vary as follows.

<p>| | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Belgium</td>
<td>5%</td>
<td>Italy</td>
<td>3%</td>
</tr>
<tr>
<td>France</td>
<td>8.5%</td>
<td>Luxembourg</td>
<td>2%</td>
</tr>
<tr>
<td>Germany</td>
<td>4%</td>
<td>Netherlands</td>
<td>4%</td>
</tr>
</tbody>
</table>

While the French rate is higher than that of others, it is important to note that under an agreement between France and the


\(^{44}\) Procès-Verbal with France, effective February 15, 1956, CCH Tax Treaties, para. 2876.
United States, an American licensor (company or individual) will be completely exempt if the licensor can qualify as the inventor. It is also significant that a similar agreement exists between France and several other countries (Austria, Belgium, Denmark, Germany, Netherlands, Norway, Sweden, Switzerland, and the United Kingdom). Under the agreements, where an American firm transfers its patent to a holding company in, for example, Switzerland, that holding company can obtain the exemption if the American parent itself can qualify as the inventor. The extension of immunity in this case is subject, however, to approval of the French tax administration.

It may well be that Common Market countries will contend for purposes of their turnover taxes that additional payments literally earmarked as consideration for furnishing "know-how" should also be treated as royalties. The reasoning which might justify such a contention, and the limitations applicable thereto, were indicated in the preceding sub-topic. In this connection, France, on agreeing to immunize royalties paid an American inventor, adopted the following line:

The exemption will cover not only the royalties collected in consideration for the licensing of the right to utilization of the inventions mentioned above (paragraph 1) but also the royalties paid for the whole group of steps necessary for the practical utilization of the invention (know-how), for the protection of the invention and for the technical assistance which is indispensable to the exploitation of the invention (for example, making available to the French licensee the American licensor's technicians in connection with getting the invention started; supervision of the putting into place of the installations necessary for the exploitation of this invention and the utilization of blueprints; instruction of the licensee; supervision of the initial manufacturing results). On the other hand, this exemption will not apply to royalties relating to accessory operations, such as the hiring of labor, the furnishing of supplies, advertising, carried out on French territory.

(d) American tax treatment of foreign earned royalties.

While the Internal Revenue Code attributes to a foreign source

---

45 This arrangement was consummated by an exchange of letters between the Treasury and the French Minister of Finance. Prior thereto, and for a long period, France had not imposed its turnover tax on royalties paid to nonresident licensors. A decision by the French government to overturn this earlier administrative practice was followed immediately by protests from American licensors. The above mentioned exchange of letters grew out of the negotiations undertaken by the two governments.

46 Procès-Verbal, effective February 15, 1956, CCH Tax Treaties, para. 2876.
any royalties or rentals received by an American company for the right to use its patents, secret processes, etc., outside the United States,\(^47\) such income—like other income from a foreign source—must be included in its gross.\(^48\) Deductions which may then be taken in arriving at taxable income will be comparable to those enjoyed with reference to a like amount of domestic income. For example, in determining the amount of costs amortizable over the useful life of a patent, the question of whether such costs will include research and developmental expenditures will turn on whether the taxpayer invoked the right under § 174 of the Code to deduct research and developmental costs in the year incurred.

Since five of the six Common Market nations are precluded by treaty from imposing their respective income taxes on royalties received by American companies which do not maintain permanent establishments abroad, only those received from Luxembourg would require and enjoy the credit against American tax which § 901 of the Code grants for any "income, war profits, or excess profits taxes paid or accrued during the taxable year to any foreign country. . . ."

Computation of the amount of credit allowable in this latter instance may be more complicated than usual if the licensing agreement also requires the American company, for additional stated periodic consideration, to provide intermittent instruction in the United States for employees of the foreign licensee with reference to the licensor's "know-how." While details regarding the computation of the credit are covered in PART III, infra, it should be noted here that credit is generally allowed only for that tax attributable to income which had its source in the foreign country.\(^49\) On this point, Luxembourg might contend that the entire consideration constituted a royalty for the right to use, all of which had its source there, and that the United States was simply the place where the nature of the right granted was communicated in practical terms. In a somewhat related setting, the United States acknowledged that "the personal services have only nominal value apart from the license to use such 'know-how,'" but went on to indicate that the "nominal sum" which should be attributed to the service rendered would have its source in the United States,\(^50\) the balance being allocated to the license and having its source abroad.\(^51\)

\(^{47}\) I.R.C., § 862(a)(4).
\(^{48}\) I.R.C., § 61.
\(^{49}\) I.R.C., § 904.
\(^{50}\) See I.R.C., § 861(a)(3).
With reference to turnover taxes, it is most unlikely that the previously quoted language from § 901 of the Code would authorize any credit for taxes of this type which five of the six countries would always impose on royalties and which France, the sixth, would assess except in the instance where the licensor or its affiliate can qualify as the inventor.\textsuperscript{52} Admittedly the impact of such taxes, when imposed on royalties, is equivalent to a tax on gross income. But turnover taxes, have an even more general sweep, embracing also gross receipts from sales, etc. An over-all perspective regarding an earlier French turnover tax which had been applied to American exports led the Board of Tax Appeals to conclude that it was something other than a profits tax. It was deemed an “excise tax on the privilege of carrying on in France businesses of the kinds enumerated . . . ,” and this was thought to be none the less true though in reaching gross sales of services the tax was measured by the “equivalent of gross income or profits.”\textsuperscript{53} This same over-all perspective constituted one reason why the Internal Revenue Service more recently ruled against allowance of a credit for the German turnover tax imposed on royalties received by an American firm not having a permanent establishment there.\textsuperscript{54} The Service, however, had to go on to deal with the question of whether a credit was allowable under another provision in the Code which authorized such in the case of any foreign tax paid “in lieu of a tax on income, war profits, or excess profits otherwise generally imposed by . . . [such] foreign country. . . .”\textsuperscript{55} The taxpayer claimed that it was enough under this language that the royalty would suffer only a turnover tax, having been freed by a bilateral tax treaty from the reach of a German income tax which was otherwise generally imposed. The Service concluded, however, that the turnover tax was not a quid pro quo for the relief granted against the German income tax. The latter relief was simply a concession to avoid double income taxation. Consequently, the turnover tax did not satisfy the alternative requirement that it be “in lieu of” an income tax.

\textsuperscript{52} For details regarding such qualification and the meaning of inventor in a Procès-Verbal made effective as of February 15, 1956, see CCH Tax Treaties, para. 2876 et seq.

\textsuperscript{53} Eitingon-Schild Co., Inc. and Subsidiaries, 21 B.T.A. 1163, 1174 (1931).


\textsuperscript{55} I.R.C., § 903.
PART III. COMPARATIVE TAX EFFECTS OF CONDUCTING INTERNATIONAL TRADE THROUGH FACILITIES IN THE COMMON MARKET

SECTION A. INTRODUCTION

(a) Alternative business arrangements.—An American enterprise which has been shipping goods to Europe in response to orders received directly from its European customers may believe that something more than a promotional representative is needed there. From a business standpoint, apart from tax considerations, it may favor establishment of a permanent sales office. Or tariff walls, together with transportation and comparative production costs, may suggest that its goods would be more competitive if manufactured or assembled there. Rather than enter into the previously discussed licensing arrangement with an existing European firm, it may prefer to establish its own foreign manufacturing facility.

Whether it chooses to establish a sales office or a manufacturing facility, it must also decide whether to operate through a permanent establishment, in the nature of a branch, or transact its affairs through a foreign subsidiary. It must also choose the country in which to base its operations and decide whether and how its foreign business can be best extended into other member nations. Tax considerations may contribute, of course, to the shape of the final plan.

In order to facilitate comparisons, discussion in this PART proceeds first on the assumption that a facility is to be established in only one country and that trade will be confined within its boundaries. Data regarding the tax loads in each of the six countries will be compared in the settings of a branch operation and an incorporated foreign subsidiary, and then integrated with American tax implications.

Thereafter the discussion will assume that trade is also to be carried on with one or more other member nations. It is in this circumstance that the tax implications arising from exports by the one foreign facility to the other member nations are compared
with those which would arise from creation of yet another facility. That second facility might be either a subsidiary or a branch of the first. Or it might be a sister branch or subsidiary directly controlled by the American parent. And if it takes on the form of a sister subsidiary, the parent may want to create a foreign holding company to hold the shares of the two different subsidiaries. The tax implications of all of these possibilities will be considered in turn on a comparative basis, i.e., concurrently in the setting of each member nation. Some attention will even be given to the way tax costs may be affected if a holding company is established in a so-called “tax haven” outside the Common Market.

Finally, the relative tax costs of exporting goods from within the Common Market to non-member nations will be compared with the establishment in those non-member nations of permanent establishments or subsidiaries owned or controlled by Common Market corporations.

(b) Need for caution in assessing comparative data; also the varying roles of direct and indirect taxes compared to national product.—One must be careful not to place too much stress on the type of comparative data which can be reflected in this type of study. In this connection, assume that a company has a *gross* profit of $1,000,000. The ultimate taxable profit to which comparisons must be geared may be quite different depending on whether it is located in one country or another. Depreciation arrangements, stock valuation methods, special investment allowances, and loss carry-over privileges are only illustrations of matters about which there may be differences from country to country. Again, the tax on distributed profits may differ from that on undistributed profits. There are also varying property taxes, the impact of which in terms of a percentage of income will differ depending on the ratio between profits and the invested capital of the particular business. The danger of being misled through overemphasis on the comparative data set forth in this PART will be less, however, in the case of those who have studied the country-by-country survey which appears in PART I.

Comparative data regarding the total tax load borne by all taxpayers in each country can be equally misleading. Much depends on the way tax revenues are used by the different governments. Illustratively, part of these may be used by a given country to finance social security, whereas another supposedly lower tax country may finance old age benefits by direct contributions from those
covered, and this may affect wage rates. Again, a country with high taxes may provide an excellent system of railroads and highways, whereas a low tax country may have an inferior transportation system complemented by higher costs in doing business. Indeed, in assessing the comparative data which appears in Table III A regarding the total tax loads borne in various countries in terms of a percentage of national product, account must even be taken of differences which may exist among the countries in calculating the national product, the income, and the net wealth of its people.

### Table III A

**TOTAL TAX BURDEN**

<table>
<thead>
<tr>
<th>Country</th>
<th>Gross Natl. Product per Person</th>
<th>Tax Revenue as a % of Gross Natl. Product</th>
<th>% of Total Taxes Derived from Income and Net Wealth</th>
<th>% of Total Taxes Derived from Other Sources</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belgium</td>
<td>B. Fr. $1,196} 59,780}</td>
<td>17%</td>
<td>47%</td>
<td>53%</td>
</tr>
<tr>
<td>France</td>
<td>Fr. Fr. $ 931} 465,400}</td>
<td>18%</td>
<td>40%</td>
<td>60%</td>
</tr>
<tr>
<td>Germany</td>
<td>DM $ 969} 4,070}</td>
<td>20%</td>
<td>53%</td>
<td>47%</td>
</tr>
<tr>
<td>Italy</td>
<td>Lire $ 519} 322,340}</td>
<td>17%</td>
<td>30%</td>
<td>70%</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>B. Fr. $1,388} 69,410}</td>
<td>20%</td>
<td>59%</td>
<td>41%</td>
</tr>
<tr>
<td>Netherlands</td>
<td>Fl. $ 845} 3,210}</td>
<td>23%</td>
<td>60%</td>
<td>40%</td>
</tr>
</tbody>
</table>

In terms of a percentage of gross national product, total revenues derived by the federal, state, and local governments in the United States would align it alongside the Netherlands, the latter being the Common Market country the taxes of which absorb the highest percentage of its product. In this connection, however, it must be remembered that the gross national product of the United States, per person, is approximately 85% more than the amount produced by the most productive Common Market country.

The federal government's tax collections are also about 2½

---

times that of states and local units. While it relies far more heavily on the income tax than do the Common Market countries, the combined yield of this source to all three units would approximate the same percentage of total tax revenues as is derived from this source by the Netherlands, Luxembourg, and Germany. Table III B reflects data of a character comparable to that presented above with reference to the Common Market countries.

**Table III B**

<table>
<thead>
<tr>
<th>Gross Natl. Product per Person</th>
<th>Tax Revenue as a % of Gross Natl. Product</th>
<th>% of Total Taxes Derived From:</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. Federal govt.</td>
<td>$2,580²</td>
<td>17.6% ³</td>
</tr>
<tr>
<td>State and local</td>
<td></td>
<td>6.3% ⁴</td>
</tr>
<tr>
<td>Combined Federal, State and local</td>
<td></td>
<td>24. % ⁷</td>
</tr>
</tbody>
</table>


² The Annual Report, Commissioner of Internal Revenue (1959), p. 3, indicated that federal tax collections in fiscal 1959 amounted to $79,797,973,000. See note 2, supra, for the gross national product.

⁴ The Wall Street Journal, April 13, 1960, indicated that state and local tax collections in 1959 approximated $29,000,000,000. For the gross national product, see note 2, supra.

⁷ This is the figure for the year 1956. The percentage is based on data appearing in Michigan Tax Study, Legislative Committee, House of Representatives (1958) pp. 40 and 41. It is not likely that the percentage has changed substantially since that date.

⁸ This involves a combination of the 1959 figures for the federal government and the 1956 figures for state and local governments. It is believed, however, that the figure would be substantially correct today.

⁹ This percentage is based on data appearing in Michigan Tax Study, Legislative Committee, House of Representatives (1958) p. 39.

¹⁰ Excise taxes, including those on alcohol, tobacco, retailers, manufacturers, estates, and gifts yielded 15.1% of total federal tax collections. The balance (11.2%) came from employment taxes designed mainly to accommodate old age benefits and disability insurance.

¹¹ Of this, 2.4% is derived from “business taxes” of which some resemble an income tax in one degree or another.

¹² This combines federal figures for fiscal 1959 with state and local figures for 1956. However, it is believed that the figure would be approximately correct today.
SECTION B. COMPARING FOREIGN TAX COSTS OF A PERMANENT ESTABLISHMENT WITH A SUBSIDIARY SERVICING ONE MEMBER NATION

SUBSECTION 1. COMPARING FOREIGN DIRECT TAXES

(a) Comparing the role of treaties re permanent establishments and subsidiaries: In general.—As previously noted, the United States has concluded tax treaties with all Common Market countries except Luxembourg with which a treaty is under negotiation. These are intended to limit tax liability to a greater degree than would otherwise be the case under national laws. This is particularly so in the cases of Italy and France. According to the national laws of both countries, a nonresident person becomes liable to tax if he regularly and habitually performs activities which constitute a complete cycle of business. Under the tax treaties with them, as with others, the nonresident individual or corporation is only taxable if a “permanent establishment” is maintained there. National laws relating to jurisdiction remain important in such cases only where the treaty creates an ambiguity regarding the meaning of “permanent establishment” in a given setting. While the treaties generally go beyond national law in sharpening the definition of a “permanent establishment,” a given nation may be inclined to resort to its own historic definition in the event of an ambiguity in the relevant treaty.

The effect of tax treaties on subsidiary companies is quite different in character. Generally, the treaties exclude subsidiaries, as such, from the definition of a permanent establishment. Under the national laws of all countries, profits of a corporation, domestic to them, are taxed twice, once to the corporation and then in one way or another to the stockholders on receipt of dividends. The latter tax is usually withheld at the source, at least in part. The tax treaties are designed either to avoid, as in the case of the Netherlands, or mitigate, as in the case of France or Germany, the second tax, i.e., the one which would otherwise fall on dividends received by the American parent company. It is possible for a subsidiary to occupy a dual role, i.e., be fully taxable on its own profits and also serve as a “permanent establishment” for the parent. For example, a manufacturing subsidiary located in a member nation might also serve as sales agent for products manufactured by the parent company in the States. The subsidiary’s own manu-
facturing profits and agency fees would be fully taxable to it by the member nation, while the American parent company would be liable for tax on the profit derived from sales which it made through its permanent agent, the subsidiary.

(b) **Comparing direct taxes of member nations on “permanent establishments.”**—Under the tax treaties, an American enterprise would not generally be taxable on commercial or industrial profits derived from trading in a member nation unless it transacts business through a “permanent establishment.” While the enumeration of facilities covered is not always the same, most treaties define this to include a branch, factory, office, warehouse, workshop, mine, stone quarry, or permanent display and sales office, and all close by referring to the most common underlying denominator, “or other fixed place of business.”

In only two significant instances does the concept “permanent establishment” go beyond that common characteristic.

The first of these instances was discussed earlier in PART II where it was noted that all treaties include an agent who has, and habitually exercises, a general authority to negotiate and conclude contracts on behalf of the American enterprise or who has a stock of merchandise from which he regularly fills orders on behalf of the enterprise. However, the concept does not include business conducted through a bona fide independent commission agent, broker, or custodian acting in the ordinary course of his business as such, nor does it include a fixed place used exclusively for the purchase of goods.

The second instance where a treaty goes beyond the concept of a fixed place of business involves the arrangement with Germany regarding construction projects. Under Germany’s national law, the notion of “permanent establishment” includes a construction or assembly project the duration of which exceeds or is likely to exceed 6 months. The treaty serves only to extend the dateline to 12 months. While the national laws of the Netherlands are similar to those in Germany, the treaty between the former and the United States does not characterize a construction project, standing alone, as a permanent establishment with the consequence that the matter of timing in that setting is now irrelevant. Luxembourg poses the third alternative. Its national laws are similar to those in the Netherlands and Germany. Since the United States has not yet concluded a treaty with Luxembourg, a construction or assembly project the duration of which exceeds 6 months will
be deemed a permanent establishment, the profits of which will be taxed by Luxembourg.

While a permanent establishment is considered separate from the American enterprise for the purpose of determining how much profit was earned by the facility, that calculated profit is deemed to be owned by the American enterprise as it is earned and is, therefore, taxable to it without regard to the question of whether the profit has been transferred to the States.

Calculation of the amount of profit which is properly attributable to the permanent establishment, and thus taxable by a member nation, is not always easy. Where an American enterprise’s facilities in the United States carry on business with a European permanent establishment which in turn carries on business activity in a member nation, the total profit must be divided between the two, for only that properly attributable to the permanent establishment is taxable by the member nation. Most treaties face up to this problem by attributing to the permanent establishment the industrial or commercial profits which it might be expected to derive if it were an independent enterprise engaged in the same or similar activities under the same or similar conditions and dealing at arm’s length with the enterprise of which it is a permanent establishment. In keeping with this principle, expenses reasonably allocable to the permanent establishment, including a proper share of executive or general administrative expenses, are deductible by it in determining its taxable profit.

Set forth in Table III C is a comparison of the direct taxes which each member nation would impose on a permanent establishment.

(c) Comparing direct taxes of member nations on subsidiary arrangements.—An American enterprise can create a subsidiary, i.e., an independent entity, domiciled in any one of the member nations. All would permit its organization as a limited liability company or, except in the Netherlands, as a private company (a société à responsabilité limitée in Belgium, France, or Luxembourg; a società a responsabilità limitata in Italy; a Gesellschaft mit beschränkter Haftung, GmbH, in Germany).

The subsidiary would be taxed by the appropriate member nation in the manner described in the country-by-country survey set forth in PART I and later summarized on a comparative basis in this PART. Bilateral tax treaties with the United States would have no effect on that tax. At most, the treaties only influence the
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Belgium</td>
<td>30% (^{10})</td>
<td></td>
<td>30% (^{10})</td>
<td></td>
<td></td>
</tr>
<tr>
<td>France</td>
<td>50%</td>
<td></td>
<td>50% (^{11})</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
| Germany | 49%                    | 1. Deductible for corp. income tax purposes.  
                           2. Calculation:  
                           a. Basic rate of 5% of profit, multiplied by coefficients fixed by municipalities averaging 2.7; plus  
                           b. Basic rate of .2% on value of property multiplied by same municipal coefficients; plus  
                           c. Basic rate of .2% on wages paid, municipal coefficients averaging 9.\(^{10}\) | 57% \(^{10}\) (Including property factor of business tax) | 1% on net value |                                                                                |
| Italy   | 31.25% (Maximum)       |              | See last column  
                           .75% on net value  
                           15% on profits in excess of 6% on value of property | 1. 31.25% on profits up to 6% on value of property; and  
                           2. 46.25% on profits in excess of 6% on value of property |                                                                                |
<table>
<thead>
<tr>
<th>Country</th>
<th>Deductible for corp. income tax purposes</th>
<th>Calculation:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Luxembourg</td>
<td>45%</td>
<td>1. Basic rate of 4% of profit, multiplied by coefficients fixed by municipalities averaging 2.1; plus</td>
</tr>
<tr>
<td></td>
<td>.5% on net value</td>
<td>2. Basic rate of .2% on value of property, multiplied by same coefficients; plus</td>
</tr>
<tr>
<td></td>
<td></td>
<td>3. Basic rate of .2% on wages paid, multiplied by coefficients from 5 to 6.</td>
</tr>
<tr>
<td>Netherlands</td>
<td>47% (If profits do not exceed $13,200 the rate goes down to a low of 44%)</td>
<td>1. Basic rate of 4% of profit, multiplied by coefficients fixed by municipalities averaging 2.1; plus</td>
</tr>
<tr>
<td></td>
<td></td>
<td>2. Basic rate of .2% on value of property, multiplied by same coefficients; plus</td>
</tr>
<tr>
<td></td>
<td></td>
<td>3. Basic rate of .2% on wages paid, multiplied by coefficients from 5 to 6.</td>
</tr>
</tbody>
</table>

17 This is the effective rate, account having been taken of the fact that the income tax of one year is a deduction in computing taxable profits of the next year.
18 In addition, there are small municipal taxes which are levied at variable rates, depending on the amount of energy used, number of employees, etc.
14 The franchise tax (contribution des patentes) has not been included. It is a small variable burden, depending on the place of business, kind of industry, number of employees, rental value, etc.
12 This percentage is very rough. It would be slightly higher, e.g., if all three factors of the deductible business tax applied significantly to a given enterprise.
19 This last factor is not applied in all parts of Germany. Where it is not, the average coefficients relating to the other two factors are usually higher than would otherwise be the case, except in small municipalities.
17 This approximation will vary, of course, with variations in the amount of the deductible business tax.
member nation's treatment of dividends and interest paid by the subsidiary to the American parent company.

Conceptually speaking, the two primary differences between utilization by an American enterprise of a foreign permanent establishment in the nature of a branch and a foreign subsidiary appear most dramatically in that circumstance where all profits of a new foreign facility are to be retained abroad either to discharge indebtedness created in connection with establishment of the facility or to finance further expansion. In the case of a permanent establishment, the Common Market country would include the entire profit, as earned, in the gross income of the American company. The United States would do likewise, though according to the discussion in Section C, infra, a credit for the foreign income tax would serve to cushion or completely neutralize the effect of an otherwise double tax.

While the profit of a subsidiary would also be taxed in full by the member nation, in the absence of a distribution the American parent company would not be subjected to the member nation's dividend tax, if any, nor would it immediately suffer an American tax. Any attempt to compare the income and property taxes which would be exacted from such a subsidiary by each member nation can be quite misleading, for the reasons outlined in the Introduction to this PART. This difficulty is minimized, but not eliminated, if the comparison is directed to a common fact situation. For example, while an assumption that the subsidiary earned $400,000 (before direct taxes) on its assumed net worth of $4,000,000 (10%) accommodates itself to progressive rate variations or to the fact that a given member nation might be exacting its toll through two different income taxes with varying rates, such an assumed situation ignores differences which may actually exist among member nations with regard to depreciation and other deductions which may be taken in arriving at taxable profit. It is also difficult to take into account the deductible direct trade or enterprise taxes which, as discussed in PART I, are levied in all countries, except the Netherlands, and are imposed primarily by reference to profits and net wealth, except in Italy where it constitutes a surcharge only on the national income tax. Nevertheless, for illustrative purposes, the income and property taxes which would be exacted from such a subsidiary by the member nations are

---

18 If the ratio is higher than 10%, the tax burden will be relatively lower in Germany and Luxembourg and higher in Italy. If the percentage is less than 10%, the reverse would be true.
compared in Table III D. Insofar as practicable, the figures reflecting those taxes have also been adjusted to take account of the more significant corporate enterprise taxes.

### Table III D

<table>
<thead>
<tr>
<th>Country</th>
<th>Income and Property Taxes Payable by the Subsidiary</th>
<th>Profits Remaining for Expansion (apart from that retained as a consequence of initial or other special investment deductions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belgium 20</td>
<td>27.47%</td>
<td>72.53%</td>
</tr>
<tr>
<td>France 21</td>
<td>50%</td>
<td>50%</td>
</tr>
<tr>
<td>Germany 22</td>
<td>69.95%</td>
<td>30.05%</td>
</tr>
<tr>
<td>Italy 23</td>
<td>44.67%</td>
<td>55.33%</td>
</tr>
<tr>
<td>Luxembourg 24</td>
<td>51.67%</td>
<td>48.33%</td>
</tr>
<tr>
<td>Netherlands 25</td>
<td>47%</td>
<td>53%</td>
</tr>
</tbody>
</table>

19 The figures set forth here and the formulae which appear in notes 20 through 25, 30, and 31, infra, are taken, with the consent of the author and publisher, from INTERATIONAL BUREAU OF FISCAL DOCUMENTATION, COMPANY TAXATION IN WESTERN EUROPE (R. Mees & Zoonen, Rotterdam, 1959).

20 From PART I, it will be recalled that a Belgian corporation pays the Taxe Professionnelle on undistributed profits, a National Crisis Tax on distributed profits, the Taxe Professionnelle on that part of the profits used to pay the National Crisis Tax, and that the Taxe Professionnelle is allowed as a deduction in determining taxable profits.

The formula for the computation of the tax is as follows: \( TP = d + p (P - TP - e) \).

The symbols in that formula carry the following meaning: \( TP \) is the Taxe Professionnelle; \( d \) represents the TP which is levied before reaching the rate applying to the next bracket; \( p \) is the percentage applying to the next bracket and this is reached after deduction of the amount on which \( d \) was calculated, and is represented by \( e \). The amount on which \( p \) is levied is thus equal to the profit \( P \) less the Taxe Professionnelle \( TP \), this being a deductible item, and less \( e \).

By reference to the rate brackets set forth in PART I, Section A, a tentative tax can be computed as follows:

<table>
<thead>
<tr>
<th>Bracket</th>
<th>Taxable Income (X %)</th>
<th>Taxable Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>First bracket</td>
<td>$3,000 \times 25%</td>
<td>$750</td>
</tr>
<tr>
<td>Second bracket</td>
<td>$7,000 \times 30%</td>
<td>2,100</td>
</tr>
<tr>
<td>Third bracket</td>
<td>$10,000 \times 35%</td>
<td>3,500</td>
</tr>
<tr>
<td>Fourth bracket</td>
<td>$180,000 \times 37.5%</td>
<td>67,500</td>
</tr>
<tr>
<td></td>
<td></td>
<td>$73,850</td>
</tr>
</tbody>
</table>

Top bracket: Over $200,000 at 40%

Under the previously stated formula, the value of \( d \) is $73,850, \( p \) is 40%, and \( e \) is $200,000. The formula can then be applied as follows:

\[
TP = \frac{73,850 + \frac{40}{100} (400,000 - TP - 200,000)}{100}
\]

\[
TP = \frac{153,850 - 0.4 TP}{100}
\]

\[
TP = \frac{109,893}{100} = (27.47\% \text{ of the pre-tax profit of } 400,000; \text{ leaves } 290,107 \text{ or } 72.53\% \text{ in the corporation}.)
\]

21 The only French tax on corporations is the Impôt sur les Sociétés of 50% on total income, whether or not distributed.

22 The German formula is as complicated as that used in determining the Belgian tax.

(Footnote continued on next page.)
While the comparisons just drawn assumed that none of the profits would be currently distributed in the form of dividends, some interest on indebtedness running to the parent company may have been paid.

(Footnote continued.)

Under the Körperschaftsteuer, a German corporation is subject to a 51% tax on retained earnings and a 15% tax on distributed profits. The German Gewerbesteuer or enterprise tax (3 factor: profits, net wealth, and payroll) is subject to a multiplication factor fixed by each municipality. The formula below takes account only of net wealth and profits, and at maximum rates. Where a municipality does not use the payroll factor, rates regarding the other two factors may be somewhat higher. The enterprise tax is a deductible item. Finally, the Vermögensteuer or net worth tax of 1% is also imposed.

With K, G, and V representing the three above named taxes, and y the total tax, the basic formula would be \( y = K + G + V \). That formula becomes the following:

1. \( G = \frac{6}{100} \times NW + \frac{15}{100} (P - G) \) when \( NW = \) net worth and \( P = \) profit
   
   \[ G = \frac{6}{100} \times 4,000,000 + \frac{15}{100} (400,000 - G) = \]
   
   \[ G = \frac{73,043}{100} \]

2. \( V = 1\% \text{ of } NW = 40,000. \)

3. \( K = \frac{51}{100} (P - G) = \frac{51}{100} (400,000 - 73,043) = 166,748 \)

   \[ y = 166,748 + 73,043 + 40,000 = 279,791 \text{ or } 69.95\% \]

   There remains in the corporation \( 120,209 \text{ or } 30.05\% \) of \( 400,000 \)

20 The Italian formula must accommodate the Imposta sui redditi di Ricchezza Mobile (R.M.), and the Imposta sulle Società (I.S.) on profit and net worth. If \( y \) equals the total tax, the formula would be \( y = \text{R.M.} + \text{I.S.} \) or:

1. \( \text{R.M.} = 27.85 \times 6,450 + 31.23\% \times 393,550 = 124,701 \)

2. \( \text{I.S.} = .75\% \times 4,000,000 + 15\% (P - \frac{6}{100} NW) = 54,000 \)

3. Tax Amount (44.675% of pre-tax profit) \( 178,701 \)

4. Profit remaining in the corporation (55.325%) \( 221,299 \)

21 Luxembourg levies the following taxes on corporations: Impôt sur le revenu des collectivités (IC); Impôt sur la fortune (IF); and Impôt commercial or Business Tax (BT) which includes, at maximum rates, a .4% tax on net worth (NW) and an 8% tax on profit (P). Thus the basic formula could be applied as follows:

1. \( y = \text{BT} + \text{IF} + \text{IC} \)

2. \( \text{BT} = \frac{4}{100} \times NW + \frac{8}{100} (P - BT) = \frac{4}{100} \times 4,000,000 + \frac{8}{100} (400,000 - BT) \)
   
   \[ \text{BT} = 16,000 + 32,000 - 0.08\% \text{ BT} \]
   
   \[ \text{BT} = 44,444 \]

3. \( \text{IF} = \frac{5}{100} \times NW = \frac{5}{100} \times 4,000,000 = 20,000 \)

4. \( \text{IC} = 40\% \text{ of } (P - BT) = 0.4(400,000 - 44,444) = 142,222 \)

\[ \text{Total tax amounts to } 206,666 \text{ or } 51.67\% \]

There remains in the corporation \( 193,334 \text{ or } 48.33\% \) of \( 400,000 \)

22 The Dutch tax is always 47% of total income. But see PART VI, note 1, infra, with respect to pending legislation calling for reformation of the Dutch tax system.
In all countries, such interest would be deductible in computing the subsidiary's profit, provided the amount is fair and reasonable and does not represent a disguised dividend. In the absence of a bilateral treaty, the national laws of three of the six member countries would make the nonresident parent company liable for tax on the interest received. Germany, the Netherlands, and in some cases France would immunize the parent company, provided the loan was not secured by a mortgage on real property. While the immunity in France does not cover interest on bonds, by treaty, both France and Belgium have agreed to place a ceiling on the rate which would otherwise be applied to any interest taxed under their respective national laws. Table III E indicates the rate under national laws as well as ceilings pursuant to treaty arrangements, if any.

### Table III E

<table>
<thead>
<tr>
<th>National Law Rate</th>
<th>Ceiling Fixed by Treaty</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belgium</td>
<td>15%</td>
</tr>
<tr>
<td>18%, or 12.2% if tax is paid by the debtor</td>
<td></td>
</tr>
<tr>
<td>France</td>
<td>15%</td>
</tr>
<tr>
<td>Bonds generally, 24%</td>
<td></td>
</tr>
<tr>
<td>Industrial bonds, 12%</td>
<td></td>
</tr>
<tr>
<td>Germany</td>
<td>Exemption</td>
</tr>
<tr>
<td>0</td>
<td></td>
</tr>
<tr>
<td>Italy</td>
<td>No limitation</td>
</tr>
<tr>
<td>25.18%</td>
<td></td>
</tr>
<tr>
<td>Luxembourg</td>
<td>No treaty</td>
</tr>
<tr>
<td>5.0%</td>
<td></td>
</tr>
<tr>
<td>Netherlands</td>
<td>0 29</td>
</tr>
<tr>
<td>0</td>
<td></td>
</tr>
</tbody>
</table>

The foreign direct taxes associated with the previously described subsidiary arrangement may change in two respects when the subsidiary reaches the point where some of its current profits can be distributed as dividends, say 40% of that which remains after allowance for the subsidiary's own foreign direct taxes.

26 In France the deduction is limited by a ceiling; interest is deductible only to the extent the loan does not exceed half of the corporation's capital. Moreover, in Germany, interest on long term debts is not deductible for purposes of the business tax.

27 Immunity under the national laws of the Netherlands would not extend to interest received by one owning 25% or more of the stock of the company except where the shares are considered business property of the stockholder. The latter exception would always apply in the case of a parent corporation.

28 The treaty provisions relating to interest are limited to cases where the American enterprise does not have a permanent establishment in the Common Market nation.

29 The treaty with the Netherlands does not limit taxability of interest if the creditor owns more than 50% of the voting stock in the debtor corporation. However, under its national laws, the Netherlands does not normally reach interest received by a nonresident shareholder where the shares constitute a part of the latter's business property. In such case, interest is taxed only if the loan is secured by a mortgage on real property.
The first additional tax implication involves the member nation's treatment of the American parent company with regard to the dividend received by it. In the absence of a tax treaty, dividends, as distinguished from interest, would have been reached by the national laws of all member nations except Italy. However, by treaty three of the other five countries have agreed to reduce their withholding tax on dividends to a percentage below that otherwise applicable under national law. Rates applicable under national law, and reductions required by treaty, if any, appear in Table III F.

<table>
<thead>
<tr>
<th>TABLE III F</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Withholding Tax per National Law</strong></td>
</tr>
<tr>
<td>Belgium</td>
</tr>
<tr>
<td>France</td>
</tr>
<tr>
<td>Germany</td>
</tr>
<tr>
<td>Italy</td>
</tr>
<tr>
<td>Luxembourg</td>
</tr>
<tr>
<td>Netherlands</td>
</tr>
</tbody>
</table>

The second additional tax implication arising from distribution of a part of the profits involves a change in the income tax load which would be assessed against the subsidiary itself in two of the six countries. In Belgium, the Taxe Professionelle which is applicable only to undistributed profits would be substantially reduced, with the National Crisis Tax, applicable only to distributed profits, absorbing much of that reduction. In Germany, while the enterprise or trade tax would remain more or less constant, as indicated in PART I the subsidiary would enjoy a substantially reduced rate under the income tax with respect to that part of the profit distributed.

Table III G compares the income, property, and significant corporate enterprise taxes which would be levied by each member nation on the subsidiary in that year when 40% of its after-tax profits are distributed, and the amount of dividends which would be received by the American enterprise after paying foreign dividend taxes, if any.

At some point, the previously described subsidiary may have
### Table III G

<table>
<thead>
<tr>
<th>Income and Property Taxes Payable by the Subsidiary</th>
<th>Profit Retained for Expansion</th>
<th>Profit Distributed</th>
<th>Withholding Tax on dividends</th>
<th>Net Dividends Received in U.S.A.</th>
</tr>
</thead>
<tbody>
<tr>
<td>% of pre-tax profit</td>
<td>% of pre-tax profit</td>
<td>% of pre-tax profit</td>
<td>% of Clm. 3</td>
<td>% of pre-tax profit</td>
</tr>
<tr>
<td>Belgium</td>
<td>24.9</td>
<td>45.06</td>
<td>30.04</td>
<td>30.</td>
</tr>
<tr>
<td>France</td>
<td>30.</td>
<td>20.</td>
<td>15.</td>
<td>17.</td>
</tr>
<tr>
<td>Germany</td>
<td>64.89</td>
<td>21.066</td>
<td>14.044</td>
<td>15.</td>
</tr>
<tr>
<td>Italy</td>
<td>44.67</td>
<td>33.20</td>
<td>22.13</td>
<td>0</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>51.67</td>
<td>28.998</td>
<td>19.332</td>
<td>15</td>
</tr>
<tr>
<td>Netherlands</td>
<td>47.</td>
<td>31.8</td>
<td>21.2</td>
<td>0</td>
</tr>
</tbody>
</table>

30 The formula used in note 20, supra, is more complicated here because of the need to take account of the National Crisis Tax (NCT). The formula would run as follows:

(1) \( y = 0.4 \times (P - (NCT + TP)) \), where \( y \) is the distributed profit, and NCT represents the National Crisis Tax of 20% thereon.

(2) \( NCT = 0.2 \times y \)

(3) \( TP = d + p \times (P - y - TP - e) \)

(4) \( TP = 73,850 + 0.4 \times (400,000 - y - TP - 200,000) = 109,893 - \frac{0.4}{1.4} y \)

Formula (1) becomes:

\[
\begin{align*}
(1) \quad y &= 0.4 \left(400,000 - \left(73,850 + 0.4 \times (200,000 - y - TP) + 0.2 y\right)\right) \\
&= 0.4 \left(400,000 - (153,850 - 0.4 y - 0.2 y - TP - 0.2 y)\right) \\
&= 0.4 \left(400,000 - 109,893 - \frac{0.4}{1.4} y + 0.2 y\right) \\
&= 0.4 \left(290,107 + \frac{0.12}{1.4} y\right) \\
&= \$120,163 \text{ or } 30.04\% \text{ of total profit}
\end{align*}
\]

31 The German formula used in note 22, supra, also becomes more complicated when account must be taken of distributed profits. The formula would run as follows:

(1) \( y = 0.4 \times (P - (G + V + K)) \)

As in note 22, \( G = 73,043 \)

\( V = 40,000 \)

(2) \( K = \frac{51}{100} \times y + \frac{51}{100} \times (P - y - G) = \frac{51}{100} y + \frac{51}{100} \times (400,000 - 73,043) = \frac{51}{100} y \)

\( K = 166,748 - \frac{36}{100} y \)

By substitution, formula (1) becomes:

\[
\begin{align*}
(1) \quad y &= 0.4 \times (400,000 - \{73,043 + 40,000 + (166,748 - \frac{36}{100} y)\}) \\
&= 0.4 \times (286,957 - 166,748 + \frac{36}{100} y) = 0.4 \times (120,209 + \frac{36}{100} y) \\
&= \$56,172 \text{ or } 14.043\% \text{ of total profit}
\end{align*}
\]

32 The figures are pursuant to Luxembourg's national laws, as a bilateral tax treaty has not yet been concluded.

33 See Table F for the withholding tax which would be assessed in the absence of the bilateral tax treaty with the United States.
discharged its indebtedness and abandoned further plans for expansion. Current distribution of all of that part of the $400,000 in earnings which remain after payment of the subsidiary's own tax will serve, as in the immediately preceding case, to change the subsidiary's own tax liability in two of the six member nations, Belgium and Germany. And for the reasons cited in discussing the immediately preceding case, the net change in those two countries involves a further reduction, as is indicated in Table III H.

### Table III H

<table>
<thead>
<tr>
<th></th>
<th>Income and Property Taxes Payable by the Subsidiary</th>
<th>Profit Distributed</th>
<th>Withholding Tax on Dividends</th>
<th>Net Dividends Received in U.S.A.</th>
</tr>
</thead>
<tbody>
<tr>
<td>% of pre-tax profit</td>
<td>% of pre-tax profit</td>
<td>% of Clm. 2</td>
<td>% of pre-tax profit</td>
<td></td>
</tr>
<tr>
<td>Belgium</td>
<td>21.34</td>
<td>78.66</td>
<td>30% rate</td>
<td>55.062</td>
</tr>
<tr>
<td>France</td>
<td>50.</td>
<td>50.</td>
<td>15% rate</td>
<td>42.5</td>
</tr>
<tr>
<td>Germany</td>
<td>53.04</td>
<td>46.96</td>
<td>15% rate</td>
<td>39.916</td>
</tr>
<tr>
<td>Italy</td>
<td>44.67</td>
<td>55.33</td>
<td>0</td>
<td>55.33</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>51.67</td>
<td>48.33</td>
<td>15% rate</td>
<td>41.0805</td>
</tr>
<tr>
<td>Netherlands</td>
<td>47.</td>
<td>53.</td>
<td>0</td>
<td>53.</td>
</tr>
</tbody>
</table>

**SUBSECTION 2. COMPARING PRIMARY INDIRECT BUSINESS TAXES OF MEMBER NATIONS**

(a) *Turnover taxes.*—Each member nation's turnover taxes were discussed in the country-by-country survey in PART I, and certain general principles evolving from that discussion were applied in PART II in connection with an analysis of the tax effects of direct exports. The intention in Table III I is to chart a comparison of the *effective* rates which will normally be applied by each member nation at various stages of the manufacturing and distribution process. Effective, rather than stated, rates are used because in all countries except Belgium and Italy the turnover tax itself forms a part of the tax base (price) to which the stated

---

31 See note 32, supra.
32 See Table F for the withholding tax which would be assessed in the absence of a bilateral tax treaty with the United States.
rates are applied. Normal rates only are shown; legislation bearing on such taxes is so complex as to preclude a chart of all possibilities.

### Table III I

<table>
<thead>
<tr>
<th>Manufacturer sells to:</th>
<th>To Be Added to Wholesaler's price on Sale to Retailer</th>
<th>To Be Added to Retailer's Price on Sale to Consumer</th>
</tr>
</thead>
<tbody>
<tr>
<td>Whole-saler</td>
<td>Retailer</td>
<td>Consumer</td>
</tr>
<tr>
<td>Belgium</td>
<td>5. %</td>
<td>0 %</td>
</tr>
<tr>
<td>France</td>
<td>25. % *</td>
<td>25. % *</td>
</tr>
<tr>
<td>Germany</td>
<td>4.17%</td>
<td>4.17%</td>
</tr>
<tr>
<td>Italy</td>
<td>3.30%</td>
<td>3.30%</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>2.04%</td>
<td>2.04%</td>
</tr>
<tr>
<td>Netherlands</td>
<td>5.26%</td>
<td>5.26%</td>
</tr>
</tbody>
</table>

(* Since the French tax is actually a tax on added value, any such tax paid in earlier stages may be deducted by manufacturers or wholesalers except in the instance where the wholesaler pays only the local turnover tax of 2.83%. In fact, the manufacturer could even deduct turnover taxes previously paid on acquiring machinery, from turnover taxes due on the sale of his products. In case a manufacturer, in the capacity of a retailer, sells direct to consumers, instead of paying the 25% on the whole price, he may pay 25% on a hypothetical wholesale price plus 2.83% on the whole price.)

From Table III I, it appears that the amount of tax a consumer will ultimately bear depends in some instances on the character of the outlet from which his purchase is made as well as on the number of times the product has “turned over” prior to his purchase. In order to chart a comparison of the way the variable tax impact would affect the total price he would pay for a product from each outlet in each of the various countries, certain non-tax constants must be assumed. Table III J assumes that the pre-tax price charged by each outlet (manufacturer, wholesaler, and retailer) would include a flat $20 net profit margin, the first such margin being included in the manufacturer's net pre-tax price of $100 to wholesalers. It is further assumed that if a manufacturer or wholesaler sells directly to consumers, he will also enjoy the net profit margin which would have been normally received by the omitted outlets. Thus, a manufacturer selling directly to consumers would contemplate a pre-tax price of $140.
Table III J

Manufacturer to Consumer

<table>
<thead>
<tr>
<th></th>
<th>Through Wholesaler and Retailer</th>
<th>Through Retailer Only</th>
<th>Direct</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belgium</td>
<td>151.25</td>
<td>146.00</td>
<td>140.00</td>
</tr>
<tr>
<td>France</td>
<td>174.80</td>
<td>174.80</td>
<td>172.75</td>
</tr>
<tr>
<td>Germany</td>
<td>151.48</td>
<td>151.05</td>
<td>145.84</td>
</tr>
<tr>
<td>Italy</td>
<td>147.37</td>
<td>143.96</td>
<td>144.62</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>145.58</td>
<td>145.36</td>
<td>142.86</td>
</tr>
<tr>
<td>Netherlands</td>
<td>146.21</td>
<td>146.31</td>
<td>145.84</td>
</tr>
</tbody>
</table>

(b) Registration and stamp duties.—Each member nation imposes registration and/or stamp duties in connection with payment of capital into a subsidiary or capitalization of its reserves. The varying percentages charged on amounts originally paid in are reflected in Table III K.

Table III K

<table>
<thead>
<tr>
<th></th>
<th>Registration Duty:</th>
<th>Stamp Duty:</th>
<th>Total:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belgium</td>
<td>1.6 %</td>
<td>.7 %</td>
<td>2.3 %</td>
</tr>
<tr>
<td>France</td>
<td>1.6 %</td>
<td>—</td>
<td>1.6 %</td>
</tr>
<tr>
<td>Germany</td>
<td>2.5 %</td>
<td>—</td>
<td>2.5 %</td>
</tr>
<tr>
<td>Italy</td>
<td>1%–2.5 % *</td>
<td>$.02–$1.90 (10–1,200 Lire)</td>
<td>2.5 %</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>.32 %</td>
<td>.4 %</td>
<td>.72 %</td>
</tr>
<tr>
<td>Netherlands</td>
<td>2.5 %</td>
<td>.75 %</td>
<td>3.25 %</td>
</tr>
</tbody>
</table>

* The 1% is applied to cash; 2.5% is applied to other capital assets brought into the business.

After formation of the subsidiary, subsequent increases in the subscribed or paid in capital may be subjected to somewhat different rates.

Introduction of capital into a permanent establishment, as dis-

---

36 As previously noted, if the French manufacturer, on the purchase of raw materials, auxiliary goods, machines, etc., has paid a turnover tax, he may deduct the amount thereof from the tax payable by him on the sale of his product. This means that he is able to charge a selling price to the wholesaler (all other things being equal) which will be lower than that of his competitors in other countries. The actual consumer's price may, therefore, be lower than the amounts stated above.

37 If the wholesaler pays the local turnover tax of 2.75% (effective rate, 2.83% in lieu of the value added tax (see PART I), the price will be $173.88.
tiquished from a subsidiary, is also subjected to somewhat similar taxes in two of the six countries, Belgium and Germany. Illustratively, in Belgium the basic rate is .1% of the nominal paid in capital, with a minimum tax of $360 (B. fr. 18,000) and a maximum of $20,000 (B. fr. 1,000,000).

Section C. Integration of Foreign Taxes into American Taxation of Branches and Foreign Subsidiaries Serving One Member Nation

(a) Introduction.—Earlier discussion in Section B of this PART indicated that direct taxes imposed by some Common Market countries differed by reference to the form in which the operation there was conducted. The difference between carrying on business there through a permanent establishment, as distinguished from a foreign subsidiary, can also give rise to substantial differences in the amount of income taxes imposed by the United States on any profits derived from abroad.

One will also discover that the American tax cost associated with activities carried on through a foreign subsidiary will vary, just as there was a variation in the tax cost imposed by some member nations, depending on whether profits are distributed or are plowed back into the operation.

In order to dramatize the practical significance of these various differences in American tax costs and in the total costs imposed domestically and abroad, discussion in this section will be confined, like that in preceding sections dealing solely with foreign tax costs, to operations which do not extend beyond the boundaries of a given member nation. Discussion of American and total tax costs in more expansive settings will be dovetailed between later sections which look only at the foreign tax costs of the same kind of expanding operation.

The analysis here will be divided into four parts. Discussion of the basic differences between American taxation of foreign branches and foreign subsidiaries, in terms of income, deductions, and credits, will be followed in Subsection 2 by an attempt to integrate the foreign and domestic tax costs associated with these two forms. Subsection 3 will consider the problem of allocating income and deduction items between American and foreign operations in the instance where the two conduct business with each other. Finally, Subsection 4 will focus on certain special or unusual problems which may be encountered in connection with the credit for foreign taxes.
The discussion with reference to all of these matters is based on the American tax pattern as it existed in September, 1960. Pending legislation which, if adopted, would dramatically alter the existing pattern, is discussed in Section B of PART VI, infra.

SUBSECTION I. BASIC DIFFERENCES BETWEEN AMERICAN TAXATION OF FOREIGN BRANCHES AND FOREIGN SUBSIDIARIES

(a) Introductory note.—The fact that United States taxes on profits earned abroad can differ markedly, depending on whether an American corporation chooses to conduct its Common Market business through a foreign branch or foreign subsidiary, is actually due to a quite limited number of conceptual differences in basic tax patterns, affecting however, all three parts of the ledger (gross income, deductions, and credits). From these few conceptual differences spring a host of practical tax differences.

The discussion below approaches the matter first by reference to differences in the amount of American gross income created by the two different forms. Analysis of the variation between those two settings in deductions and credits allowable for foreign income taxes then follows.

(b) American "gross" income differences between branch and subsidiary operations.—Differences on the gross income side are attributable to four basic tax concepts. The first is jurisdictional in nature; a domestic corporation's gross includes income earned by every branch or department from all sources, foreign as well as domestic. Thus, jurisdictionally speaking, a foreign branch's gross, like that of a domestic branch, is includible as it is earned, whether or not remitted to the home office.

The second relevant basic tax concept relates only to operations conducted through a foreign subsidiary and, generally speaking, involves recognition of it as a taxable entity separate and apart from the domestic parent. This notion of separateness, coupled with

29 This basically stems from I.R.C., § 11. The concept of separateness here exceeds even that applied to a parent and subsidiary in a wholly domestic setting. Contrary to the case in the latter circumstance, a parent may not file a consolidated return with a foreign subsidiary. I.R.C., § 1504(b)(3). Nor is the 85% dividends received deduction allowed. I.R.C., § 243. The one circumstance where the corporate form of a foreign corporation is penetrated involves foreign personal holding companies the "undistributed foreign personal holding company income" of which may be taxed to American shareholders even though not distributed.
the third basic concept—another jurisdictional principle to the effect that a foreign corporation itself is taxable by the United States only on income having its source within the States, serves in our situation to immunize the foreign subsidiary itself from American taxation. However, when the notion that the two corporations are separate is coupled with the first mentioned jurisdictional principle, the effect will be to swell the domestic parent's own gross by the amount of any dividend received from the subsidiary.

The fourth relevant basic concept involves the matter of accounting methods, a much more detailed discussion of which appears later in Section B of PART IV. While it is theoretically true, jurisdictionally speaking, that the gross income of a foreign branch is includible in American gross income, for accounting purposes, i.e., in terms of an accounting method, only the branch's separate pre-tax net profits—computed according to American standards—need actually be brought across the ocean in the more usual circumstance. Equally important, but again only as a matter of accounting, computation of those separate net profits may include reflection of any shift in the net worth of the branch's current assets by reason of changes in exchange rates, though nothing is actually remitted to the home office. The current asset accounts of a subsidiary, on the other hand, are not normally penetrated in this fashion, for it is a separate entity.

These diverse conceptual patterns can have more than one practical effect on American "gross" income.

First, the American gross from a branch operation will normally exceed the amount which would be included if the foreign operation is conducted through a subsidiary. Even if it is decided that a subsidiary will not retain any of its net profits for expansion, the dividend which will be included in the parent's gross will relate only to that part of the subsidiary's profit which remained after payment of any foreign income taxes. For example, of a subsidiary's pre-tax profit of $400,000 in the Netherlands, only $217,000 would be available for dividends, the balance being absorbed by that country's 47% income tax. From a branch operation located there, how-

40 I.R.C., § 882(b).
ever, the American parent's gross would be enhanced by the branch's entire pre-tax profit of $400,000.

The ultimate American tax differential in this instance is not as great, however, as the difference between the two amounts of American gross income ($212,000 and $400,000) might suggest. Discussion in the next subtopic discloses in a branch setting that the domestic corporation may treat the foreign income tax of $188,000 as a deduction from gross income or as a credit against the American tax itself. But it is also indicated there that some difference in American tax costs will remain even if, under the subsidiary arrangement, all of its after-tax profits are remitted to the parent. The exclusion from American gross income of that part of the subsidiary's profit devoted to the foreign income tax is one of the contributing factors, for that exclusion is economically equivalent to a deduction for the foreign tax. Nevertheless, in addition to that exclusion, the parent will enjoy a credit for a part, and in this instance a substantial part, of the subsidiary's foreign income tax. In the branch setting, it will be recalled, a choice between the two methods of accommodating foreign taxes (deduction and credit) had to be made.

Going back, however, to the gross income side of the ledger, the determination of the amount to be included by the American company depends, in the case of both forms of operation, on American tax concepts, not on those of a foreign country. When applied, however, this notion gives rise to certain peculiar twists, and when commingled with the circumstances where foreign tax law plays a slightly different role, it can give rise to a second kind of difference in the amount of American gross income, one wholly apart from the difference attributable to reasons explained in the preceding paragraphs.

The basic idea, that the amount to be included in American gross income is determined by federal tax concepts, is easy to see in the setting of a branch. Theoretically, i.e., at least for jurisdictional purposes, all of its transactions are reached at the gross income level by § 61 of the Code. Again speaking jurisdictionally, since both domestic and foreign operations are housed in one corporate

---

44 I.R.C., § 164(a) and (b)(6).
45 I.R.C., § 901.
46 I.R.C., § 902.
47 See note 44, supra.
48 Since Doyle v. Mitchell Bros. Co., 247 U.S. 179, 38 S. Ct. 467 (1918), it has been recognized that American tax statutes have not formally taken gross receipts as the point of departure.
entity domiciled in the States, after integrating the foreign transactions with domestic ones at the gross income level, deduction for expenses on both sides of the water, but only as permitted by American law, would be taken in arriving at a consolidated American version of "taxable income." The fact, for accounting purposes, that the net profits of a foreign branch are actually computed in the usual case separate from those attributable to domestic operations means only that integration in fact relates just to the net result, not that the latter is computed by reference to something other than the American version of "taxable income." 49

Applicability of this same choice-of-law principle to operations housed in a foreign subsidiary is less obvious only because there is a difference in the jurisdictional reach of the United States over profits earned by the two different forms of operation. Whenever a foreign subsidiary does distribute property to its American parent, thus bringing the item within the taxing jurisdiction of the United States, the extent to which that item will be deemed a "dividend" and, therefore, includible in the parent's gross income, depends—according to § 316 of the Code—upon the distributing foreign corporation's "earnings and profits" structure calculated by reference to federal rules.50 Illustratively, if a foreign corporation distributes an amount greater than its earnings and profits as computed under foreign tax law, the entire amount of the distribution may still be treated as a taxable dividend, fully includible in American gross income, if the total amount could be accommodated under the American version of that foreign corporation's "earnings and profits." 51 But one should not suppose from this that the shape of foreign tax law will never affect the amount of American gross income. Suppose that the foreign country imposes a 52% corporate tax, but that it allows less by way of deductions than would be permitted under American law. Since the foreign corporation will normally not distribute more than its after-tax profit, foreign tax law has had the indirect effect of reducing American gross income, for the latter will not include more than the amount of dividend actually paid. In a branch setting, however, the differential just noted would not affect American gross income, though, as

49 The fact that a foreign branch's operations will usually be conducted in terms of a foreign currency does create problems in computing taxable income which are peculiar to foreign operations. But these too are resolved according to American tax concepts. See Part IV, infra.

50 Untermyer v. Comm'r, (2d Cir. 1932) 59 F. (2d) 1004. For the general definition of "earnings and profits," see I.T. Regs., § 1.312-6.

51 Ibid.
we shall later see, the credit allowed for foreign taxes may be affected in both cases.

The factual situation at the other extreme, i.e., where all profits of the foreign operation are to be retained there to discharge indebtedness or facilitate expansion, highlights the difference in America’s taxing jurisdiction and dramatizes the third and most striking practical difference in the amounts of American gross income which would be derived from the two different methods of operation. While the parent would still have $400,000 in gross income from a branch—the remission of profits being a neutral consideration, the absence of a dividend in the setting of a subsidiary would immunize its foreign profits from the American tax. Something more than mere deferral for a short period may be involved, for dedication of those profits to machinery, bricks, and mortar may well mean that those profits are isolated from the reach of the American treasury for the entire period during which business will be conducted through that subsidiary, though increased profits generated by the expansion may lead to larger dividends in the interim.

The opportunity through a foreign subsidiary arrangement to isolate foreign earnings from the domestic parent’s gross income and, therefore, from American tax is most advantageous in a country with a tax pattern like that of Belgium. The total Belgian and American income taxes suffered by the profits of a permanent establishment in Belgium will equal the effective rate of that country which imposes the greater tax, here the 52% figure imposed by the United States which will then give a credit for the smaller Belgian tax. A foreign subsidiary which derived its entire income from Belgian sources could, on the other hand, retain more than 70% of its earnings for further development, suffering only Belgian income taxes of less than 30% during the retention period. The retained profit would also be sheltered from the American penalty tax on unreasonable accumulations; since the foreign profit has not yet taken on the complexion of American gross income, it could not be “accumulated taxable income” to which this U.S. surcharge relates. And this would be so even if the profit were deposited in an American bank, provided the foreign subsidiary made the deposit without declaring a dividend to the parent. Nor, according to the discussion in PART I, do any of the Common Market countries have a counterpart penalty tax on unreasonable accumu-

52 I.R.C., § 531 et seq.
lations. Section C of that PART did indicate, however, that Germany's regular corporate income tax imposed a much higher rate on a subsidiary's retained profits than on its distributed profits, the rate on the former usually being higher than that imposed on a branch operation.

Any advantage enjoyed by a subsidiary arrangement over a permanent establishment *solely* because of the opportunity of the former to store up profits free of the American tax necessarily becomes less significant as the foreign rate on *undistributed* profits begins to approximate the American rate. Illustratively, if one considers only *stated* comparative rates, the flat 47% Netherlands rate on the retained profits of a subsidiary domiciled there is not markedly different from the 52% American rate which, being the greater of the two, would create a higher, though only slightly higher, tax cost for a permanent establishment. The flat 50% French rate on retained profits is an even more persuasive illustration of the same principle.

Going back to the first factual situation, i.e., where all profits were currently remitted, it will be recalled that the two forms would create different amounts of American *gross* income only because that portion of a subsidiary's profits used by it to pay foreign income taxes would not come within the jurisdictional reach of the United States, it being otherwise in the case of a branch operation. From this principle emerges a fourth practical difference in the amounts of American gross income which would be derived from the two forms of operation. This fourth difference is attributable to the fact that the tax pattern used by a Common Market country with reference to permanent establishments may differ from that associated with subsidiary arrangements. In both cases, the Netherlands imposes only one 47% tax. Belgium, however, again illustrates the effect of a variable tax pattern. A Belgian subsidiary distributing all of its after-tax profits would suffer a 20% National Crisis Tax on the gross dividend. Whereas the foreign subsidiary itself would suffer the more demanding 30% effective rate of the Taxe Professionnelle only with respect to that part of its profits used to pay the lower 20% National Crisis Tax, the higher rate of the Taxe Professionnelle would apply to the entire income of a permanent establishment. Even in the absence of this variation, there would, of course, be a difference in the amount of American gross income created by the two different forms; as previously noted, that portion of a subsidiary's
profits used to pay its own foreign income taxes is not includible by the parent, the opposite being true in the case of a branch. This constant difference is further affected in degree, however, by the variation in the tax imposed directly on the two forms by the foreign country. Even so, one should not jump merrily to the conclusion that the total Belgian income tax associated with a subsidiary arrangement is actually less than that associated with a branch in the instance where all profits are distributed. In fact, as we saw in Section B supra, the contrary is true. Again assuming a foreign pre-tax profit of $400,000, in addition to the $85,360 tax borne by the foreign subsidiary itself, Belgium would also withhold 30% of the $314,640 dividend as a tax against the recipient, this being another $94,392. While the latter tax will not reduce American gross income, it will bring the total Belgian tax on the subsidiary arrangement to $179,752, compared with $120,000 assessed against the permanent establishment. But again, it is important to distinguish between the effect of the foreign tax on American gross income and its quite different effect on the American tax itself. Indeed, as we shall later see, because of the peculiar way in which the American credit for foreign taxes works in this type of case, the total two-country tax associated with the subsidiary arrangement will be less than that borne by the branch operation.

Loss situations furnish a fifth circumstance in which the amount of American gross income will be affected by the organizational arrangement. Operating losses suffered by a foreign branch will serve immediately to offset income earned by the parent in the United States. Integration of this type is not permitted, however, where the loss is suffered by a foreign subsidiary. Its affairs may not even be integrated with that of the parent on a consolidated return.58 Outside of the Netherlands, a subsidiary’s operating losses can only be used to offset its own income in future years through resort to foreign carry-over provisions. As indicated in PART I, all Common Market nations permit such a carry-over. The usual limitation is 5 years, though Luxembourg confines the privilege to 2 years, and the Netherlands extends it to 6 years and to an indefinite period in the case of new businesses. The Netherlands is also the only member nation which permits the loss to be carried back, a refund being available through an offset

58 I.R.C., § 1504(b)(3).
of income of an earlier year. This privilege is limited, however, to the year immediately preceding the loss year.

Also with respect to loss operations abroad, differences in the effect of the two forms may arise in the event a foreign facility which started as a loss operation continues downhill to a point where the American company decides to rid itself of the undertaking. The character which the Internal Revenue Code would assign to losses arising from disposition of a foreign permanent establishment’s assets would depend upon the exact nature of each separate asset. Illustratively, inventory losses would offset ordinary income realized by the American company from its United States operations. Losses from the sale of depreciable equipment or buildings might also be treated in this favorable fashion; under § 1231, it would seem that these should be packaged with like transactions growing out of American operations, and if the net effect of all such transactions is a loss, the foreign dispositions are not treated as sales or exchanges of capital assets.

On the other hand, loss arising from an American company’s sale of stock in a foreign subsidiary would normally be treated as a capital loss, deductible only against the parent’s capital gains, if any. The one prime exception to this involves the case where the stock of an almost wholly owned foreign subsidiary becomes completely worthless, in which case the American domiciled parent corporation will usually enjoy an ordinary loss deduction in the year the stock became worthless. Partial worthlessness, i.e., a mere reduction in value below the parent company’s adjusted basis, cannot, however, be so treated even though realized by a sale of the stock. Absent complete worthlessness of the parent’s stock, the same unfavorable capital loss treatment would follow if the foreign subsidiary first sold its assets and then, on liquidation, distributed proceeds to the parent in an amount less than the latter’s adjusted basis. Of course, as is sometimes attempted in wholly American settings, an effort might be made to liquidate the subsidiary prior to disposition of its assets, the thought being that those assets would then be sold by the American parent while

---

64 This principle goes back to Williams v. McGowan, (2d Cir. 1945) 152 F. (2d) 570.
65 While the Service has generally recognized that the profits of a branch are to be computed separately (see note 41 supra), it is doubtful that it intended, or is free, to disregard the mandate of § 1231 in determining the character of income.
66 I.R.C., §§ 1221 and 1211(a).
67 I.R.C., § 165(g).
68 I.R.C., §§ 331(a)(1) and 1221.
the foreign facility occupies its new status as a permanent establishment. The aim of the parent corporation, to shift what would have been a capital loss on sale of stock to the more favorable treatment which might be accorded a loss on sale of inventory and § 1231-property, will not be realized, however, if the added tax benefit constituted one of the principal purposes behind the subsidiary’s earlier liquidation.  

If current operating losses are incurred by facilities in the United States rather than those in a foreign country, a foreign branch’s profit, if any, will serve immediately to reduce the loss, for it must be integrated into the parent’s gross income whether or not remitted to this country. But a foreign subsidiary’s profit will not be integrated so as to offset a part of the operational loss in the United States unless it is paid out as a dividend. Using the previous illustration of a $400,000 pre-tax profit in the Netherlands as an example, a dividend of the subsidiary’s after-tax profit of $212,000 would neutralize that much loss in United States operations. While a branch’s entire profit of $400,000 would be integrated with the American loss, election to deduct the foreign income tax of $188,000 would lead to a result similar to that which followed a subsidiary’s distribution of its after-tax profit of $212,000. In both cases, losses attributable to the American operation would be offset by a net of $212,000.

(c) Origin of the “deduction” for foreign taxes, and the difference in its applicability to subsidiary and permanent-establishment operations.—The first income tax act passed pursuant to the Sixteenth Amendment authorized corporations, but not individuals, to deduct from gross income taxes “imposed by the government of any foreign country.”

While something more than foreign income taxes was accommodated by this provision, income itself was not thereby confined, even in terms of ultimate effect, to taxability by but one country. The effect on a corporation which conducted its affairs abroad through a permanent establishment was to shift the economic burden of foreign income taxes to the federal treasury only to

59 I.R.C., § 367.  
60 Rev. Act of 1913, Section II, G(b) (Fourth). Like provision for individuals was made in Rev. Act of 1916, § 5(a) (Third). The present counterpart of the early provision makes it clear that the deduction would also be available to a corporation in the case of taxes imposed by foreign states, provinces, or local units of government except where assessed against local benefits of a kind tending to increase the value of the property assessed. I.R.C., § 164(a) and (b)(5).
the extent of the corporation's effective domestic rate. Illustratively, the highest rate imposed on corporations prior to World War I was 2%. The over-all ultimate effect then was that a domestic corporation, operating a foreign permanent establishment, actually had to bear all of the American tax load plus 98% of the direct taxes imposed by the foreign country. While this was not very critical at a time when corporate rates were so low, in the following sub-topic we shall see that Congress was to view the adequacy of the deduction in a different light as the world moved into the higher tax rates required by World War I.

Where an American corporation chose to operate abroad through a foreign subsidiary, it could, of course, deduct any withholding tax which the foreign country might impose directly on the parent with reference to dividends received from the subsidiary. But, unlike domestic corporations which housed foreign operations in a permanent establishment, the American parent could not deduct foreign taxes imposed directly on its subsidiary. Like other deductions, this particular deduction then, as now, was generally available only to the person or entity upon whom the expense was directly imposed. As a practical matter, however, it must be remembered that the subsidiary would normally confine distributions to those profits which remained after payment of its own foreign taxes. In effect, and contrary to the circumstance in the setting of a permanent establishment, that portion of the subsidiary's profits absorbed by foreign taxes was actually excluded from American gross income. And this exclusion, available only in the case of operations conducted through a foreign subsidiary, was just as beneficial as the deduction to which the permanent-establishment arrangement was then confined. Thus, in terms of over-all effect, the deduction provision did not actually discriminate against foreign subsidiary arrangements. In fact, insofar as one looked only at America's total response to foreign taxes, parity between the two different organizational arrangements had been achieved as this country approached World War I.

(d) Parity retained: Denial of a deduction for intercorporate dividends received from a foreign corporation.—Ameri-

---

62 It is not always easy to determine whether a dividend tax is imposed on the recipient or on the distributor. Illustrative of the difficulty, see Rev. Rul. 56-289, C.B. 1956-1, 321.
ca’s entry into World War I and the concurrent increase in rates was accompanied by elimination of the double domestic tax which fell on those corporate profits earned by domestic subsidiaries. Until 1917, profits on which a domestic subsidiary had paid a tax were again taxed when received as a dividend by the domestic parent. The provision adopted in that year, freeing intercorporate dividends from the second tax, is now characterized as the 85% dividends received deduction, meaning that 15% of such dividends will not now enjoy immunity at the dividend stage. However, care was taken then, as now, to deny this benefit to dividends received from a foreign subsidiary, the reason being that the latter, unlike a domestic subsidiary, was not itself taxed by the United States with reference to its foreign profits. Looking at the matter only in terms of domestic taxation, the double tax difficulty did not exist in such case.

In the instance where a foreign subsidiary distributed all of its after-tax profits as a dividend, the foregoing statutory limitation served to keep the American tax on a par with that which would fall on a permanent-establishment arrangement. The deduction which the latter enjoyed with respect to foreign taxes was matched by an exclusion of that part of the subsidiary’s profits devoted to foreign taxes.

(e) Parity eliminated: Origin and differences between the “direct” and “deemed-paid” credits, and their basic relationship to the deduction for foreign taxes.—Because of increased costs associated with the conduct of World War I, to a new regular corporate rate of 12% in 1918, the government tacked on an increase in the tax on excess profits, the first bracket of which was now subjected to a rate of 30%.

On the one hand, because of the deduction allowed for foreign taxes, the higher rate schedule meant that the United States Treasury would be assuming an increased share of a corporation’s own foreign tax load. But this was small comfort when account was taken of the fact that foreign countries were also tacking on much higher war profits taxes, a substantial part of which—in

---

65 I.R.C., § 243.
66 Rev. Act of 1917, § 4 limited the immunity to dividends received from a corporation “which is taxable upon its net income as provided in this title....”
67 I.R.C., § 243 limits the deduction to dividends received from a “domestic” corporation.
69 Ibid., § 301 (a).
spite of the deduction—had to be borne by the American enterprise. It was in response to this circumstance that Congress, in 1918, authorized corporations, as well as individuals, to take a credit against their American tax liability for foreign "income, war profits, and excess profits taxes" paid or accrued during the taxable year.70

While the new provision did not deprive taxpayers of the right to deduct from gross income any foreign tax which, because of its type, was ineligible for the credit, benefits with reference to qualifying types could not be doubled by also taking the previously permitted deduction.71 In fact, the present counterpart of the earliest prohibition prevents a taxpayer from availing himself of the deduction with reference to qualifying taxes if he "chooses to take to any extent the benefits" of the credit.72 While more will be said of this matter later, in practice the limitation means that taxpayers will deduct qualifying taxes, instead of taking a credit, only where they are interested in increasing the amount of a current net operating loss which can be carried back for immediate refund purposes.

Standing alone, the basic provision regarding the credit did not accommodate all of the foreign income taxes which might be imposed in connection with a foreign subsidiary arrangement. Contrary to the case where the foreign business was carried on through a permanent establishment, foreign income taxes imposed directly against a subsidiary itself were not taxes, qua taxes, against the American parent. Accordingly, the latter, by reference only to the basic provision, could have taken a credit only for such income taxes, if any, which the foreign government might have assessed, and withheld, against the parent in connection with dividend payments. In 1918, however, the Senate Finance Committee was also concerned with a second and quite different problem, the tentative resolution of which ultimately had an effect on the right of a parent to enjoy some credit for a foreign subsidiary's own income taxes.

That committee felt that affiliated corporations, even those engaged only in domestic activities, were not properly allocating the burdens and benefits of inter-company transactions. Moreover, it was thought that the then existing law "put an almost irresistible

72 I.R.C., § 164(b)(6). Italics added.
premium on a segregation or a separate incorporation of activities which would normally be carried as branches of one concern." 73

Over and above these considerations, it was also felt that "the principle of taxing as a business unit what in reality is a business unit is sound and equitable and convenient to the taxpayer and to the Government." 74 The proposed solution: to require affiliated corporations to file a consolidated return under regulations prescribed by the Treasury. 75 Since this would have the effect of converting a subsidiary into a branch for American tax purposes, as applied to a domestic parent and a foreign subsidiary it was only right that the same Committee went on to propose allowance of a full credit against the consolidated tax for any qualifying foreign taxes of the subsidiary 76 as well as of the parent. Because of this credit, though American gross income would have included the pre-tax profit of the foreign subsidiary, a further deduction against consolidated gross income for qualifying foreign taxes was to be prohibited. 77

For unstated reasons, a conference committee eliminated the consolidated return requirement as it related to foreign affiliates, 78 thus freeing that part of a foreign subsidiary's income sourced abroad from the reach of the Treasury except to the extent such was distributed as a dividend to the parent. But with some revision, the committee retained and the Congress adopted the provision which authorized the American parent, upon receipt of a dividend, to take some credit for qualifying foreign taxes paid by the foreign subsidiary. 79 This result was accomplished by saying that the parent would be "deemed" to have paid such taxes.

While that early statute did go on expressly to deny a deduction for those same taxes, 80 it completely ignored the fact that elimination of the consolidated return requirement, of which the pass-through arrangement as to foreign taxes was originally only a part, had the effect of enabling the parties to exclude from American gross income that part of the subsidiary's profits used to pay the foreign taxes. Thus, if the foreign subsidiary distributed its entire

74 Id. at 9.
76 Ibid., Senate's bill, § 240(c).
77 Id., § 234(a)(3).
79 Ibid. Revenue Act of 1918, § 240(c).
after-tax profit, exclusion from American gross income of that part of its profits used to pay its own taxes was the economic equivalent of a deduction for those taxes. Moreover, in this factual circumstance, the added benefit of the “deemed paid” credit—under the provision as originally enacted—apparently related to all of the subsidiary’s qualifying taxes, subject to one limitation not relevant to the present discussion.81 And this was so though that part of its profits used to pay the foreign tax was not itself being taxed by the United States. Three years later, however, the language of the earlier credit provision was changed; under the 1921 Act, as today, the parent, upon receipt of a dividend, was deemed to have paid only that proportion of the qualifying taxes as were paid by the subsidiary “upon or with respect to the accumulated profits of such foreign corporation from which such dividends were paid, which the amount of such dividends bears to the amount of such accumulated profits. . . .” 82

While a very substantial controversy arose thereafter as to the reason for this change, and over the question of whether a meaningful change had in fact taken place, the Supreme Court finally decided that the law had taken on a new complexion.83 Illustratively, suppose that out of its pre-tax profits of $100,000 for the current year, a foreign subsidiary paid $26,000 in income taxes to a Common Market country, remitting the balance of $74,000 to an American parent as a dividend. The American Chicle Co. case84 decided that the pre-dividend “accumulated profits” in this situation would amount only to $74,000 with the consequence that the fraction mentioned in the statute’s proportional formula, quoted supra, was $74,000 or 1. By the same token, the ultimate statutory multiplicand to which this fraction was to be applied (“taxes paid by such foreign corporation. . . . upon or with respect to the accumulated profits from which such dividends were paid”)85 amounted to $26,000 × $74,000 or $19,240.

82 Rev. Act of 1921, § 238(e), now I.R.C., § 902(a).
83 One of the difficulties, e.g., was the fact that an explanation on the Senate floor was opposite to the specific result which the Supreme Court reached. See statement of Senator Smoot, 61 Cong. Rec. 7184 (1921).
84 This example is similar to one used in the lower court’s decision, American Chicle Co. v. U.S., (Ct. Cl. 1941) 41 F. Supp. 537, but the result was affirmed in 316 U.S. 450, 62 S. Ct. 1144 (1942).
85 Italics added.
In other words, $6,760 or 26% of the subsidiary's own income tax was paid to the foreign country with respect to something other than its "accumulated profits" of $74,000. Specifically, the $6,760 was linked to that part of the subsidiary's pre-tax profits which was absorbed by the foreign tax itself ($26,000). Two countries were not, of course, taxing that part; of the $100,000 taxed by the foreign country, only $74,000 (the dividend) remained to be taxed by the United States.

Thus, out of the chronology previously related emerged two basic ideas which prevail to this day:

(1) Time-wise, whereas the permanent-establishment arrangement enables an American corporation to take a direct credit for a branch's qualifying foreign taxes in the year the foreign tax is paid or accrued and without regard to the matter of remittances to the States, the availability of the quite different "deemed-paid" credit to an American parent of a foreign subsidiary was linked to the former's receipt of a dividend; and

(2) Using the earlier example again as an illustration, whereas a permanent-establishment arrangement would have led to an American gross income of $100,000 with the American corporation having a choice between a credit or deduction in the amount of the full foreign tax of $26,000, the subsidiary arrangement gave rise to an exclusion of that same $26,000, leaving American gross income (a dividend) of $74,000—the American tax on which could also be credited with $19,240 or 74% of the foreign tax which, in its entirety, had been the subject of the previously mentioned exclusion.

While it was assumed in the latter illustration that the foreign tax was the same under the two arrangements ($26,000), the net effect of the foregoing developments on the American tax created a difference in the two settings, and because of this the combined foreign and domestic income taxes suffered by the two arrangements differed. Assuming a flat 52% American rate, the net American tax in the setting of a permanent-establishment arrangement would also be $26,000 ($100,000 × 52% less the direct credit for foreign taxes of $26,000), and this, coupled with the foreign tax of $26,000, resulted in combined foreign and domestic taxes of $52,000. Where a permanent establishment is used, the combined income taxes will always be 52% in that instance where the foreign tax is less than the American tax.
A different result is reached, however, in the case of a foreign subsidiary which has declared a dividend of all of its after-tax profits. Pursuing the original illustration further, the net American tax would be only $19,240 ($74,000 dividend $\times 52\% = $38,480 less the deemed-paid credit of $19,240) as against $26,000 in the permanent-establishment setting. The combined taxes of the two countries with reference to the subsidiary’s profits and subsequent dividend would then be only $45,240 or 87% of that suffered if a permanent establishment were used.

It will be noted that the effective foreign rate in our illustration (26%) was exactly half the American rate (52%). Assuming a subsidiary distributes all of its after-tax profits, this particular rate relationship represents that point where the subsidiary arrangement will have the greatest tax advantage over the permanent-establishment setting. The tax advantage of the former arrangement decreases in the assumed situation (full dividend) as that rate relationship is changed, up or down.

If the foreign country does not resort to income taxation at all, the effective rate being 0, the subsidiary type of organization will provide no advantage whatever over a branch arrangement—assuming again that the subsidiary distributes all of its profits as a dividend ($100,000 dividend \times 52\% = $52,000 less 0 deemed-paid credit). Indeed, pursuant to that same assumption of full dividends and laying aside for the moment any comparison to permanent establishments, the combined income taxes of the two countries on a subsidiary arrangement will be less if the foreign country imposes some income tax than if it imposes none at all, provided only that its tax is not as great as the tentative (pre-credit) American tax.

This startling result stems from the fact that the foreign income tax enjoys the equivalent of a deduction (exclusion) as well as some credit.

Returning to the comparison with permanent establishments, and to the fact that the subsidiary’s advantage during a period of full dividends will also be reduced as the foreign country’s effective rate moves from the mid-point (26%) to the other extreme corresponding to the American rate of 52%, it will be noted that a foreign tax of 52% will alone equal the combined tax in the setting of a permanent establishment, $52,000. The American tax on a subsidiary’s dividend will also be completely neutralized in such case ($48,000 dividend \times 52\% = $24,960 less a deemed-paid credit of
$24,960 computed as follows: $52,000 \times \frac{$48,000}{$100,000} = $24,960$.

The ultimate advantage which the foreign subsidiary type of arrangement may enjoy over a branch—the exact degree being dependent upon the foreign rate and attributable to the combined exclusion and credit allowed for that foreign tax, would be lost, of course, if dividends received by an American parent from such a subsidiary were "grossed up" by the amount of the foreign income tax, full credit for that tax then being allowed as in the case of a branch. Present congressional interest in such a "gross up" requirement is dealt with in Section B of PART VI, infra, in the setting of other projections regarding possible future changes in both foreign and American tax patterns.

While it appears under the present pattern that the advantage of the subsidiary in a period of full dividends gradually decreases as the effective rate of the foreign tax moves up or down from a mid-point fixed at exactly half of the American rate, equally important are two other correlative principles.

The first of these is most dramatically illustrated in that circumstance where a subsidiary retains all of its after-tax profits in order to discharge long term liabilities or facilitate expansion. The deemed-paid credit, since linked to dividends, will not presently be available; but neither will there be any American gross income. The total current tax liability will be determined solely by reference to the effective foreign rate.

In terms of current tax liability, the subsidiary’s advantage over a permanent establishment increases in the last assumed situation (no dividends) as the foreign rate moves downward from 52%. In the setting of our original illustration of a 26% foreign rate, the current combined tax load on the subsidiary arrangement would be just half of that amount suffered by the permanent-establishment arrangement.

The difference in the amount of advantage enjoyed by the subsidiary arrangement in the absence of dividends, and that enjoyed by it even where all after-tax profits are distributed, is whittled down if the subsidiary distributes even a part of its after-tax profits, retaining the balance. Illustratively, if it distributes half of its after-tax profits of $74,000, the numerator of the previously quoted statutory fraction governing the deemed-paid credit becomes $37,000, the fraction then being $\frac{37,000}{74,000}$ or \( \frac{1}{2} \). Multiplied by the ultimate statutory multiplicand ($26,000
$X \frac{74,000}{100,000}$ or $19,240) which remains unchanged, the deemed-paid credit allowed with reference to the $37,000 dividend turns out to be $9,620 ($19,240 \times \frac{1}{2}) which is set off against the tentative American tax liability of $19,240 ($37,000 \times 52\%)$, producing a net American tax of $9,620 ($19,240 tentative tax less deemed-paid credit of $9,620). This, together with the foreign tax of $26,000, results in a combined current tax for the subsidiary arrangement of $35,620 compared with $52,000 which would be assessed in the setting of a permanent establishment.

The second important correlative principle, discussed more fully in the next subtopic, has the effect, inter alia, of foreclosing the chance that the credit for foreign taxes might neutralize American tax liability on income which the parent corporation derives from sources within the United States. Thus the combined taxes can be greater than $52\%$ if the effective foreign rate exceeds the effective American rate.

(f) The per-country limitation.—It was in 1921 that Congress first acted to prevent credits for foreign taxes from offsetting any part of one's tax attributable to income earned within the States. While that provision, known as the "over-all" limitation, was later discarded and then revived in 1960, a complementary and in some respects more confining ceiling, first enacted in 1932 and characterized as the per-country limitation, has remained intact since its inception. Its general thrust is to the effect that the total credit claimed for qualifying taxes paid or accrued to a particular country should not exceed the amount of tax which the United States would impose, before credits, on income having its source in that foreign country.

That part of the provision's limiting fraction which is most likely to be applied to the taxpayer's pre-credit American tax, the aim being to fix a ceiling on the total direct and deemed-paid credits otherwise available for taxes paid or accrued to a particular country, reads as follows:

\[
\frac{\text{"Taxable income from sources within such country"}}{\text{"Entire taxable income for the same taxable year"}}
\]

86 Rev. Act of 1921, §238(a).
87 Rev. Act of 1932, §131(b).
88 I.R.C., §904.
89 The limiting fraction can never be more than 1, for the provision adds, in the case of the numerator, that it may never exceed the "taxpayer's entire taxable income," and this latter figure will always correspond to the denominator.
This fraction has three main features, the first of which is a direction to the effect that the numerator and the denominator be determined solely by reference to American tax concepts, foreign tax notions being irrelevant. One such concept, expressed quite clearly in both elements of the fraction, involves the term "taxable income."

The requirement, that the computation of this limiting fraction be guided exclusively by the American concept of "taxable income," comes into play only in calculating the final ceiling on credits, and must not be confused with certain other less demanding ideas which bear on initial computation of the credit—a matter governed by quite different provisions of the Code. Illustratively, one of these other provisions is to the effect that a credit will not normally be allowed in the first instance with respect to any foreign tax other than "income, war profits, and excess profits taxes." As is later more fully explained in Subsection 4, here too American ideas will be used in determining whether a given foreign tax measures up to the characterization, "income tax," but in this instance the test may be satisfied though the foreign levy does not conform precisely to American notions regarding gross income and deductions. Again, assuming this more general standard is satisfied in a given case, the entire amount of foreign income taxes paid or accrued may actually enjoy the credit though the foreign income tax law allowed more by way of deductions or did reach some items of income sourced there which the United States exempted or subsumed under a nonrecognition provision.90 In other words, with respect to the credit, it is only after the initial computation, i.e., when one reaches the limiting fraction of the per-country limitation, that the American notion of "taxable income," and its precise standards regarding gross income, deductions, exemptions, nonrecognition provisions, etc., can affect the amount of the credit, and then only by way of establishing the ceiling.91 In the end,

90 But in practice it has not always been so. A 1936 decision, Hubbard v. United States, (Ct. Cl. 1936) 17 F. Supp. 93, cert. denied, 300 U.S. 666, 57 S. Ct. 508 (1937), was to the opposite effect insofar as the foreign tax was attributable to an item which would not have been subject to taxation by the United States. But Helvering v. Nell, (4th Cir. 1944) 139 F.(2d) 865, and I. B. Dexter, 47 B.T.A. 285 (1942), acq., C.B. 1948-2, 1, took a contrary view. And this was adopted for a time by the government in G.C.M., 25723, C.B. 1948-2, 131. Its subsequent modification of that ruling, in G.C.M. 26062, C.B. 1949-2, 110, was abandoned, however, in Rev. Rul. 54-15, C.B. 1954-7, 129, on the basis of the Tax Court's decision in James H. Brace, 11 T.C.M. 906 (1932).

91 However, in the case of individuals, estates, and trusts, I.R.C., § 904(b) provides that no allowances for personal exemptions can be taken under I.R.C., §§ 151 or 642(b).
however, this calculation may turn out to have been in vain, for
the initially computed credit will stand as the final credit if the
foreign tax actually paid or accrued turns out to be less than the
per-country limitation. An illustrative case is one where the amount
of the foreign tax paid or accrued equalled an effective rate of,
say, 40%—as determined by reference to American notions of
taxable income, with the effective rate in the States being higher.
On the other hand, it is conceivable that the ceiling itself could be
0. Illustrative would be a case where the foreign operation would
have operated at a loss except for an income item which, while
taxed abroad, would be in an exempt class in the United States.
In this event, the numerator of the limiting fraction would be
0, with the consequence that the fraction would become 0.

A second American tax concept relates only to the numerator
of the limiting fraction and is implied from the interdependent
structure of the Code; it is to the effect that American rules of
jurisdiction will be employed for the purpose of determining that
part of the taxpayer's taxable income which will be deemed to have
its "source" in the particular foreign country.\(^92\) For example, prior
thereto, it was possible that the United States and the foreign
country would each claim to be the source of the profit made on an
exported item. While the United States looked to the place where
title passed in resolving this question,\(^93\) other countries sometimes
used a different test. And in that event, because of the applicability
of American standards, it was possible that the numerator of the
limiting fraction would be 0, thus foreclosing the opportunity to
take a credit for the foreign tax.\(^94\) The importance of this feature,
in the case of those doing business with five Common Market coun-
tries with which the United States has a tax treaty, has been some-
what reduced by the adoption of those treaties. Pursuant to the
tax treaties, the five Common Market countries have agreed to
forego any tax on an American corporation's export profit except
in the instance where that corporation is engaged in a trade or
business through a permanent establishment situated in the foreign
country in question.\(^95\)

In the setting of a foreign-subsidiary arrangement, the two
\(^92\) In effect, I.R.C., § 904 incorporates the source rules of Subchapter N, particularly
§§ 862 and 863.
\(^93\) U.S. v. Balanovski, (2d Cir. 1956) 236 F.(2d) 298, cert. den., 352 U.S. 968, 77
S. Ct. 357 (1957) ; Comm'r v. East Coast Oil Co., S.A., (5th Cir. 1936) 85 F.(2d) 322;
\(^94\) Burk Brothers, 20 B.T.A. 657 (1930).
\(^95\) See PART II, supr.
American tax concepts incorporated in the numerator of the limiting fraction ("taxable income" from the foreign country, and the domestic rules fixing the source) will have one effect which can be easily overlooked as applied to the credit for foreign taxes paid on dividends. The Code provisions fixing the source of income in a foreign country deal first with the matter of gross income.\textsuperscript{96} They then go on to provide that from such gross income, in arriving at "taxable income" from the foreign source, there shall be deducted the expenses, etc., "properly apportioned or allocated thereto, and a ratable part of any expenses, losses or other deductions which cannot definitely be allocated to some item or class of gross income."\textsuperscript{97} The Tax Court has insisted that a part of the general administrative expenses of the parent corporation must be allocated to the dividend in arriving at the numerator of the fraction, and in this it has been affirmed on appeal.\textsuperscript{98}

Since foreign taxes normally will have been paid with a part of the foreign currency received in the course of operations abroad, questions relating to timing, as it affects the initial determination of income and credits for both cash receipts and accrual taxpayers, are considered, together with the conversion problem, in PART IV, infra. It should be noted here, however, that the per-country limitation creates a separate timing problem. The numerator and the denominator are calculated by reference to the accounting period used for federal tax purposes, and the limiting fraction is then applied to the credit for foreign taxes properly paid or accrued within that period. Because variation between the United States and the foreign country with respect to the matter of timing could, inter alia, lead the per-country limitation to spring into operation where it would not otherwise do so, three steps at the federal level have been taken.

The first involved congressional action; cash basis taxpayers were allowed to elect the accrual method for purposes of the credit, thus in general permitting such taxpayers to link the credit to the year foreign taxable income was earned.\textsuperscript{99} The second step was accomplished by administrative action; a ruling was designed so as to accommodate the situation where the

\textsuperscript{96} I.R.C., § 862(a).
\textsuperscript{97} I.R.C., § 862(b). Italics added.
\textsuperscript{99} Rev. Act of 1924, §§ 238(c) and 222(c), now I.R.C., § 905(a). See PART IV, Section E, infra.
foreign tax was based on a fiscal year different from that of the American tax. In such case, those properly using the accrual method were permitted to accrue on a pro rata basis the foreign income tax for a particular foreign-tax year, allocating that tax between the two American tax years in which the foreign year fell.  

There were still other timing matters which created fluctuations of a type prejudicial to a taxpayer because of the way the per-country limitation worked. Illustratively, for federal purposes, the taxpayer might have elected to report sales on the installment basis though such method was not permitted by the foreign government. Again, differences between the two countries in inventory practices or in depreciation methods could in effect lead to differences in the year in which profits would be reflected. The same difficulty could be encountered in connection with the fact that only the Netherlands permits a carry-back of net operating losses, and even that carry-back does not coincide in point of years with the practice followed in the United States. As indicated in PART I, most Common Market countries permit only a carry-over.

Problems such as these led a congressional committee in 1958 to conclude as follows:

> Double taxation can occur at present because of the manner in which this country-by-country limitation works where the methods of reporting income are different in the United States and the foreign country. These differences may result in the same income being reported in one year in the United States and in another year in the foreign country. When this occurs the foreign tax credit available will tend to be less than the taxes paid or accrued to the foreign country in the year the income is reported in that country but not in the United States. In another year when this income is reported in the United States but not the foreign country, the credit which would be available under the limitation will tend to exceed the foreign taxes paid or accrued.  

It was for the asserted purpose of cushioning the impact of these difficulties that the committee induced Congress to adopt a new provision permitting a carry-back and carry-over of such portion of a foreign country's income tax as may exceed the ceil-

---

100 I.T. 4033, C.B. 1950-2, 52.
101 H. Rep. No. 775, 85th Cong., 1st Sess. (1957), C.B. 1958-3, 811 at 817. The Committee also mentioned differences in fiscal years as an operating difficulty. On the one hand, it may have been questioning the vitality of the ruling in note 100, supra, or it may have been referring to cash basis taxpayers with respect to whom that ruling is inapplicable.
ing fixed by the per-country limitation. The excess may be carried back successively to the 2 prior years and then forward to the 5 succeeding years, being used in those years—provided election is made to take a credit rather than a deduction—to the extent the foreign taxes for such years are less than the amount allowable under the country-by-country limitation.\textsuperscript{102} Carry-backs to years beginning before January 1, 1958, are not permitted, however.

This carry-back and carry-forward was about as attractive as any cushion Congress might have provided with respect to an American company of the type assumed here, namely, one which established a facility in, and suffered the income tax of, only one foreign country. In fact, even before the adoption of this cushion, in cases where the total foreign effort involved only one foreign country, the effect of the per-country limitation was similar to that associated with the older, but for a time discarded, overall limitation. It was only where the American company, directly or indirectly, suffered income taxes of two or more foreign countries that a difference could arise with respect to the two types of limitation. The overall limitation quite generally permitted taxes of two or more foreign countries to be averaged, thus leveling out the highs and lows and making it less likely that the effective foreign rate would exceed the American rate. The discussion \textit{infra}, in Sections E, F, and G of this PART, indicates that the same was and is true, oddly enough, with reference to multi-country operations carried on by certain organizational forms which come under the per-country limitation. That this is not so, however, with respect to other forms, and because one limitation is not consistently more advantageous than the other, furnished the reasons for the determination by Congress in 1960 to allow any domestic taxpayer to elect to submit its foreign tax credit to an “overall” limitation, rather than to the per-country limitation. Since such a shift will actually be meaningful only where the American taxpayer’s foreign operations spread across two or more foreign countries, the newly revived alternative overall limitation will be discussed later in connection with such settings, in Sections E, F, and G, \textit{infra}.

\textbf{SUBSECTION 2. INTEGRATING AMERICAN AND COMMON MARKET DIRECT TAXES RE PERMANENT ESTABLISHMENTS AND SUBSIDIARIES}

\textit{\textbf{(a) Introductory note: need for caution in assessing comparative data.}}—Section A of this PART indicated the reasons why

\textsuperscript{102} \textit{Tech. Amendments Act of 1958, § 37, now I.R.C., § 904(c).}
one should not place too much stress on comparative data which can be presented in this kind of study regarding direct tax loads imposed by Common Market countries. For those reasons, as well as others, like caution is essential with reference to comparisons of the integrated direct tax costs, American and foreign, of doing business abroad. Assumptions previously made in looking only at foreign tax costs, including a specific set of facts, must also be availed of here. In addition, because the Internal Revenue Service has not published rulings identifying all of those Common Market taxes which will be deemed to satisfy the American credit provisions, some assumptions, based on analogy, must also be made with reference to this question.

The comparisons below deal first with the integrated direct tax costs incurred by an American corporation which conducts its foreign activity through a permanent establishment. The same comparison is then made in the setting of a foreign subsidiary arrangement. The story concludes with a comparison between these two arrangements.

As in Section B of this PART, it is assumed that the American company has only one foreign facility which earned $400,000 (before direct taxes) on an investment of $4,000,000. To facilitate comparison, it has again been necessary to assume that the Common Market countries and the United States would follow identical concepts with respect to income and deductions in arriving at the $400,000 in pre-direct tax profit.

(b) Comparing integrated direct tax costs in the setting of a permanent establishment.—Since the income of a foreign permanent establishment is included in that of the American corporation whether or not remitted, the effective rate in the United States will always fix the minimum integrated direct tax cost of this kind of an arrangement. Normally, the total direct tax costs would actually exceed this in only two circumstances.

The first involves that situation where the effective foreign income tax rate, calculated as a percentage of the pre-direct tax profit of $400,000, exceeds the effective American rate expressed in terms of that same base, in which instance the American tax would be completely neutralized by the direct credit which is allowed.

The second instance where foreign direct taxes may in effect establish the minimum borne by a permanent establishment involves those foreign countries which, in addition to an income tax, impose
other types of direct taxes which will not qualify for the American credit, being only deductible for U.S. tax purposes. In other words, the effective American tax rate fixes only the minimum income tax burden; other types of foreign direct taxes which do not qualify for the credit will constitute an additional direct tax burden to the extent not absorbed by the American treasury as a result of the deduction which presumably would be allowed under § 164 in arriving at the American tax base.

Only if the assumed permanent establishment is situated in Germany are both of these circumstances likely to be encountered. That both will arise in that setting rests on the two-country effect of Germany's three primary taxes, as follows:

(1) On the one hand, because the three-factor German enterprise tax is deductible from the pre-direct tax profit of $400,000 in arriving at the amount subject to the regular German income tax rate of 49%, the effective rate of the latter, as applied to the pre-direct tax profit, is considerably less than 49%;

(2) On the other hand, the profit factor of that three-factor enterprise tax is itself an income tax,¹⁰³ and more than offsets the deductible effect of the whole, thus increasing the effective rate of the two-pronged German income tax, as applied to the $400,000, almost to 52%; and

(3) While the other two factors of the three-factor German enterprise tax and the separate German 1% net wealth tax serve as additions to the final two-country income tax load, they also serve as deductions from the $400,000 in arriving at the American tax base to which the stated 52% is applied,¹⁰⁴ the effect being to reduce the effective American rate to a point below 52% of the $400,000 pre-direct tax profit and below the percentage absorbed by the two-pronged German income tax (the regular and the profit factor of the enterprise tax).

As a consequence of the foregoing, the total two-country income tax load is determined by the German pattern, to which must be added its net wealth tax and two factors of its enterprise tax, leaving less than 33% of the $400,000 remaining after direct taxes.

If the setting is shifted to Luxembourg, that portion of the

¹⁰³ See discussion infra, Subsection 4(d) of this Section.
¹⁰⁴ Germany's 1% net wealth tax is not deductible, however, in computing that country's own income tax base as applied to the permanent establishment.
$400,000 absorbed by the American income tax would not be exceeded by Luxembourg’s two-pronged income tax (regular and profit factor of its enterprise tax). And this is so though the non-profit factors of the latter’s enterprise tax and its net wealth tax would be deducted from the $400,000 in arriving at the American tax base. However, in calculating the total integrated or two-country direct tax costs, to the effective American rate which fixes the minimum income tax load, one must add the two Luxembourg direct taxes which fail to satisfy the credit, specifically, the non-profit factors of the enterprise tax and the net wealth tax, producing total integrated direct taxes equaling approximately 57% of the $400,000.

Presumably, Italy’s property tax would also fail to satisfy the American credit though it could be deducted from the $400,000 in arriving at the American income tax base. In effect, that portion not absorbed by the United States treasury through the deduction would constitute an additional direct tax burden, for the effective American income tax rate would fix only the minimum income tax load. The total integrated direct tax costs of the assumed permanent establishment, if located in Italy, would then approximate 55% of the $400,000.

If the foreign permanent establishment is just a sales office, the peculiar incidence of property taxes in the three countries mentioned above will be markedly reduced or perhaps completely eliminated. In the latter event, only the two-pronged German income tax rate schedule is likely to exceed the American rate and fix the ultimate total direct tax burden.

According to the earlier country-by-country survey and the comparisons in Section B, supra, the other three member nations, Belgium, France, and the Netherlands, do not impose significant property taxes, and since their effective income tax rates (30%, 50%, and 47%, respectively) do not exceed the effective American rate, the latter will equal the amount of the integrated direct tax costs.

(c) Comparing integrated direct tax costs of foreign subsidiaries which retain all profits for expansion.—If a foreign subsidiary retains all of its after-tax profits in order to facilitate expansion or discharge indebtedness, the integrated direct tax

Since the profit factor of the Luxembourg enterprise tax is quite similar to that in Germany, it is assumed that the Service would consider the profit factor as an income tax for purposes of the credit. Cf. Rev. Rul. 59-208, C.B. 1959-1, 192.
costs will be confined to foreign taxes. In the absence of a dividend, the subsidiary’s profits will not be included in those of the American parent; nor will the latter currently enjoy the deemed-paid credit with reference to the subsidiary’s own income tax.

A comparison of the foreign direct taxes which would be imposed in this setting, if the facts were like those just assumed in the setting of permanent establishments, appears in Section B, supra, and can be summarized as follows:

<table>
<thead>
<tr>
<th>Direct Taxes</th>
<th>Direct Taxes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belgium</td>
<td>27.47%</td>
</tr>
<tr>
<td>France</td>
<td>50.69</td>
</tr>
<tr>
<td>Germany</td>
<td>69.95</td>
</tr>
<tr>
<td>Italy</td>
<td>44.67%</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>51.67</td>
</tr>
<tr>
<td>Netherlands</td>
<td>47.50</td>
</tr>
</tbody>
</table>

(d) Comparing integrated direct tax costs of subsidiary arrangements where all after-tax profits are distributed.—In the situation discussed above, where a foreign subsidiary retained all after-tax profits, Belgium provided the locale where the lowest total direct tax costs would be encountered. Subject to one caveat, that locale will retain its favorable position even through a later period when the subsidiary has matured to a point that all current after-tax profits are to be distributed. In contrast to the inter-country comparisons drawn above, those drawn below with respect to this later stage require an integration of American tax costs with the foreign direct tax costs. The isolated significance of this will be more discernible and distinctions between the two stages in the life-line of a subsidiary will also be more obvious if one indulges in the same assumptions here as there, including the fact that the subsidiary earns $400,000 in pre-tax profits on property worth $4,000,000.106

The caveat mentioned earlier with respect to Belgium relates to an assumption, which must be made in the absence of a published ruling, to the effect that the Belgian withholding tax on dividends will be deemed, for purposes of the direct credit provision in the Code, to be an assessment against the American parent.

A combination of two factors continue to favor Belgium:

(1) According to earlier discussion, an income tax is the only really significant direct tax imposed against the subsidiary itself, and its effective rate (21.34%) comes close to that point

106 Disregarded also is the fact that administrative overhead of the parent must be apportioned in part to the dividend, in computing the per-country limitation on the credit. See Subsection 1, supra, and Subsection 3, infra.
(26%) where the greatest benefit is reaped from the combined
deemed-paid credit and exclusion enjoyed by the American parent
with regard to that amount which the subsidiary devoted to
foreign income taxes; and

(2) While Belgium imposes an even larger withholding rate
(30%) against dividends (78.66% of pre-tax profits), the
direct credit which presumably would be allowed with respect
to this entire tax will, when coupled with the deemed-paid credit
for the subsidiary’s tax, approximate the tentative (pre-credit)
52% tax which the United States would impose on the dividend
(78.66% of pre-tax profits).

As a consequence of the two foregoing considerations, total
Belgian taxes, approximating 45% of pre-tax profits, will come
very close to being the total direct tax load in our assumed factual
situation.

The importance of the first of the two foregoing considerations
is illustrated by the fact that while the two Belgian income taxes,
approximating 45% of pre-tax profits, are almost as great as the
single 47% which the Netherlands would impose directly on the
subsidiary in lieu of any withholding tax against the parent for
dividends received, the integrated direct tax cost of doing business
through subsidiaries in the two locales would actually differ by a
slightly greater amount, provided it be assumed that the same in-
come and deduction concepts prevail in America as well as in those
two foreign countries. The 47% imposed by the Netherlands comes
close to one of the extremes (52%) where the combined exclusion
and deemed-paid credit for foreign income taxes yields the least
benefit. In fact, after taking the deemed-paid credit, an American
tax equal to more than 2\(\frac{1}{2}\)% of the subsidiary’s pre-tax profit
will remain, producing an integrated tax which absorbs almost 50%
of the subsidiary’s pre-tax profits.

France, the third and last country which, for all practical pur-
poses, confines its direct taxes to those on income, would provide
a less favorable locale, taxwise, than the Netherlands.

107 Since the dividend is 78.66% of pre-tax profits, the tentative American tax at 52%
would be 40.9% of the subsidiary’s pre-tax profits against which a total credit of
40.38% of pre-tax profits could be taken.
108 To the tax on the subsidiary (21.34% of pre-tax profits), one must add the with-
holding tax of 30% on the dividend (30% \times 78.66 of pre-tax profits), being another
23.6% of the subsidiary’s pre-tax profits.
109 The American tentative tax (52% \times 53% of the subsidiary’s pre-tax profits) of
27.56% of pre-tax profits would be offset by a deemed-paid credit (47% \times
\frac{53\% \text{ of pre-tax profits}}{100\%} ) equal to 24.9% of pre-tax profits.
While the deemed-paid credit for the 50% tax which the former would impose on the subsidiary, when coupled with the direct credit for the 15% withholding tax on dividends, would wipe out the American tax liability, the two French taxes—standing alone—would absorb around 57% of the subsidiary's pre-tax profits. While Italy ranked next to Belgium in providing a favorable direct tax climate during the period when the subsidiary retained all of its profits, during a later period of full distribution one ultimate consideration serves to eliminate the gap which existed in the earlier non-distributive stage between Italy and the then lower-ranking Netherlands, the two now being almost side by side. Whereas the percentage of pre-tax profits absorbed by integrated direct taxes in a Netherlands setting changed very little between the two stages, integrated costs associated with an Italian subsidiary will increase during the second or distributive stage by an amount approximating 7% of pre-tax profits. Responsibility for this fairly substantial increase can be traced ultimately to the addition of an American tax which will not be completely offset by credits even though American income taxes, approximating 29% of the subsidiary's pre-direct tax profits, will actually be less than the total Italian direct taxes of 44.67% of pre-tax profits.

This ultimate result is in turn traceable to two limitations on the credit enjoyed by the American parent:

1. While the Italian direct tax costs (44.67% of pre-tax profits) will remain constant through the two periods, that portion attributable to the Italian property tax (equal to 7.5% of pre-tax profits) cannot be credited against the American tax (approximately 29% of pre-tax profits) of 52% on a dividend which equaled 55.33% of pre-tax profits;

2. Since Italy does not split its income tax assessments between a corporate tax and a withholding tax on dividends, imposing just the former, the deemed-paid credit only will be applied in offsetting the U.S. tentative tax on the dividend. As a consequence, the whole of the Italian income tax (37.17% of pre-tax profits) will not actually serve as a credit against

---

110 As in the earlier case of Belgium, it is again assumed that this tax will ultimately also be deemed a tax against the parent, not against the subsidiary.

111 A 15% withholding tax on a dividend equal to 50% of pre-tax profits is equal to a tax on 7.5% of pre-tax profits.

112 52% on a dividend equal to 55.33% of the subsidiary's pre-tax profits equals 28.77% of pre-tax profits.

113 It is assumed that the Italian excess profits tax will also ultimately qualify for the credit.
the American income tax, for the deemed-paid credit is limited to that portion of the Italian income tax which was actually paid with respect to the distributed profit. The net effect: the deemed-paid credit \(^{114}\) will not even neutralize the whole of the 52% which the U.S. will impose on dividends.

Luxembourg and Germany, ranking, respectively, fifth and sixth during both stages in terms of tax attractiveness, provided account is taken of integrated direct tax costs, would share one problem encountered by Italy were it not for a compensating consideration. Both levy certain significant direct taxes which will not qualify for purposes of the credit allowed against the American income tax on the ultimate dividend. Nevertheless, in the case of subsidiaries located in those two countries, the total U.S. tax will be completely offset by credits. In part, this is due to the fact that, unlike Italy, both also levy a 15% withholding tax on dividends which, presumably, is fully creditable, dollar for dollar. The relatively high direct tax costs associated with subsidiary arrangements in Luxembourg and Germany during a period of full distributions is traceable then to their own direct taxes which, according to the earlier discussion in Section B, would absorb, respectively, 58.9% and 60.1% of pre-tax profits. These figures may be compared with integrated direct tax costs during this stage of approximately 45% of pre-tax profits in the case of a subsidiary located in Belgium, of approximately 50% in Italy and the Netherlands, and of 57% where France is the locale.

In conclusion, it must again be emphasized that the total integrated direct tax costs could change substantially if the subsidiary does not own substantial property; in that event, the integrated tax problems growing out of the foreign property tax imposed by three member nations would be eliminated.

(e) Comparing integrated direct tax costs of subsidiary arrangements where 40% of after-tax profits are distributed.—The circumstance where a foreign subsidiary distributes 40% of its after-tax profits obviously falls between the two previously discussed situations involving subsidiaries which (1) retained all, and (2) distributed all, current after-tax profits.

In terms of integrated direct tax costs, all countries but two retain the relative rankings maintained in the previously discussed

\(^{114}\) The deemed-paid credit would appear to be only 22.4% of pre-tax profits \((37.17\% \times \frac{55.33\%}{100\% - 7.5\%})\). For the purposes of this formula, the term accumulated profits would only be 92.5% of pre-direct-tax profits of $400,000; the other 7.5% represents non-qualifying property taxes.
stage (full distribution) with reference to tax attractiveness. Italy and the Netherlands "swap" places, the former regaining by a margin of less than 1% the position it held during the first stage (no distribution), as the second most favorable locale tax-wise. In the case of every country, however, the integrated direct tax cost in this third stage falls in between that which would follow where all profits are retained and where full distribution is made. This is another way of also saying that the factors discussed in the previous sub-topic are also at work in this third stage, though to a lesser degree. And in this third stage, the integrated direct tax costs run from approximately 34% of pre-tax profits where the subsidiary is situated in Belgium to 67% where the locale is Germany, the Netherlands falling closest to the mid-point at 48%.117

(f) Conclusion: Comparing a subsidiary-arrangement's integrated tax costs in all three stages with that of a permanent establishment.—As previously indicated, the integrated or two-country direct tax costs of a permanent establishment would remain constant during all three stages, i.e., without regard to whether foreign profits are actually remitted. Table III L compares those costs with the approximate integrated direct taxes which would be encountered in all three stages of a subsidiary arrangement provided one indulges in all three stages of a subsidiary arrangement.

115 Since the subsidiary's own Belgian tax is 24.9% of pre-tax profits, a dividend equal to 40% of the balance will run to 30.04% of pre-tax profits, and on the latter figure a 30% Belgian withholding tax will absorb another 9% of pre-tax profits. The U.S. tentative tax (52% X 30.04% of pre-tax profits) will be easily neutralized by the total of direct and deemed-paid credits, leaving the total Belgian tax of 33.9% as final tax cost.

116 The German direct taxes on the subsidiary itself (64.89% of pre-tax profits) leaves a dividend (40% of the balance) of 14.044% of pre-tax profits out of which the 15% withholding tax will absorb 2.1% of pre-tax profits, resulting in a total German tax of 67% of pre-tax profits. The U.S. tentative tax of 7.302% of pre-tax profits (52% X 14.044%) will be neutralized by the total direct and deemed-paid credits even though a part of the German direct tax was other than an income tax.

117 The Netherlands tax on the subsidiary (47%) leaves a dividend (40% of the remaining profits) of 21.2% of pre-tax profits on which the U.S. tentative tax (52% X 21.2%) would equal 11.02% of pre-tax profits. The deemed-paid credit would fall a little short of neutralizing that tentative tax, being only 9.964% of pre-tax profits.
TABLE III L

<table>
<thead>
<tr>
<th>Locale</th>
<th>Permanent Establishment</th>
<th>Subsidiary Arrangement</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>All Profits Retained</td>
<td>40% of After-tax Profits Distributed</td>
</tr>
<tr>
<td>Belgium</td>
<td>52. %</td>
<td>27.5%</td>
</tr>
<tr>
<td>France</td>
<td>52. %</td>
<td>50. %</td>
</tr>
<tr>
<td>Germany</td>
<td>67.4%</td>
<td>70. %</td>
</tr>
<tr>
<td>Italy</td>
<td>55.6%</td>
<td>44.7%</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>57. %</td>
<td>51.7%</td>
</tr>
<tr>
<td>Netherlands</td>
<td>52. %</td>
<td>47. %</td>
</tr>
</tbody>
</table>

SUBSECTION 3. ALLOCATING INCOME AND DEDUCTION ITEMS BETWEEN AMERICAN AND FOREIGN OPERATIONS

(a) Introductory note.—Where an American enterprise conducts its foreign activities through a branch, i.e., through a non-separatedly incorporated permanent establishment, proper allocation of income and deduction items between the two operations is essential to the determination of the foreign tax base as well as the per-country limitation which has been imposed on the American credit for foreign income taxes. Except with reference to the latter limitation, the allocation problem in the branch setting is not usually as important to American taxation as it is to foreign taxation. The reason is attributable to the fact that net profits of the foreign branch’s operation, whether or not remitted, will always be commingled with domestic profits in determining “taxable income” for federal income tax purposes.119 This is not so, however, where the foreign activity is conducted through a foreign subsidiary. In that setting, proper allocation can be just as important in establishing the tax base of the parent for American tax purposes, as it is in fixing the tax base of the subsidiary for foreign tax purposes. Here, too, the problem can affect the credit

118 For a description of changes which would take place in the Netherlands’ tax structure pursuant to a bill now pending, see PART VI, Section A, infra.
119 See PART IV, Section B for the accounting aspects.
for foreign taxes. Indeed, it could ultimately even affect the parent company's basis for stock held in the foreign subsidiary.

Because the problems are slightly different in the two settings, and because there is some variation in the basic legal data through which the interested countries have sought to police the matter, the discussion below deals separately with branch and subsidiary arrangements.

(b) Allocation between American operations and non-separately incorporated foreign permanent establishments.—In the case of a foreign branch, the integrity of the per-country limitation on the American credit for foreign income taxes can be preserved only if the United States has the power to assure proper allocation of income and deductions between the domestic operation and that of the branch. One of the statutory provisions to which it can look is a sweeping catchall, for its allocation principles apply alike to divided operations which are wholly domestic, to those which are wholly foreign but split between two or more countries, as well as to operations partly domestic and partly foreign. Its earliest counterpart was inspired to a substantial degree, however, by related domestic and foreign operations actually conducted through a subsidiary rather than through a branch. In 1921, a congressional committee called attention to a practice designed to minimize the amount of income which would be subject to American rates, noting:

Subsidiary corporations, particularly foreign subsidiaries, are sometimes employed to "milk" the parent corporation, or otherwise improperly manipulate the financial accounts of the parent company. 120

The congressional enactment which followed,121 to the effect that the Commissioner could re-allocate income and deductions between "related trades or businesses" in order to reflect the true circumstances, was the forerunner of § 482 of the present Code. Today, the Commissioner's power to effect a re-allocation is said to exist whether or not the two trades or businesses are separately incorporated and whether they are organized in the United States or abroad. The power extends to gross income, deductions, credits, and other allowances, provided such re-allocation is necessary "in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades or businesses." 122

Complementing the foregoing wholesale type of provision are

121 Rev. Act of 1921, § 240(d).
122 T.R.C., § 482.
three sections of the code, §§ 861, 862, and 863, which—absent a superseding treaty—fix the source of income, identifying whether an item will be treated as domestic or foreign. On the income side, two of those sections deal with items which are allocated exclusively to one country or the other. Both then go on to provide that expenses and other deductions shall be attributed to the income items on the same basis; in addition, however, there must be a proper apportionment of a "ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income." The third provision, § 863, deals with income derived partly from within and partly from without the United States, including, e.g., sales abroad of personal property produced in the United States. In circumstances where this principle is applied, apportionment of expenses and deductions is also required. However, in the case of simple export arrangements, earlier discussion in PART II indicated that this third statutory provision (§ 863) was less important with respect to sales in foreign countries with which the United States has a tax treaty. By such treaties, the foreign countries have abandoned the right to tax an American enterprise’s export profits except where it maintains a permanent establishment in the treaty country. Where such an establishment is maintained, those treaties would apply an allocation philosophy similar to that reflected in the sweeping provision now found in the previously mentioned § 482 of the Code.

Illustrative is the treaty with Belgium, which provides that "there shall be attributed to such permanent establishment the net industrial and commercial profit which it might be expected to derive if it were an independent enterprise engaged in the same or similar activities under the same or similar conditions." Unlike the other treaties, that provision—like certain rulings of the Service—goes on expressly to require such net profit to "be determined on the basis of separate accounts pertaining to such establishment." The Belgian and French treaties, though not those with other member nations, also add what would otherwise seem to be the case in any event, namely, that the competent authority of a particular taxing state may rectify such accounts, if need be, in order to reflect the apportionment principle described above. This recognition, that each state may make its own interpretation of the way the apportionment of expenses and other deductions shall be attributed to the income items on the same basis; in addition, however, there must be a proper apportionment of a "ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income."
tionment principle applies to a given case, is theoretically cushioned by four of the treaties which expressly recognize the right of competent authorities in both countries to “lay down rules by agreement for the apportionment of industrial or commercial profits.” 127

While the basic allocation provision in the treaties generally deals with net profits, three of the treaties add an express comment with regard to deductions. For example, the Belgian treaty authorizes a permanent establishment to avail itself of deductions “wherever incurred, insofar as they are reasonably allocable to the permanent establishment, including executive and general administrative expenses so allocable.” 128

(c) Allocation between an American corporation and its foreign subsidiary.—In the case of a foreign subsidiary which conducts all of its activity in one member nation, an allocation problem generally arises only in connection with inter-company transactions and dividends. A 1959 case, decided by the Tax Court, is illustrative of the former. There an American enterprise sought to deflect the great bulk of its profit on foreign sales to its foreign sales subsidiary. The latter was billed at a price which enabled it to enjoy 90% of the total profit whereas sales through independent commission agents were handled on a 20% commission basis. The Commissioner’s power to re-allocate under the previously discussed § 482 of the Code was sustained. 129

Now, in the case of related corporations, tax treaties with five of the six member nations include language very much like that found in the earliest counterpart to § 482. For example, the Belgian treaty provides that if the parent company, “by reason of its participation in the management or financial structure” of a Belgian corporation “makes with or imposes on the latter enterprise, in their financial or commercial relations, conditions different from those which would be made with an independent enterprise, any profits which, but for those conditions, would have accrued to one of the enterprises may be included in the taxable profits of that enterprise subject to applicable measures of appeal.” 130

127 The quotation is from the German treaty, Art. III(5). Only the French treaty lacks a provision to this effect. Italics added.
128 Art. IV(4). Also, German treaty, Art. III(4), and Italian treaty, Art. III(5). Italics added.
130 Art. V. Cf. the allocation language in Revenue Act of 1921, § 1331(b); French treaty, Art. 5; and Art. IV of the German, Italian, and Netherlands treaties.
ican regulation construing that provision notes that its obvious purpose is to achieve "tax parity with uncontrolled" enterprises, and adds that the previously described § 482 of the Code will be followed in effecting the implementation.\textsuperscript{131}

A slightly different kind of allocation problem arises in connection with dividends received by the parent. As noted elsewhere, by reference solely to American law, a proper portion of the parent's general administrative or overhead expenses must be allocated to the dividend in determining the amount of "taxable income" derived by the parent from the subsidiary.\textsuperscript{132}

\textbf{SUBSECTION 4. SPECIAL PROBLEMS RE CREDIT FOR FOREIGN TAXES OF A FACILITY SERVING ONE MEMBER NATION}

\textit{(a) Introductory note.---}The more frequently recurring mathematical aspects of the American credit for those foreign taxes suffered by a facility serving only one Common Market country were dealt with in Subsection 1, \textit{supra}. Within this same limited setting, the discussion below focuses attention on certain special substantive and procedural problems which may be encountered in connection with the credit. Following a description of the treatment accorded "delayed" distributions received by a parent from a foreign subsidiary, the discussion shifts to the fact that the deemed-paid credit will generally be available only where the payment received is in the nature of a "dividend." Thereafter, a quite different overall restriction, generally limiting both direct and deemed-paid credits to foreign "income, war profits, and excess profits taxes," is considered. This Subsection then concludes with a description of the requirements relating to the procedure to be followed in claiming a credit.

\textit{(b) "Delayed" distributions from accumulated earnings and profits.---}Directors who declare a dividend just before the close of a taxable year normally contemplate that they are distributing profits of that year. But such a declaration might also be made in a loss year; the directors of a foreign subsidiary may have been unwilling to "pass" a regular dividend date because of the expectations of certain foreigners who held some shares in the American enterprise's foreign subsidiary. Dividends are also frequently declared.

\textsuperscript{131}T.D. 6160, § 504.106.

in the early part of one year, it being contemplated that the distribution was of the preceding year’s profits.

In circumstances such as these, for purposes of the deemed-paid credit it is necessary to determine which year’s profit will be deemed to have been distributed. Only then is it possible to identify which year’s foreign taxes are to be credited against the American tax liability on the dividend.

The enactment of the deemed-paid credit in 1918 was followed shortly thereafter by delegation of power to the Treasury to resolve this question of timing in each case, subject to two important limitations.133 This same arrangement prevails today.134

The first limitation is to the effect that dividends paid within the first 60 days of any taxable year are to be treated by the Secretary of the Treasury as having been paid from the accumulated profits of the preceding year or years “unless to his satisfaction shown otherwise. . . .”135 In all other respects, according to the second limitation, dividends are to be treated as having been paid from the “most recently” accumulated profits. This latter rule means that dividends declared in December 1960 in an amount exceeding the profits of 1960 will normally be deemed, to the extent of the excess, to have been paid first from profits of 1959, if any, and to the extent not absorbed by the accumulated profits of that year, then from those of 1958, etc. And to the extent the declaration was deemed to be from 1958 profits, the deemed-paid credit allowed at the time of the dividend in 1960 will normally relate to foreign taxes paid by the subsidiary on the 1958 profits. As a consequence, the deemed-paid credit attributable to the 1960 dividend could require separate computations with respect to the subsidiary’s foreign taxes for 1960, 1959, 1958, etc., in order to determine for each of those years, pursuant to § 901, what portion of each particular year’s tax was paid on the profit actually distributed.136 In other words, to each of those years one first must separately apply the formula previously discussed in Subsection 1, supra, reading as follows:

\[
\text{Share of 1960 Dividend} = \frac{\text{Foreign Tax Paid by Subsidiary for a Particular Year}}{\text{Entire Accumulated Profits of That Particular Year}} \times \text{Attributable to Profits of a Particular Year}
\]

133 Rev. Act of 1921, § 238(e).
134 I.R.C., § 902(c).
135 The problem of proof is illustrated by P. H. Peavey & Co. v. U.S., (Ct. Cl. 1932) 73 Ct. Cl. 600, 55 F. (2d) 516.
136 General Foods Corporation, 4 T.C. 209 (1944).
The results from those separate determinations are then aggregated for the purpose of determining the deemed-paid credit attributable to the 1960 dividend. 137

It will be recalled also from the earlier discussion in Subsection 1, supra, that the per-country limitation will require a further computation. But this will be less complex. Its limited purpose, to prevent the credit for a particular foreign country’s tax on the distributed profit from offsetting American taxes on income derived from sources other than that foreign country, does not require the type of unscrambling essential to the original computation of the credit. The per-country ceiling on the total direct and deemed-paid credit 138 otherwise ascertained is determined by the same formula used where the subsidiary distributes dividends only from current profits, 139 namely:

\[
\text{Parent’s U.S. Tax on Entire Taxable Income} \times \frac{\text{Total Dividends From Country Y}}{\text{Parent’s Entire Taxable income}}
\]

(c) Extent to which the deemed-paid credit is limited to “dividend” situations.—From 1918 to 1954, a deemed-paid credit could only be taken upon the receipt of a “dividend.” 140 The significance of this limitation is illustrated by a decision of the Court of Claims to the effect that a parent corporation could not take such a credit in connection with liquidation distributions received from a subsidiary even though the distribution included previously accumulated profits on which the subsidiary had paid substantial foreign income taxes. 141 The Code treats such payments as proceeds from an “exchange,” rather than a dividend. 142 And because this is so, the parent corporation will usually enjoy the preferential treatment accorded capital gains, i.e., a 25% rate on the realized gain, 143 rather than suffer the ordinary tax rate—assumed in this study to be 52%—on the entire proceeds. The Court of Claims, in restricting the deemed-paid credit in accordance with the literal language of the statute, was comforted by the supposition that Congress could not

138 United Shoe Machinery Corp. v. White, (1st Cir. 1937) 89 F. (2d) 363.
140 Rev. Act of 1918, § 240(c), now reflected in I.R.C., § 902(a) through (c). The term “dividend” is controlled by the definition in I.R.C., § 316.
142 I.R.C., § 331.
143 This assumes that the corporation is not collapsible. See I.R.C., § 341.
have intended to allow both this preferential treatment and a credit for foreign taxes. 144

Presumably the deemed-paid credit was not originally extended to cover interest payments because of the absence of a double tax problem with reference to such payments. Most foreign countries, including all Common Market nations, allow a subsidiary to deduct interest paid its parent, up to a reasonable amount, in arriving at the subsidiary's foreign tax base. 145 This is not to say, of course, that all member nations also immunize the parent with respect to the interest payment it receives. Indeed, in the typical situation, four of the six member nations will apply a withholding tax against the parent. 146 But in this circumstance, the direct credit is allowed, 147 dollar for dollar, subject only to the per-country limitation upon total credits attributable to income from the source country.

In 1954, for the first time, Congress did link the deemed-paid credit to a type of payment which a foreign subsidiary might be able to deduct in computing its own foreign tax base, specifically to "property" paid "in the form of royalty or compensation" for "property or services . . . furnished" by the parent to the subsidiary. 148

In this instance, however, three conditions, otherwise not applicable to the deemed-paid credit, must be satisfied:

(1) In contrast to dividend situations where the deemed-paid credit is allowed if the domestic corporation owns at least "10% of the voting stock" 149 of the foreign corporation from which it received the dividend, here the former must own, directly or indirectly, "100% of all outstanding stock" of the subsidiary; 150

(2) In contrast to the dividend situation where the deemed-paid credit is available without regard to the nature of a sub-

---

144 In any instance where the deemed-paid credit would be more valuable than the preferential treatment accorded capital gains, the subsidiary might stagger the distribution, declaring a large regular dividend before proceeding with liquidation. But in such case, care must be taken or the Service may claim that all of the payments fall on the liquidation side of the line.

145 See Section B, supra, and the country-by-country survey in PART I, supra, with reference to the French and German limitations.

146 Ibid. Belgium and France are limited by treaty to 15% (Arts. VIII(A) and 6A, respectively); Germany must exempt such payments (Art. VII); Italy and Luxembourg are free to apply their respective national laws (26.32% and 5%, respectively); and the Netherlands own law does not normally provide for a tax except where the loan is secured by a mortgage on real property. Cf. its treaty provision, Art. VIII.

147 Unlike the deemed-paid credit, the direct credit is available with respect to any income item, so long as the foreign country also exacted a qualifying tax.

148 I.R.C., § 902(d). The congressional committee reports say nothing about the motive which led to this enactment.

149 I.R.C., § 902(a).

150 I.R.C., § 902(d) (1).
subsidiary's foreign business activity, covering even sales subsidiaries, this credit is extended here to the different type of payment only if the subsidiary is engaged in "manufacturing, production, or mining"; 151

(3) Here the property received as royalty or compensation must be pursuant to a contractual arrangement which must also provide that the payment "shall be accepted in lieu of dividends and that such foreign corporation shall neither declare nor pay any dividends . . . in any calendar year in which such property is paid to" the parent. 152

If these conditions are satisfied, then the property received by the parent shall be deemed a "distribution" 153 and ultimately a dividend—assuming the foreign subsidiary has adequate earnings and profits to pay such 154—to the extent of the difference between the value of that distributed and the cost to the parent of the "property or services so furnished" to the subsidiary.

By subsequently agreeing that the expression, "property" received, included money, the Internal Revenue Service has made this provision much more meaningful. 155 The Service has also properly called for a slight modification in the formula which is normally otherwise used in calculating the amount of the deemed-paid credit. The formula typically used,

\[
\text{Foreign Taxes} \times \frac{\text{Dividend}}{\text{Subsidiary's Accumulated Profits Before Foreign Income Taxes}},
\]

contemplates that the denominator of the fraction will include the subsidiary's profits for the year before deducting its income, war profits, and excess profits taxes. In the case of this new special arrangement, the Service has ruled that the "dividend" portion of the royalty or other compensation must be restored to the denominator even though, pursuant to foreign tax law, it had been deducted by the subsidiary. 156 Illustratively, assume that a domestic parent received $50 in service fees from a wholly owned foreign subsidiary, the full amount having been deducted by the latter for foreign in-

151 Ibid.
152 I.R.C., § 902(d) (2) and (3).
153 Controlled by I.R.C., § 301 except with respect to the amount and basis.
154 See I.R.C., § 316.
155 Rev. Rul. 55-312, C.B. 1955-1, 80. This interpretation rested on the fact that § 902(d) is expressly made dependent upon I.R.C., § 301 which uses the term "property" as defined in I.R.C., § 317. The latter includes "money" in the definition.
156 Rev. Rul. 59-71, C.B. 1959-1, 194, relying on the underlying philosophy of Biddle v. Commissioner, 302 U.S. 573, 58 S. Ct. 379 (1938), and the fact that, for purposes of the new § 902(d), a portion of the distribution is a "dividend" under American law, however it may be treated by foreign law.
come tax purposes, leaving it with $500 in foreign income on which it paid foreign income taxes of $200. The cost to the parent of the service extended to the subsidiary amounted to $2. The deemed-paid credit would be computed as follows:

$$\frac{$48 \text{ Dividend}}{$548 \text{ Accumulated Profit}} \times $200 \text{ Foreign Tax} = $17.50$$

As indicated in PART II, Section C, *supra*, subsidiaries in all Common Market countries may treat royalties paid a U.S. parent—for use of a patent, copyright, etc.—as a deductible business expense, but only to the extent the royalties are fair in amount and do not represent a hidden distribution of profits. One would certainly expect this limitation to be policed most carefully in those cases where the parent contractually commits itself, as it must under the new § 902 (d), to accept the royalty “in lieu of dividends.” Moreover, in the unlikely event a subsidiary did succeed in deflecting all of its profit to the parent via deductible royalty payments, there would be no foreign income tax against which the new § 902 (d) deemed-paid credit could be applied. This suggests that the new provision will be most useful over the long run in circumstances similar to the illustration above, where the subsidiary retained its own taxable profits for expansion, only a reasonable royalty having been paid to the parent during the taxable year. And in this case, again by reference to PART II, Section C, five of the Common Market countries are also precluded by treaty from withholding an income tax against the parent for the royalty it receives so long as (1) the royalty related to “the right to use copyrights, patents, secret processes and formulae, trade marks, and other analogous rights,” 158 and (2) the parent did not maintain a “permanent establishment” in the country in question. 159

(d) Required characteristics of a foreign tax if it is to qualify for the credit.—The credit for foreign taxes was originally confined to foreign “income, war profits, and excess profits taxes.” 160

157 While a part of the parent's overhead entered into the calculation of the $2 in cost, it may also be necessary, for purposes of the credit, to attribute another part of the parent's overhead to the collection of the dividend, in which case the latter would be less than $48. *Cf.* International Standard Electric Corporation v. Comm'r., (2d Cir. 1944) 144 F. (2d) 487, *cert. denied*, 323 U.S. 803, 65 S. Ct. 560 (1945).

158 PART II, Section C indicates those instances where coverage differs from this.

159 PART II, Section C outlines the dispute which exists with reference to this question.

160 Rev. Act of 1918, § 238(a)[1], now I.R.C., § 901.
In the middle of World War II, at a time when the United States had tacked an excess profits tax on to increased regular corporate rates, the Senate Finance Committee’s attention was called to new tax patterns which had been developed in Latin America, this being the area to which American foreign trade had then become restricted because of war-time conditions.161 Several countries in that area had encountered difficulty in determining the portion of an American enterprise’s profit which should be deemed to have its source there. In some cases, tax administrators there found it impractical to attempt to unravel deductions covering expenses alleged to have been incurred in the United States with reference to items exported into Latin America. In other instances, the difficulty related to the proper allocation of profit derived from items exported from Latin America to the States. International shipping operations also presented difficult allocation problems. Because of these difficulties, some of the Latin American countries substituted more simply designed special taxes for the income tax which the enterprise would have otherwise borne. While at least some of these levies were intended to produce an amount approximately equal to that which the Latin American country believed should have been produced by their income tax in a normal year, the formal character of the tax itself departed rather markedly from the typical net income tax which had evolved in the States. That formal difference led the Internal Revenue Service to deny that the taxpayer was entitled to a credit, arguing that American tax concepts controlled the meaning of the eligible categories, “income, war profits, and excess profits taxes.” 162

The Senate Finance Committee,163 and ultimately the Congress, responded to this problem by providing that the eligible category would also include “a tax paid in lieu of a tax upon income, war profits or excess profits otherwise generally imposed” by any foreign country.164

This latter provision has been said to extend the credit to an otherwise ineligible foreign tax only if the foreign country has in force a general income tax to which the taxpayer would have been subject in the absence of a special immunizing provision.165 More-

162 E.g., note the government’s position in Seatrain Lines, Inc., 46 B.T.A. 1076 (1942), and its subsequent nonacquiescence to the decision reached there. C.B. 1942-2, 31.
165 I.T. Regs., § 1.903-1(a).
over, the government insists that the statutory phrase, “a tax paid in lieu of” an otherwise eligible tax, means that adoption of the former tax must have been the quid pro quo for that freedom which the taxpayer received from the otherwise generally applied income tax. 166 In other words, there must be a link between the two; if the taxpayer's freedom from the general income tax was not attributable to its payment of a special foreign tax, the in-lieu-of provision will not apply. For example, the government denies that the provision covers German turnover taxes on royalties received from Germany even though such royalties were not subjected to the latter’s income tax. The denial was grounded on the fact that freedom from the foreign income tax grew out of bilateral tax treaties designed to prevent double income taxation rather than out of any arrangement calling for substitution of a turnover tax. 167

Of more general interest than the in-lieu-of provision with respect to the Common Market is the problem of identifying those taxes which will be deemed “income taxes” under the original basic provision.

The courts have not fully agreed on the underlying standard or yardstick to be used in determining whether or not a given tax will be deemed an income tax. As previously noted, it is, on the one hand, definitively settled that American, rather than foreign, income concepts control, 168 and as a consequence the typical gross receipts tax will usually fall short of the mark. 169 For example, as was true of the German turnover tax, 170 the Service has indicated that the French registry tax imposed on the transfer of real estate by reference to the total purchase price is not eligible for the credit. 171

At the other extreme, it is also generally recognized that the foreign tax need not coincide at all points with our statutory concept. For example, there may be some difference with respect to inclusions and deductions. 172 Indeed if this were not so, the congressional aim in enacting the original credit provision would have been completely frustrated; all foreign income taxes differ in one degree or

---

170 See note 167, supra.
171 Rev. Rul. 56-507, C.B. 1956-2, 120. However, the tax may be deducted from gross income by the person against whom it is imposed. Also, see G.C.M. 8478, C.B. IX-2, 224 (1930) re a special French turnover tax.
another from the American statutory version. Uncertainty necessarily increases, however, as the differences become more marked; for example, what result should be reached if the foreign tax reaches gross income as distinguished from gross receipts, provision not having been made for any of the more important deductions? One court, pointing to the fact that the Sixteenth Amendment had been held to embrace gross income, indicated that it was perhaps enough that this constitutional norm be satisfied. To this decision, however, the government filed a non-acquiescence. On a later occasion, the same court talked as though the American statutory concept really constituted the basic point of reference, only thereafter to see the Service exclude a Mexican tax because "liability for the tax arises at the time the operation to the tax takes place, whether or not income in the [American] constitutional sense results." Interestingly enough, these twists and turns came after the Supreme Court, while deciding a related but admittedly different question arising out of the credit provision, had stated in Biddle v. Commissioner:

The phrase "income taxes paid," as used in our revenue laws, has for most practical purposes a well understood meaning to be derived from an explanation of the statutes which provide for the laying and collection of income taxes. It is that meaning which must be attributed to it as used in § 131 [now I.R.C., § 901 et seq. governing foreign tax credits].

That Court actually had before it a question which will be common, though quite probably less prejudicial, to all of the Common Market withholding taxes on dividends. The issue was whether an individual stockholder, at the point of receiving a dividend, was entitled to a direct credit for his equitable share of the regular corporate tax suffered by the distributing company at the time its profits were earned. While the stockholder, pursuant to British surtax provisions, "grossed up" the dividend by also including in his gross income an allocate share of the corporate tax and then credited the latter against his British surtax, the Court denied him an American tax credit for his portion of the British corporate tax. That American tax laws—the basic yardstick—did not attribute taxes assessed

175 See Lanman & Kemp-Barclay & Co. of Columbia, 26 T.C. 582 (1956); L. Helena Wilson, 7 T.C. 1469 (1946).
177 302 U.S. 573 at 579, 58 S. Ct. 379 (1938).
against the corporation to stockholders as such was said to be decisive.

While the principle of the Biddle case, as applied to the United Kingdom, was subsequently modified by treaty,178 the point decided there is still relevant to Common Market withholding taxes on dividends paid by subsidiaries or by their sub-subsidiaries. Unless foreign law treats those taxes as assessments against the distributee, withholding serving as a collection device, so-called dividend taxes paid by a foreign subsidiary on dividends distributed to the American parent will come under the deemed-paid credit provision, if any, rather than under the direct credit provision.179 And in like fashion, the dividend tax withheld by a sub-subsidiary would come under the special deemed-paid credit arrangement applicable to a sub-subsidiary’s own tax, and would not be treated as a part of the distributee-subsidiary’s own direct tax liability.180

The same type of problem arises, of course, in connection with the deduction allowed for other foreign taxes. For example, a foreign stamp tax is deductible only by the person against whom the tax is imposed, even though another may actually suffer its economic burden.181

Unfortunately for those engaged in tax planning, the Internal Revenue Service has not published many rulings directly responsive to the foregoing questions in the setting of Common Market taxes. This may be due to its realization that, at least theoretically, such rulings would have a relatively short effective life in that each amendment of a given foreign tax law would require reconsideration of the government’s position even though, in the end, it might not be changed.182 In any event, the paucity of published rulings plus the possibility that amendments to a foreign law might lead the government to reconsider its position suggest that one engaged in planning should, after making preliminary comparisons, seek advance rulings before tentative plans are finalized.

In this connection, a final common problem involves the multiple

180 The credit arrangement, as it bears on a sub-subsidiary, is discussed in Section E, Subsection 2, infra.
181 Rev. Rul. 56-507, C.B. 1956-2, 120. In holding that the French registry tax fell into the deductible category, the Service avoided deciding on which person the tax was imposed, saying only that it was deductible by the person who properly paid it.
182 E.g., since the last published ruling on the Netherlands income tax as applied to dividends (I.T. 3371, C.B. 1940-1, 102), the tax pattern of that country has been changed.
TAXATION

base Common Market enterprise or trade taxes. On the one hand, as previously noted, full credit—subject only to the per-country limitation—may be enjoyed though the foreign tax includes within its base some items which the United States does not in fact tax as income. For example, the Cuban income tax was not disqualified even though it reached stock dividends, an item not in fact taxed by the Internal Revenue Code and perhaps even constitutionally beyond its reach. In explaining its favorable position in such cases, the Internal Revenue Service has said:

When such a unified tax is imposed by a foreign country, its predominant character will determine whether the tax is an income tax and credit will be denied for the entire amount or allowed for the entire tax subject to the limitations of section 904 of the Code [the per-country limitation].

This “all-or-nothing” notion, geared to a balancing of the competing characteristics, will not be applied, however, if the foreign assessment does not actually rest on a unified interdependent tax base. Both the Tax Court and the Service have unraveled a multiple base foreign assessment, qualifying the income tax component while rendering ineligible the non-income tax factors. One such instance involved the German three factor enterprise tax, credit being allowed for the profit factor but not for that portion of the assessment representing taxes on capital employed in the business and on wages paid.

---

183 Helvering v. Campbell, (4th Cir. 1944) 139 F. (2d) 865.
185 I.R.C., § 305.

Contrary to the rationale of the stock dividend ruling was the decision denying a credit to that part of a British income tax assessment based on the “annual value” of real property. Woolworth Co. v. U.S., (2d Cir. 1937) 91 F. (2d) 973, cert. den., 302 U.S. 768, 58 S. Ct. 481 (1938). An earlier decision had allowed a credit for a somewhat similar tax imposed in France. Herbert Ide Keen, 15 B.T.A. 1243 (1929), approved in I.T. 2485, C.B. VIII-2, 252. Cf. denial of the credit for a so-called income tax imposed by Canada on a legacy, L. Helena Wilson, 7 T.C. 1469 (1946).

188 Lanman & Kemp-Barclay & Co. of Columbia, 26 T.C. 582 (1956) re a multiple base income and property tax; Rev. Rul. 56-51, C.B. 1956-1, 320.

While the general income tax in Italy, known as “RM,” was approved for credit
Procedure in initially claiming the credit.—The Treasury designed Form 1118 as the device by which to secure from corporations that information deemed essential to allowance and computation of the credit.\textsuperscript{190} In claiming a credit for foreign taxes already paid, the receipt or sworn copy,\textsuperscript{191} together with an accurate translation, must accompany the form. In the absence of a receipt, secondary evidence—such as a photostatic copy of the check or draft—will suffice.\textsuperscript{192} In the case of foreign taxes withheld from dividends, etc., secondary evidence—including submission of evidence relating to the foreign country's rates and withholding procedures—may be submitted absent direct evidence of the withholding.\textsuperscript{193}

Normally an appropriate copy of the foreign return must accompany Form 1118 if claim is made for accrued but unpaid foreign taxes.\textsuperscript{194} Excerpts from the taxpayer's accounts may serve, however, as a substitute if need be.

The immediate future is likely to see some change in the amount and type of information which must be furnished. In late 1960, Congress adopted an additional policing measure, clearly establishing the right of the government to obtain from domestic parents certain types of information relative to their foreign subsidiaries and sub-subsidiaries, which information the Treasury had always had the clear right to obtain with reference to foreign branches.\textsuperscript{194a} Included among the types of information which the Treasury may require are explanations regarding inter-company transactions, balance sheets, and analyses of accumulated earnings and profits covering even inclusions, deductions, etc. At this writing, regulations implementing the new provision have not been issued.

Finally, with reference to accrued foreign taxes, the District Director may also condition allowance of the credit upon the submission of a proper bond.

Conversion problems as they affect the credit, and questions relating to the use of the cash and accrual methods, are dealt with in Section E of PART IV.

\textsuperscript{190} I.T. Regs., § 1.905-2(a) (2) and (b) (1).
\textsuperscript{191} A duplicate original or a certified, authenticated or sworn copy. I.T. Regs., § 1.905-2 (a) (2).
\textsuperscript{192} I.T. Regs., § 1.905-2 (b) (3).
\textsuperscript{193} Pub. Law 86-780, 86th Cong., 2d Sess. (1960), § 6, adding a new § 6038 to the Code, the old § 6038 being renumbered as § 6039.
SECTION D. FURTHER FOREIGN AND AMERICAN TAX EFFECTS WHERE FOREIGN PERMANENT ESTABLISHMENT OR SUBSIDIARY IN ONE MEMBER NATION EXPORTS DIRECTLY TO CUSTOMERS IN ANOTHER

(a) Introductory note.—In developing plans for marketing a product in more than one member nation, an American enterprise may well consider, *inter alia*, creation of a foreign permanent establishment or subsidiary in one country with the expectation that it will also export directly to customers in one or more other affiliates of the Common Market. Potential tax implications of such an arrangement depend on: (1) whether the export profits will be taxed by more than one member nation; (2) whether multiple turnover taxes will be encountered; (3) whether one country, as distinguished from another, offers a more favorable direct tax climate; and (4) the extent to which the increase in foreign taxes, if any, will serve further to reduce American tax liability. These questions are considered separately under the sub-topics which follow.

(b) Extent to which export profits will be taxed by the importing as well as the exporting member nation.—Under the respective national laws of member nations, the exporting country in which the permanent establishment or subsidiary is located will, of course, reach the entire profit made from direct export operations. For a comparison of the direct tax load which each member nation would impose if it were the exporting country, see the discussion and charts in sub-topics (b) and (c) of Section B, *supra*.

With regard to the importing country, it should be noted at the outset that the Common Market arrangement does not include a multilateral tax treaty dealing with double taxation. Only bilateral arrangements exist. The status of treaties of this sort is reflected in Table III M.

Under the treaties in force or concluded but not yet ratified, the importing countries will respond in a manner similar to that provided for in other bilateral tax treaties to which the United States is a party. This means, according to the more detailed discussion in PART II *supra*, that the importing country will not attempt to reach any part of such profits unless a permanent establishment or subsidiary has been established in the importing country.

The chart on the next page indicates that a treaty between
Table III M
TREATY STATUS CHART

Meaning of Symbols

<table>
<thead>
<tr>
<th>Symbol</th>
<th>Meaning</th>
</tr>
</thead>
<tbody>
<tr>
<td>F</td>
<td>In force</td>
</tr>
<tr>
<td>C</td>
<td>Concluded but not yet in force</td>
</tr>
<tr>
<td>OFC</td>
<td>Old treaty in force, but to be replaced by new treaty which is concluded but not yet in force</td>
</tr>
<tr>
<td>N</td>
<td>Under negotiation</td>
</tr>
<tr>
<td>NONE</td>
<td>Treaty not even under negotiation</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Belgium</th>
<th>France</th>
<th>Germany</th>
<th>Italy</th>
<th>Luxembourg</th>
<th>Netherlands</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belgium</td>
<td>—</td>
<td>F</td>
<td>N</td>
<td>F</td>
<td>F</td>
<td>F</td>
</tr>
<tr>
<td>France</td>
<td>F</td>
<td>—</td>
<td>OFC</td>
<td>OFC</td>
<td>F</td>
<td>F</td>
</tr>
<tr>
<td>Germany</td>
<td>N</td>
<td>OFC</td>
<td>—</td>
<td>F</td>
<td>NONE</td>
<td>C</td>
</tr>
<tr>
<td>Italy</td>
<td>F</td>
<td>OFC</td>
<td>F</td>
<td>NONE</td>
<td>—</td>
<td>NONE</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>F</td>
<td>F</td>
<td>F</td>
<td>NONE</td>
<td>—</td>
<td>NONE</td>
</tr>
<tr>
<td>Netherlands</td>
<td>F</td>
<td>F</td>
<td>F</td>
<td>C</td>
<td>NONE</td>
<td>—</td>
</tr>
</tbody>
</table>

Luxembourg, on the one hand, and Italy and the Netherlands, on the other, is not even under negotiation. Accordingly, where the former or the latter receives imports from the other, direct taxes imposed by the two countries would depend entirely upon the character of their respective national laws. However, in the case of exports between Luxembourg and the Netherlands, the tax effect is quite similar to that which would follow under a typical treaty. While the exporting country will reach the entire profit, the importing country will not assess direct taxes if a permanent establishment has not been created there. A different consequence follows in the case of exports from Luxembourg to Italy. The latter, as the import country, will impose its income tax whether or not a permanent establishment exists there, provided the exporter is active in Italy in a regular and habitual manner. While Luxembourg, as the exporting country, will also tax the entire export profit, it will allow a deduction against income for the amount of Italian taxes paid, if any.

(c) Extent to which exports from one member nation to customers in another will encounter multiple turnover taxes.—Generally speaking, as distinguished from customs duties, the turnover tax imposed by a member nation at the point of import will not vary
by reference to the different countries from which the goods could have originated. Illustratively, the turnover tax imposed by Italy at the point of import will be the same whether the goods originated in the United States or in France. The one exception grew out of a special formal economic relationship which includes Belgium and Luxembourg. Pursuant to that arrangement, Belgium has agreed to forego the increased turnover tax which it would otherwise assess at the point products are imported from Luxembourg.

Earlier discussion in Section B of PART II indicated in some circumstances that certain import countries (Netherlands, Germany, Luxembourg, and France) may assess one turnover tax at the point of import and another at the point of delivery. In the Netherlands, for example, reservation of title up to the point of actual delivery will lead to a second taxable event (normal rate .75% at the point of delivery). The same result will follow in Luxembourg and Germany if the goods are transported by the exporter's own vehicles (2% and 4% applied, respectively, if exporter was the manufacturer or if he delivers the goods directly to private consumers). The earlier mentioned discussion in Section B of PART II, supra, also explores various means by which the second taxable event might be avoided. While arrangements relating to delivery in France can also theoretically complicate the turnover tax problem, the end result is less serious there because France's tax is essentially one on added value with the consequence that the tax paid on a second taxable event will be offset by a credit for the tax paid on the first taxable event.

In all member nations, the exporting country will allow the export transaction itself to be exempt from its turnover tax. But only four of them (Netherlands, Germany, France, and Italy) quite generally provide some kind of refund for turnover taxes paid in connection with earlier transfers in the course of which the product was created. While the German formula for computing the refund is less exact than that of the Netherlands, in general both refund the turnover taxes previously paid when the exporter bought the goods or the raw materials out of which he manufactured the goods or, if imported by him, they refund the tax paid on that occasion. Under the French system, on the other hand, the entire turnover tax burden previously suffered by the product will be refunded, as well as that portion of turnover taxes borne in connection with the acquisition of capital goods which were used in manufacturing the exported item. Administratively, it is easier for the French to calculate and refund
the exact amount of turnover taxes previously borne by a product. Under its turnover tax system, records of taxes previously borne must be kept quite generally, for these serve as a credit against the gross tax due at later stages, the aim being to reach only the value added at any given stage. Finally, in Italy, factors reflecting a rough approximation of turnover taxes previously paid are used in determining refunds allowed on special lists of various types of goods.

Belgium does not attempt at the point of export to make restitution of any turnover taxes previously paid. However, it is possible to import goods or raw materials into Belgium tax free if they are ultimately destined for export.

Luxembourg provides a modest restitution (0.5%) at the point of export only in the case of certain metallic products.

(d) Conclusion: Foreign tax factors to consider if a foreign permanent establishment or subsidiary is to engage in direct export to customers in other member nations.—All other things being equal, differences in the direct tax structure of member nations may well affect the location of a foreign permanent establishment or subsidiary if it is also expected to export directly to customers in other member nations. But in assessing the significance of direct tax differences, the American enterprise may not be going far enough, at least theoretically, if it compares just those burdens which each member nation would impose if it were the exporting country. Consideration should also be given to differences which may appear if each were placed in the position of being an importing country, instead of being the home of the permanent establishment or subsidiary. The possible importance of this last feature is illustrated by a case where Italy is to be a significant market. In that event, Luxembourg would suffer one disadvantage, at least in principle, if it were considered as the potential site for the permanent establishment or subsidiary. It does not have an income tax treaty with Italy. And as noted in sub-topic (b) supra, in some circumstances Italy, as an import country, would apply its income tax to the trade profit. And Luxembourg would take account of the Italian direct tax only by allowing a deduction from gross income, as distinguished from a credit against the Luxembourg tax itself.

In choosing the site for the permanent establishment or subsidiary, it is also necessary to compare turnover taxes of each member nation, not just in terms of its possible role as an export nation, but also by reference to its practices if cast in the role of an import nation. For example, from an export standpoint, France offers the
most attractive turnover tax arrangement, because in principle all turnover taxes paid prior to export are refunded. Thus on the export side, a permanent establishment or subsidiary located there would encounter only the turnover taxes of those member nations into which goods are imported. While on this same count, the Netherlands and Germany constitute a close second and third to France, Luxembourg would again, at least in principle, provide the least attractive site. Turnover taxes paid there prior to the export transaction itself are not refunded except in a limited amount in the case of certain metallic products.

The foregoing discussion of direct as well as turnover taxes indicated that, *in principle*, Luxembourg suffered certain tax disadvantages as an export nation. In making comparisons, however, care must be taken to distinguish disadvantages in principle from those in fact. The two previously mentioned circumstances regarding Luxembourg are in point. While it does not have an income tax treaty with Italy, and though profits on exports to Italy might be taxed twice in some circumstances, the prejudicial circumstances are not in fact very great. Again, while Luxembourg does not refund turnover taxes paid prior to the export transaction, it will be remembered from the discussion in Section B of this PART that, comparatively speaking, turnover taxes in Luxembourg are not very high. Moreover, as previously mentioned in this Section, exports from Luxembourg to Belgium enjoy particularly favorable turnover tax treatment in the latter nation.

The difference between a disadvantage in principle and one in fact can also be illustrated by the problem of resolving ambiguities in the bilateral income tax treaties. In principle, the interpretative process in France is less attractive than that of certain other countries from a taxpayer’s viewpoint. There, more or less final interpretations are made by an administrative department, rather than by the courts. In the general run of cases, however, it is not believed that the effect has in fact been unfavorable.

(e) *Extent to which the importing member nation's taxes will serve to reduce American tax liability.*—According to the previous discussion, the *importing* member nation will not normally impose an income tax on any portion of the profits derived in the exporting member nation from simple export arrangements. Therefore, the export arrangement will not normally *further* complicate the computation of either the deemed-paid or direct credit for foreign income taxes in determining American tax liability, if any. The
credit for income taxes paid the exporting member nation will be available and determined, of course, in accordance with the principles described in Section C, supra. Subsection 2 of Section E, infra, will indicate the complication which will arise should the importing nation assess an income tax because it determines that a permanent establishment was in fact created therein or if, as in Italy—with respect to imports from Luxembourg, it is determined that the exporter was locally active in a regular and habitual manner.

To the limited extent the export arrangement may give rise to multiple turnover tax liability, prices will be increased or profits reduced. If a subsidiary corporation handled the export from the first member nation, that part of its gross profit devoted to the increased turnover tax liability, if any, will never be declared as a dividend and as a consequence will never be brought into the American parent’s gross income.

If, on the other hand, the exports were from an American corporation’s branch or permanent establishment in the first member nation, the increased turnover tax liability would be deducted in computing American “taxable income,” provided the liability was actually asserted by the foreign nation against the exporter and not against the importing vendee.\(^\text{195}\)

Section E. Further Tax Implications If a Foreign Operating Subsidiary in One Member Nation Creates Its Own Permanent Establishment or Subsidiary in Another Member Nation

Subsection I. Further Foreign Tax Implications

(a) A foreign subsidiary creates a permanent establishment in another member nation: The direct tax problem.—The discussion in Section D, supra, indicated that export profits realized by a subsidiary domiciled in one member nation would not normally be taxed by other member nations to which the products were exported. However, if the exporting subsidiary goes on to create its own permanent establishment in the importing member nation, the latter’s income tax will quite generally be applied to that part of the total profit which is properly attributable to the permanent establishment. While there are minor variations in bilateral tax treaties

\(^{195}\) The problem associated with the “liability” question is illustrated in Rev. Rul. 56-507, C.B. 1956-2, 120.
and relevant national laws with regard to the standards which will be applied in determining whether a permanent establishment has been created, reference to the general discussion of definitions in Section A of PART II and Section B of this PART must suffice for purposes of this study. Reference is also made to Section B of this PART for a comparison of the direct tax loads which each Common Market country would impose on such an establishment if subject to its jurisdiction.

The more important question is whether the profit of that permanent establishment will also be taxed by the quite separate domicile of the foreign subsidiary which created it. Such a second tax is one of the targets of bilateral tax treaties which are in force, or have been executed but not ratified, between various European countries. The status of those treaties is indicated in Section D, supra. Under such treaties, where the domicile of the subsidiary has a progressive rate structure (see PART I), the usual scheme is for that country to take account of the foreign permanent establishment’s profit only for the purpose of determining the rate bracket on the subsidiary’s other income. In short, the applicable percentage figure is determined by reference to the total income, but is actually applied only with reference to income other than that earned by and attributable to the foreign permanent establishment.

In the absence of a treaty precluding double taxation, one must look to unilateral provisions, if any, to mitigate the double tax possibility. Belgium, Germany, and the Netherlands have incorporated such in their national laws. Belgium reduces by \( \frac{3}{4} \)ths the normal rate which it would otherwise apply under its professional tax to the income of the foreign permanent establishment. Germany responds to the problem by allowing a tax credit. The same could be said with respect to the Netherlands, though relief there will normally be more favorable, leading in most instances to an exemption of foreign profits. Theoretically, the Netherlands would compute the amount of the credit without regard to the actual tax burden assessed on the foreign income by the other member nation. The credit would be determined by reference to the amount of the Dutch tax rate on the foreign income. As a practical matter, this generally relieves the foreign profit from the Dutch tax, for the Dutch rate schedule has little progression.

Although France does not have any specific unilateral relief provisions, the result there (and to some extent in Italy) will correspond for all practical purposes to the situation in the Netherlands,
for in principle only profits from domestic sources are taxed by France.

As previously indicated, any member nation in which the permanent establishment is located would apply its regular tax load to the income attributable to the establishment. Table III N indicates the instances where the domicile of the subsidiary which created the establishment would free that same income from double taxation, either through operation of a bilateral treaty or unilateral provision. The expression, "tax free," is used in Table III N in a more or less loose sense. In the instance where the domicile of the subsidiary has a progressive tax, that expression ("tax free") is used even though the domicile of the subsidiary would take the foreign profit into account in determining the rate which would be applied to the subsidiary's other income.

Immunity which might otherwise exist from a double tax will be prejudiced, of course, if the two countries do not allocate the overall profit in the same fashion. When this problem is encountered, the matter must be thrashed out with the proper tax authorities, for determination of a proper allocation is largely a question of fact.

(b) A foreign subsidiary creates its own subsidiary in another member nation: The direct tax problem.—If the first operating subsidiary which the American enterprise created in one of the Common Market countries (assume country A) establishes its own second tier subsidiary in yet another member nation (assume country B), the profits earned by the second tier subsidiary (No. 2) will be taxed to it only by country B, its domicile. Direct taxes which each member nation would impose on that second subsidiary if domiciled therein are compared in Section B, supra. Account is also taken there of differences which may arise in subsidiary No. 2's own tax load depending on whether its profits are retained in whole or in part.

At that point when the second subsidiary distributes profits in the form of dividends, there is the further question of whether both countries will assess a tax against the recipient, subsidiary No. 1. Any tax imposed on the latter by the distributing subsidiary's domicile would, of course, be handled on a withholding basis, as in the case of other non-residents. Table III O indicates whether and to what degree the two countries would seek to tax the recipient by reference to the dividend.

In determining the total direct tax costs, the tax exacted from the recipient of the dividend must be combined with the tax load orig-
<table>
<thead>
<tr>
<th>Location of Subsidiary's Foreign Permanent Establishment</th>
<th>Belgium</th>
<th>France</th>
<th>Germany</th>
<th>Italy</th>
<th>Luxembourg</th>
<th>Netherlands</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belgium</td>
<td>—</td>
<td>Tax Free</td>
<td>Tax Credit</td>
<td>Tax Free</td>
<td>Tax Free</td>
<td>Tax Free</td>
</tr>
<tr>
<td>France</td>
<td>Tax Free</td>
<td>—</td>
<td>Tax Free</td>
<td>Tax Free</td>
<td>Tax Free</td>
<td>Tax Free</td>
</tr>
<tr>
<td>Germany</td>
<td>Decreased Rate</td>
<td>Tax Free</td>
<td>—</td>
<td>Tax Free</td>
<td>Tax Free</td>
<td>Tax Free</td>
</tr>
<tr>
<td>Italy</td>
<td>Tax Free</td>
<td>Tax Free</td>
<td>Tax Free</td>
<td>—</td>
<td>Fully Taxed</td>
<td>Tax Free</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>Tax Free</td>
<td>Tax Free</td>
<td>Tax Free</td>
<td>Tax Free</td>
<td>—</td>
<td>Tax Free</td>
</tr>
<tr>
<td>Netherlands</td>
<td>Tax Free</td>
<td>Tax Free</td>
<td>Tax Free</td>
<td>Tax Free</td>
<td>Fully Taxed</td>
<td>—</td>
</tr>
</tbody>
</table>

196 Because of unilateral relief provisions.
197 The foreign tax is only deductible from income in arriving at the tax base.
<table>
<thead>
<tr>
<th>Domicile of Distributing Subsidiary</th>
<th>Belgium</th>
<th>France</th>
<th>Germany</th>
<th>Italy</th>
<th>Luxembourg</th>
<th>Netherlands</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividends from Belgium (Domicile of Distributee)</td>
<td>30%</td>
<td>30%</td>
<td>30%</td>
<td>30%</td>
<td>30%</td>
<td>30%</td>
</tr>
<tr>
<td>Dividends to Belgium (Domicile of Distributee)</td>
<td>nil</td>
<td>nil</td>
<td>nil</td>
<td>net amt. is reduction by 3%ths</td>
<td>nil</td>
<td>nil</td>
</tr>
<tr>
<td>Dividends from France (Domicile of Distributee)</td>
<td>24%</td>
<td>24%</td>
<td>15% **</td>
<td>24% **</td>
<td>24% **</td>
<td>nil</td>
</tr>
<tr>
<td>Dividends to France (Domicile of Distributee)</td>
<td>nil</td>
<td>nil</td>
<td>net amt. is subject to excess profit tax</td>
<td>credit of 15%; balance ded. from income</td>
<td>nil</td>
<td>nil</td>
</tr>
<tr>
<td>Dividends from Germany (Domicile of Distributee)</td>
<td>25%</td>
<td>25%</td>
<td>nil *</td>
<td>25%</td>
<td>25%</td>
<td>partly exempt</td>
</tr>
<tr>
<td>Dividends to Germany (Domicile of Distributee)</td>
<td>nil</td>
<td>nil</td>
<td>nil</td>
<td>net amt. is partly exempt</td>
<td>nil</td>
<td>nil</td>
</tr>
<tr>
<td>Dividends from Italy (Domicile of Distributee)</td>
<td>nil</td>
<td>nil</td>
<td>nil</td>
<td>nil</td>
<td>nil</td>
<td>nil</td>
</tr>
<tr>
<td>Dividends to Italy (Domicile of Distributee)</td>
<td>nil</td>
<td>nil</td>
<td>nil</td>
<td>nil</td>
<td>nil</td>
<td>nil</td>
</tr>
<tr>
<td>Dividends from Luxembourg (Domicile of Distributee)</td>
<td>15%</td>
<td>15%</td>
<td>10%</td>
<td>15%</td>
<td>nil</td>
<td>nil</td>
</tr>
<tr>
<td>Dividends to Luxembourg (Domicile of Distributee)</td>
<td>nil</td>
<td>nil</td>
<td>net amt. is subject to excess profit tax</td>
<td>nil</td>
<td>nil</td>
<td>nil</td>
</tr>
<tr>
<td>Dividends from Netherlands (Domicile of Distributee)</td>
<td>15%</td>
<td>15%</td>
<td>10%</td>
<td>nil ***</td>
<td>net amt. taxed</td>
<td>nil</td>
</tr>
<tr>
<td>Dividends to Netherlands (Domicile of Distributee)</td>
<td>nil</td>
<td>nil</td>
<td>net amt. taxed</td>
<td>net amt. taxed</td>
<td>nil</td>
<td>nil</td>
</tr>
</tbody>
</table>

See footnotes on facing page.
in use on the distributing subsidiary by its own domicile. Appraisal of the practical significance of the figures in the above chart would require, illustratively, that account be taken of the fact that Belgium and Germany would have assessed relatively low direct taxes against the distributing subsidiary itself, if domiciled there. And in all circumstances, it must be remembered that the recipient's tax base—the dividend—will be in an amount less than the distributing subsidiary's original taxable income even if the latter company distributed all of its available profit. That portion of its taxable income used to discharge its own tax liability to its domicile would not, of course, be available for distribution.

(c) Further foreign turnover tax implications.—In keeping with the principles discussed in Section D, supra, an export transaction from subsidiary No. 1 in country A to its own subsidiary in country B will be free of the export country's turnover tax. Also as indicated in that Section, the export subsidiary can obtain restitution of turnover taxes previously paid the export country at earlier stages of the product's development, this restitution being more or less complete except in Belgium and Luxembourg. While only the

* According to a new treaty.

** According to an old treaty.

*** According to a new treaty, otherwise 15%.

As is indicated in the next paragraph, the regular corporate income tax imposed by France will have little impact when a French parent company receives a dividend. However, it is true that the French withholding tax of 24% must be paid when the dividend is received, though at a reduced rate of 12% when received from Belgium and, when received from Luxembourg, less a credit for the Luxembourg withholding tax. But upon immediate distribution by the French parent company to its own stockholders, the withholding tax will not again be assessed. The stockholders are even granted a credit of the full 24% against the general income tax on their total incomes (including the dividend in question). Since other countries, in the absence of a tax treaty, would impose a withholding tax on this second event (see Section B, supra), i.e., when the parent distributes the dividend, an overall comparison would lead to the conclusion that the French withholding tax should be disregarded or treated, at least, as a prepayment of the kind of tax due elsewhere when the parent distributes a dividend.

As stated above, the regular French corporate income tax will have little effect when the parent company first received the dividend. It will be levied on only 25% of the dividends received by the parent. This tax is designed to take into account the fact that a certain amount of the parent's overhead costs, though deducted by it from its profits, actually related to a dividend which was not, in principle, otherwise taxable.

The 36% will apply if the parent company does not immediately distribute the amount as a dividend to its own shareholders.

Treaty provisions between the two countries limit Luxembourg as follows: For purposes of the Luxembourg corporate income tax, only the net amount received by the Luxembourg corporation from the German subsidiary may be taken into account, i.e., the 75% which remains after the German withholding tax is applied. Only 50% of that net is then subject to the Luxembourg corporate income tax. However, the full net is subject to the Luxembourg business or enterprise tax.
importing country's turnover tax is generally encountered under the foregoing arrangement, the chance of multiplying that tax is greater in this circumstance than when shipments are made from country A direct to independent customers in country B. The import or first taxable transaction will be followed by a second event, i.e., delivery by the receiving permanent establishment or subsidiary to its customers; in principle, that inland delivery will usually be treated as a second taxable event.

One might suppose that the rate applied to that second transaction would quite generally vary depending, inter alia, on whether the operation in country B was handled by a permanent establishment or a subsidiary. Assume, e.g., that the first subsidiary in country A had manufactured the product, shipping it to its sales office, a permanent establishment in country B. Since a permanent establishment is an extension of the manufacturing company in country A, delivery by the sales office to its own customers would be subjected in some countries to the rate applicable to manufacturers. A sales subsidiary in country B would usually be treated, however, as an independent entity for turnover tax purposes as well as other legal purposes. In other words, the rate applicable to wholesalers would usually be applied to its delivery, assuming this was not to the ultimate consumer. The two patterns just outlined have not always been adhered to, however, by Common Market countries.

Germany has frequently denied independent status to sales subsidiaries for the purpose of determining turnover tax rates, and in this circumstance has frequently applied the normal 4% manufacturer's rate, rather than the 1% wholesaler's rate, to the sales subsidiary's deliveries.

The Netherlands has followed the opposite tack; delivery by a sales office, whether a permanent establishment or a subsidiary, is deemed to have been made by a "dealer" subject to the ¾% rate, assuming the sale is not to the ultimate consumer in which case delivery is free of tax. This result stems from the fact that the first import transaction was deemed equal to a manufacturer's sale within the Netherlands.

Italy and Belgium do not normally impose different rates on manufacturers and wholesalers. Accordingly, the problem noted above is not significant in that locale.

(d) Conclusion: Choosing locale of foreign parent subsidiary, as affected by foreign tax considerations.—Comparison of the tax costs associated with the selection of a locale for a foreign subsidiary which is to create its own permanent establishment or sub-
sidiary in another member nation will be much less complex if the two will not be engaging in business transactions, such as exports, with each other. If in that circumstance, a permanent establishment is to be created in the second member nation, one need only integrate the effect of that nation's direct taxes with the direct taxes, if any, of the foreign subsidiary's domicile. If the latter of these two tax problems could be viewed in isolation, the ideal solution would be found in a fiscally neutral country, i.e., one which would not impose any direct tax on profits earned by a permanent establishment maintained elsewhere. From the chart in subtopic (a), supra, it appears, because of bilateral treaties or unilateral provisions, that France, Italy, and the Netherlands could provide such a neutral forum, with Belgium and Germany providing somewhat less attractive settings. It would be a mistake, however, to view the tax position of the controlling subsidiary's domicile in isolation. Indeed, when the tax costs of the two countries are integrated, a non-neutral country may actually furnish a more attractive domicile for the controlling subsidiary. Illustrative is the case where the controlling subsidiary's own earned income makes up the great preponderence of the total income earned by the two. In that circumstance, the fact that a country's tax on income earned domestically is lower than elsewhere may be more important in choosing the domicile for the controlling subsidiary than the fact that the country does impose some tax on income earned by a permanent establishment maintained elsewhere. This principle is illustrated in Table III P by comparing the total direct tax costs if non-neutral Belgium, rather than neutral Netherlands, were chosen as the site for a subsidiary which will earn $500,000 from its own activities, its permanent establishment in country X earning only $50,000.

The charted comparison indicates in the foregoing circumstance that, if all other things were equal, Belgium would provide a much more advantageous site for the controlling subsidiary. Table III Q illustrates that a different result can be reached, however, if one assumes the opposite facts, i.e., that the income earned by country X's permanent establishment (say, $450,000) will far exceed that earned by the controlling subsidiary (assume $100,000) from its own activities.

The two tables indicate that while Belgium was preferred as the site for the controlling subsidiary in the first assumed situation, the Netherlands would be preferred in the second, if all other things were equal. The fact that there are varying degrees in between the two situations suggests that absolute comparisons cannot actually
<table>
<thead>
<tr>
<th>Earned Income of Country X's Permanent Estab.</th>
<th>Country X's Assumed Rate</th>
<th>Country X's Tax</th>
<th>Parent Subsidiary's Earned Income</th>
<th>Netherlands' Rate</th>
<th>Netherlands' Tax</th>
<th>Belgian Rate</th>
<th>Belgian Tax</th>
<th>Total Tax Load</th>
</tr>
</thead>
<tbody>
<tr>
<td>Parent Subsidiary Domiciled in Neutral Netherlands</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>$50,000 50% $25,000 $500,000 47% $235,000</td>
<td>$25,000</td>
<td>$235,000</td>
<td>$260,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Parent Subsidiary Domiciled in Non-neutral Belgium</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>$50,000 50% $25,000 $500,000</td>
<td>3% of 30% 30% 150,000</td>
<td>3,000</td>
<td>150,000</td>
<td>$28,000</td>
<td>$178,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>--------------------------------------------</td>
<td>-------------------------</td>
<td>----------------------------------</td>
<td>----------------------------------</td>
<td>-----------------------------</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total Tax Load</strong></td>
<td>Parent Subsidiary in Netherlands</td>
<td>Parent Subsidiary in Belgium</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Parent Subsidiary Domiciled in Neutral Netherlands</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>$450,000</td>
<td>50%</td>
<td>$225,000</td>
<td>$100,000</td>
<td>47%</td>
<td>$47,000</td>
<td>$225,000</td>
<td>$272,000</td>
<td></td>
</tr>
<tr>
<td><strong>Parent Subsidiary Domiciled in Non-neutral Belgium</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>$450,000</td>
<td>50%</td>
<td>$225,000</td>
<td>$100,000</td>
<td>30%</td>
<td>$30,000</td>
<td>$252,000</td>
<td><strong>$282,000</strong></td>
<td></td>
</tr>
</tbody>
</table>
be made; results will differ depending on the precise circumstances.

The same is true if the controlling subsidiary creates a subsidiary in country X instead of a permanent establishment. Effective comparisons can only be made on the basis of certain assumptions, like those noted above. Here, however, it may also be necessary to take account of an additional tax on dividends. With reference to this circumstance, the Netherlands is the only neutral country, as is indicated in the charted comparison in subtopic (b), supra.

It was assumed throughout the foregoing discussion that the two affiliates would not indulge in business transactions with each other, such as exports from the parent subsidiary to the organization which it created in country X. While the direct tax loads will remain the same if such exports are contemplated, bilateral tax treaties, or—in their absence—unilateral provisions, require that the prices charged for products or services coincide for tax purposes with those which would be associated with transactions entered into at arm’s length by independent companies. Turnover taxes would also complicate the comparisons in this setting, in the manner described in sub-topic (c), supra.

SUBSECTION 2. INTEGRATING FOREIGN AND AMERICAN INCOME TAX IMPLICATIONS

(a) Introductory note.—The method of determining an American company’s gross income will not be further affected by the question of whether its own operating subsidiary in one Common Market country creates a permanent establishment or a subsidiary in a second member nation. The parent’s gross will still be dependent upon dividend payments from its own subsidiary. And everything said in Section C, supra, and in PART IV, infra, with reference to this question would be applicable here. In terms of principles, the prime previously undiscussed complication created by the subsidiary’s extension of facilities into a second member nation relates to the credit for foreign income taxes. Since this will be affected in different ways, depending on whether a branch or sub-subsidiary is created in the second Common Market country, the two arrangements will be discussed under separate sub-topics below.

While the succeeding Section F will then go on to compare the principles governing these two-tier foreign arrangements with those applicable to the American parent’s own establishment of “sister” foreign facilities, it should be noted here that the former’s
practical advantages are actually similar, though not identical on all counts, to those associated with the use of a pure foreign holding (or "base") company created to own operating facilities. Reference is made, therefore, to Section G, infra, for an analysis of those practical advantages, though in the setting of a foreign base company arrangement.

(b) Credit for foreign taxes where foreign subsidiary creates own permanent establishment in a second member nation. —Where a foreign operating subsidiary creates its own permanent establishment (branch) in a yet different member nation, the initial computation of the credit for foreign income taxes is not affected. The provisions authorizing both direct and deemed-paid credits are addressed to the income, war profits, and excess profits taxes of "any" foreign country, not, in our illustration, just to those taxes of the first member nation in which the American parent's own subsidiary was incorporated. Illustratively, when the parent receives a dividend from the subsidiary, the deemed-paid credit allowed by § 902 would be computed in the first instance by multiplying the aggregate foreign income taxes of the subsidiary by the traditional fraction, the dividend being the numerator, and the pre-tax accumulated profits being the denominator.

The literal language of the per-country limitation in § 904 is not so easily applied. That provision expressly limits the total credit for taxes paid "any country" by a fraction, the numerator generally being the "taxpayer's taxable income from sources within such country," with the denominator being the taxpayer's entire taxable income. Of what significance is it that the subsidiary in our illustration would pay income taxes to more than one foreign country, while the American parent would actually derive foreign "taxable income" (a dividend) from only one such country? Admittedly, it was originally contemplated that the per-country limitation would generally be applied on a country-by-country basis. But it is equally true that the deemed-paid credit provision itself generally contemplated that an American parent would enjoy some credit with respect to the foreign income taxes paid by a foreign subsidiary to "any foreign country." In resolving the interpretative difficulty posed by the statutory language used in connection

201 I.R.C., §§ 901(b)(1) and 902(a).
202 The term "pre-tax accumulated profits" is used here to mean accumulated profits after deducting all direct taxes except those types which qualify for the credit.
203 Discussed generally in Subsection r(f) of Section C, supra.
204 The numerator cannot exceed the taxpayer's "entire taxable income."
205 I.R.C., § 902(a).
with the per-country limitation, the Treasury has neutralized any prejudice which the parent otherwise might have suffered as a result of the fact that the dividend had its source in but one country, that in which the subsidiary was incorporated. To that same country, the Treasury has attributed all of the income, war profits, and excess profits taxes paid or deemed to have been paid by that subsidiary even though such taxes may have been imposed by and paid to two or more different foreign countries.

In effect, this permits an averaging of the foreign tax loads imposed by two or more foreign countries, thus permitting some escape from the per-country limitation in that instance where one of the foreign countries had a higher, and the other had a lower, effective rate than the United States. The result is similar to that which would follow if an overall limitation, rather than per-country limitation, were applied to the credit.

(c) Foreign operating subsidiary creates own subsidiary in a second member nation.—Until World War II, the deemed-paid credit allowed an American corporation was confined to the foreign income taxes of its own foreign subsidiary; neither were "deemed," for purposes of the American credit, to have paid the foreign income taxes of a second tier foreign subsidiary, the stock of which was held by the first subsidiary. At that time, at least for deemed-paid credit purposes, it made greater sense if the parent's own foreign subsidiary created a permanent establishment instead of a subsidiary in the second European country. Or the latter's income taxes could also have been brought within the sweep of the deemed-paid credit provision if the parent itself created a second "sister" subsidiary there.

For a variety of reasons, a parent organization often preferred to handle its affairs in the second country through an entity incorporated there. But only if the latter was an unincorporated branch of the parent's first subsidiary was it easy to satisfy both of two succeeding tax aims: (1) to use the first facility's profits to develop and expand the second facility without having to route those profits through the American parent's gross income; and (2) in a later distribution stage, to enjoy a deemed-paid credit for the income

206 I.T. Regs., § 1.902-1 (c).
206a By virtue of legislation enacted in late 1960, the American parent could reach the same result by electing to submit its foreign tax credit to the newly revived "overall" limitation. Its ramifications, and the differences which may arise between it and the per-country limitation in a multiple-tier setting, are discussed in Sections F and G infra.
TAXATION

527

taxes of the second European country. Only the second of these could be achieved if the parent itself formed the second subsidiary, absent some sort of loan arrangement between the two subsidiaries.

In the middle of World War II, Congress resolved an American corporation's planning problem by extending the "deemed-paid" concept. It provided that a foreign subsidiary, upon receipt of a dividend from its own foreign incorporated subsidiary, "shall be deemed to have paid" a portion of the latter's income tax, the fraction to be of the same type as that previously used in connection with the parent's previously existing deemed-paid credit for the first subsidiary's tax.207

When initially enacted, the first subsidiary was deemed to have paid a fractional part of the second subsidiary's tax only if the former owned "all the voting stock (except qualifying shares)" in the second subsidiary.208 However, in 1950—in connection with the tax hearings designed to give further impetus to the Point 4 Program, Congress was urged by business to relax this requirement.209 The consequent reduction coincided with a downgrading in the proportion of ownership which the parent had to hold in the first subsidiary in order to be deemed to have paid a fractional part of its income taxes. A reduction to 10% in the latter situation210 was complemented by changing the word "all" to "50%" with reference to the voting stock which one foreign corporation had to hold in the sub-subsidiary.211 Indeed, these limitations were assertedly retained only because of certain "administrative" problems.212

Under the two deemed-paid arrangements, if the profits of both subsidiaries suffered the same amount of foreign tax, and if both distributed all of their after-tax profits, American gross income and the parent's deemed-paid credit would be equal to what they would have been if the first subsidiary had earned the entire foreign profit. Assume for example that each earned $100,000 on which

209 For example, see statement of Mitchell B. Carroll, Hearings, Committee on Ways and Means, 81st Cong., 2d Sess. (1950) Vol. 3, 623 at 626.
210 Rev. Act of 1951, § 332(a), now I.R.C., § 902(a).
211 Rev. Act of 1951, § 332(b), now I.R.C., § 902(b).
212 S. Rep. No. 781, 82d Cong., 1st Sess. 55 (1951). These administrative difficulties did not appear quite so formidable to a later inquiring House committee. In 1960 the Committee on Ways and Means proposed, and the House agreed, to reduce the 50% requirement as it related to a sub-subsidiary to 20%, the sponsoring Committee stating that this would "provide fully for any administrative problems." H. Rep. No. 2100, 86th Cong., 2d Sess. 3 (1960) re H.R. 11,681. When the session closed, the Senate had not reached consideration of this bill.
a foreign tax of 26% ($26,000 by each) was suffered. The first subsidiary would be "deemed to have paid" $19,240 of its own subsidiary’s foreign tax, computed as follows:

\[
26,000 \times \frac{74,000}{100,000} = 19,240
\]

The first subsidiary’s total foreign tax would now be $45,240 (own tax of $26,000 plus deemed-paid tax of $19,240) for which the American parent would get a deemed-paid credit of $38,480, computed as follows:

\[
148,000 \times \frac{45,240}{174,000} = 38,480
\]

If the first subsidiary had earned the entire profit of $200,000, suffering a 26% tax ($52,000), the parent’s deemed-paid credit would be computed as follows:

\[
38,480 \times \frac{148,000}{200,000} = 38,480
\]

The one-tier and two-tier deemed-paid arrangements will not give rise to like results, however, if there is a variation in the amount of tax suffered by the two facilities. In such case, the American parent could actually enjoy a slightly greater ultimate tax advantage from the sub-subsidiary or two-tier deemed-paid arrangement than from the older single subsidiary or one-tier deemed-paid arrangement. The reason is the same as that which was responsible for the ultimate tax advantage which a subsidiary arrangement enjoyed over a branch operation even in that case where all after-tax profits are remitted. In a period when the subsidiary and sub-subsidiary distribute all of their respective after-tax profits, that portion of the sub-subsidiary’s profits devoted to its own income tax never becomes gross income to the first subsidiary. Though this exclusion is economically equivalent to a deduction for that tax, the first subsidiary will still be deemed to have paid a part of that tax for credit purposes.

Even if an American enterprise intended only to have one subsidiary which in turn would have but one subsidiary of its own,

\footnote{A somewhat similar example is contained in H. Rep. No. 2333, 77th Cong., 2d Sess. 101 (1942).}

\footnote{See discussion in Section C, supra.}
the range of possible tax patterns and rate relationships in the Common Market is so varied as to preclude, at least in this type of study, any really meaningful comparison of the integrated American and foreign direct tax costs with respect to all of the location possibilities. With only the simple two-tier organizational structure described above, there would be 36 location possibilities within the Common Market. Comparisons, to be meaningful in the sense of being generally applicable, would have to go on to accommodate the infinite variety in relative sizes of the two facilities. And to the variety of rate structures which could be applied directly on operating profits, one would have to add the variation in rate patterns which might be applied to the inter-corporate dividends—in terms of the withholding taxes imposed by the sub-subsidiary's domicile as well as any tax which might be imposed by the distributee's own domicile at the time it received the dividend and again when the net was re-distributed to the American parent. On this one count, for example, only if the sub-subsidiary is incorporated in Italy, and the parent's own subsidiary is in the Netherlands, will there be no tax on dividends as such, except that imposed by the United States when the parent ultimately receives a distribution. But even in this setting, as in certain others, the fact that some Italian direct taxes would not seem to qualify for the credit further complicates the matter.

With reference to this general arrangement, however, it should be noted that—as in the case where the first subsidiary created a permanent establishment in the second member nation—those qualifying taxes of the sub-subsidiary deemed paid by the parent's own subsidiary will be treated, for purposes of the per-country limitation, as though imposed on the latter by its own country of incorporation. Here too, then, an averaging of the foreign tax loads is in effect substituted for the per-country approach in determining the limitation on the credit for foreign taxes.

Section F. Tax Implications If An American Enterprise Creates "Sister" Foreign Permanent Establishments Or Foreign Subsidiaries

(a) Introductory note.—The discussion in Section D, supra, indicated that double taxation within the Common Market itself would almost never arise in that instance where an American enterprise's Common Market subsidiary exported directly to customers in other member nations. Business reasons, however,
might make it desirable to have some sort of facility in the second member nation. Accordingly, the immediately preceding Section E considered the tax implications where the first operating subsidiary created its own permanent establishments (branches) or subsidiaries in one or more of the other member nations. That same Section indicated, however, that double taxation within the Common Market itself would be one cost associated with a few choices of locale in that instance where the Common Market subsidiary created its own permanent establishment in another member nation. That same result would follow in a few more instances if the first Common Market subsidiary created a subsidiary in the second member nation instead of creating a permanent establishment. Because certain choices of locale in these last two instances would involve double taxation within the Common Market itself, the total European direct tax load might exceed the American rate on dividends eventually received by the American parent. In that event, the unilateral relief provisions (a credit) in the Internal Revenue Code would be inadequate to avoid further double taxation.

Other difficulties may also be associated with the tier or chain arrangement. As is more fully explained in the discussion of base company operations in Section G, infra, the American parent might encounter some difficulty in availing itself of the special credit provision with respect to any royalties received from sub-sub­sidiaries. Also, as is more fully explained there, if the first operating subsidiary created permanent establishments in the other member nations, losses, if any, incurred by the latter would prejudice the opportunity to take a full credit for income taxes paid in those countries where the operations were profitable.

For the foregoing reasons, consideration might be given to a different type of organization, as follows:

![Diagram of American Parent with Common Market Permanent Establishments or Subsidiaries](attachment:diagram.png)
(b) Foreign direct taxes re "sister" facilities created by an American parent.—The charted arrangement above, involving creation by the American enterprise itself of "sister" foreign permanent establishments or subsidiaries, would completely avoid double taxation within the Common Market itself. The foreign direct tax implications would be identical to those discussed supra, in Section B.

If the American enterprise also contemplates direct exports to customers in those same member nations, an appropriate part of the export profit will generally be attributed to the permanent establishment located in the importing country. Sub-topic (b) of the preceding Section B compares the differences in tax loads which would be imposed by the various member nations in this circumstance. This same problem will arise if Common Market subsidiaries are used to represent the American enterprise in member nations, for in fact such a representative will usually constitute a permanent establishment. In this connection, see the discussions in PART II and in Section B of this PART III.

(c) American tax implications: In general.—Subject to one basic exception which arises only if a domestic parent so elects, the American tax implications associated with creation by a domestic parent of "sister" permanent establishments or subsidiaries in different Common Market countries would be governed by the principles described in the preceding Section C where discussion actually centered on creation of but one foreign facility designed only to serve one member nation. Illustratively, as distinguished from the chain arrangement discussed in the immediately preceding Section F, the profits of sister facilities in different countries would be isolated, one from the other, in applying the per-country limitation on the credit. Losses incurred by a branch in one country would not prejudice allowance of a full credit for foreign income taxes paid by a profitable branch in another country.

Another advantage, where sister subsidiaries are established, involves the American parent's opportunity, without difficulty, to avail itself of the special credit allowed under certain circumstances for royalties received in lieu of dividends. Tax-wise, the two most general shortcomings of this arrangement involve, first, the fact that, absent some inter-subsidiary loan ar-

---

216 I.R.C., § 904, discussed more fully in Section C, Subsection 1, supra.
217 Discussed more fully in the succeeding Section G.
217a Id.
rangement, profits of one subsidiary could not be used to expand another without routing that profit through the American parent’s income ledger. If branches are used, this would not be an additional difficulty, however; their respective incomes would be includible by the American parent whether or not remitted. The second disadvantage grows out of the application of the per-country limitation on the credit; that limitation would prevent averaging for the purpose of leveling out the different high- and low-tax countries, such as Germany and Belgium. However, by virtue of new legislation enacted in late 1960, this result can be avoided if the taxpayer chooses, by election, to substitute an “overall” limitation for the per-country limitation, as is more fully discussed in the immediately succeeding sub-topic.

(d) American tax implications: The alternative “overall” limitation.—Congress has not “hewn a straight path” with reference to the kind of limitation which should be applied to the credit for foreign taxes. The story 217b goes back to 1918 when, for a period of three years, a corporation’s affairs were viewed on a world-wide basis, the credit then being so designed that foreign taxes imposed at rates exceeding those prevailing in the United States could reduce American tax liability on domestic income. In terms of net effect, a world-wide average rate was actually applied. Then for eleven years, from 1921 to 1932, corporate affairs were divided into two parts, domestic and foreign, with an “overall” limitation on the credit serving to prevent total foreign taxes, wherever paid, from reducing the American tax on domestic income.217c The net effect, with respect to the limitation, was to permit a taxpayer to average out the high and low foreign income taxes, a disadvantage, generally speaking, only where losses were encountered in one of the foreign countries. Then for the succeeding twenty-two years, 1932 to 1954, two different sets of divisions were applied to a corporation’s affairs; its activities were first divided into two parts, domestic and foreign, to the same end as that noted above. Then they were re-divided on a per-country basis, the aim being to prevent the taxes of one country which might have a higher effective rate than the United States from being averaged with the rates of a low-tax country in determining the limit on the credit for foreign taxes paid the high-tax country.217d Only this latter per-

217b Discussed more fully in Section C, Subsection 1(f), supra.
country limitation survived the comprehensive revision of the Code in 1954, the overall limitation being eliminated.\textsuperscript{217e} The asserted reason related to the disadvantage which some taxpayers suffered as a result of the overall limitation, i.e., to the previously mentioned fact that losses incurred in one foreign country were averaged with profits in another country, thus increasing the chance of a reduction in the American credit for taxes actually paid the foreign country where profits had been reaped. Congress concluded that this tended to discourage companies from using their foreign profits to open new businesses in countries in which they had not previously carried on business.\textsuperscript{217e}

During the period when only the per-country limitation was in vogue (1954 to 1960), it was still possible, as noted in Subsection 2 of the preceding Section E, for an enterprise to organize its affairs so as to avoid the strict impact of the country-by-country approach. As noted there, where the American parent had its first foreign operating subsidiary create its own permanent establishments or sub-subsidiaries in other countries, for purposes of the per-country limitation, the American parent's entire income from the multi-country foreign operation (dividends) was deemed to have been derived from the country in which the first tier foreign subsidiary was incorporated, thus permitting what was in effect an averaging of high- and low-tax countries. The immediately succeeding Section G indicates that a like result was reached where ownership of the foreign permanent establishments or subsidiaries was consolidated under one foreign holding company.

In 1960, Congress re-examined the "limitations" question. Embarrassing any mutually exclusive congressional choice between the two methods ("per-country" and "overall") was the fact, as noted above, that for years taxpayers had enjoyed what was tantamount to an election between the two limitations; organizational form, not substance, made the difference.

In late 1960, the appropriate House and Senate committees agreed to resolve the problem by writing an election into the law itself, giving corporations a choice to conform either to the per-country or to an overall limitation. Those which had already been subject to the per-country limitation were given the unrestricted right to shift, at their own election.\textsuperscript{217g} While the Treasury Depart-

\textsuperscript{217e} I.R.C., § 904.
\textsuperscript{217g} Pub. Law 86-780, 86th Cong., 2d Sess. (1960) § 1, amending I.R.C., § 904.
ment had objected earlier to a somewhat similar proposal—pri-

marily because of the revenue loss involved, it indicated a will-
ingness to accept the Senate's variation on the House committee's proposal. Whereas the House would have permitted a corpora-
tion to shift from one limitation to the other every five years, the Senate would permit a company which invoked the overall limitation to shift to the per-country limitation, or later again shift back to the overall limitation, only with the consent of the Treasury. While the Senate's restrictions were written into the law as enacted, the damaging thrust—from a taxpayer's viewpoint—will probably be cushioned because of the Senate committee's expressed view that such consent should be granted by the Treasury whenever there are basic changes in the taxpayer's business, such as where taxpayers are "about to enter substantial operations in a new foreign country and anticipate that the operations in that country will prove risky with the possibility of their resulting in a loss for a number of years," in which case the taxpayer who previously had invoked the overall limitation might now want to shift to the per-country limitation. It was also contemplated that the shift back to the per-country limitation would be permitted where "substantial losses are realized with respect to existing investments because of nationalization, expropriation, or war." 

Assuming administrative compliance with the Senate committee's views as to when a further shift will be permitted after the taxpayer has once elected to come under the overall limitation, such shifts, assuming satisfaction of those standards, can presumably be accomplished on the basis of "hindsight." More specifically, assuming Treasury consent can be obtained because there has been the type of operational change contemplated by the Senate committee, the shift from or back to the overall limitation may be made with respect to any taxable year for which the statute of limitations has not yet run on refund rights.

This possibility of resorting to hindsight, i.e., making an election retroactive where the standard requisite to further change was actually met in an earlier year, may cushion in at least one circum-

---

217h Letter from the Secretary of the Treasury to the Chairman of the House Com-
mittee on Ways and Means, May 6, 1959, in ’59 Vol. 6 CCH para. 6469.
217j Id., at 2.
217k Note 217g, supra, subsection 1 (b).
217l Note 217i, supra, 5.
217m Id.
217n Note 217g, supra, subsection 1 (b).
stance another generally applicable and quite significant restriction. While the House committee would have permitted excess unused credits of a per-country-limitation year to be carried forward or back into an overall-limitation year as well as into a per-country year, though not *vice versa*, the Senate and ultimately the Congress decided not to permit any such commingling between the two different types of years. Where, at the time a basic change in operations occurs, it is not clear that a further shift to a different limitation should be invoked, it will be at least theoretically possible to change later, *on a retroactive* basis but within the refund period, if as events turn out the taxpayer's old limitation resulted in unused excess credits which could have been accommodated had the other limitation been in force.

Finally, the new bill would deny averaging under the overall limitation to the extent foreign taxes are above those of the United States because of the fourteen-percentage-point tax differential allowed Western Hemisphere Trade Corporations. In short, it was not thought that the excess foreign tax on the latter type of corporation should be allowed to wipe out U.S. taxes imposed at the *regular* corporate rate on income earned in countries where the foreign taxes involved are less than those imposed by the United States.

It was previously noted that even before enactment of the new statutory election, taxpayers had enjoyed what was tantamount to an election between the two types of limitation because of their right to choose the organizational form in which foreign operations would be housed. Whereas averaging, of the type associated with the overall limitation, resulted if one foreign subsidiary created its own diverse branches (permanent establishments), the strict country-by-country approach applied if the American parent itself created sister foreign branches or subsidiaries. There are certain significant practical differences, as well as similarities, between what was formerly, and remains today, only tantamount to an election, and the new specific statutory election.

First, where business reasons forced a choice of organizational form which itself led to averaging, as in the first of the two types

---

217c Pub. Law 86-780, 86th Cong., 2d Sess. (1960), § 1(d), adding subsections 904(e) and (f) to the Code.
217d Id., § 2, amending I.R.C., § 1503.
of cases mentioned supra, that organizational form did not and will not have the opportunity to invoke a strict country-by-country approach to the limitation. The reason: averaging or an overall approach results from the way the per-country limitation itself is interpreted in that setting. On the other hand, under the new legislation, foreign operations involving sister subsidiaries created by the American parent itself enjoy a real option between a strict country-by-country approach and an overall approach.

Second, if it be assumed in the two foregoing situations that both domestic parents had computed the limitation by reference to an averaging technique, one because of organizational form, the other having previously invoked the overall limitation by an election, both could still isolate a new substantial operation to be initiated in a yet different foreign country if there is concern over the prospect that losses there incurred would reduce the credit for foreign taxes paid other countries in which profitable businesses had been carried on. The American parent which had established sister foreign facilities would simply establish another sister facility, simultaneously revoking its election to conform to the overall limitation. The other American parent would have to deviate from its own organizational practice in isolating the new facility; the parent itself, rather than its top tier foreign subsidiary, would have to create the new facility. The per-country limitation, having previously applied to the parent's older chain arrangement though there having an averaging effect, would now serve to isolate the losses of the new facility.

Third, implicit in the solution of the immediately preceding problem is a yet more sweeping difference between that averaging which is accomplished by organizational form under the per-country limitation and that which would be accomplished through invocation of the new statutory election. The statutory election to invoke the overall limitation affects a company's total or world-wide foreign operations, subject only to the previously noted restriction regarding Western Hemisphere Corporations. Averaging accomplished, on the other hand, solely by reference to the impact of organizational form on the per-country limitation can be applied on a selective basis, in two different respects. The first is illustrated by a previously mentioned example, i.e., by a case where a chain organization is used in covering certain foreign countries, averaging being the goal,

217 It is assumed here that the standard requisite to securing the Treasury's consent can be met by reference to the Senate committee's expressed views regarding the contemplated shape of those standards.
with the American parent itself creating sister facilities in all other
countries where a strict country-by-country approach is desired. The
second type of selectivity is illustrated by the case where two or
more top tier subsidiaries, each with its own satellites, are created by
the parent on the same foreign continent but in different countries,
or on different continents. While the per-country limitation would
require averaging of foreign taxes within each chain, the two chains
would be dealt with separately under that limitation.

A final major difference between that averaging which is accom­
plished under the per-country limitation by reference to organiza­
tional form and that which could be accomplished through the
statutory election involves the opportunity, though only in the
latter case, to resort to the type of hindsight described earlier.

SECTION G. TAX IMPLICATIONS RE USE OF FOREIGN
HOLDING COMPANY HOLDING STOCK IN ONE
OR MORE FOREIGN SUBSIDIARIES

(a) Introduction.—Various business reasons may make it
desirable to control several foreign operating subsidiaries through
a foreign holding company. Control may be more effectively ex­
ercised in this manner than through a domestic department of the
American enterprise. Financial and commercial policies may be more
easily integrated into those of the Common Market. Use of Euro­
pean banking facilities, including credit arrangements, may be
facilitated. Such a holding company could also be used as a buffer
to shield European profits from American taxation; profits made
by a subsidiary in one member nation could be deflected to an ex­
panding subsidiary in another, without routing dividends through
the American parent. The advantage of this practice can be meas­
ured by the degree to which the American tax rate exceeds the
European tax load imposed on the operating facilities, provided
the foreign holding company enjoys a favorable tax regime.

The tax laws of five Common Market countries do not dis­
tinguish between a “pure” holding company and an operating
company which also holds shares in other operating companies.
Luxembourg, however, has established a most favorable tax climate
for pure holding companies. Of the others, the Netherlands pro­
vides the most attractive setting for a holding company arrange­
ment. The tax position of other member nations and of so-called
tax havens outside the Common Market will be discussed after
consideration of the tax implications associated with use of Luxembourg and the Netherlands as sites for the holding company.

(b) Luxembourg as a domicile for the holding company.

—For all practical purposes, a pure Luxembourg holding company, having a paid-in capital of less than $20,000,000 (L. Fr. 1,000,000,000), is exempt from income as well as property taxes. Moreover, dividends and interest which it pays out are also exempt from the tax on movable capital even where payment is made to a nonresident.

The one significant exception to the foregoing involves the situation where the Luxembourg holding company holds shares in a local Luxembourg operating subsidiary. Dividends paid by the latter will be subjected to the normal withholding tax on movable capital.

In the end, Luxembourg holding companies of the type first described will pay only three taxes, all of which are related to the capital structure:

1. **Droit d'apport** is imposed on the payment of capital into the corporation, the rate being .32%. This tax is also levied at the time the company is liquidated;

2. **Droit de timbre** is imposed at the rate of .1% on the issuance of shares and debentures, measured by their values; and

3. **Droit d'abonnement** is an annual tax on the capital of the holding company, the rate being .16%.

Another class of Luxembourg holding companies are those to which a foreign corporation has paid in capital of $20,000,000 (L. Fr. 1,000,000,000) or more. These, known as Société holding Milliardaire, are free of the above described **Droit d'abonnement** as well as normal income and property taxes. They are subject, however, to the **Droit d'apport** at the time capital is paid in, and to the **Droit de timbre** on the issuance of shares and debentures, both being geared in this instance to a regressive rate schedule, as in Table III R.

<table>
<thead>
<tr>
<th>Paid-in Capital</th>
<th>Droit d'apport</th>
<th>Value of Shares</th>
<th>Droit de timbre</th>
<th>Value of Debentures</th>
<th>Droit de timbre</th>
</tr>
</thead>
<tbody>
<tr>
<td>First $20,000,000</td>
<td>.32%</td>
<td>First $20,000,000</td>
<td>.1%</td>
<td>First $60,000,000</td>
<td>.1%</td>
</tr>
<tr>
<td>Next $20,000,000</td>
<td>.24%</td>
<td>Next $30,000,000</td>
<td>.08%</td>
<td>Next $20,000,000</td>
<td>.08%</td>
</tr>
<tr>
<td>Next $20,000,000</td>
<td>.12%</td>
<td>Next $40,000,000</td>
<td>.04%</td>
<td>Next $20,000,000</td>
<td>.025%</td>
</tr>
<tr>
<td>Next $20,000,000</td>
<td>.06%</td>
<td>Next $20,000,000</td>
<td>.02%</td>
<td>Balance</td>
<td>.02%</td>
</tr>
<tr>
<td>Next $20,000,000</td>
<td>.01%</td>
<td>Balance</td>
<td>.005%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Balance</td>
<td>.015%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
From Table III R, it appears that the total tax at the time capital is paid in, and shares or debentures are issued, will run at least to $84,000, assuming a minimum $20,000,000 is paid in. Apart from the Droit de timbre, a special annual tax is levied on this second class of larger holding companies, covering interest paid on debentures issued by the holding company, dividends paid out on its stock, and salaries or other remuneration paid directors and managers who do not stay in Luxembourg at least 6 months out of the year. Interest paid out on debentures is taxed at a uniform rate of 3%. The rate on dividends and the type of remuneration described above falls, however, into two classes, each class being determined by reference to the amount of interest paid out, as in Table III S.

<table>
<thead>
<tr>
<th>Amount of Interest Paid on Debentures</th>
<th>Amount of Dividends and Special Class of Remuneration</th>
<th>Rate on Dividends and Remuneration</th>
</tr>
</thead>
<tbody>
<tr>
<td>Class I</td>
<td></td>
<td></td>
</tr>
<tr>
<td>$2,000,000 or less</td>
<td>a. First $1,000,000 or less</td>
<td>.18%</td>
</tr>
<tr>
<td></td>
<td>b. Excess over $1,000,000</td>
<td>.1%</td>
</tr>
<tr>
<td>Class II</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Over $2,000,000</td>
<td>a. To the extent the amount is less than the amount by which interest payments exceed $2,000,000</td>
<td>3.0%</td>
</tr>
<tr>
<td></td>
<td>b. Next $1,000,000</td>
<td>.18%</td>
</tr>
<tr>
<td></td>
<td>c. Balance</td>
<td>.1%</td>
</tr>
</tbody>
</table>

The minimum amount assessed under this special tax is $32,000 (L. Fr. 1,600,000) per year.

In analyzing the amount which could be subjected to the foregoing taxes, it must be remembered that the holding company will not always receive the gross amount of dividends declared by the operating facilities, for certain Common Market countries will have imposed a withholding tax on dividends declared by operating facilities domiciled there, as follows:

<table>
<thead>
<tr>
<th>Country</th>
<th>Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belgium</td>
<td>Taxe Mobilière, 30%</td>
</tr>
<tr>
<td>France</td>
<td>Withholding tax, 24%</td>
</tr>
<tr>
<td>Germany</td>
<td>Tax on income from movable capital, 25%</td>
</tr>
<tr>
<td>Italy</td>
<td>No dividend tax</td>
</tr>
<tr>
<td>Netherlands</td>
<td>Dividend tax, 15%</td>
</tr>
</tbody>
</table>
(c) Netherlands as a domicile for the holding company.—The Netherlands does not confine its favorable tax climate to "pure" holding companies. Equally attractive benefits are available if an American enterprise chooses to have its operating subsidiary in the Netherlands hold the shares in other European operating companies.

Dividends received by a Netherlands corporation from foreign companies are exempt from the regular taxes which the Netherlands would otherwise impose if (1) the Netherlands corporation holds at least 25% of the foreign corporation's shares and (2) the foreign corporation itself was liable for a domiciliary income tax on its profits.

By treaty, the Netherlands has also abandoned the right to tax dividends which the Netherlands corporation would in turn pay the American parent corporation. Thus, apart from the registration fees and stamp duties which would be imposed on the formation of the Netherlands corporation (see PART I) dividends received by the Netherlands holding company and distributed to the American parent would have been subjected only to the withholding taxes imposed by certain Common Market countries at the time the operating subsidiaries distributed their profits, as follows:

<table>
<thead>
<tr>
<th>Country</th>
<th>Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belgium</td>
<td>Taxe Mobilière, 30%</td>
</tr>
<tr>
<td>France</td>
<td>No withholding tax (Treaty)</td>
</tr>
<tr>
<td>Italy</td>
<td>No dividend tax</td>
</tr>
<tr>
<td>Germany</td>
<td>Tax on income from movable capital, 25%</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>Tax on income from movable capital, 15%</td>
</tr>
<tr>
<td>Netherlands</td>
<td>No dividend tax</td>
</tr>
</tbody>
</table>

(d) Other Common Market countries as domiciles for the holding company.—Common Market countries other than Luxembourg and the Netherlands do not offer special benefits for holding company arrangements. For example, dividends received by a German corporation are tax exempt only if received from a German subsidiary, and even then the receiving company will suffer a 36% tax if the amount received is not immediately distributed by it. Nor do France and Belgium provide exemptions.

218 The French 24% withholding tax will apply upon receipt of the dividend, though upon re-distribution of that dividend by the holding company another withholding tax will not be applied. Upon the receipt of the dividend, the holding company is also allowed a 75% dividends-received deduction for purposes of the regular French corporate income tax. The 25% not neutralized is taxed as a means of compensating for that portion of overhead expenses which, though deducted by the parent, were properly attributable to the dividend.
for dividends received. However, when the holding company itself distributes profits derived from dividends, those two countries do not again exact their respective withholding tax, and Taxe Mobilière, in the instance where a subsidiary had been the source of the holding company’s earnings.

Finally, on formation of a holding company, all Common Market countries except Luxembourg exact the regular registration fees and stamp duties imposed, as discussed in PART I, on formation of corporations generally. Luxembourg’s special arrangements were considered in sub-topic (b), supra.

(e) Incorporation of the holding company in a so-called “tax haven.”—The term, “tax haven,” is usually applied to a country which does not exact any tax, or at most only a nominal amount, from holding companies. As previously indicated, Luxembourg is the only Common Market country which fits that classification, though the Netherlands also may be considered as such. Among non-member European nations, Switzerland and Liechtenstein are the most frequently mentioned tax havens.

Holding companies in Switzerland do not pay an income tax on dividends received. Since cantonal (state) tax laws are generally more burdensome than the Swiss federal income tax, it is also important to note that some cantonal laws also provide an exemption for interest and royalties received, as well as dividends received. On the other hand, federal, cantonal, and sometimes even local property taxes are imposed on a holding company’s net wealth or paid-in capital. While the rates of these taxes rarely run as high as 1%, dividends paid out by the holding company to the American parent company will suffer a withholding tax of 5% provided the American parent owns at least 95% of the holding company’s stock. Otherwise, the rate would be 15%.

Liechtenstein also frees dividends received from its income tax. While the holding company will suffer a .1% tax on its property, an agreement as to this can be made with the tax department covering a 30-year period. Finally, dividends paid by the holding company to the American parent will be subjected to a 3% coupon tax.

When account is taken of the 5% and 3% taxes which Switzerland and Liechtenstein would impose, respectively, on dividends paid by the holding company to the American parent, and of the property taxes which would be assessed in each of those countries, it should be apparent that they do not offer holding companies any
significant tax advantage superior to those available in certain Common Market countries. While the tax which those two countries would normally impose on dividends to the American parent would not be incurred if the holding company retained its profits for expansion purposes, such accumulation would serve to increase the company's property taxes. It should also be noted that the two countries in question do not have as many tax treaties with Common Market countries as the latter have among themselves. In some instances, this may further prejudice their selection, particularly a choice of Liechtenstein, as the domicile for the holding company. Common Market countries will assess the following withholding taxes on dividends paid by operating subsidiaries domiciled there to a holding company domiciled in one of those two countries as appears in Table III T.

<table>
<thead>
<tr>
<th>Dividend Paid by Operating Subsidiary Located In:</th>
<th>Tax Assessed by Domicile of Operating Subsidiary on Dividends Payable to Holding Co. In Switzerland Liechtenstein</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belgium</td>
<td>30% 30%</td>
</tr>
<tr>
<td>France</td>
<td>— 24%</td>
</tr>
<tr>
<td>Germany</td>
<td>25% 25%</td>
</tr>
<tr>
<td>Italy</td>
<td>— —</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>15% 15%</td>
</tr>
<tr>
<td>Netherlands</td>
<td>— 15%</td>
</tr>
</tbody>
</table>

Comparison of these figures with those set forth in sub-topics (b) and (c) as applied to Luxembourg and the Netherlands indicates that in some instances the latter two countries enjoy an advantage in this respect.

**Subsection 2. American Tax Implications Re Use of a Foreign Base Company**

(a) *Introductory note.*—Following consideration of the American tax implications associated with a base company arrangement during the operational phase, certain problems peculiarly incident to the creation of such companies will be analyzed.

(b) *General tax implications.*—With respect to the normal operational stage, it is from two principles that the practical American tax advantages of the base company arrangement arise.
The first such principle is common to all foreign corporations, namely, that the income which the foreign base company derives from Common Market sources will not be included in American gross income unless distributed as a dividend to the American parent. Thus, as indicated in the Introduction to this Section, where the effective American tax rate is higher than the total effective income tax rate imposed by the country which houses an operating facility, the latter facility’s profit could be deflected through the base company to other expanding foreign facilities without suffering what may be an expensive tax detour through the American parent.

Fear that exchange controls will emerge in the operational country may actually be the only immediate reason for a current or timely extraction of profits made by the operating facility located there; these profits could be stored in a base company situated elsewhere until such time as they are needed for expansion of foreign facilities in yet other countries. Storing them in such a company in this circumstance, instead of remitting them to the United States, may also be motivated by a desire to avoid the risks associated with the American tax on unreasonable accumulations. As noted in PART I, generally speaking the Common Market countries have not resorted to this type of penalty tax.

The first principle, that a base company’s income is not reachable by American authorities until distributed as a dividend to the American parent, also enables this type of organizational structure to accommodate, without American tax cost, dividend requirements of European interests which may own shares in the operational subsidiaries. The amount which otherwise would have been distributed as the American parent’s share would be deflected to the foreign base company. Where outside interests are involved in this way, the base company type of organizational structure would not be so acceptable, however, if the outsiders owned more than 50% of the voting stock of one or more of the operating companies. As is explained more fully in Subsection 2(c) of Section E, supra, the American parent’s eventual deemed-paid credit for foreign income taxes of an operating company will be lost unless the foreign base company, in which the American parent must hold at least

---

219 I.R.C., § 882(b). This principle is discussed more fully in Section C, supra.

220 Since the foreign profit will not have become a part of American gross income, it would not be a part of the base to which the penalty tax attaches, i.e., “accumulated taxable income.” I.R.C., § 531.
10% of the voting stock, in turn owns at least 50% of the voting stock of the sub-subsidiary.\textsuperscript{220a}

The second basic tax principle to which a base company arrangement's tax advantage is attributable involves another provision bearing on the credit. As was also explained more fully in Subsection 2 of Section E, \textit{supra}, when profits derived by a holding company from two or more Common Market countries are ultimately remitted to the States, an averaging arrangement\textsuperscript{221} is read into the per-country limitation\textsuperscript{222} on the credit for foreign income taxes. Normally, this will be advantageous in the instance where one operating facility is situated in a low income tax country like Italy, another being in a country having a higher effective rate than the United States. By treating the foreign income as though derived from the one country in which the base company is incorporated, and by attributing to that single country the total foreign tax paid to the operational countries, there is less likelihood of prejudice from the per-country limitation.

In at least one circumstance, however, the averaging arrangement could have an unfavorable effect. This may be so where the base company owns branch operations, as distinguished from subsidiaries, in two or more countries and one of the branches suffers a loss, say of $50,000, while the other makes a profit, say of $100,000 on which it paid $50,000 in foreign income taxes. In that event, averaging will serve to make the numerator (foreign source net or "taxable income"—$50,000) of the per-country limitation \textit{less} than the profits of the one profitable branch ($100,000) which did pay a foreign tax ($50,000). The effect is to create a greater possibility, in our illustration—a certainty, that the average effective rate of foreign taxes on foreign source income, here 100%, will exceed the effective American rate. The consequent loss of a current credit for part of the foreign tax, assuming a distribution by the base company of the profitable branch's gain, would not have been suffered currently if the operating facilities had been housed in sub-subsidiaries, rather than branches. With a sub-subsidiary organizational structure, averaging on a current basis could have been avoided; foreign source income of the base company and of

\textsuperscript{220a} This difficulty will be less serious if Congress ultimately passes a bill which was approved by the House in the 1960 session but which the Senate did not have time to consider. That bill would reduce the required degree of ownership from 50% to 20%. H.R. 11,681, 86th Cong., 2d Sess. (1960).

\textsuperscript{221} I.T. Regs., \textsection 1.902-1(c).

\textsuperscript{222} I.R.C., \textsection 904, discussed generally in Section C, \textit{supra}. 
the American parent would have been based solely on the dividend declared by the profitable operating subsidiary, with the effective foreign tax rate in our illustration being 50%, not 100%.

Because of legislation enacted in late 1960 and discussed more fully in Section F, supra, averaging can now also be accomplished without regard to the form of organization, i.e., can even be applied where the American parent itself creates sister facilities in two or more countries. As noted in Section F, an election by such a taxpayer to conform to an “overall” limitation, rather than the per-country limitation, serves as the new statutory device by which that domestic parent would shift to an averaging technique. But if averaging in the setting of that sister-type organizational structure is really important in order to level out high- and low-tax countries, the parent may be confronted with a hard choice at a later point when it contemplates opening a new facility in a yet different foreign country from which, for a few years, it anticipates losses. As noted in the preceding paragraph, averaging these losses in with the older profitable foreign operations may reduce the credit allowed for taxes actually paid those countries in which profitable operations are conducted. Of course, this could be avoided by obtaining the Treasury’s consent to revocation of the election to conform to the overall limitation. But the price would be a forfeiture of the right to average the profits from those high- and low-tax countries which house the profitable operations, for revocation would mean that a strict country-by-country approach would be applied as a limitation on all foreign operations. This world-wide statutory choice between one or the other type of limitation is not required, however, where averaging of high- and low-tax countries is accomplished solely by reference to organizational structure because of the way the per-country limitation itself is interpreted. A parent which had enjoyed averaging only because it had operated through a base company could isolate what will initially be a new loss operation in a yet different country by creating its own facility there, the per-country limitation serving to prevent the loss there from affecting the averaging which is applied to the operations conducted through the base company. Theoretically, and perhaps even from a practical standpoint, this too is not without a price tag. One advantage normally associated with base company operations will be lost. Absent some inter-company loan arrangements, if profits of the base company operations are to be used in creating the new facility, they must first be routed through the parent and become a part of American gross
income, for as previously noted, isolation will be accomplished only if the parent itself creates the new facility. The practical disadvantage of this is not likely to be very great, however, if averaging was really important to the base company operation. That fact alone probably means that the average foreign rate suffered by the base company operations comes fairly close to the American rate, in which event, because of the credit, the additional American tax is not likely to be of overriding significance.

The final operational problem in base company settings involves the policing problem.

Absent distributions to the American parent, transactions between the base company and the operating subsidiaries would not be policed by the Internal Revenue Service under § 482 of the Code. But at the point of distribution to the American parent, it is entirely possible that the Service is free to invoke § 482 in applying the American concept of "accumulated profits" to the various organizational tiers; only in this way could it effectively preserve the integrity of and difference between, the one-tier and two-tier deemed-paid credit arrangements. In this connection, the congressional adoption of an additional policing measure in late 1960 is not without meaning. A new bill clearly establishes the right of the Treasury to obtain from domestic parents various types of information relative to their foreign subsidiaries and sub-subsidiaries, including not only balance sheets, but also data pertaining to inter-company transactions and the make-up of the accumulated earnings and profits of such foreign corporations. Moreover, prior to distribution by the base company, inter-company arrangements between it and operating companies would fall within the policing jurisdiction of the foreign countries. Also in this connection, it should not be forgotten that most bilateral tax treaties provide that transactions will be unscrambled for tax purposes if they are not entered into in accordance with standards comparable to those which would be applied by strangers.

(c) American tax problems peculiarly incident to the creation of a base company.—The first of the three prime American tax problems immediately incident to the creation of a foreign holding company involves the sweeping response made by Congress to a fairly limited and obviously unwarranted type of avoidance device practiced in the late 1920's and early 1930's. Some taxpayers who owned securities which had increased substantially in value sought

\[292a\] Note 194a, supra.
to reduce these to cash without suffering any tax whatever. Their first step involved a tax-free transfer of the securities in exchange for the entire stock of a foreign corporation created in a country which did not tax capital gains. In seeking immunity from American tax with respect to this first step, reliance was placed upon a non-recognition provision similar to §351 of the Code. The foreign holding company would then make a tax-free sale of the portfolio for cash which it then transferred to a newly created American corporation in exchange for all of its stock, the latter being distributed to the original American taxpayer in reliance on the reorganization provisions. Through the new wholly owned American corporation, the taxpayer would now control cash which had been realized without tax cost, provided the judiciary approved the application of the two nonrecognition provisions. In 1932, a congressional committee expressed some doubt as to what the judiciary might do with the latter question; accordingly, it proposed and the Congress adopted two complementary remedies which literally go far beyond the dimensions of the original problem.

The first such remedy, as currently designed, neutralized the right under §351 to make a tax-free transfer of appreciated property to a controlled foreign corporation unless, before the exchange, it is established to the satisfaction of the Treasury that the exchange is not "in pursuance of a plan having as one of its principal purposes the avoidance of federal income taxes." A like limitation is placed upon the reorganization and tax-free intercorporate liquidation provisions.

Though the practice which gave rise to this grant of administrative discretion involved attempts by taxpayers to avoid the American capital gain tax while realizing effective control over cash, the statutory language itself—in identifying the type of transfers covered—is sufficiently broad to encompass any transfer of appreciated stock in foreign operating subsidiaries to a foreign base or holding company. Moreover, the delegation of administrative discretion would also seem to be sufficiently broad to permit the Commissioner to deny nonrecognition if he determines that one of the principal purposes is to avoid the American tax on future ordinary income through use of the base company as a storehouse.

224 Ibid.
225 Rev. Act of 1932, § 112(k).
226 I.R.C., § 367.
227 Ibid.
or deflection instrumentality for the profits of operating facilities. In any event, where creation of a base company is postponed until after one or more operating companies have expanded out of retained profits, thus increasing the value of the stock, the Commissioner's determination must first be secured if the American parent is to have any hope for nonrecognition of what would be realized gain on transferring the appreciated stock to the base company. Presumably because the issue in each case is largely one of fact, the Service has refrained from publishing any rulings which otherwise might have served as guideposts.

The second or complementary remedy enacted by Congress in 1932 is similar to the first, except as now written (1) it relates only to a transfer of "stock or securities," (2) it imposes a 27 1/2% excise tax on any appreciation in value, and (3) it does not have a supplementary provision which, following application of the tax, steps up the basis of the stock received in the base company. Thus while transfer of a foreign branch operation which had appreciated in value could be prejudiced by the Treasury only under the first provision, a transfer of stock in operating companies could be affected by either provision.

Creation of the base company before stock of the operating facilities has appreciated in value through retained earnings will, of course, avoid the immediate costs described above. It should also be clear that the above provisions will constitute less of a problem where the operating subsidiaries are really sales organizations which do not own substantial assets. Their future profits could be deflected to the base company which might in turn invest them in manufacturing facilities located in the most appropriate country or countries.

But even in the two recited circumstances where nonrecognition of immediate gain will not be a serious problem, it would be wise to see that the holding company actually performs a meaningful control function; otherwise, there is some risk that it may be caught up in any drive which the Service may some day launch in an effort to neutralize—as a recognizable tax entity—any foreign corporation which serves only as a passive receptacle of, and shield for, profits earned by operating sub-subsidiaries. While there is nothing to indicate that such a drive is about to be launched, or—assum-

---

229 I.R.C., § 358 complements §§ 367 and 351, but not § 1491.
230 I.R.C., § 351, on which § 367 rides "piggy-back," relates to transfers of "property."
231 Cf. Aldon Homes, Inc. 33 T.C. 582 (1959).
ing a "tidy" arrangement—that it would be successful, the same could have been said of Clifford trusts before the Treasury launched what turned out to be a successful attack against them.\textsuperscript{232}

By legislation enacted in late 1960, Congress also increased the likelihood that the Treasury would learn of the creation or reorganization of foreign corporations in which American individuals or corporations hold a 5% interest, direct or indirect, or with respect to which Americans will serve as officers or directors. The Treasury is now empowered by regulation to prescribe the contents of an information return which such officers, directors, or stockholders must submit upon the creation or reorganization of a foreign corporation with which they are associated.\textsuperscript{232a} At this writing, the Treasury had not yet had a chance to promulgate such regulations.

The second major American tax problem immediately incident to the creation of a foreign holding company involves licensing arrangements. Assume that the American parent had previously licensed its patents to one or more of the foreign operating subsidiaries. While the deemed-paid credit for foreign income taxes is normally allowed only in connection with the receipt of dividends, the discussion in Subsection 4 of Section C, \textit{supra}, indicated, in the absence of dividends, that a credit would be allowed under certain circumstances upon the receipt of royalties.\textsuperscript{233} The advantages of that arrangement, as outlined in the previously mentioned Section, will probably be lost if stock of the licensee-subsidiary is transferred to the holding company. According to the Code, this unique credit arrangement is authorized only where an American corporation owns "directly or indirectly, 100% of all classes of stock" of the foreign licensee-corporation. Transfer of the latter's stock to the holding company would vest direct ownership in a foreign entity. While the statutory provision also literally encompasses situations where the American enterprise "indirectly" owns all shares in the licensee-corporation, it does not literally incorporate the precise rules of constructive ownership reflected in other parts of the Code. Indeed, certain conditions set forth in the provision seem to suggest that ownership through an intermediate corporation is not con-

\textsuperscript{232} Helvering v. Clifford, 309 U.S. 331, 60 S. Ct. 554 (1940).

\textsuperscript{232a} Pub. Law 86-780, 86th Cong., 2d Sess. (1960), § 7, amending I.R.C., § 6046. Also enacted was a provision preserving the opportunity to obtain the 85% dividends received deduction with respect to dividends paid out of earnings and profits which were accumulated at a time when a corporation was domestic to the United States, but where the dividend was actually paid after the corporation had taken on a foreign complexion through the tax-free reorganization provisions. Pub. Law 86-779, 86th Cong., 2d Sess. (1960), § 3, amending I.R.C., § 243.

\textsuperscript{233} I.R.C., § 902(d).
templated. And if not, nothing would be gained by entering into a substitute licensing arrangement with the holding company, the stock of which would be "directly" owned by an American corporation. The statute specifically prescribes that the 100% ownership must relate to a foreign corporation engaged in "manufacturing, production, or mining," 234 a standard to which a pure holding company would not conform. The difficulties just described would be avoided, of course, if the operations were conducted through permanent establishments (branches) of the base company, rather than through sub-subsidiaries.

The third major American tax problem incident to the creation of a foreign holding company involves the case where stock in the American parent is centralized in a very few persons. Viewing this circumstance solely in practical terms, the parent's foreign holding company would be closely akin to a personal holding company. At least, since 1937, Congress has thought the similarity to be sufficient in some cases to justify such an equation. The prejudicial quality of that equation stems from the treatment accorded true foreign "personal" holding companies.

Such a company is said to exist whenever (1) more than 50% in value of its outstanding stock is owned, "directly or indirectly," by or for not more than five American residents or citizens, and (2) at least 60% (in some cases, 50%) of its gross income is so-called "foreign personal holding company income," i.e., is derived in the form of dividends, interest, royalties, etc. 235 Generally speaking, when these two standards are met, the foreign personal holding company income is taxable to the holding company's stockholders whether or not distributed. 236 This means, when coupled with the complementary doctrine of constructive ownership, 237 that an American parent which owns all of the stock of a pure foreign holding company will be taxable on its undistributed earnings if over half the stock of the parent is divided among no more than five stockholders.

This neutralization of the tax advantages otherwise associated with foreign base companies could be avoided if the base company itself also has an active operational function from which it derives sufficient "gross income" to enable it to fall short of the second of

---

234 Ibid. Italics added.
235 I.R.C., § 552.
236 I.R.C., § 551.
237 I.R.C., §§ 554 and 544.
the two previously enumerated definitional standards. But that the active operational function must be truly significant is at once recognizable when account is taken of the fact that the standard is geared to "gross income," not gross receipts. For example, if it engaged only in a selling activity, only that part of its gross receipts in excess of the cost of goods sold would be deemed "gross income" for this purpose.

SECTION H. FURTHER TAX IMPLICATIONS IF A COMMON MARKET FACILITY EXPORTS OUTSIDE THE COMMON MARKET

An American enterprise may contemplate that any Common Market facility which it creates will also export to countries outside the Community. While sub-topic (c) of Section D, supra, indicated that any Common Market nation in which the facility might be located would free the export transaction itself from turnover tax, it also noted some variation among member nations in the degree to which any turnover tax previously paid at earlier stages in the production process would be refunded. Comparison of the rates which each might have applied in those earlier stages appears, supra, in Section B.

While all Common Market countries in which the facility might be located would more or less free the exported item from the impact of its turnover tax, all would impose an income tax on any profit derived by the facility from the export. According to the discussion in Section D, supra, a double income tax would not normally be suffered, however, if the goods were sold by the facility directly to customers in another member nation. Normally, the latter's income tax would only be applied if a permanent establishment had also been created there. There may be cases, however, where importing nations outside the Common Market will seek to reach the exporter's profit whether or not a permanent establishment of the type heretofore described is maintained therein. To avoid this possibility, Common Market nations have entered into or are negotiating bilateral treaties with a number of non-member nations. The status of such treaties with a number of countries is indicated in Table III U.
<table>
<thead>
<tr>
<th>Country</th>
<th>Belgium</th>
<th>France</th>
<th>Germany</th>
<th>Italy</th>
<th>Luxembourg</th>
<th>Netherlands</th>
</tr>
</thead>
<tbody>
<tr>
<td>C - Concluded</td>
<td>N - Under Negotiation</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>South Africa</td>
<td>C</td>
<td>C</td>
<td>C</td>
<td>C</td>
<td>C</td>
<td>N</td>
</tr>
<tr>
<td>New Zealand</td>
<td>C</td>
<td>C</td>
<td>C</td>
<td>C</td>
<td>C</td>
<td>N</td>
</tr>
<tr>
<td>Pakistan</td>
<td>C</td>
<td>C</td>
<td>C</td>
<td>C</td>
<td>C</td>
<td>N</td>
</tr>
<tr>
<td>Ceylon</td>
<td>C</td>
<td>C</td>
<td>C</td>
<td>C</td>
<td>C</td>
<td>N</td>
</tr>
<tr>
<td>Japan</td>
<td>C</td>
<td>C</td>
<td>C</td>
<td>C</td>
<td>C</td>
<td>N</td>
</tr>
<tr>
<td>India</td>
<td>C</td>
<td>C</td>
<td>C</td>
<td>C</td>
<td>C</td>
<td>N</td>
</tr>
<tr>
<td>Egypt</td>
<td>C</td>
<td>C</td>
<td>C</td>
<td>C</td>
<td>C</td>
<td>N</td>
</tr>
<tr>
<td>Canada</td>
<td>C</td>
<td>C</td>
<td>C</td>
<td>C</td>
<td>C</td>
<td>N</td>
</tr>
<tr>
<td>Eire</td>
<td>C</td>
<td>C</td>
<td>C</td>
<td>C</td>
<td>C</td>
<td>N</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>C</td>
<td>C</td>
<td>C</td>
<td>C</td>
<td>C</td>
<td>N</td>
</tr>
<tr>
<td>Switzerland</td>
<td>C</td>
<td>C</td>
<td>C</td>
<td>C</td>
<td>C</td>
<td>N</td>
</tr>
<tr>
<td>Sweden</td>
<td>C</td>
<td>C</td>
<td>C</td>
<td>C</td>
<td>C</td>
<td>N</td>
</tr>
<tr>
<td>Norway</td>
<td>C</td>
<td>C</td>
<td>C</td>
<td>C</td>
<td>C</td>
<td>N</td>
</tr>
<tr>
<td>Greece</td>
<td>C</td>
<td>C</td>
<td>C</td>
<td>C</td>
<td>C</td>
<td>N</td>
</tr>
<tr>
<td>Finland</td>
<td>C</td>
<td>C</td>
<td>C</td>
<td>C</td>
<td>C</td>
<td>N</td>
</tr>
<tr>
<td>Denmark</td>
<td>C</td>
<td>C</td>
<td>C</td>
<td>C</td>
<td>C</td>
<td>N</td>
</tr>
<tr>
<td>Russia</td>
<td>C</td>
<td>C</td>
<td>C</td>
<td>C</td>
<td>C</td>
<td>N</td>
</tr>
<tr>
<td>Austria</td>
<td>C</td>
<td>C</td>
<td>C</td>
<td>C</td>
<td>C</td>
<td>N</td>
</tr>
</tbody>
</table>
PART IV. THE PROBLEM OF CONVERTING FOREIGN PROFITS AND TAXES INTO AMERICAN DOLLARS, AS IT AFFECTS AMERICAN TAXES ON THOSE ENGAGED IN FOREIGN TRADE OR BUSINESS

SECTION A. INTRODUCTION

Even those American businesses which engage only in *domestic* activity are affected by constant changes which take place in the value of the dollar. Cost of living adjustments in wages scales, pursuant to labor contracts, may be matched on the tax side by realization of, and a tax on, illusory capital gains. Again, predictions regarding future monetary changes may well affect a choice of inventory methods for tax as well as other purposes, leading, illustratively, to the adoption of L.I.F.O. While choices such as this may affect the amount of ultimate tax on a business which confines its endeavors to the United States, from the beginning of American tax history each stage of the computation has always been reflected in terms of American dollars assumed to be stable.

When businesses, accustomed only to domestic activity, first began to conduct foreign trade in countries with gold-backed, fully convertible currencies enjoying a stable rate of exchange, their accounting problems did become more involved, but in that earlier day such complications had little American tax significance. Those businesses which paid or accrued their foreign income taxes in a stable, easily converted foreign currency and went through the year without having converted their foreign profits into American dollars did have to resolve such questions as, (1) the choice of a date on which conversion into American dollars would be effected, and (2) in the case of a branch operation, whether the conversion would relate only to foreign profits computed in the manner of domestic profits or would penetrate into the net worth position of the foreign operation, reflecting a profit or loss based on a comparison—in dollar values—of net worth at the beginning and end of the year. But tax-wise these questions were of little practical significance when the British pound was equal to $4.86 in American money, with a maximum variation of about 2¢ in each direction, and when every reasonable man had the right to believe this state of affairs would continue as an undisputed fact of economic life.
Foreign exchange questions became highly relevant for tax purposes, however, when the devaluation process of foreign currencies set in.

An additional complication developed when blocked or restricted currencies became commonplace. We are familiar with a few American tax concepts which permit deferment of taxes even on certain domestic earnings which have been locked up and thus rendered completely unavailable for current use. Employer contributions to pension trusts in which an employee-taxpayer has a vested right furnish the best illustration. Foreign profits reflected in blocked foreign currency added this question of possible deferment to those previously enumerated. Ancillary to it was the further question of whether a deduction for expenses associated with blocked income should also be deferred. Finally, blocked or restricted foreign currency set the stage for three rates of exchange—the official, the black market, and the commercial rate in the United States. The problem of choosing from among these was added to the previous list.

The four sections which follow deal with the more typical tax accounting complications associated with the conversion and deferment problems. The first relates to the method by which foreign profits will be reflected as well as to the timing question, absent blockage or other restriction. The discussion here assumes an understanding, however, of the general tax differences noted in PARTS II and III with respect to direct exports and other foreign operations conducted through a permanent establishment or foreign subsidiary.

The second section concerns the possibility of deferring blocked or restricted foreign profits, while the third focuses on the choice of the market place which will be resorted to for the purpose of fixing the conversion rate.

The last section explores the conversion problem as it affects the credit for foreign income taxes which have been paid or accrued in a foreign currency.

**Section B. Method and Time for Converting Foreign Profits Into Dollars, Absent Blockage or Restriction**

(a) *Introductory note.*—For tax purposes, the time and method for converting into dollar values foreign profits tied up in
foreign currency will differ, depending on whether the American business is engaged only in direct exports to foreign customers or instead operates a foreign facility through a permanent establishment or foreign subsidiary. Accordingly, the problem must be discussed separately in these three settings.

(b) Conversion problem re profits from direct exports to foreign customers.—There is nothing to indicate that American manufactures engaged in direct exports to foreign customers are freed from the usual rule requiring sales to be reflected on an accrual basis for federal tax purposes.\(^1\) Not all such vendors, however, will encounter exchange problems and possible attendant tax complications. Such problems will be avoided, for example, if the American enterprise sells its product to, say, a Netherlands importer who agrees to make payment in American dollars. The need to exchange Dutch guilders for American dollars and the attendant problems associated with rates of exchange rest wholly upon the Dutch firm. Even if the American exporter sells goods under an agreement to accept payment in guilders, it does not necessarily follow that the exchange problem will complicate its tax affairs. The taxpayer may design the transaction so that accrual, payment, and conversion take place on the same date, the overall effect being akin to payment in dollars. In this connection, even accrual basis taxpayers engaged only in domestic business have some control over the time when a sale must be brought into gross receipts. According to the regulations, “a taxpayer engaged in a manufacturing business may account for sales of his product when the goods are shipped, when the product is delivered or accepted, or when title to the goods passes to the customer, whether or not billed, depending upon the method regularly employed in keeping his books.”\(^2\) If payment in a foreign currency and conversion into American dollars are normally expected to coincide with delivery, the regulation would permit the latter to be chosen as the occasion for accrual, but presumably only if the taxpayer’s books were regularly kept in that manner also with respect to domestic sales. Even where domestic sales have regularly been reflected in gross receipts as of the date of sale, it still might

\(^1\) The regulations do not distinguish between foreign and domestic sales. I.T. Regs., § 1.446-1(c)(i)(iv)(b). The Tax Court has said that a taxpayer who accrued such profits properly reflected the item. Foundation Co., 14 T.C. 1333 (1950), Acq., C.B. 1950-2, 2. While certain general rulings of the Service pick the time of receipt as the pivotal dateline, it is believed that the facts to which those rulings were addressed involved other types of income in the setting of a cash basis taxpayer. E.g., see O.D. 419, C.B. 2, 60 (1920). This was certainly the case in Rev. Rul. 291, C.B. 1953-2, 42, 48.\(^2\) I.T. Regs., § 1.446-1(c)(i)(ii). (Italics added.)
be possible to design sales to foreign customers so that the benefits and burdens of ownership passed only upon delivery. 3

In the absence of some such arrangements, it is possible, though not probable, that in the course of the total transaction, three different rates of exchange may be in effect; at the time of accrual, later at the time of payment in the foreign currency, and still later on the date of conversion into American dollars. A change in the conversion rate, occurring between any two of these events, will complicate the tax problem.

In one sense, the sale transaction itself is closed on the date of accrual; the then conversion rate must be applied to the amount thereafter receivable in foreign currency in order to determine the amount includible in gross receipts. That same rate fixes the basis for the foreign currency when later received. 4 The fact that the dollar value of the foreign account receivable may have declined as of the end of the taxable year because of a change in exchange rates apparently does not serve, in the eyes of the Internal Revenue Service, to justify a loss deduction for the exporter, 5 though a contrary rule is now recognized in the case of foreign branch operations. 6 A second transaction has not yet been closed. Assuming, however, that the American exporter does not thereafter hold the foreign currency, when received, as an investment, subsequent conversion of it into dollars at a different rate of exchange than prevailed at the time of accrual will give rise to further ordinary income or to an ordinary loss, depending on whether intervening changes, if any, in the exchange rate were favorable or unfavorable. 7

(c) Conversion problem re profits derived through a foreign permanent establishment.—Theoretically, and certainly for jurisdictional purposes, § 61 of the Code has always included in the gross income of an American corporation the gross from all sources, foreign as well as domestic. As early as 1920, however, the In-

3 While treaties with 5 of the Common Market countries would guarantee immunity of the profit from foreign income taxes, such an arrangement might lead to multiple turnover taxes. See discussion in PART II, supra.
6 See discussion in sub-topic (c), infra.
TAXATION

ternal Revenue Service ruled in O.D. 550 that only the net result of a foreign branch's operations need be consolidated with that of the American enterprise in the instance where the branch kept a separate set of records. This accommodation of the jurisdictional rule to an accounting principle was complemented in the same ruling by a more detailed outline of the accounting technique approved by the Service in determining the net result of the foreign branch's operation. In essence, it established what has been described as the "profit-and-loss" method. The branch's profits were to be determined first in terms of the foreign currency, though in accordance, of course, with American law with respect to inclusions, deductions, capitalizable items, etc. From this figure, remittances during the year—expressed in the foreign currency—were to be subtracted, though these were then to be picked up by the American enterprise at the rate of conversion which applied as of the date of remittance. The balance of the branch's net profits, expressed initially in the foreign currency, were to be accounted for by the American enterprise as of the end of the year, the rate of exchange on that date to be applied in converting the unremitted foreign profits into American dollars.

Under the foregoing method, a branch might show a taxable profit though unfavorable mid-year shifts in the rate of exchange would show that the dollar value of its current assets had declined from the beginning to the end of the year. In just such a situation, an American enterprise sought to reflect a foreign branch's operations in accordance with what has become known as the net worth or balance sheet method. In short, from the branch's tentative profit—computed first according to a profit-and-loss method, it deducted the dollar amount which its current assets had declined in value, from the beginning to the end of the year, solely because of unfavorable changes in exchange rates.

The government argued that this improperly permitted the taxpayer to take advantage of what was essentially an unrealized loss. However, a court sided with the taxpayer; it rejected the notion that foreign currency and other current assets required incident to the operation of a branch engaged, illustratively, in a manufacturing operation should be treated like fixed assets with reference to which an unrealized decline between the two points of time in

*C.B. 2, 61 (1920).
*That American law controls inclusions, etc., see PART III, supra.
American-dollar value was admittedly not recognizable for tax purposes.10 In calling for a comparative translation of the current assets into dollar values at the two points of time, the court agreed that the net worth adjustment was proper with respect to inventories, accounts receivable and payable, cash, and bank deposits, but not, of course, with respect to fixed assets such as land, buildings, and machinery. The latter were to be carried on a dollar value balance sheet at the rate of exchange prevailing at the time of acquisition, and to that same figure the depreciation reserve would also be responsive.

More recently the Tax Court has indicated that the taxpayer really has a choice of methods, the profit-and-loss and the net-worth methods being characterized as the "main approaches." 11 Since, within limits, "the question is one of accounting and not of substantive law," 12 the overriding requirement was said to be consistency in practice. Only in this way will the various methods reflect like amounts over the long haul.13

(d) Conversion problem re dividends derived from a foreign subsidiary.—A dividend is not the only type of profit which an American enterprise may derive from operations conducted through a foreign subsidiary. Illustratively, the American parent may also sell its own exported products to the foreign subsidiary or treat the latter, at least in part, as a permanent establishment in the nature of a sales agent for those American products not manufactured by the subsidiary. The problem of converting the latter types of profit into American dollars has been considered, however, in the preceding subtopics; attention here is limited to the matter of dividends.

For tax purposes, the date on which an American parent should convert dividends declared in foreign currency is clear enough in the limited instance where the parent otherwise keeps its books on a cash basis. Conversion takes place on the date the dividend is actually or constructively received.14 Contrary to what others have ap-

12 Ibid.
13 It would appear that long term liabilities should also generally be reflected at the rate prevailing on the date the liability was incurred.
14 Mim. 5297, C.B. 1942-1, 84; Frank W. Ross, 44 B.T.A. 1 (1941); O.D. 419, C.B. 2, 60 (1920). Because of the constructive receipt doctrine, the date of payment will be the
The matter is not so clear, however, in the more frequently recurring circumstance where the parent keeps its books on an accrual basis. The difficulty here is not attributable to the foreign character of the dividend; it stems from uncertainty regarding the more basic question of when a dividend derived from an American source is properly accruable.

In this latter connection, at one time the Board of Tax Appeals looked to the declaration date. And in that era, the government failed to raise this particular question in at least one contested case where a taxpayer had used that date in translating foreign dividends into American income. Throughout that period, however, those regulations which dealt specifically with dividends, as distinguished from the more general provisions bearing on accounting methods, failed to distinguish between shareholders whose books were kept on the accrual basis rather than on the cash basis. Dividends were said to be “included in the gross income of the distributees when the cash or other property is unqualifiedly made subject to their demands.” This meant the date on which the dividend was payable except in the instance where the item could not be said to have been constructively received on that date, in which case the actual date of receipt governed. This shotgun type of regulation led the Court of Appeals for the Second Circuit to reverse in 1942 the historical position of the Board. By the previously quoted regulation, dividends were said to have been carved out for treatment which differed from that associated with other income items, reflection of which was generally determined by reference to the taxpayer’s regular method of accounting. The appellate court ignored the declaration and record dates, choosing instead the date of payment and receipt which, in this case, happened to coincide.

The Tax Court (known before 1942 as the Board of Tax Appeals) thereafter noted that “certainty of the answer” was most

---

16 Archer M. Campbell, 6 B.T.A. 60 (1927), Non-acq., C.B. VI-2, 8; Tar Products Co., 45 B.T.A. 1033 (1941), rev’d. (3d Cir. 1942) 130 F.(2d) 866.
18 E.g., see I.T. Regs. 118, §§ 39.42-3 and 39.115(a)-1(d).
19 I.T. Regs. 118, § 39.115(a)-1(d).
20 The regulation included an illustration in which the constructive receipt doctrine would not be applied.
21 Tar Products Corporation v. Comm'r., (3d Cir. 1942) 130 F.(2d) 866, rev’g. 45 B.T.A. 1033 (1941).
important; for this reason, it chose not to reconsider "the relative merits of the opinion of the Circuit Court of Appeals and our own." It adopted the view of the former.\textsuperscript{22} Its new position was affirmed on appeal by a quite different court of appeals, that of the seventh circuit.\textsuperscript{23} While the Supreme Court during the period of the 1940's did not go beyond saying that dividends do not in any event accrue prior to the record date,\textsuperscript{24} it is of some significance that the previously mentioned decision by the Court of Appeals for the Seventh Circuit, postponing inclusion to the date of payment, was selected for publication by the Internal Revenue Service in its own Cumulative Bulletin, a fact which usually meant that the government intended to follow the result.\textsuperscript{25}

On the basis of the foregoing, one might conclude with some assurance that an accrual basis taxpayer resolves the timing question, as it relates to inclusion of dividends, in the same manner as cash basis distributees. The one note of caution relates to a slight change made in the new regulations issued under the 1954 Code. While the statute itself was not changed in any respect relevant here, and while the new regulations do incorporate the statement previously quoted,\textsuperscript{26} they go on now at another point to say that the constructive receipt doctrine is not generally applicable if, e.g., an item would be accruable at a different date under the taxpayer's regular method of accounting.\textsuperscript{27} At least one writer has suggested that by this device the government may attempt to re-open the accrual question as it relates specifically to dividends.\textsuperscript{28}

In any event, apart from the matter of dividends and contrary to the case where operations are conducted through a foreign branch, the American parent will not be permitted to take advantage of any shift, resulting from movement of exchange rates, in the dollar value of the foreign subsidiary's current assets.\textsuperscript{29} The two are separate entities for American tax purposes. Nor may the American corporation revalue at year's end its own accounts receivable running against

\textsuperscript{22} American Light & Traction Company, 3 T.C. 1048, 1050 (1944).
\textsuperscript{23} (7th Cir. 1946) 156 F. (2d) 398.
\textsuperscript{24} Putnam Estate v. Comm'r., 324 U.S. 393, 65 S. Ct. 811 (1945).
\textsuperscript{25} C.B. 1678, C.B. 1946-2, 135. The government also withdrew the non-acquiescence previously published in 1944 C.B. 32 with reference to the Tax Court's decision. See C.B. 1946-2, 1.
\textsuperscript{26} I.T. Regs., § 1.451-2(b).
\textsuperscript{27} I.T. Regs., § 1.451-1(a).
\textsuperscript{28} Rabkin and Johnson, Federal Income, Gift and Estate Taxation § 21.04(7), (1954).
TAXATION

the subsidiary in order to reflect changes, since the date of sale, in exchange rates.\footnote{Ibid. Cf. Appeal of Louis Roessel \& Co., Ltd., 2 B.T.A. 1141 (1925); Appeal of Theodore Tiedmann \& Sons, Inc., 1 B.T.A. 1077 (1925). But Anderson, Clayton \& Co. v. United States, (Ct. Cl. 1958) 168 F. Supp. 542, does indicate that on occasion the government has entered into an agreement permitting accounts between a parent and subsidiary to be revalued at year's end by reference to the then prevailing rate of exchange.}

Section C. Timing The Reflection Of Blocked Or Restricted Foreign Profits

(a) Introductory note.—Fiscal manipulations by foreign countries have usually coincided with wars and depressions—local or world-wide. Restrictions have run the gamut, ranging, \textit{inter alia}, from a series of varying limitations on extraction of profits by foreigners—including American enterprises—to complete blockage of those profits. Not until the world-wide economic crisis of the 1930's were the American tax implications of these restraints considered, however, by the judiciary. And even the cases decided in that era were few in number; the only important conclusion was to the effect that a total lock-up justified deferral of income which otherwise would have been deemed realized. Later decisions during World War II indicated, on the other hand, that certain less severe restrictions would not justify a deferral. That period, characterized by restraints of all sorts, did not, however, bring forth meaningful administrative rulings to reduce the sizeable no-man's land in between the two results; the regulations were amended only for the purpose of assuring that deductions and credits would be linked to income properly deferred. But post-war restrictions did bring forth administrative guidelines as precise as could be expected.

As indicated elsewhere in this volume, currency restrictions imposed in Common Market countries today are not nearly so serious as those of an earlier time; comparatively speaking, profits from licensed investments enjoy unusual freedom. Nevertheless, the discussion below of the way American tax law has evolved in response to various types of restrictions is not wholly academic, for times can change. Moreover, there are other kinds of profits with reference to which restrictions are more significant.

(b) Circumstances calling for deferral of income.—In 1937, the Supreme Court concluded in one case, contrary to the usual rule, that a \textit{domestic} exchange out of which the taxpayer received
certain peculiarly circumstanced stock did not furnish an appropriate occasion for tax reckoning. The decision rested on a finding that these particular shares did not have a "fair market value, capable of being ascertained with reasonable certainty," and "in the absence of such value, the ownership of the shares did not lay the basis for the computation of gain..." The difficulty was attributable "to their highly speculative quality and to the terms of a restrictive agreement making a sale thereof impossible..." Within 3 months, the theory embodied in that decision was applied by the Board of Tax Appeals to the first case which had come before it involving restricted foreign profits, International Mortgage and Investment Corporation.

A bank crisis in the early 1930's had led the German government to prohibit the transfer of marks out of Germany. While on the next to the last day of the taxable year, that government did establish a procedure whereby, upon permission, blocked marks could be reinvested on a long-term basis in Germany, repayment on any such reinvestment was also blocked. The Board of Tax Appeals also found as a fact that no market existed within the taxable year for such marks and "no one could form an opinion as to their value at that time."

In this setting, the Board determined that an American enterprise was not presently taxable even though it had realized a profit in German marks upon disposition of a German investment. The result was bottomed on the fact that "income for our Federal income tax purposes is measured only in terms of dollars," and here the taxpayer's profit was simply "not measurable in terms of dollars."

Foreign profit realized by the same taxpayer from other dispositions which took place during the same taxable year, but prior to the blockage, were, however, included in its gross income though, through failure to effect a timely conversion into dollars, those profits were also entrapped by the subsequently adopted monetary restrictions. It was enough that the taxpayer had unrestricted power

---

32 Id. at 499.
33 Ibid.
34 36 B.T.A. 187 (1937).
35 Id. at 189.
36 Id. at 190.
37 Ibid. Accord, Stuart, James & Cooke, Inc., P-H B.T.A. Memo. Dec., para. 38-095 (1938). A like result was later reached in United Artists Corporation of Japan, 3 T.C.M. 574 (1944) though the blocked item was actually on deposit in a San Francisco branch of a Japanese bank. See note 47, infra.
to convert at the moment the profit was realized in the foreign currency.

While the Internal Revenue Service did file an acquiescence to that part of the Board's decision which allowed the taxpayer to defer income realized in blocked German marks, it took a different view of the problem in later taxable years as the German government began to relax its currency restrictions.

In Credit and Investment Corporation, the taxpayer failed to show that it could not have obtained permission to take out of Germany certain marks which it had realized on disposing of an asset, which marks—because of the various uses to which they could be put—did have some market value on the New York exchange though in an amount less than the official blocked rate. Indeed, in that same taxable year it had used that market place to convert certain other restricted German marks. In deciding against the taxpayer, the Board drew a distinction between this situation and that presented earlier in the International Mortgage and Investment Corporation case. In the latter case, contrary to the situation here, it had been shown that the taxpayer could not obtain permission to transfer any of its marks out of Germany and, because of the nature of the restrictions on their use, no outside market place catered to such marks.

That the government accepted the distinction between the two cases, and recognized that the earlier decision which was adverse to it still retained its vitality, was demonstrated by its promulgation, at approximately this same time, of a ruling wherein it acknowledged that certain types of profit tied up in blocked British pounds were not presently includible for federal income tax purposes. And this was so though the blocked profits could have been reinvested in British securities, interest on which could have been converted. Otherwise, however, the government did not attempt at this stage in history to chart a more exacting line between deferable and non-deferable income insofar as the matter turned on foreign monetary restrictions. Its more or less concurrent amendment of the regulations was confined to the other side of the ledger and was predicated

[Footnotes]

38 Acq., C.B. 1937-2, 15.
39 47 B.T.A. 673 (1942).
40 The importance of the burden of proof was the center of the court's focus in Corn Products Refining Co. v. Comm'r., (2d Cir. 1954) 215 F.(2d) 513 where the taxpayer sought to include a dividend which the government claimed was blocked. The government prevailed.
41 Mim. 5297, C.B. 1942-1, 84.
on the conclusion that, in a given case, foreign income had been properly excluded because of "monetary exchange, or other restrictions imposed by a foreign country." In such event, the deductions and credits attributable to such excluded items were also to be postponed, account being taken of them proportionately as and if the deferred income items properly became includible in gross income. 42

Before the government again spoke administratively, separate arms of the judiciary evolved in one case two other reasons for denying deferment to foreign income which suffered from some restriction. In Phanor J. Eder, 43 the Service assessed a deficiency against a lawyer-stockholder by reference to the undistributed income of a foreign personal holding company domiciled in Colombia. In connection with his practice, the lawyer-stockholder had spent two months of the year in that Latin American country.

While the exchange laws and regulations of Colombia prohibited the company from transferring its profits or pesos outside that country, the "spending or investment of pesos within" the country were not restricted. But if articles bought with pesos were sold outside the country, the vendor was obligated to return the sales proceeds to Colombia.

None of these latter circumstances, involving the exact nature of the exchange restrictions, seemed important to the Board of Tax Appeals. It was enough that Congress—in attempting to thwart avoidance—had specifically called for a tax on stockholders with reference to any undistributed income of a foreign personal holding company. 44 The fact that such income would have been blocked, had it been distributed as a dividend, was thought to be beside the point. The immunizing philosophy of the earlier International Mortgage and Investment Co. case had to give way in the face of such specific legislation.

An appellate court was not satisfied to rest only on this theory. It denied that "inability to expend income in the United States, or to use any portion of it in payment of income taxes, necessarily precludes taxability." 45 Of importance was the fact that the taxpayers "could have invested, or spent, the 'blocked' pesos in Colombia and, as a result, could there have received economic satisfaction." The fact that the taxpayer himself spent a part of the year

43 47 B.T.A. 235 (1942).
44 Revenue Act of 1938, § 337, now I.R.C., § 551 et seq.
45 Eder v. Comm'r., (2d Cir. 1943) 138 F. (2d) 27.
in Colombia suggested that it was actually necessary for him to expend "some" pesos in Colombia.

This theory, geared to a power to obtain economic satisfaction through foreign reinvestment or other expenditure, necessarily called for an appraisal of the value of that potential satisfaction—but in terms of American dollars. The court suggested that this might be accomplished through a comparison of various price indices prevailing in the United States and Colombia. To this end, the case was remanded to what had now been renamed the Tax Court, and it proceeded to make the comparison in question, though account was also taken of expert testimony the basis for which was not disclosed.46

The loosely worded suggestion by the court of appeals, to the effect that deferment was not available if the blocked income could be "reinvested or spent" in the foreign country, may have contributed to the government's effort thereafter to sustain a 1938 deficiency against a corporate taxpayer the foreign profits of which were tied up in Japanese yen. For at least part of the taxable year, that corporation could have reinvested the yen in Japanese securities—a practice then frowned upon by the State Department, or in items deemed essential to Japan—such as scrap iron, provided a permit authorizing the purchase could be obtained from that government. These circumstances did not, however, impress the Tax Court. It distinguished the Eder case on its own original theory, to the effect that the question of blockage was irrelevant there because of specific legislation which called for a tax on stockholders of a foreign personal holding company without regard to the question of distribution. Deferment of the blocked yen here was deemed justified because the taxpayer did not have "'unrestricted use and enjoyment' " of his gain.47

It was after this decision, in the setting of post-war foreign monetary restrictions, that the government made it possible for taxpayers to obtain assurance that it would not attempt to deny deferment because of a power to reinvest blocked foreign profits. The device, established in Mimeograph 6475,48 involved what was described

46 3 T.C.M. 460 (1944).
47 United Artists Corporation of Japan, 3 T.C.M. 574 (1944). Later on in the same taxable year, an agreement was reached with the Japanese government pursuant to which the blocked yen could be converted into dollars, but these had to be placed in a non-negotiable deposit for 3 years, without interest, with a San Francisco branch of a Japanese bank. The Tax Court thought that deferment was still justified.
as a method of accounting which, under prescribed conditions, taxpayers might elect with respect to "deferable income." This classification included that income which, "owing to monetary exchange or other restrictions imposed by a foreign country, is not readily convertible into United States dollars or into other money or property which is readily convertible into United States dollars." 40

Such income could be deferred until the earlier to occur of any one of three events, i.e., (1) until that point when the item no longer satisfied the definition of deferable income, or (2) until the item was in fact converted into dollars or into property readily convertible into such, or (3) until it was used for nondeductible personal expenses, was disposed of by way of gift, bequest, device, or inheritance, or by dividend or other distribution, or, in the case of a resident alien, a taxpayer terminated his residence in the United States.

On the one hand, the first of the three possibilities demonstrated that actual conversion into dollars of previously blocked income was not a sine qua non to taxability. It was enough that the item became "readily convertible." On the other hand, it was equally clear from this mimeograph, as well as from a complementary ruling of the same year, 50 that actual reinvestment, as well as the power to reinvest, in foreign investment or business property did not, standing alone, serve to take blocked profits of an electing taxpayer out of the deferable class. Nor would the mere existence of a power to use the foreign currency for foreign personal expenses prohibit deferral, provided the amounts were not in fact so used. While no mention is made of the circumstance where deferable income is used to pay off foreign loans repayable in foreign currency, it could be argued that deferral should still be allowed if the loan was obtained after blockage set in and was invested in investment or business property. In such circumstance, deferral would have been allowed if the blocked foreign currency had been used to make the investment in the first instance. In other circumstances, such as where the loan was obtained prior to restrictions on foreign currency, the government could argue that the loan transaction was a separate and closed matter when repaid, justifying inclusion of the funds previously deferred because of blockage.

(c) Circumstances requiring deferral of deductions and credits.—As noted supra, the regulations were amended in 1943 so

40 Ibid.
The later promulgated Mimeograph 6475 elaborated on this principle as applied to taxpayers invoking the benefits of the method of accounting there prescribed.

Depreciation, obsolescence, and depletion, when measured in terms of foreign currency, were to be taken into account, like other expenses incurred in foreign currency, in subsequent taxable years in the same proportion as the deferable income, to which they were linked, was includible in taxable income. Where blocked foreign profits were reinvested abroad in investment or business property, a complementary ruling indicated that such property originally took on a deferred income basis measured by its cost in terms of the foregoing currency. It was contemplated that an annual information return covering blocked income would reflect that basis as well as adjustments thereto, such as depreciation, allowed by the Code. When the foreign currency originally used to acquire the assets took on a non-blocked status, two steps were to be taken. First, the original amount so devoted was to be translated into American dollars at the exchange rate prevailing when the funds became unblocked, that amount then being includible in gross income. Second, the adjustments made in the property acquired, as well as the funds originally used to make the acquisition, would be converted at the same rate as that applied in fixing the amount of income; the resulting figure established the basis for the property.

The deferment principle also included costs and direct expenses incurred in American dollars, to the extent attributable to deferable income. As the proceeds became unblocked, the entire cost of goods sold in a given transaction was to be recovered first, before any amount was includible in gross income. Only after those costs were recovered was account to be taken of other direct dollar expenses attributable to the sale. Even then, absent permission to do otherwise, these expenses, unlike the cost of goods sold in the transaction, were to be taken into account proportionately by reference to the relationship which the amount included in gross income during that taxable year bore to the transaction's total proceeds in excess of the cost of goods sold. 53

51 See note 40, supra.
53 The mimeograph provided for a special arrangement as to these costs if more than one foreign country was involved in the transaction. See para. 7(b) of the mimeograph as amended by Mim. 6494, C.B. 1950-1, 54.
Deferment of the foregoing costs and expenses incurred in dollars will also cease, of course, if the items reflecting the deferable income become worthless.

The mimeograph does not call for deferment of indirect expenses incurred in dollars. Absence of any mention of them presumably means that the taxpayer will not be required to undertake the complicated task of unscrambling these for purposes of affecting allocation to particular transactions only some of which may involve the problem of blockage.

(d) Mechanics and effect of election under Mimeograph 6475.—The mimeograph, as amended, calls for the election to be made “no later than the time prescribed by law (including any extension thereof) for filing the income tax return for the first taxable year for which the election is to be applicable.”

Along with his regular return, the taxpayer is required to file separate information returns, on the same type of form, with respect to each country in which a deferable account exists. On these returns, which must be labelled “Report Of Deferable Foreign Income, pursuant to Mimeograph No. 6475,” the taxpayer must enter into two agreements: (1) that the deferable income will be included in taxable income in that taxable year in which it ceases to be deferable under the provisions of the mimeograph, and (2) that no claim will be made that such deferable income was includible in gross income for any earlier year. While like agreement need not be expressly entered on the return with reference to losses, the mimeograph itself does provide that taxpayers electing this method of accounting must also treat losses in a consistent manner. Finally, once the election is made, it may not be changed without securing the consent of the Commissioner.

By way of general summary, the taxpayer’s gross receipts in blocked foreign currency is reported, though only for information purposes, and the cost of goods sold—in terms of such currency—are subtracted. From the resulting figure—foreign currency gross income—expenses incurred in terms of the foreign currency are deducted in arriving at foreign currency net income.

When some part of the foreign currency net income ceases to be deferable by reference to the standards previously indicated, that amount is reduced by the dollar costs attributable to that transac-

54 Mim. 6584, C.B. 1951-1, 19, amending para. 9 of Mim. 6475.
55 That the election is binding with regard to losses even in the instance where books regarding foreign profits are otherwise kept in accordance with the net worth method, see Anderson, Clayton & Co v. United States, (Ct. Cl. 1958) 168 F. Supp. 542.
tion, the remainder being included in the taxpayer's gross income from which dollar direct expenses, as previously explained, are deducted in turn on a proportionate basis. The Service has also taken the position that a partial remittance of unblocked income covering several years is to be reported, as it becomes unblocked, on a first-in-first-out basis. 56

(e) Conclusion.—The foregoing discussion suggests that Mimeograph 6475 permits restricted foreign income to be deferred in some instances where deferment might not have been permitted under case law. Certainly the right to reinvest in foreign investment or business property without loss of the deferment privilege would not have been permitted by the court of appeals which decided the previously discussed Eder case. It was, perhaps, because of this variation that the government characterized the mimeograph as descriptive only of a "method of accounting." While prior cases in this precise area had approached the problem as though it involved a question of law, other cases in related areas have stated that reflection of profits in foreign currency poses an accounting question for which there may be more than one answer—provided the taxpayer follows a sensible practice consistently. 57 In any event, there is also authority to the effect that taxpayers who elect to be treated under the mimeograph must also be consistent in abiding by its various provisions though one or more may operate to his prejudice. 58

It is also true that the mimeograph provides a more comprehensive set of answers with reference to the overall method it prescribes than is available under case law. This is so even though the Service could not be perfectly precise in resolving the most basic of all questions. The range of conceivable variations in factual patterns quite rightly restrained it from saying anything more precise than that deferable income consisted of that which was not "readily convertible" into dollars.

Taxpayers remain free, of course, to ignore the mimeograph, falling back on the less precise case law pattern. And particularly in these cases, the question will arise: What market place is to be chosen for valuation of foreign currency in the event deferment is not to be allowed in a given case? This is the subject matter of the next section.

57 E.g., see American Pad & Textile Co., 16 T.C. 1304 (1951).
Section D. Choice of Market Place in Determining the Conversion Rate

(a) Introductory note.—At some point, foreign profits and the amount of foreign income taxes paid must be reflected in dollars for American tax purposes. Particularly where a foreign country's currency is blocked or restricted, differences may well exist between that country's official rate of exchange, its black market rate, and the commercial rate at which such foreign money is transferable in the United States. Thus, if the income cannot be deferred for American tax purposes under the principles set forth in Section C, supra, it may be necessary to determine which of these several market places will be resorted to in fixing the conversion rate.

As indicated below, the government has not always maintained a consistent position, though in all but two significant cases it has fostered the official rate, a view for which the courts have generally substituted the American commercial rate. The fact that the government has acquiesced in all of the Tax Court cases which were adverse to its position and that the matter has not been further litigated within the past five years may be some indication that it is prepared to accept what may seem to be inevitable. On the other hand, its most recent published ruling, as described below, is so equivocal that it might feel free to argue, without embarrassment, that those acquiescences rested on the peculiar facts of the litigated items.

About half of the litigated items have concerned the estate or gift tax, rather than the income tax, but the Tax Court has insisted that common principles apply to all three and has indiscriminately commingled citations.

(b) Evolution of relevant developments.—In 1920, the Service's then Committee on Appeals and Review found the abnormal conditions associated with foreign exchange during the World War I sufficient cause to justify authorizing a taxpayer to "convert current assets less current liabilities payable in the foreign currency at the current rate of exchange or at any rate less favorable to him." 59 But it then went on to drain most of the vitality from this notion by adding an equivocal caveat, "The Commissioner should consider in any case applications to adopt a rate more favorable to

the taxpayer or may on his own motion apply such a rate where the facts in the particular case warrant such departure.”

The government did not again speak for publication until 1941; in the interval, the elasticity of its earlier position was seemingly unchanged in such private rulings as were reported by recipients. In one, the government is said to have called for the selection of that market place which would most clearly reflect the income, and in another it was said that there could be no general rule, for each case turned on its own peculiar facts.

The peculiar facts deemed important by it in connection with the British government’s restrictions on exchange during World War II turned out to be the effectiveness of the British restraining orders. Required compliance reached the point where there was said to be “little ‘free sterling exchange’” and “little difference between the controlled ‘official’ exchange rate and the ‘free exchange’ rate on sterling still available on open market.” In that circumstance, with respect to those unblocked accounts for which the British government would permit an exchange, but only at the official rate, the Service insisted that “the rates of exchange, both for conversion of British current assets at the beginning and end of the taxable year and for conversion of British taxes paid with respect to the income involved, either for foreign tax credit purposes or deduction from gross income in the taxpayer’s United States return, should be taken at the ‘official’ rate” except where actual realization had taken place at some other rate.

A year later, however, the government—in I.T. 3568—was still insisting that the overall problem could not be reduced to a general rule. In rejecting the notion that exchange rates certified by the Federal Reserve Bank of New York for customs purposes could be used in all cases, it stated:

Notwithstanding present conditions of disturbances and the control of trading and exchange by foreign countries, free or open market rates lower than either official or controlled rates were in certain cases realizable on December 31, 1941, dependent upon regulations of the particular foreign country and the degree of control which was

---

Ibid. (Italics added.)


Roberts, Effect of Blocking of Currency on Gain or Loss, 7 N.Y. Inst. 1224 (1949).

Mim. 5297, C.B. 1942-1, 84 at 86.

Ibid.
exercised. In any case in which conversion rates as of that date are to be used, such rates shall be those giving a result most clearly reflecting the proper amounts of the items to which they relate as affected by the conditions and available means and rates of conversion as of that date. The rates of exchange used will be subject to verification and check upon the examination of the taxpayer’s books and records by internal revenue agents.65

More or less simultaneously with the publication of that ruling, the government litigated a case involving blocked German marks. And there it sought to reduce the taxpayer’s claimed loss on a sale by arguing that his basis for the property—purchased by the taxpayer with blocked German marks acquired from an earlier sale—should be determined by reference to the commercial rate of exchange prevailing in New York at the time of his purchase, rather than by reference to the official rate. The Board of Tax Appeals agreed, noting that while the marks were blocked at the time the taxpayer originally purchased the property, he would not have been prevented from disposing of those marks on the available New York market.66

At approximately the same time, in an effort to increase the amount of a different taxpayer’s profit, the government shifted its support to the official rate by applying to blocked income that rate which the foreign government itself allowed on unblocked or unrestricted income. Before the Tax Court, the taxpayer had conceded this issue,67 arguing only that he should not be subject to any tax. On appeal, however, the Court of Appeals for the Second Circuit remanded the case on the valuation issue, concluding that the value of blocked foreign currency was not on a par with unblocked income in the same currency.68 In the absence of a regular New York market, the Tax Court then accepted the testimony of a New York banker to the effect that income so restricted was worth half of the rate which was available for unblocked income originating in that same country.69

65 C.B. 1942-2, 112.
* Eder v. Comm’r., (2d Cir. 1943) 138 F. (2d) 27.
* Phanor J. Eder, 3 T.C.M. 460 (1944). The same approach was made in Estate of Anthony H. G. Fokker, 10 T.C. 1225 (1948), Acq., C.B. 1948-2, 2 and Estate of Oei Tjong Swan, 24 T.C. 829 (1955), Acq., C.B. 1956-2, 8. In the latter case, the court stated (at 880): “In other words, if an amount had actually been realizable in United States dollars, our holding would have been based thereon; but since there could have
In a similar case decided by the Tax Court four months later, the government had again espoused the cause of the official rate, opposing application of the less attractive established New York commercial rate. While a Brazilian administrative agency apparently had authority to redeem the taxpayer’s milreis at the official rate, the evidence indicated that this authority was seldom if ever granted in the type of case at bar and that in fact the taxpayer had resorted to the New York exchange in earlier dealings. The Tax Court was now content with the statement that “Taxation is a practical matter. We apply the commercial rate.” 70 The Court of Appeals for the Second Circuit affirmed. 71

This principle was then extended by the Tax Court to gift 72 and estate tax 73 situations. In the former, for example, a California banker appeared as an expert witness, testifying that his bank had bought and sold such blocked currency for an amount approximating 50% of the official rate for unblocked currency of that country. This ratio was then adopted by the court. Those decisions were thereafter cited as authority for the resolution of income tax cases, the Tax Court stating that the change in setting “makes no difference in the fundamental question involved.” 74

Only where the taxpayer did not raise the issue, 75 or where the higher official rate was actually available, 76 has the Tax Court accepted the government’s recurring efforts to apply the official rate. As previously suggested, the government’s acquiescences to other adverse holdings and its failure to litigate a case since 1955 may indicate that the question is now considered settled.

been no realization of dollars in respect to the blocked assets under consideration, it is necessary to translate foreign value into dollars for estate tax purposes by conversion at an appropriate rate of exchange which will reflect the various restrictions and other factors impinging on value.”

70 Edmond Weil, Inc., 3 T.C.M. 844, 849 (1944).
71 (2d Cir. 1945) 150 F. (2d) 950.
75 Waterman’s Estate, 16 T.C. 467 (1951), rev’d, on another issue, (2d Cir. 1952) 195 F.(2d) 244; Max Freudmann, 10 T.C. 775 (1948).
76 Estate of Ambrose Fry, 9 T.C. 503 (1947) re account in Barclays Bank. The official rate was also applied to an army officer stationed in England and France because the blocked foreign currencies which he received there at the official rate could be converted into dollars at the higher official rate upon his departure from those countries. S. E. Boyer, 9 T.C. 1168 (1947). Cf. Ceska Cooper, 15 T.C. 757 (1950), Acq., C.B. 1951-1, 2.
SECTION E. CONVERSION PROBLEM AS IT AFFECTS THE CREDIT FOR FOREIGN INCOME TAXES

(a) Introductory note.—As explained in PART III, supra, an American taxpayer is allowed a credit for any foreign income taxes actually borne by him (so-called direct tax credit) as well as, in the case of an American corporation, a portion of those paid or deemed paid by a foreign corporation at least 10% of the voting stock of which is held by the domestic corporation (so-called "deemed paid" tax credit). In both instances, the foreign tax will normally be payable in a foreign currency. But because the time when the amount so paid must be converted into American dollars differs by reference to the two types of credit, the conversion problem is discussed separately as to each.

(b) Conversion for purposes of the direct tax credit.—Shortly after the credit for foreign income taxes was established, the Commissioner ruled that cash basis taxpayers who paid such in a foreign currency should compute the credit by converting the amount paid into American dollars by reference to exchange rates prevailing on the date of payment.

In that same period, as to a deductible domestic tax, the government was contending that accrual basis taxpayers should reflect the item in the year in which the events occurred "which fix the amount of the tax and the liability of the taxpayer to pay it" even though the tax might not yet be due and payable. Only then was it thought that such a taxpayer would be reflecting his true income for the period. This concept, as applied to accrual basis taxpayers, was carried over by the government to the direct credit for foreign income taxes. Since the governing provision authorized an accrual of the credit, where such foreign tax had not been paid during the year the rate of exchange in effect on the last day of the year was said by the government to be the basis by which the foreign liability was to be converted into American dollars.

77 I.R.C., § 901. As explained in PART III, this credit also includes war profits and excess profits taxes as well as any tax paid in lieu of these and income taxes otherwise generally imposed. I.R.C., § 903.
78 I.R.C., § 902.
81 Revenue Act of 1921, § 238 (b), now I.R.C., § 905 (c).
82 I.T. 1645, C.B. II-1, 141 (1923).
The earliest statutory provision, like that on the books today, also provided that the domestic tax for the "year or years affected" would later be redetermined in the event the amount of foreign tax subsequently paid by the accrual basis taxpayer differed from that previously estimated and accrued as of the end of the original taxable year. The government concluded that this statutory arrangement had the effect of establishing a superseding conversion rate in such cases, the effect being to convert the earlier accrual into a "provisional or interim credit." It reasoned as follows:

... the law having directed the adjustment of the amount accrued to the amount actually paid, the necessary inference is that the amount of the payment if made in [foreign] money shall be converted into American money at the rate of exchange as of the date of payment, since this is the only way of arriving at the amount actually paid. To convert a payment made in [a subsequent year] into American dollars at the rate of exchange prevailing [in the earlier year of accrual] would be to allow the taxpayer a greater or less amount than he has actually paid, depending upon whether the rate of exchange [in the earlier year] is higher or lower than that in [the later year].

The foregoing principles, initially established by rulings, were approved shortly thereafter by the Board of Tax Appeals.

In 1924, a congressional committee called attention to the fact that many foreign countries, like our own, provided for the payment of income taxes during the year following the year for which the tax was imposed. This meant that cash basis taxpayers were taking a credit against the domestic tax in the year following the year in which their foreign income was earned. To avoid any prejudice which might result as a consequence of variation in the yearly amount of foreign income, the statutory provision regarding the credit was amended at the committee's request so as to permit cash basis taxpayers to elect to reflect the credit in the same manner as accrual taxpayers.

---

83 Revenue Act of 1918, § 238(a).
84 I.R.C., § 905(c).
86 S.M. 4081, C.B. IV-2, 201 at 202 (1925). (Italics added.)
89 Revenue Act of 1924, §§ 238(c) and 222(c), now I.R.C., § 905(a).
The special character of the provisions relating to accrual of foreign taxes for purposes of the credit has led to modification of one other doctrine which applies to accrual of domestic taxes.

In the latter circumstance, an accrual basis taxpayer must postpone accrual of any tax, liability for which he is contesting. The accrual takes place in and for the year the contest is settled. While the accrual of that part of any foreign tax being contested must also be postponed until the matter is resolved, it has been held, and the Service agrees, that the congressional aims permitting accrual in a foreign tax setting justify relating the accrual back to the year for which credit would have been taken in the absence of the contest.

Accrual basis taxpayers, as well as cash basis taxpayers who elect the accrual method, may be required to post a bond on accruing the credit prior to payment of the foreign tax. In both settings, a ten-year statutory period of limitations has also been imposed on recognition of overpayments of American tax resulting from subsequent redeterminations reflecting differences between the amount of foreign taxes accrued and that actually paid.

(c) Conversion for purposes of the "deemed-paid" tax credit.—As previously noted, an American corporation may enjoy a credit for a proper part of any foreign income taxes paid or deemed paid by a foreign corporation at least 10% of the voting stock of which is held by the domestic enterprise. This credit may be taken, however, only as dividends are drawn from the foreign corporation. Thus the question may arise as to whether, for credit purposes, the amount of foreign taxes paid by the foreign corporation should be converted into American dollars according to the rate of exchange prevailing when the foreign corporation paid the foreign tax or according to a rate later prevailing when a dividend is included in the American corporation's gross income.

The first contested situation involved a dividend received from a foreign corporation's earnings and profits of an earlier year the foreign tax on which had been paid in the earlier year. The foreign

---

92 I.R.C., § 905(c).
93 I.R.C., § 6511(d)(3). If the foreign tax is refunded and the American credit is thereby reduced, interest will not be assessed by the American government with respect to the redetermination except to the extent interest was paid by the foreign country on the refund. I.R.C., § 905(c).
94 I.R.C., § 902.
corporation had always kept its accounts in terms of the foreign currency with which it had also paid the foreign tax. The Board of Tax Appeals noted that prior to the declaration of the dividend, "neither the earnings nor the taxes of that foreign subsidiary had in any way affected the income tax liability of the domestic corporation." Since, prior to the dividend, there had never been any occasion to reduce the payment of foreign taxes into American dollars, the Board, like the government, thought that it was "reasonable and logical" to effect the conversion according to exchange rates prevailing at the time of the dividend, rather than at the time the foreign tax was actually paid by the foreign corporation.

The government thought the same principle should apply even though the foreign corporation always kept its accounts in American dollars, using the latter to pay dividends and to purchase foreign currency with which to pay its foreign tax. But the Tax Court (formerly Board of Tax Appeals) and the Court of Appeals for the Second Circuit thought otherwise. In this circumstance, the exchange rate prevailing at the time of the dividend was thought to have no relation whatever to the amount of accumulated earnings and profits, to the dividend, or to the foreign taxes actually paid. The foreign corporation itself had invoked an exchange rate at the time it used its own American dollars to buy the foreign currency with which to pay the foreign tax. Accordingly, in this circumstance it was thought that no exchange problem arose at the time of the dividend. Subsequently, the government acquiesced in the distinction between the two cases.

---

95 Bon Ami Co., 39 B.T.A. 825, 827 (1939).
96 Id. at 828.
97 American Metal Co., 19 T.C. 879 (1953).
99 Non-acq. to the Tax Court's opinion, in C.B. 1953-1, 7, was withdrawn in C.B. 1955-2, 3.
PART V. FOREIGN AND AMERICAN TAXES ON INDIVIDUALS AS THEY AFFECT MOVEMENT OF EMPLOYEES TO FOREIGN LANDS

SECTION A. INTRODUCTION

American enterprises which create foreign subsidiaries or open permanent establishments in Common Market countries are likely to transfer certain of their American employees to the foreign stations. The country-by-country survey in PART I, supra, furnishes the background for the comparison in Section B, below, of the ways and extent to which income taxes of member nations will affect American citizens so assigned. Generally speaking, until such time as the American becomes a resident of a particular Common Market country as defined under its law, each nation will assert jurisdiction only over that income for which it is the source. When residence in a particular country is established pursuant to its law, that Common Market nation will generally increase its jurisdictional sweep to include the resident's income from all sources. But even in this circumstance, unilaterally and by treaty, most of those countries have provided some form of relief to mitigate double taxation with respect, at least, to certain types of income which the displaced American continues to derive from sources in the United States. In other words, to that extent, most of them acknowledge the priority of the United States over its own citizens. Moreover, unilaterally or under bilateral tax treaties between member nations, the foreign country of residence may also grant some relief with reference to any income which the American may derive from other member nations.

While the notion of gross income which prevails in the United States generally requires a citizen to include income "from all sources" though the item may also be subject to a foreign tax, there are circumstances in which Congress has permitted Americans stationed abroad to immunize foreign service income from the American tax. This concession is geared generally to establishment of bona fide residence in a particular foreign country but pursuant to standards fixed by American law. Alternatively, extended physical presence abroad, i.e., presence in one or more countries, for a
period approximating 1 1/2 years will warrant an exclusion, though here there is a limitation on the amount. To the extent of the immunity thus granted, the United States in effect acknowledges the sole right of the foreign country or countries to tax any "earned" income which has its source there. The discussion of this matter in Section C, below, is coupled with an analysis of the way in which the foreign tax would be integrated with the American tax in the instance where the immunizing criteria specified by Congress are not satisfied.

Other employees who are permanently stationed at the home office in the States may be called upon to make more or less brief business trips to the scene of the foreign operation. Alternatively, Americans who have been stationed abroad might be called back to the States for a short time. Nonresident alien employees, i.e., citizens of Common Market countries, might also be brought from their overseas stations to the home office for consultation, etc. Within the same taxable year, any one of these three classes might perform services at home as well as in a foreign land. This could complicate their tax problems, for the Code as well as bilateral treaties generally look to the place where service is performed, rather than to the place of payment, in fixing the source of compensation for tax purposes. And source itself is generally considered the prime basis for asserting jurisdiction over compensation. However, Section D, below, calls attention to a standard which has been added to the Internal Revenue Code, and to others incorporated in treaties, for the purpose of freeing certain international business visits from such tax complications. The device involves a modification in the rules which generally designate the place of service as the source of earned income. Subject to certain conditions, each country in effect foregoes treating itself as the source of compensation even though the business visitor actually performed services there. But this variation is only applied by each country to those business visitors who are nonresident aliens, and then only if such persons are physically present for a period usually not exceeding 6 months. In other words, the United States would not forego taxability of income attributable to services performed in the States by a business visitor who is an American citizen, and this is so though he might then actually be a resident of a foreign country.
SECTION B. COMPARING COMMON MARKET TAXES ON AMERICANS ASSIGNED TO WORK IN A MEMBER NATION

(a) Foreign tax effect when an American establishes residence abroad: In general.—Aside from special exclusions designed to accommodate international business visits, the income tax of almost all countries reaches earnings derived by anyone from personal services performed locally. Common Market countries, like the United States, go on generally, however, to consider residence there a proper basis for asserting jurisdiction over a person's total income, from wherever derived. Absent special provision, this would mean that at least two countries would be asserting worldwide jurisdiction over the total income of an American citizen who has taken up residence in a Common Market country. Section C, infra, describes the two prime types of relief which have been incorporated into the Internal Revenue Code to accommodate the plight of such a person. The first, in the form of an inclusion, is limited to the American citizen's foreign service income. The second, in the form of a credit for any foreign income tax which may have been paid, would, inter alia, accommodate that citizen's other income but only to the extent it is derived from sources outside the United States. In other words, America insists upon full payment of tax attributable to that part of a nonresident citizen's income which may have been derived from sources within the United States. Many foreign countries have unilateral statutory provisions which are designed, in one degree or another, to protect any resident who is an American citizen from double taxation with respect to this latter type of income. Luxembourg has one of the least attractive arrangements of this type in that it only allows the American tax attributable to such benefits to be deducted from gross income in computing the net base. The other five Common Market countries are now hemmed in by provisions in the bilateral tax treaties. As is indicated more fully in the notes,¹ these fall into three general categories. The Bel-

¹ By Article XII of the Belgian treaty, Belgium agreed (1) to reduce to ½ the Professionelle and Nationale Crisis taxes which would otherwise be levied on income sourced in and taxed by the United States, (2) to tax income from personal and real property having a source in the United States at a maximum rate of 12%, and (3) to reduce to ¾ the personal complementary tax on the American citizen with reference to income sourced in and taxed by the United States.

Unilaterally, Italy does not apply its complementary progressive income tax on a resident alien's income from other sources until it is remitted. But by Article XV (a) (b)
gian provision calls for a substantial reduction in the rate on that income which such a person continues to derive from American sources. Italy responds by crediting the American tax against their own assessments. Germany, France, and the Netherlands, on the other hand, generally provide exemptions for such income though the latter country does not grant such in the case of dividends, interest, and royalties received by individuals.

The Common Market countries also take different approaches in resolving the question of whether an American has become a resident in one of the former countries for tax purposes. A person who has resided in Germany or in Luxembourg for a period in excess of 6 months is deemed a resident and will be taxed accordingly, beginning with the first day of his stay. While the basic period in France is five years, a person in the service of an enterprise situated there is likely to be considered a resident after one year and be taxed accordingly from that moment on. At a minimum, he will be taxed the first year on income having its source in France or on a sum equal to five times the rental value of his house or apartment, whichever is greater.

Theoretically, the other three member nations do not gear the question of residence for tax purposes to any particular period of stay. Under the taxing statutes of Belgium and the Netherlands, the question turns on the total facts. In Italy the matter is tied to the civil law interpretation of domicile. But as a practical matter, all three countries will normally assert residence at least at the point when a stay has extended beyond one year.

of the treaty, Italy agreed to reduce its tax by the amount of United States tax on income from sources in the United States where such income was not exempt from United States tax. The formula includes an arrangement to prevent the credit from immunizing Italian taxes on income derived from non-United States sources. Dividends sourced within the United States are treated separately; Italy allows a credit against tax in an amount equal to 8% of the dividend itself.

By Article XIX(3) of the Netherlands treaty, the Netherlands agreed to grant a credit, insofar as allowed by Netherlands law, for income taxes paid to the United States. But see also the reference in Section D, infra, to an exclusion permitted by the national law of the Netherlands.

By Article XV(1)(b) of the German treaty, Germany agreed to immunize from tax income of an American citizen derived from the United States and not exempt from United States tax. However, Germany reserved the right to include excluded items for the purpose of determining the rate applicable to other income.

Article 14(B) of the French treaty governs its response. A credit is allowed against the proportional tax on interest, dividends, and trust income, derived from the United States. Any other income derived from the United States is exempt from that tax. Also, Article 164 of the French General Tax Code has been frozen into the treaty, and generally exempts U.S. income from the French general income tax when derived by an American residing in France, providing such income was taxable in the United States.
(b) Comparative progressive impact of Common Market income taxes on employment income.—The country-by-country survey in PART I contained separate descriptions of the income taxes which each member nation would impose on individuals. Three countries—Germany, Luxembourg, and the Netherlands—follow a basic pattern much like that used in the United States in that only one income tax is imposed on individuals. France's reform in late 1959 also moved it toward that same type of structure. While at least temporarily it did retain a complementary tax in addition to its general income tax, only the latter applies to wages and salaries. In lieu of the former, employers pay a substitute tax which the employees may credit against their general income tax.

The two other countries—Belgium and Italy—superimpose a progressive surtax on other separately scheduled income taxes which are divided by reference to various classes of income.

Considerable variation also exists with reference to the way in which allowances for a spouse and other dependents are handled. The Italian approach to this problem most closely resembles that of the United States; the matter is accommodated by deductions from gross income in arriving at the tax base. The personal allowance for the taxpayer amounts to $387; each dependent, including a spouse, gives rise to an additional $81 deduction.

Belgium solves the dependency problem through credits against tax on the first $5,000 of income, as follows:

(a) 5% each for the first and second dependents;
(b) 10% each for the third and fourth dependents; and
(c) 20% for each additional dependent.

Belgium also exempts from tax a modest amount ($500 to $800 depending on the size of municipality in which the taxpayer resides) but only if the total income does not exceed the exemption.

The French response involves a split-income arrangement for computation purposes, the taxpayer and his spouse counting as one each, other dependents being counted as ½ each.

Germany also mitigates progression by allowing the taxpayer to split his income with his spouse for computation purposes. Allowances for children, however, are handled in a fashion similar to that in the United States and Italy, the deductions from gross income being $214 for the first child, $400 for the second, with $428 being allowed for each additional child.

Finally, Luxembourg and the Netherlands approach the prob-
lem through multiple rate tables, the choice of a particular table being dependent upon the taxpayer's family situation.

As indicated in PART I, other deductions from an individual's gross income will also vary from country to country. However, practically all have established some kind of minimum standard deduction to accommodate an employee's *business* expenses; amounts in excess of that must be itemized *en toto*. Also interesting because of its departure from American practice is the allowance frequently allowed for life insurance premiums, up to a certain amount. Germany and Luxembourg add on old age, health, and accident insurance. While Belgium also allows a deduction for social security contributions, the Netherlands even permit a deduction up to a certain amount for premiums paid on a life annuity contract. Life insurance, however, is not accommodated there. Germany and Luxembourg also permit a taxpayer to take a standard personal deduction in lieu of itemizing most other personal deductions. This is separate and apart from the standard business deduction previously mentioned.

A final significant departure from American practice involves a deduction of all or a part of the income tax itself. While France and Italy permit their complementary tax and separately scheduled income taxes, respectively, to be deducted from the amount subject to their respective progressive taxes, Belgium goes on to allow the progressive tax of one year to be deducted from that income subject to progressive tax in the next year.

Comparison of the relative impact of each member nation's income tax on individuals is only possible on the basis of assumed facts. Table V A assumes that all income (salaries of $6,000, $12,000, and $48,000) was derived from employment, and reflects the *effective* percentage which would be absorbed by taxes against single taxpayers and married taxpayers with two children, standard minimum deductions also having been taken into account. It will be noted that Italy is quite generally on the low side, with the Netherlands being consistently on the high side. Also to be noted is the fact that the United States would generally fall into the less demanding group, for real progression in Europe generally starts at a lower figure than in the United States.

Many Americans will draw an added bonus from their employers for foreign service even though the dollar has a comparatively high purchasing power in most Common Market countries. Foreign tax
TABLE V A  
EFFECTIVE RATES ON SALARY INCOME

<table>
<thead>
<tr>
<th>COUNTRY</th>
<th>Salary, $6,000</th>
<th></th>
<th>Salary, $12,000</th>
<th></th>
<th>Salary, $48,000</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Single Taxpayer</td>
<td>Married and Two Children</td>
<td>Single Taxpayer</td>
<td>Married and Two Children</td>
<td>Single Taxpayer</td>
<td>Married and Two Children</td>
</tr>
<tr>
<td>Belgium</td>
<td>22.37%</td>
<td>16.77%</td>
<td>36.61%</td>
<td>34.23%</td>
<td>56.70%</td>
<td>56.10%</td>
</tr>
<tr>
<td>France *</td>
<td>22.33%</td>
<td>8.19%</td>
<td>28.42%</td>
<td>14.98%</td>
<td>41.97%</td>
<td>31.22%</td>
</tr>
<tr>
<td>Germany **</td>
<td>25.2 %</td>
<td>16.—%</td>
<td>33.5 %</td>
<td>24.3 %</td>
<td>47.2 %</td>
<td>40.80%</td>
</tr>
<tr>
<td>Italy</td>
<td>12.36%</td>
<td>12.05%</td>
<td>14.98%</td>
<td>14.84%</td>
<td>21.74%</td>
<td>21.60%</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>28.53%</td>
<td>13.88%</td>
<td>39.65%</td>
<td>27.50%</td>
<td>51.55%</td>
<td>49.06%</td>
</tr>
<tr>
<td>Netherlands</td>
<td>36.21%</td>
<td>28.35%</td>
<td>49.07%</td>
<td>40.36%</td>
<td>64.30%</td>
<td>61.11%</td>
</tr>
<tr>
<td>United States</td>
<td>17.40%</td>
<td>10.—%</td>
<td>24.20%</td>
<td>15.40%</td>
<td>50.50%</td>
<td>35.60%</td>
</tr>
</tbody>
</table>

* In comparing the French effective rate, account must be taken of the fact that salaries are free from the 8% complementary tax, employers paying in lieu thereof a slightly progressive tax by reference to wages paid each employee. Though paid by the employer, this latter tax is credited by the employee against his general income tax. The above figures take into account a 5% credit, this being the normal percentage paid by employers.

** A church tax, usually amounting to 8% of the tax on wages, must be added.

*** Figures are those applicable to taxpayers under age 50.

Authorities generally treat this as part of their taxable incomes. Americans do, however, frequently receive quite favorable treatment on other scores; this varies from special allowances for expenses up to a certain percentage, to acceptance of currency exchange rates which are lower than those officially posted. Illustratively, where American controlled enterprises have sent employees from the head office to establish Belgian factories or offices, those employees who are deemed to retain their tax residence in the United States have received the benefit of a special ruling from the Belgian authorities. If the employee’s European activities are conducted almost exclusively in Belgium, he is permitted a standard deduction equal to 50% of the salary received in Belgium.

Generalizations with respect to the circumstances in which Americans may enjoy special tax benefits are not really meaningful, however, for such matters usually depend upon negotiation in each case. And as more and more Americans take up residence in the Common Market, it is likely to become more difficult to obtain such privileges.
Section C. Impact Of U.S. Income Tax On American Employees Assigned To Foreign Stations

(a) Introductory note.—In the first income tax act passed pursuant to the Sixteenth Amendment, Congress asserted a power to tax an American citizen on his income “from all sources,” without regard to whether he worked or resided “at home or abroad.” This sweeping view of jurisdictional power was sustained—as a constitutional matter—on the theory that “government, by its very nature benefits the citizen and his property wherever found.”

It was equally true, however, that a citizen who derived his income by performing services in a foreign country also benefitted from the activities of that government and, at least to the extent of the income earned there, was usually taxed by it. Congress began to respond to this double tax threat in 1916; within 10 years, it had instituted three relief measures. These served as mutually exclusive alternatives in some situations; in certain others they were complementary.

The first congressionally inspired relief against double taxation has survived in slightly altered form to this day. It involves a deduction from gross income of most of the different types of taxes imposed by a foreign country. But this deduction fell far short of relieving the citizen of the entire burden of his foreign tax. For example, if his effective domestic rate was 33%, the American tax was in effect reduced only by an amount equal to one-third of the foreign tax. The taxpayer himself continued to shoulder the economic burden of the remaining two-thirds.

The consequence of this limited form of relief was re-examined during World War I when both domestic and foreign income tax rates were being increased. Fear was expressed that citizens were still discouraged “from going out after commerce and business in different countries or residing for such purposes in different countries.” It was asserted that some would even “become a citizen of another country . . . in order to escape the large and double taxa-

---

2 Rev. Act of 1913, Section II, § 1, Subdiv. 1.
3 Cook v. Tait, 265 U.S. 47, 56, 44 S. Ct. 444 (1924).
4 The prime exception to this rule of taxability today relates to immunity accorded nonresident alien business visitors whose performance of services and stay do not exceed a limited period, usually 6 months. See discussion in Section D, infra.
5 Rev. Act of 1916, § 5(a) Third, now reflected in I.R.C., § 164. The deduction does not embrace estate, inheritance, legacy, succession, or gift taxes, nor taxes assessed against local benefits of a kind tending to increase the value of the property assessed.
As an alternative to the deduction, it was provided that foreign income taxes, as well as war profits and excess profits taxes, could be taken as a credit against the American tax itself. The previously existing deduction arrangement now assumed a complementary as well as an alternative status. It complemented the credit in that it was the only form of relief with regard to foreign taxes other than income taxes, though later the credit itself was extended to cover any foreign tax paid "in lieu of a tax on income, war profits, or excess profits otherwise generally imposed" by a foreign country.

From the earlier discussion in Section B, supra, it will be recalled that the effective income tax rates in several Common Market countries exceed those assessed in the United States. If a taxpayer's entire income is attributable to his foreign employment, the effect in this circumstance would be to wipe out his American tax liability. The taxpayer may not avail himself, however, of any excess foreign tax as an offset against any American tax liability attributable to income which he derived in that year from United States sources. More accurately speaking, one's credit for income taxes paid a foreign country may not exceed that proportion of the American tax which his "taxable income" from the foreign country bears to his total "taxable income." 

The comparisons made in Section B, supra, also revealed in some circumstances that the effective American rates were higher than those of some Common Market countries, Italy being the most striking example. American emphasis on the income tax was even more noticeable when compared to many non-European countries. In the mid-1920's, this meant that any differential in tax was always paid over to the federal government. In that era, however, an asserted desire to help increase our exports led the House Committee on Ways and Means to propose that under certain conditions

---

7 Rev. Act of 1918, § 222(a)(1), now, as modified, I.R.C., § 901 et seq.
9 I.R.C., § 904. For the purpose of computing this limitation, an individual's "taxable income" must be computed without any deduction for personal exemptions. Provision is made in § 904 for a carry-over of excess foreign taxes, but this will usually be advantageous only if the foreign rate is reduced in future years to a point below the American rate. For other details relating to the credit, see PART III, supra. Section F of that Part calls attention to the new statutory election which permits the taxpayer to substitute an "overall" limitation for the per-country limitation discussed in the text. In effect this would permit the taxpayer to average foreign taxes paid to high- and low-tax countries.
Americans working abroad in connection with export sales be freed of any such differential with regard to their salaries or commissions. An exclusion of such benefits from their domestic gross income was to serve as the device by which to accomplish this end.  

While the Senate agreed that certain conditions should be imposed, it insisted that this third more favorable and controversial arrangement be extended to all types of foreign earned income. This latter exclusion was to be the repeated focus of congressional concern for many years. Only where its constantly changing requirements could not be satisfied would a citizen assigned to a foreign station normally fall back on the credit for foreign income taxes and the deduction for other foreign taxes.

While the exclusionary device would obviously be most advantageous where the service was performed in a low income tax country like Italy, it must be remembered that the advantage would be diluted in some part by the prejudice which such a citizen would otherwise suffer because of the substantial reliance by low income tax countries on turnover taxes. The latter, normally not considered income taxes nor imposed in lieu of such, would not usually qualify for the credit. Nor would they qualify for the alternative deduction to the extent such taxes were imposed on persons other than the ultimate consumer, and this was so though in the end the economic, as distinguished from the legal, incidence of such taxes fell on the consumer.

A discussion of the shifting statutory standards applicable to the exclusion for foreign service income follows.

(b) Evolution of the present alternative standards applicable to the exclusion.—The House first proposed that the exclusion for foreign service income be allowed if the citizen was abroad for more than 6 months of the taxable year. This dividing line was seized upon because certain countries subjected an American to their income tax if he lived there in excess of 6 months. While the Senate Finance Committee thought it was enough in such cases to grant the previously allowed credit for foreign income taxes, in the end the exclusionary principle prevailed, but only if

10 H.R. 1, 69th Cong., 1st Sess. 7 (1926), § 213 (b) (14) of Committee Print No. 1.
12 The provision in I.R.C., § 164, which authorizes consumers to deduct retail sales taxes which are actually imposed on retail vendors, does not even apply in a foreign setting.
13 See note 10, supra.
the citizen was a "bona fide nonresident of the United States for more than six months during the taxable year." 16

The latter condition, interpreted to require nothing more than physical absence from the United States for over half of the taxable year, 17 was later thought in practice to be entirely too lax. Within 4 years, the Senate Committee discovered "to our surprise, that . . . American ambassadors and ministers and officers of the foreign service were getting clear out of the payment of any income tax . . . , which nobody in the world ever intended. . . . These people do not deserve the exemption, because they are not subject to the income taxation of the foreign countries in which they are stationed. . . ." 18 Of course, this could be, and was, remedied by neutralizing the exclusion in the case of amounts paid by the United States or any agency thereof. 19 But in 1942, the same Committee noted that the provision had also "suffered considerable abuse in the case of [other] persons absenting themselves from the United States for more than 6 months simply for tax-evasion purposes." 20

There was no guarantee, of course, that such a person would stay in one foreign country long enough to suffer its tax. This, plus the asserted belief that the whole idea of an exclusion involved "unjust discrimination" in favor of those earning income abroad, led the House Committee on Ways and Means—the original sponsors of the exclusionary principle—to call for its complete elimination. 21 But the Senate Committee thought such an elimination would "work a hardship in the case of citizens . . . who are bona fide residents of foreign countries," noting, for example, that "many employees of American business in South America do not return to the United States for periods of years. Such persons are fully subject to the income tax of the foreign country of their residence." 22 In the end, the Senate prevailed; the exclusion was still to be allowed, but only if the person was a (1) "bona fide resident of a foreign country or

---

17 G.C.M. 9848, C.B. X-2, 178. This view was also adopted in Commissioner v. Fiske, (7th Cir. 1942) 128 Fed. (2d) 487, cert. den., 317 U.S. 635, 63 S. Ct. 63 (1942).
19 Rev. Act of 1932, § 116(a), now reflected in I.R.C., § 911. However, certain immunities are provided in the case of cost of living allowances drawn by certain government employees. I.R.C., § 912. Post World War II treaties with Common Market countries provide immunity from foreign tax in the case of amounts paid by the United States or its agencies.
countries” and (2) was such “during the entire taxable year.”

The intended effect of this shift, according to the Chairman of the Senate committee, was to reach those “American citizens who are merely temporarily away from home,” while preserving the exclusion “in the case of the bona fide, nonresident American citizen who established a home and maintains his establishment and is taking on the corresponding obligations of the home in any foreign country. . . .”

To accommodate the problem which would arise under the “entire-taxable-year” rule in the case of mid-year changes of residence back to the United States, it was further provided that if the person had been a bona fide resident of a foreign country for at least a two-year period before he again took up residence in the United States, earned income attributable to the final partial year was excludable.

Almost a decade passed without further change. Then, in 1951, the Senate Finance Committee moved to liberalize the exclusion on two fronts.

To alleviate the first-year plight of one who became a bona fide resident of a foreign country in mid-year, the “entire-taxable-year” rule was modified so as to allow the exclusion where such residence was “for an uninterrupted period which includes an entire taxable year.”

Even more important was the establishment over the House Committee's objections of a general standard which continues to serve today as an alternative to the bona-fide-residence rule. This separate test involved a revival in modified form of the earlier discarded and less demanding physical absence test.

In developing this alternative, the Senate Committee noted that the United States was then trying to aid foreign countries under the Point 4 foreign aid program, and that in keeping with this program it was desirable “to encourage men with technical knowledge to go abroad.” It was further asserted that because “the term ‘bona fide’ residence abroad . . . [had] been construed quite strictly,” many persons who had gone abroad to work “even for a relatively

---

25 Rev. Act of 1942, § 148, amending I.R.C. (1939), § 116(a). While the language of the provision might not seem to limit the exclusion to income for the last partial year, the committee's report and the catchline in the statute indicated this was the limited purpose. S. Rep. No. 1631, 77th Cong., 2d Sess. 55 (1942).
long period of time” had been unable to obtain an exclusion of their foreign earned income. They had failed to measure up on either of two counts.

One difficulty was that the “nature of the individual’s work . . . [was] such as to make it difficult to establish a ‘residence’ in the more widely accepted use of the term.” Others had fallen short because they had “gone abroad only for a stated period of time. Examples of this . . . [were] managers, technicians, and skilled workmen who are induced to go abroad for periods of 18 to 36 months to complete specific projects.”

The enacted solution granted an exclusion of foreign earned income where the person was physically present in a foreign country or countries 510 days (approximately 17 months) out of any consecutive 18 month’s period, though for reasons previously stated in connection with the bona-fide-residence test, this immunity was not to be available with regard to amounts received from the United States government or an agency thereof.

Within two years, widely publicized abuses of the new alternative standard which had been added to what is now § 911 of the Code led the House Committee, in 1953, to respond to the Secretary of the Treasury’s demand for “corrective legislation” by calling for complete elimination of the new alternative. Both noted that while the provision “was designed to encourage men with technical knowledge to go abroad in order to complete specific projects, . . . individuals with large earnings [such as movie stars] have seized upon the provision as an inducement to go abroad to perform services, which were customarily performed at home, for the primary purpose of avoiding the Federal income tax.” Equally disturbing was the fact that in many such cases, the persons did “not pay income tax even to the foreign country or countries in which the income is earned. This is because they are not in any particular foreign country long enough to establish a residence or because the foreign country in question does not impose any income tax.”

28 Ibid.
29 Ibid.
30 Ibid.
34 Ibid.
In the end, a less drastic change proposed by the Senate prevailed; it was content to limit the exclusion under this alternative standard to $20,000 per taxable year, or to a pro tanto part thereof for any period less than a taxable year.\textsuperscript{35} This limitation, did \textit{not}, however, carry over to those persons who could satisfy the older and quite separate bona-fide-residence test.

\textbf{(c) Differences in the character of foreign status required by the exclusionary principle's two alternative standards.—}More handsomely paid Americans who are assigned to work in a Common Market country, particularly in one which has a low income tax such as Italy, will derive greater advantage if they satisfy § 911's foreign-bona-fide-residence test rather than its alternative 510-day rule. Satisfaction of the former would permit avoidance of the latter's $20,000 per year limitation. As we shall later see, even in the case of those less well paid, the bona-fide-residence test will also more effectively preserve the integrity of the exclusion with reference to certain deferred compensation plans, and will facilitate more flexible planning with respect to vacations and business trips back to the States. Except in the most clear cut cases, however, it has not been easy to predict in advance whether the more liberal bona-fide-residence test will be satisfied.

Little interpretative difficulty will be encountered, of course, in connection with the one mathematically fixed objective criterion to the effect that a qualified status must exist "for an uninterrupted period which includes an \textit{entire taxable year}.” But in addition to this independent requirement relating to time, a \textit{qualified} status, i.e., something more than mere physical presence in a foreign country, must also exist. Difficulty in predicting whether one has become a bona fide resident of a foreign country under \textit{American} standards stems from the fact that it turns on "his \textit{intention} with regard to the \textit{length and nature} of his stay.”\textsuperscript{36} And here one starts with two handicaps. As one court put the first, "Exemptions as well as deductions are matters of legislative grace, and a taxpayer seeking either must show that he comes squarely within the term of the law conferring the benefit sought.”\textsuperscript{37} Even if the facts are stipulated, there will be difficulty in showing that they "squarely” satisfy a rule so ill-defined.


\textsuperscript{36} I.T. Regs., § 1.911-1(a)(2) refers back to § 1.871-2(b) for this definition. (Italics added.)

\textsuperscript{37} Donald H. Nelson, 30 T.C. 1151 (1958).
Second, frequently the question is said ultimately to be one of fact with regard to which the taxpayer bears the burden of proof. And because it is a question of fact, Tax Court decisions, to which one might otherwise look for authority, generally include a statement in the "Findings of Fact" to the effect that the particular taxpayers involved there were or were not bona fide residents of a foreign country. In most cases, however, those persons intended to do just what they did do, and the standard to which the intention must relate was at least closely akin to a question of law. Courts implicitly recognized this when they made an effort in their opinions to distinguish the cases at bar from other decisions. But even when doing this, they frequently added, because all surrounding circumstances were important in deciding such cases, that it was not possible or worthwhile to attempt to harmonize the many decisions.

Certainly there is general agreement that cases involving questions of residence in non-tax statutory settings are of no value; "bona fide residence" for this purpose is to be determined in the light of the congressional purpose in enacting this particular provision.

In seeking out the congressional purpose, the report of the sponsoring Committee furnished two helpful guides, one of which had only a narrow thrust. It was to the effect that "Vacation or business trips to the United States during the taxable year will not necessarily deprive a taxpayer, otherwise qualified, of the exemption provided by this section." The other was to the effect that American tests used in determining whether an alien was a resident of the States were to be employed in deciding whether an American was a bona fide resident of a foreign country. This led courts to place great reliance on the previously existing regulations relating to aliens, and these administrative provisions turned the question on the taxpayer's intention "with regard to the length and nature of his stay."

In general, those regulations sought to distinguish transients from those who truly made their "home" abroad. With reference to

39 Burlin B. Hamer, 22 T.C. 343 (1954); Charles F. Bouldin, 8 T.C. 959 (1947).
40 Fred H. Pierce, 22 T.C. 493 (1954); Charles F. Bouldin, 8 T.C. 959 (1947).
44 Ibid.
the projected length of stay, the taxpayer would not fall short merely because he had a "floating intention, indefinite as to time, to return" to the States. But he could not attain the necessary status if, on going abroad, the purpose was one "which in its nature may be promptly accomplished." In other words, his purpose had to be of such a nature that "an extended stay may be necessary for its accomplishment, and to that end the . . . [person] makes his home. . . ." abroad. This was sufficient even though the person also intended "at all times to return to his domicile [here] . . . when the purpose" had been consummated or abandoned.46

Obviously the difference between a purpose which may be "promptly accomplished" and one which requires an "extended stay" is not easily drawn. But in interpreting the further requirement that the person make his "home" in the foreign country, though he may ultimately intend to return, some courts have been assisted by the statement which the Chairman of the sponsoring Committee made during the course of congressional hearings. He said, it will be recalled, that the provision was intended to accommodate "nonresident American citizens who established a home and maintains his establishment and is taking on corresponding obligations of the home in any foreign country. . . ." 47

It seems fairly clear from the foregoing that one might be able to predict that there would be a meaningful difference between the employee who lives abroad in company barracks, eats in a mess hall provided by the employer—mingling only with other employees,48 and another who resigns from all of his American clubs, gives up his house in the States—moving his family and furniture abroad where he takes a long-term lease on a house, opens charge accounts, and joins in some community activities of the foreign country and pays income tax to it.49 The fact is, however, that there are no reliable rules of thumb. For example, the first man might have been a resident from the beginning if he had intended, for

46 I.T. Regs., § 1.871-2(b), (Italics added.) The cases agree that the person may be a foreign resident though the United States remains his domicile. Comm'r. v. Swent, (4th Cir. 1946) 155 F.(2d) 513; Fred H. Pierce, 22 T.C. 493 (1954). In Leigh White, 22 T.C. 585 (1954), the Court stated (at 590): "It is made clear by many decisions that the term is not to be confused with 'domicile,' and that it includes a temporary residence, where an extended stay is contemplated although there is at all times an intention thereafter to return to a former residence or to establish a new residence elsewhere."


example, to bring his family over when housing became available.\textsuperscript{50} And he may not have paid a foreign income tax only because he sup­posed, in his ignorance, that none was due because of something he had heard about tax treaties.\textsuperscript{51}

To assure somewhat greater certainty of result, the taxpayer may also seek to qualify under the 510-days-out-of-18-months-foreign-physical-presence test, even though it is limited by the apportionable $20,000 per year limitation.

The 510-day requirement relates to full days (midnight to midnight)\textsuperscript{52} actually spent in a foreign country.\textsuperscript{53} It also includes the time spent in going between foreign countries so long as travel over international waters does not exceed 24 hours nor involve a detour to the United States, its possessions, or territories.\textsuperscript{54} While the 510 days need not be consecutive, being broken by a vacation or business trips back to the States, the foreign earned income attributable to a particular day is immune only if that full day is one of 510 which do fall in a consecutive 18-month’s period. Because of the peculiar way in which a taxpayer’s interim return trips are scattered, in immunizing the income of a particular day, he may find it necessary to overlap different 18-month’s periods, treating one as beginning before another ends.\textsuperscript{55}

(d) Types of benefits excluded under § 911’s alternative standards, and allocable deductions.—A taxpayer who is entitled to a § 911 exclusion with respect to foreign service income may also avail himself of other exclusions applicable to taxpayers generally. For example, suppose that an American employer either pays or reimburses an old employee for expenses incurred by him in moving

\textsuperscript{50} Cf. Seeley v. Comm’r., (2d Cir. 1951) 186 F.2d 541; Fred H. Pierce, 22 T.C. 493 (1954).
\textsuperscript{52} I.T. Regs., § 1.911-1(b) (10).
\textsuperscript{53} Defined to include only territory under the sovereignty of a foreign government and the air space above. I.T. Regs., § 1.911-1(b) (7).
\textsuperscript{54} I.T. Regs., § 1.911-1(b) (10). If he does detour to the United States, its possessions, or territories, the period of the detour, including the day he left the foreign country through the day on which he returned to a foreign country, would not be counted in the 510 days.
\textsuperscript{55} For example, assume that the taxpayer first arrived in France, from the United States, at noon, December 31, 1956. He left France for the United States at noon, December 1, 1957, arriving back in France on December 31, 1957. He again left France on August 1, 1958, returning there on August 31, 1958. He left France permanently for reassignment to the United States on July 1, 1959. Income attributable to March 15, 1957 would qualify by reference to the 18-month period, January 1, 1957 through June 30, 1958. Income earned on September 1, 1958 could qualify by reference to the overlapping period January 1, 1958 through June 30, 1959.
himself, his family, and furniture to an overseas station. This material benefit would not be covered by the § 911 exclusion. Practically all, if not all, of this benefit is attributable to a period prior to the establishment of foreign residence. Nor would the 510-day rule cover this arrangement, for its springs into operation only with the first full day in which the taxpayer is present in a foreign country. Nevertheless, the Internal Revenue Service agrees that this benefit would be excludable if the transfer was actually made for the convenience of the employer. In that circumstance, the payment is not deemed compensatory in character and is, therefore, beyond the reach of § 61 which defines gross income.56

The § 911 exclusion itself constitutes a sanctuary from domestic tax only with reference to foreign "earned income"; other types of foreign income, such as interest or dividends, will enjoy only the advantage of the previously described credit or deduction allowed by American law for foreign taxes. None of these cushions will be available, however, with reference to any kind of income which has its source in the United States. This is so even with respect to income attributable to services performed during a temporary business visit to the United States by an American citizen who has become a bona fide resident of a Common Market country.57

56 Rev. Rul. 54-429, C.B. 1954-2, 53. The same ruling calls for a different result in certain situations involving new employees. Where an employee moves from one locality in the United States to another to accept employment with a new employer, reimbursement by the latter for those moving expenses would be includible in the employee's gross income and could not be deducted in arriving at taxable income. Also U.S. v. Woodall, (10th Cir. 1958) 255 F. (2d) 370, cert. den., 358 U.S. 824, 79 S. Ct. 39 (1958); Rev. Rul. 59-236, I.R.B. 1959-28, 14. Americans hired within the United States for re-assignment to foreign branches would normally spend a period at the home office, being oriented. Reimbursement for their subsequent oceanic travel would probably be excludable. But the result is less clear if a wholly owned foreign subsidiary paid oceanic moving expenses incurred by an old employee of the American parent on the occasion of his transfer from the parent's offices in the United States to the subsidiary's offices in the Common Market. Technically at least, the employee is changing employers.

57 Looking only at the Code, it is clear that income from services has its source where the services are performed. I.R.C., § 861 (a) (3). Moreover, the Code itself immunizes income from services performed in the States only in the case of certain nonresident aliens who are here for 90 days or less. Ibid.

The tax treaties which the United States has with 5 Common Market countries do not immunize the American earned income of a nonresident American. The treaty with Belgium is typical. On the one hand, it does provide that a "resident of Belgium shall be exempt from United States tax upon compensation for labor or personal services performed within the United States. . ." if he fits certain classifications. Article XI. But in that treaty, as in the others, the United States reserved the right in the case of its own "citizens or residents or corporations . . ." to impose its regular income tax law as though the "convention had not come into effect." Article XII. Provisions similar to this have been interpreted to mean that the regular Code provisions apply to nonresident Americans. Marie G. Crerar, 26 T.C. 702 (1956).
The Code section which establishes an exclusion for foreign "earned income" goes on to relate it to "wages, salaries, or professional fees, and other amounts received as compensation for personal services actually rendered. . . ." In some settings, difficult questions of fact will arise in determining whether a given payment is truly for services or for something else. Illustrative are those situations where the taxpayer occupies a dual relationship to an enterprise, such as where he is an employee as well as a stockholder of a corporation or where he owns as well as manages a proprietorship with reference to which both capital and services constitute material income-producing factors. In the former setting, a principal stockholder—knowing that dividends would be includable in domestic gross income—may attempt to characterize a payment as compensation for his foreign services though the amount actually exceeds a reasonable allowance for these services. The government has the authority, of course, to police the provision, apportioning the excess to the dividend category. And in the case of the proprietorship where capital was also a material income-producing factor, the Code expressly includes a ceiling on that portion of the net profits which can be considered compensation for the owner's services, the limitation being 30%. A realistic apportionment may, of course, call for exclusion of less than 30%; that figure is only a ceiling.

Differences between the two forms of enterprise may also be important with reference to the loss of an exclusion in the case of "amounts paid by the United States or an agency thereof." For example, because of this statutory language, it has been held that an exclusion will not be enjoyed with reference to the distributive share of a professional partnership's profits which arose out of a government contract with the firm for its foreign services. On the other hand, where one is truly an officer or employee of a corporation, he will not lose the benefit of the exclusion merely because the employer is working on a government contract.

While the Code excludes earned income attributable to a qualified period only if it is "received from sources without the United States," the latter requirement is satisfied if the personal services

58 I.R.C., § 911(b).
59 Ibid.
60 Ibid.
61 I.T. Regs., § 1.911-1(a) (5).
62 Leif J. Sverdrup, 14 T.C. 859 (1950). But that case did approve the exclusion with respect to a so-called salary paid one partner.
are "performed" abroad. The "place of receipt" is immaterial. But only under the bona-fide-residence test is the time of receipt immaterial. Under that test, deferred payments which are attributable to earlier foreign service and are paid in the years following the employee's return to the States may be excluded if the other requirements are satisfied. In some instances, a contractually deferred payment of this type may completely escape taxation because of the inability of a Common Market country to collect tax once the American has returned to his native land. However, if the amount in question is properly chargeable for tax purposes to a foreign permanent establishment or is paid by a foreign subsidiary, in all probability the withholding requirements of a particular Common Market country at least theoretically apply. But in five of the Common Market countries this is probably not the case if the contractually deferred compensation takes the form of a "pension." It is assumed in this connection that the American citizen abandoned his foreign residence immediately upon returning to the United States, concurrently re-establishing his residence in his native land, after which the contractual "pension" payments were to be received. Bilateral tax treaties with the five provide that private pensions paid to American citizens residing in the United States will not be taxed by the Common Market country even though the latter is the source from which the pension is derived. And "pensions" are generally defined in those treaties, illustratively in the case of Belgium, to mean "periodic payments made in consideration of services rendered or by way of compensation for injuries received."

In the case of qualified funded retirement plans having their situs in the United States, unless an American working and residing in a Common Market country is taxed by the latter at that point of time when contributions to the fund were made by the American employer, a significant part of pension payments subsequently re-

---

64 I.R.C. §§ 911 and 862(a)(3), respectively. (Italics added.)
65 I.T. Regs., § 1.911-1(a)(6) and (b)(5); James D. Mooney, 9 T.C. 713 (1947); Herman A. Kollmar, 4 T.C. 727 (1945).
67 The benefit in any event is believed to be taxable in Belgium and the Netherlands, though difficulty in realizing upon the claim is recognized. In Germany, while so-called "home salaries" are fully taxable, the tax authorities have held that bonuses paid an employee after he has finished his work in Germany are not taxable.
68 Article X of the Belgian treaty is illustrative. On the other hand, the treaty with South Africa provides an opposite rule. Art. VIII(2). Cf. Rev. Rul. 56-235, C.B. 1956-2, 1125.
69 Ibid. (Italics added.)
70 It would be particularly surprising if a Common Market country would attempt currently to tax the employee on the employer's contribution if the employee's rights
ceived following the employee's return to the States will also be completely immune from tax. Such pension payments would be immune from American tax in the proportion the payment is directly attributable to the contribution which the employer made with reference to that earlier foreign service which qualified under the foreign bona-fide-residence test. However, that portion of the pension which represents earnings on or accretion in the value of those employer contributions will not be excludable for American tax purposes, for that part does not really constitute "earned" income entitled to the § 911 treatment. If the American has re-established residence at home, the treaty provisions noted above would, of course, foreclose the Common Market country from asserting tax liability by reference to the pension payments themselves, even if collection of tax were otherwise possible. The same overall degree of tax freedom might even be enjoyed by returning American employees who are beneficiaries of certain types of funded plans which have their situs in a Common Market country.

Returning employees whose foreign status qualified only under the 510-day rule will not fare so well, with reference at least to certain deferred compensation arrangements. Their difficulty stems from the way the government interprets the $20,000 limitation. Until this limitation was added, amounts which qualified under the 510-day rule, like those associated with the bona-fide-residence test, were excludable from gross income "irrespective of when they... [were] received." But in fixing the $20,000 ceiling, the statute was amended to read as follows:

the amount excluded under this paragraph for such taxable year shall not exceed $20,000. If the 18-month period does not include the entire taxable year, the amount excluded under this paragraph for such taxable year shall not exceed an amount which bears the same ratio to

were not vested. In the Netherlands, it is not believed that the benefit will be taxed in any event as long as the contribution is to a regular pension arrangement. Germany will immunize contributions at least if made to a company administered fund.


Ibid.

I.R.C., § 402(c) and note 71, supra. The statement assumes, with reference to an exclusion under foreign tax law for contributions made by the employer, that the foreign trust also meets requirements that might be imposed by foreign tax law.

$20,000 as the number of days in the part of the taxable year within the 18-month period bears to the total number of days in such year.\(^7^5\)

On the one hand, Congress clearly intended to restrict the $20,000 per year ceiling by a further pro-tanto type of limitation where the period of absence in a particular year was less than the whole year.\(^7^6\) The Treasury, however, also interprets the statutory language to mean that no exclusion will be permitted if none of the actual payment was received in a taxable year which fell, at least in part, within the 18-month period.\(^7^7\) According to its interpretation, where a calendar year taxpayer qualified under the 510-day rule and left Europe on July 1, 1960 for reassignment to the States, a maximum compensation of approximately $10,000 would be excludable provided it was attributable to the foreign service and was received within the taxable year 1960, a part of which did fall within the 18-month period. No part of any payment received in 1961 would qualify, however, even if it were the only compensation the taxpayer received for that six months of foreign service which fell in 1960.\(^7^8\) It is quite possible that these limitations, developed in the setting of deferred contractual payments, will also serve to restrict immunity with regard to pension payments under funded plans if the returning taxpayer's foreign status qualified only under the 510-day rule.

Taxpayers who enjoy the benefit of a § 911 exclusion will not be permitted to offset other U.S. income by deducting expenses allocable to the excluded amounts. But while the Code denies a deduction for any expense which is "properly allocable to or chargeable against" excluded amounts,\(^7^9\) so-called personal deductions, such as personal exemptions, charitable contributions, real estate taxes on a home, interest paid on a mortgage against the home, and medical expense are not adversely affected; these are not deemed allocable to any particular income item.\(^8^0\)

\(e\) Conclusion re Americans working abroad: Filing requirements, etc.—Traditionally, Americans have been required to

\(^7^5\) Technical Changes Act of 1953, § 204(a), now reflected in I.R.C., § 911(a)(2). (Italics added.)
\(^7^7\) I.T. Regs., § 1.911-1; Rev. Rul. 54-72, C.B. 1954-1, 117.
\(^7^8\) Ibid.
\(^7^9\) I.R.C., § 911. Where the $20,000 limitation precludes a complete exclusion of foreign earned income, deductions chargeable to such income are lost on the same proportionate basis. I.T. Regs., § 1.911-1(b)(6).
\(^8^0\) I.T. Regs., § 1.911(a)(3) and (b)(6).
file an income tax return when their gross income exceeded $600, or in the case of those over 65 years of age—$1200.\textsuperscript{81} Even before a recent statutory amendment, this meant that many who had gone abroad to work would still have to file a domestic return. Americans working abroad frequently realized more than $600 (or $1200 as the case may be) in other than \textit{foreign} "earned income" to which the special exclusion was confined. In fact, even with this exclusion and a full allowance for so-called personal deductions including full exemptions, returns of many of them could easily show that some tax was actually owing to the United States. This was so even if the non-excluded income was also derived from a foreign source, for the cumulative effect of the credit and deduction for foreign taxes will not necessarily wipe out the American tax liability. The Internal Revenue Service reported to Congress, however, that many such Americans were not even filing a domestic return, in part because they apparently supposed that their entire income was excludable.\textsuperscript{82} Certainly it is more difficult for an American working abroad to obtain information concerning his domestic tax liability, if any, than it is for those working in the States. In any event, absence of the information which would have been disclosed by such returns made it difficult for the Service to pick out those taxpayers whose affairs should be audited. Congress responded to this problem in 1958 by providing that even the foreign income which qualifies for an exclusion in determining tax liability will be included in gross income but \textit{only} for the purpose of determining whether the taxpayer had an amount of gross income ($600, or $1200 if over 65 years of age) sufficient to require the filing of a return.\textsuperscript{83} The obvious effect is that practically all Americans working abroad must now file a domestic return, though in the end many of them will not actually owe an American tax.

Because of the difficulty in filing a return if one is abroad on the regular filing date, the Treasury has granted an automatic extension of 3 months to calendar year taxpayers and 2 months to taxpayers on a fiscal year.\textsuperscript{84} A delay of 3 months is also allowed in the case of declarations of estimated tax, and while this extension is granted without any charge for interest, it is otherwise in the case of the final return.

Where a citizen, on departure from the United States, contem-

\textsuperscript{81} I.R.C., \S 6012.


\textsuperscript{83} Technical Amendments Act of 1958, \S 72, amending I.R.C., \S 6012.

\textsuperscript{84} Rev. Rul. 55-171, C.B. 1955-1, 80.
plates compliance with the 510-day requirement, the final return for the taxable year during which he left will normally be due before that exclusionary standard has been satisfied. The Congress and the Service have accommodated themselves to this problem. The former has provided that the government’s authority to grant extensions only up to 6 months shall not be so limited in the case of those who are abroad. In turn the Treasury has issued a ruling whereby one who desires to postpone determination of his tax liability until the exclusionary standard is met may, upon request, obtain a special extension regarding the regular filing date. Otherwise the matter will be handled on a refund basis.

Section D. Tax Implications Of Business Visits By Employees Between The United States And Common Market Nations

(a) Introductory note.—The preceding discussion in Section C outlined the requirements which an American citizen working in a Common Market country must meet if he hopes to obtain an exclusion of his foreign service income under § 911 of the Code. But even if such an exclusion is obtained, that individual may complicate his tax problem by making short intermittent visits back to the States. Double taxation will normally be avoided, however, for as noted in Section B, supra, most Common Market countries will defer in one degree or another to the American tax on compensation attributable to his work in the States, with Luxembourg having the least attractive arrangement—a deduction of the American tax from gross income.

Less tax complication will normally be encountered on similar trips made by a Common Market country citizen who has been working in his native land for an American owned facility. The same is true of trips made abroad by Americans who normally work at the enterprise’s head office in the United States. In these two cases, as distinguished from the situation first mentioned, the country being visited normally forgoes its right to tax any compensation attributable to services performed there.

The aims and period of time covered by such trips may run the gamut, from very short stays designed to enable the individual to purchase merchandise and equipment, to longer excursions devoted

80 I.R.C., § 6081(a).
to an analysis of sales promotion and production techniques of the
head office, of the foreign facility, or of a foreign licensee to whom
"know-how" must be communicated. A vacation may also be thrown
in for good measure.

The extent to which arrangements have been made to simplify
the tax problems associated with trips made by the three classes
of individuals described above is indicated in the discussion which
follows.

(b) Intermittent trips to the States during the period an
American is otherwise qualified for the § 911 exclusion.—Satisfac-
tion of the foreign-bona-fide-residence test or the alternative 510-
day rule of § 911 of the Code serves only to exclude an American
citizen's foreign earned income. Compensation attributable to his
business trips back to the States are not affected by those statutory
tests. The Code itself expressly designates the foreign country as
the "source" of compensation only with respect to services "per-
formed" there. Thus the place or origin of payment with respect
to work done on a business trip back to the States is irrelevant;
the amount so attributable must be included in American gross in-
come under § 61.

The statutory requirement that such compensation be included is
not neutralized by the bilateral tax treaties which the United States
has entered into with five of the Common Market countries. From
a casual reading of those treaties, one might at first think otherwise
if the American has become a resident of a Common Market coun-
try for tax purposes; those treaties do open by extending to Com-
mon Market "residents" an exemption from United States tax in
the case of income earned from services performed in the States
during the course of brief business trips. But those treaties close
with a reservation which accomplishes the same result which the
American treaty with the United Kingdom more directly accom-
plished by definition. Whereas the latter expressly defines English
"residents" for this purpose so as to exclude "a citizen of the United
States," the treaties with the Common Market countries achieve
a like result through a provision which expressly reserves to the

87 See discussion in Section C, supra.
88 I.R.C., § 861(a) (3) provides the only exclusion for circumstances of this type, and
it is limited to nonresident aliens. See subtopics (c) and (d), infra.
89 I.R.C., § 862(a) (3).
90 I.T. Regs., § 1.861-4(a).
91 Articles XI, 9, XI, XI, and XVI, respectively, of the treaties with Belgium, France,
Germany, Italy, and the Netherlands.
92 Article II(i) (g).
United States the right to tax its own citizens under the regular provisions of the Internal Revenue Code. 93

The fact that the compensation attributable to the United States trip is includible in his American gross income does not necessarily mean that the citizen will actually suffer an American tax. In most cases, of course, he would have had to file a United States return—though perhaps showing no actual tax liability—even in the absence of the trips in question. 94 If that compensation which is attributable to business trips to the States is the only income he realizes other than that excluded under § 911, the fact that he will be allowed full exemptions for himself and his dependents, as well as all other purely personal deductions, 95 may leave him with little or no American net or "taxable income." However, where the compensation is completely neutralized for American tax purposes by offsetting personal deductions, in only one instance is it probable that such compensation will completely escape taxation. Assuming in this connection that the American citizen has become a resident of the Common Market country in which he is stationed, he will usually find that the income attributable to his trip back to the States is also includible in the return which he files with that member nation.

This would be so if the country were Luxembourg; and there only a deduction in computing the tax base would be allowed for any American tax—here assumed to be none because of exemptions, etc.—which he might have paid. However, some of the other Common Market countries are more liberal with reference to earned income which a resident American derived from his native land. According to the discussion in PART I, the Netherlands would completely exempt the compensation in question even though an American tax is not actually suffered because of the offsetting personal exemptions, etc. 96 That income will be taken into account, however, for the purpose of determining the Dutch rate on the taxpayer’s other income.

While the bilateral tax treaties with five member nations include a provision aimed at compensation derived by a nonresident citizen

93 Articles XII, 14, XV, XV, and XIX; respectively, of the treaties with Belgium, France, Germany, Italy, and the Netherlands.
94 Every American citizen, as well as certain others, must file a U.S. return if he has a gross income over $600, or if over age 65, of $1,200. And for this purpose, but only this purpose, foreign service income otherwise excludable must be included. I.R.C., § 6012(c).
95 I.R.C., § 911 deprives him only of those deductions properly chargeable to the excluded income. See discussion in Section C, supra.
96 PART I, Section F(i)(h).
from his native land, they are not usually so liberal as is the unilaterial treatment accorded by the Netherlands.97 For example, the rate reduction formula of the Belgian treaty which was more fully discussed in Section B, supra, applies only where the compensation derived from American sources was "taxed by the United States."98 The treaty with Germany, also more fully described in Section B, calls for an exemption, but only if the item was "not exempt from United States tax."99 And, of course, the credit which Italy would allow springs into operation only if the compensation did, in fact, suffer an American tax.100

A vacation, rather than business, may motivate a return trip to the States by an American who qualifies for a § 911 exclusion under the foreign-bona-fide-residence rule. The absence of labor or services in the United States should mean that any compensation attributable to the vacation period will not have its source within the United States, but will instead be attributable to work previously done abroad and should then also come within § 911 if otherwise qualified.101

After a certain period of foreign service, some employers pay the transportation expenses associated with a vacation back to the States, covering the employee's family as well as the employee. Even if such a benefit is deemed additional income under American tax concepts, it would appear to be attributable to the foreign service and, therefore, also excludable by one who is qualified under the foreign-bona-fide-residence test.102 The same should be true of one

97 Indeed, the treaty with Netherlands requires only a credit to the extent permitted by its law.
98 Article XII(3).
99 Article XV. The leading commentary on Germany's tax treaties, that by Korn-Dietz, confirms the effective taxability requirement at p. USA-35.
100 Article XV.
101 Cf. Chidester v. United States, (Ct. Cl. 1949) 82 F. Supp. 322; Rev. Rul. 57-316, C.B. 1957-2, 626. An apportionment problem may arise where a part of the vacation is attributable to the period in which work was done in the United States.
102 It is entirely possible that one or more Common Market countries would treat this as a taxable benefit attributable to work done there. This is believed to be the rule in the Netherlands and in Germany. In the latter country, however, some immunity might be obtained under § 31 Abs. 1 EStG (Income Tax Act) pursuant to which those immigrating to Germany may petition the highest tax authorities of the Länder for the purpose of obtaining by negotiation a lump sum settlement of their income tax during each of the first 10 years. While no reduction is ordinarily granted under this provision with respect to income arising in Germany, it is entirely possible that special treatment might be obtained for matters such as the vacation trip in question. Indeed, in order to obtain the limited deduction allowed for life insurance premiums, a taxpayer who makes such payments to an American company must invoke the above procedure if he is to have any chance to enjoy the deduction; the statute itself limits such deductions to premiums paid German companies.
qualified under the 510-day rule, but in that circumstance the additional amount may run the employee over the $20,000 per year limitation. In such event, as well as in the case where the employee falls completely short of § 911, it would be necessary to determine whether such benefit is actually embraced by the American concept of income. On the one hand, it is clear that vacation expenses paid by an employer for a domestic employee’s trip within the United States constitutes additional income to him. However, to extend this principle to those transportation expenses which are designed to allow the employee and his family to return for a vacation in his native land would embarrass even the United States government itself. For, as an employer, it too pays transportation expenses associated with vacation trips to the States by foreign service officials of the State Department. The Internal Revenue Service has not yet, however, published the position it will ultimately take in such cases.

It is not unusual for a visiting American citizen employed abroad to dovetail a vacation with his business trip to the States. And in trying to keep compensation attributable to United States sources within an amount which can be offset by his personal exemptions and deductions, it may be important to such persons that the time spent vacationing be isolated. To provide adequate safeguards in the event his return is audited, it may be desirable for the employee to have a realistic written understanding with the employer regarding the respective amounts of time to be devoted to the two different purposes.

(c) American statutory exclusion designed to accommodate intermittent trips to the States by Common Market citizens.—The American tax problems which will be encountered by the typical nonresident alien who is temporarily brought to the United States for business purposes will usually be much less complex than are those associated with like trips by American citizens residing abroad. Congress has always drawn a sharp distinction between citi-

...
zens and residents, on the one hand, and nonresident aliens on the
other, being content in the latter case to reach nothing more than
gross income which was derived from sources within the United
States. Until 1936, this was enough, however, to call for inclusion of all compensation attributable to any labor or service performed
by the nonresident alien in the States. In that year, however, Con­
gress did add a specific statutory exclusion designed to accommo­
date, within limits, compensation attributable to short business trips.
Later, the Senate ratified tax treaties with five of the Common
Market countries, and in some circumstances these included even
more generous exclusionary standards with respect to such income.
But alien employees from the sixth country (Luxembourg), and in
some situations those from the other five can look only to the
statutory exclusion for protection, if any. And sometimes the em­
ployee will fall short of the exclusionary corridors marked out by
both, coming face to face then with the overall statutory tax treat­
ment of nonresident aliens. The latter pattern may also be important
for other reasons. For example, some of the treaties do not immu­
nize a nonresident alien’s capital gains which have their source in
the States. Since employees of the type in question may well own
American securities, particularly in the American enterprise with
which they are directly or indirectly associated, the statutory treat­
ment of such may be important. Indeed the existence of such a gain
can even affect the American tax on that part of a visitor’s earned
income attributable to services performed during his business trips
to the States. However, this study is confined to the exclusionary ar­
rangements designed to accommodate international business trips.
Because the American statutory exclusion still has practical signifi­
cance, it will be discussed first; an analysis of the related provisions
in the tax treaties will then follow.

Since compensation for labor or personal services performed in
the States was deemed to have its source there, without regard to
the origin or place of payment, Congress early found it necessary
to add a collection procedure requiring the nonresident alien, upon
his departure from the States, to file what was tantamount to an
information return and pay a tentative tax or provide security there­
for, notions which survive to this day. This demand for pay-

105 Rev. Act of 1913, Section II, § A, Subdiv. 1, now I.R.C., § 872.
106 Rev. Act of 1921, § 217(a) (3), now I.R.C., § 861(a) (3). If the trip is solely a
business trip, the service attributed to the States will presumably begin when the per­
son comes within the territorial limits. Cf. I.T. Regs., § 1.861-4(c).
107 Rev. Act of 1921, § 250(g).
108 I.R.C., § 6851(d). See also T.I.R. No. 225, April 21, 1960, '60 Vol. 6 CCH para.
6442.
ment before an alien business visitor could leave the country was later found by a congressional committee to have "created irritation and ill will quite disproportionate to the slight revenue involved." It was that committee which then pushed through a statutory exclusion which was expressly confined to those cases where labor or services were performed as an employee or under contract with truly foreign entities not engaged in a trade or business in the United States. In other words, the employee could not qualify for the exclusion if the employer, not otherwise engaged in a trade or business in the States, was other than a "nonresident alien, foreign partnership, or foreign corporation." This had the effect, inter alia, of rendering ineligible for the exclusion nonresident alien employees of the foreign branch of an American corporation.

Later, as is more fully discussed below, a like limitation was incorporated in some of the tax treaties. But still later, after those treaties were signed, Congress extended the statutory exclusion, qualifying also local services performed by a nonresident alien for an office or place of business maintained in a foreign country by an American corporation.

Before that amendment, as well as now, the exclusion was otherwise available only where the nonresident alien (1) was temporarily present in the States for periods not exceeding a total of 90 days during the taxable year, and (2) then only if the compensation for the services rendered here did not exceed $1,000 in the aggregate. Failure on either count results in a loss of the entire exclusionary privilege.

As is true of Americans who are employed by a foreign facility to work abroad, it is not unusual for nonresident aliens to dovetail vacations with business trips to the States. And in trying to stay within the aggregate $3,000 statutory limitation, it may also be important to such persons that the time spent vacationing be isolated. Even though they are entitled to a so-called "paid vacation," compensation attributable to the period devoted to sightseeing, etc., is free of American tax without regard to the specific statutory exclusion. The absence of labor or services in that part of the period devoted to vacationing means that the applicable compensation is not from sources within the States and is, therefore, beyond the

110 Rev. Act of 1936, § 119(a) (3).
112 I.R.C., § 861(a) (3).
113 Ibid.
reach of the American tax gatherer under the general rule which confines the gross income of
nonresident aliens to that which has its source within the States.\textsuperscript{115}

To facilitate a proper apportionment, for tax audit purposes, of that compensation attributable to the vacation portion of the trip, it may also be desirable for these employees to have realistic written understandings with employers regarding the respective amounts of time to be devoted to the two different purposes. It must be remembered, however, that the quite separate 90-day limitation relates to the aggregate physical presence in the United States without regard to purpose. But where this period is too short to accommodate all of the visitor's purposes, it may be possible to salvage tax immunity either by resorting to what may be a more generous provision in the governing treaty or by spreading his presence in the States across two taxable years. The fact that the statutory 90-day limitation is geared to aggregate presence "during the taxable year"\textsuperscript{116} means that a visitor who comes to the States in the last quarter of a taxable year, and otherwise qualifies, can safely spread his visit over into the first quarter of the succeeding taxable year.

Similar planning may be useful to an alien visitor who would otherwise be entrapped by the separate statutory $3,000 limitation. For example, one who earns $3,000 for each 30-day period and plans to stay 45 days may qualify by starting his visit in December, thus taking advantage of two qualifying amounts instead of one. But it seems worthwhile to repeat that failure to satisfy either one of the two different limitations means loss of the entire statutory exclusionary privilege.

Many persons will not be able to take advantage of the spreading devices related above. In certain circumstances they may still obtain refuge from the American tax by relying on more generous standards which appear in certain of the tax treaties discussed immediately below, provided they can also meet the other treaty specifications.

\textit{(d) Reciprocal treaty exclusions to accommodate a Common Market citizen's trips to the United States and an American citizen's trips abroad.}—Each of the American treaties with five of the member states provides for a specific exclusion of compensation attributable to "labor or personal services" performed within the United States by "residents," whether or not citizens, of the specific

\textsuperscript{115}\textsuperscript{I.R.C., § 872(a).}

\textsuperscript{116}\textsuperscript{I.R.C., § 861(a)(3).}
Member State. The same treaty articles include a reciprocal provision, designed to accord like treatment in the case of business trips to Europe by Americans whose normal employment stations them in the United States.

Table V B, which appears at the conclusion of this sub-topic, indicates the varying requirements expressly reflected in the relevant provisions. From it, laying aside refinements, two different basic patterns emerge.

First, all of the treaties establish a wider tax free corridor than that made available to visiting nonresident aliens by the American statute, provided the employer is a resident or other entity of the traveler’s own residence. Where that important condition is met, an exclusion is allowed by the country being visited regardless of the amount of compensation involved so long as the aggregate periods of physical presence there do not exceed what generally approximates twice the aggregate time permitted by the Code in the case of nonresident aliens. Under all treaties, except that with Italy, the aggregate periods of physical presence in the country being visited may extend through 183 days during any one taxable year. The Italian treaty is identical with the Code in restricting the periods to a total of 90 days in any one year.

The second basic grouping relates to the question of whether any exclusion at all is provided for in the instance where the employer is other than a resident or entity of the visitor’s own place of residence. One of the treaties—that with the Netherlands—like the earlier American Code provision which existed when that treaty was signed, does not permit an exclusion in such cases. But where residents of that member nation are employed by branches of an American corporation, on visiting the States they may now look to the amended statutory provision which does authorize an exclusion in such cases, but then the other statutory specifications must also be satisfied. In other words, the absence of a treaty authorization does not prohibit reliance on statutory privileges accorded by the American Code.

Treaties with the other four countries do authorize an exclusion in such cases, though three of the four impose an amount limitation similar to that imposed by the American Code. The treaties with

117 Articles XI, 9, X, IX, and XVI, respectively, of the treaties with Belgium, France, Germany, Italy, and the Netherlands. American citizens, resident in such countries, would not be eligible, however, for this exclusion. See discussion, sub-topic (b) supra.

118 The French treaty was originally so limited, but it was later amended to accommodate employees of a corporation’s foreign branch.
Belgium and Germany require that the aggregate amount of compensation in any one year must not exceed $3,000; the Italian treaty restricts the amount to a total of $2,000. Only the French treaty allows an exclusion in this circumstance without regard to the amount. Moreover, in this circumstance, i.e., where the employer is other than a resident or entity of the traveler's place of residence, only in the French and German treaties may the aggregate period of the visits during any one year exceed that authorized by the Code to nonresident aliens. Those two treaties conform in this circumstance to the time limitation applicable in the opposite situation, i.e., to 183 days in any one taxable year. The conventions with Italy and Belgium, like the Code, contain a more confining 90-day restriction.

Finally it should be noted that certain kinds of personal activity are ineligible for exclusions otherwise made available by treaty. Illustratively, the treaty with Belgium specifically denies the exclusion to an otherwise qualified American who visits Belgium in order to perform his function as a director of a Belgian corporation. While the German treaty provides otherwise in the case of the nonresident visiting director, it should be noted that under German law the remuneration of nonresident directors of German corporations are taxed even if they never set foot in Germany.

The prime standards set forth in the various treaties, as well as those prescribed by the American statute to deal with the case of nonresident aliens visiting the United States, are consolidated in the chart which follows, insofar as they affect four situations:

(1) The exclusion allowed by Common Market countries, pursuant to treaty, in the case of visiting American citizens who regularly work in the States for the home office; and

(2) The exclusion allowed by the United States where a Common Market country citizen who is regularly employed in his native land visits the American company's home office in the States. In this situation, the chart reflects those differences, if any, which are dependent upon whether the visitor was regularly employed by the American company's (a) foreign subsidiary or a foreign incorporated licensee, (b) foreign permanent establishment, or (c) home office, the employee serving regularly as a Common Market promotional representative.
**TABLE V: REQUIREMENTS**

<table>
<thead>
<tr>
<th>Requirement</th>
<th>Belgium Treaty</th>
<th>France Treaty</th>
<th>Germany Treaty</th>
<th>Italian Treaty</th>
<th>Netherlands Treaty</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employer located in visitor's place of residence</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Service must be performed for or on behalf of a resident or entity of the visitor's place of residence</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Service must be performed as an extension of, or under contract with, the establishment of the visitor's place of residence</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Service must be performed by an employee of an undertaking or entity of a foreign country not engaged in trade or business within the United States, or by a foreign individual, if such individual has a place of business maintained in a foreign country or in a possession of the United States by such corporation</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
</tbody>
</table>

**Notes:**
- **X** indicates that the requirement is applicable.
- **Nonresident Employer** is defined as an employer located in the visitor's place of residence.
- **Foreigner** is defined as an individual who is not a resident of the United States.
- **Resident Employer** is defined as an employer located in the United States.
- **Employee** is defined as an individual who is employed by an employer located in the United States or the visitor's place of residence.
- **Employed by** is defined as an employer located in the United States or the visitor's place of residence.
- **Establishment** is defined as a place of business or a facility where business is conducted.

---

**Footnotes:**
1. As amended by supplemental convention of June 9, 1929, Article 1(c).
2. Specifically Enumerated Activities in the Country Being Visited by Nonresident
3. Specifically Enumerated Activities in the Country Being Visited by Nonresident
4. Specifically including exercise of a liberal profession.
5. Specifically excluded from the general rule under the French treaty is the exercise of a liberal profession. While Article X of that treaty goes so far as to provide that income from such work is taxable only by the country to which the professional activity is exercised, this section is limited by another provision to the effect that a liberal profession will be deemed to be exercised in a country only when the professional activity has a

---

**Clarifications:**
- "Statutory" in the context of U.S. tax law refers to laws and regulations enacted by the U.S. Congress and issued by the U.S. Treasury Department.
- "Statutory requirements" refer to the specific legal obligations under U.S. tax law.
- "Specifically Enumerated Activities" in the context of treaties refer to specific types of income that are subject to withholding taxes or other tax obligations.
PART VI. THE FUTURE TAX SITUATION AS IT MAY AFFECT DOING BUSINESS IN THE COMMON MARKET

Introductory note.—Foreign political relations aside, many businessmen are convinced there are few norms as unstable as those embodied in tax laws. Despite the existence of an almost day-to-day amending process, too great attention to these amendments can be misleading, for more often than not, it is tantamount to a "cleaning up" operation.

Revision of internal basic principles, affecting as they do the whole economic paraphernalia of a nation, is not easily achieved. Newly founded external relationships, such as those formed through the establishment of the European Common Market, do, however, tend to force each affected member nation to undertake a more penetrating examination into the basic structure of its tax laws. Other countries, such as the United States, who would do business with such newly founded communities may be likewise affected.

The likelihood of basic changes in the Common Market tax picture is the subject matter of the abbreviated discussion below in Section A. Subsequent Section B identifies the relevant major changes which are being given thoughtful consideration in the United States.

SECTION A. FUTURE TAX SITUATION IN THE COMMON MARKET

(a) Tax premises of the Common Market treaty.—Those who framed the Common Market treaty apparently concluded that tax aspects relevant to greater economic cooperation were too complicated to solve in the treaty itself. The latter has only a few provisions bearing on the subject (Articles 95–99), and these deal only with indirect taxes (turnover taxes and excise duties). Direct taxes (income, property, and enterprise taxes) are not specifically mentioned; Article 220 does, however, refer to the necessity of avoiding double taxation.

With respect to indirect taxes, all of the relevant provisions but
one assume the existing tax pattern and provide only for certain limitations. The one exception, Article 99, charges the Commission (the Community’s principal administrative body) with the responsibility of conducting a study in order to determine how these taxes might be harmonized. The preceding Articles of the treaty assume continuation of the existing practices with reference to exports and imports, as more fully described in PART II, supra. In the case of exports, refund of turnover taxes previously paid is limited to those actually suffered by the product. In short, a refund system may not be used as a device by which to subsidize export trade. The aim on the import side, on the other hand, was to preclude the possibility of disguised tariffs; thus turnover taxes imposed on imports may not exceed the burden assessed with respect to similar products manufactured in the importing country itself.

(b) The likelihood and adequacy of harmonized indirect tax systems.—Appraisal of the logic behind the treaty provisions should turn on the extent to which the incidence of taxation is actually a factor in fixing competitive conditions.

The treaty assumes that indirect taxes are in the nature of costs which directly influence competition in that they are passed on to the consumer. In other words, if the same article is subject to a different tax burden, and if all other costs are equal, that which suffers the least tax burden will be more easily sold. From this premise, many tax specialists are led to the conclusion that in a community like the Common Market all merchandise must bear the same indirect taxes, without regard to the country of origin. From this, it would follow that the exporting country must refund all previously paid turnover taxes, and the importing country should levy a tax identical to that imposed on locally manufactured merchandise.

Apart from the merits, an almost insurmountable practical difficulty will be encountered in effectuating this scheme unless the member nations revise the basic structure or theory of their respective turnover taxes. As indicated in PARTS I and II, supra, five of the six members levy a multiple stage tax, i.e., one on each succeeding stage in the production and distribution process. This fact alone would make it difficult to develop a refund formula which would be accurate in each case. Each product bears different cost factors, starting with raw materials and spreading across plant, machinery, and overhead costs, each of which comprise a different tax element. Theoretically, the French added-value tax (Taxe sur la Valeur
Ajoutée) is the only one which can compensate for these difficulties. And in Germany, where reformation of the turnover tax system is under advisement, there are those who favor the adoption of the French system, though experience has exposed deficiencies in the latter system also. As indicated in Sections A and D of PART I, supra, with reference to some products, Italy and Belgium have substituted a single transfer tax for the otherwise applicable multiple-stage arrangement, but the substitution was not effected with reference to a host of products, such as raw materials, machinery, etc.

In any event, adoption of one turnover tax system by all member nations is not to be expected in the near future. Nor would such a move serve actually to equalize tax burdens. Three reasons, each shading into the other, contribute to the difficulty.

First, because economic and social circumstances in the six countries differ, different systems of exemptions and internal variations in applicable rates will have to be maintained by most member nations. This, of course, makes calculation of the exact burden borne by a given product more difficult.

Second, the Introduction to PART III, supra, indicated the differences in the degree to which each member nation relies upon indirect taxes, as distinguished from direct taxes. The variation is considerable and attributable to differences to be found in the tax psychology of the member nations. Illustratively, France and Italy would now find it almost impossible to impose higher taxes on income. On the other hand, it would be equally difficult to raise indirect taxes in the Netherlands and Luxembourg, and to a lesser extent in Germany. Admittedly, this problem would be of less significance to international trade if the amount of indirect taxes could be accurately determined and refunded at export, while being levied on imports in an amount exactly equal to that borne by local products. Enthusiasm for this, as a solution, has been dampened, however, by the third and final major consideration.

In this latter connection, there is growing awareness that direct taxes—matters not really dealt with by the Common Market treaty—also influence competition. Laying aside direct taxes on the income of individuals such as wage earners (though such might also be shifted), greater numbers have come to the realization that enterprise taxes, such as the corporate income tax, will influence the price of manufactured products. A common illustration in the international setting should suffice. Assume that two companies from different countries (A and B) bid on the right to build a hydro-
electric plant in a third country, C. Assume further that both will pay an income tax to C, but that their respective countries of residence differ in that A provides a credit for foreign taxes while B does not. As a consequence, the firm from the latter country must either offer a higher bid than the other firm, thereby affecting the former’s competitive position, or take a lower profit—a prospect which may lead it not to bid at all.

The foregoing is another way of saying that harmonization of indirect taxes will not actually equalize tax burdens suffered by international traffic. Equality of tax burdens will be achieved only if all taxes are harmonized, but even this would lead to ultimate equality of the burden borne by international trade participants only if all other factors are equalized, including national incomes (in general and per capita), the percentage of national income absorbed by tax revenues, and services rendered by the member nations to residents and business interests. Comparison and harmonization of total tax burdens is less significant as long as differences exist in services provided by the member nations, wherein residents of one pay for services of a type which residents of another enjoy at the expense of the nation.

The difficulty of establishing one economic community out of member nations which have diverse interests is obvious enough. And this is also true in the tax area, since, as before stated, the internal tax philosophy of each member nation depends largely on its own economic and social circumstances. Because the totality of its ensuing tax structure affects competitive conditions, it seems illogical to distinguish between taxes. Yet such a distinction is the underlying premise indulged in by those who argue in support of a system which relies upon a refund of indirect taxes at the point of export, with a compensatory tax being imposed at the point of import. Inter alia, this fails to accommodate differences in the direct tax burden borne by products.

One solution—highly theoretical—would be to refund direct as well as indirect taxes at the point of export, compensatory taxes being levied at the point of import. The practical difficulty of implementation is obvious and almost insurmountable.

A more practical and logical solution would call for abolition of the refund system in recognition of the fact that all taxes of a given member nation are inter-locked and determine together the tax burden borne by a product. This proposed solution is gaining increasing support.
This does not necessarily mean, however, that there will be, or need be, great diversity in all tax rules. Many tax problems lend themselves to a common solution, such as the matter of stock valuation, depreciation methods, loss carry-forwards, and, in the field of turnover taxes, the question of whether a multiple stage system is to be preferred over a single tax. These differences are largely responsible for the difficulty one encounters in trying to compare tax burdens. It is also more feasible to obtain uniformity in these respects than with reference to total tax rates.

While changes of the type noted are feasible, the likelihood that uniformity of this type will be achieved in the near future is quite another question. Each country would be forced to complicate its amending process by consulting with five other countries before effecting changes. All too often, this is not done for internally valid reasons. On the other hand, there is in fact some tendency toward greater uniformity. For example, France's adoption in 1948 of the Impôt sur les Sociétés (corporation income tax) was a step in the direction of those income taxes imposed by Germany, Luxembourg, and the Netherlands. Again, the French tax reform in late

1 Tax Reform Bill No. 6,000, dated July 27, 1960 and now pending in the Dutch Parliament, would make a few rather substantial changes in the tax pattern of that country, as it affects corporations.

The most important change involves a proposal to discriminate in favor of distributed profits. While the present temporarily increased rate of 47% (regular rate, 43%) would continue to apply to undistributed profits, a reduced rate of 32% (or 28% if the Netherlands returns to its regular rate schedule) would be applied to distributed profits. Subsidiaries which distribute profits to a parent would also enjoy the lower rate, though the parent, if Dutch, would suffer an additional 15% levy if it did not immediately re-distribute the profit. This 15% surcharge would not apply, however, to a foreign parent, for example, one domiciled in the United States. This means, if the pending legislation is adopted, that there could be a substantial difference between Dutch taxation of American branches (permanent establishments), on the one hand, and subsidiaries, on the other. The former would suffer the rate on undistributed profits (now 47%) whether or not its profits were remitted, while the subsidiary could enjoy the 32% reduced rate insofar as its profits are distributed. A quite separate factor may at some point compensate, at least in part, for this differential. The same legislation proposes to increase the Dutch withholding tax on dividends from the present 15% to 25%. At the moment, because of a treaty provision, even the 15% does not apply to dividends paid by an American controlled subsidiary to its U.S. parent. However, it is said that the Dutch government intends to start negotiations leading to a revision of this immunity, substituting instead, perhaps, a 10% or 15% rate, with the possibility of a distinction of some type being drawn if the subsidiary is wholly owned.

The pending legislation would also enlarge the chance that a corporate distributee would itself be immune from the regular corporate tax on dividends received from another corporation. The proposal is to allow the immunity if the distributee owns 5% or more of the distributing corporation's capital, as distinguished from the presently required 25%.

Another proposal would involve abandonment of the special tax on remuneration of corporate directors. Instead, limitations would be placed on the deduction allowed
1959, the ultimate aim being to substitute a single income tax on individuals for the previously existing multiple system (proportional tax and progressive tax), also brought the French tax structure into closer alignment with the income taxes imposed on individuals by the three previously mentioned countries. A year earlier, in 1958, the Belgian Minister of Finance announced that his country would also re-study its tax structure and that it would be desirable to adopt a system similar to that of the countries noted above.

In spite of this progress, it must be recognized that, for the reasons previously given, harmonization, which—to the foreigners who wish to trade in the Common Market—also carries with it a welcome overtone of simplification, will not take place overnight.

(c) Harmonization through modernization of the bilateral tax treaties among Common Market countries.—A chart in Section D of PART III, supra, shows the present status of the bilateral tax treaties which exist among Common Market countries. Some of these pre-date World War II and came into being before the dramatic increase, following that war, in international business activity. In certain respects, some treaties are, therefore, obsolete, as in the case of those between Germany and Italy, Belgium and France, and Belgium and the Netherlands. Others, such as those between France and Germany, and France and Italy, have been replaced by more modern versions. Belgium and Luxembourg chose, on the other hand, to supplement their earlier agreement.

This tendency toward modernization will be facilitated by two circumstances, apart from the fact that increasing business activity necessarily makes the matter one of urgent necessity.

The first such circumstance relates to the new tax systems which have been recently adopted, as explained in the preceding subtopic. It is obviously easier to enter into bilateral tax treaties where the two national tax systems coincide in terms of basic structure.

The second contributing circumstance goes beyond the Common Market itself. It relates to the work of the Fiscal Committee set up by the Organization for European Economic Cooperation, cov-
ering all free European countries and with which the United States cooperates to a substantial extent. The Committee is charged with the responsibility of developing provisions which could be adopted by all member countries, thus giving rise to the first real prospect for a multilateral tax treaty.

Model tax treaties have been designed before; illustrative was one drafted by the League of Nations. While some of its provisions were incorporated in many bilateral tax treaties, a multilateral treaty did not result. There is greater hope, however, for the product of the Fiscal Committee of the O.E.E.C. The national delegations to it are composed of those senior officials in each country who normally have much to do with the preparation of their own national tax laws and with bilateral tax treaties. Each group of problems has been assigned to a working sub-committee composed of two or three delegations. The proposed texts are brought into plenary session for discussion and, if need be, amended in order to obtain unanimity at the point of adoption. Two reports, consisting of 14 provisions to which rather extended official commentaries were added, were published in 1958 and 1959. These reports recommended that each member country incorporate the articles either in their own tax laws or in bilateral tax treaties to which they were parties. The character of the competent membership of the committee, and the fact that the ultimate product resulted from negotiation, will contribute markedly to the acceptance of their work. In fact, some of the proposed articles have already been included in the newest treaties concluded by France, Germany, and the Netherlands. One can even expect that all treaties drafted in the future will be based on the Fiscal Committee's recommendations. Because of the extensive official commentaries appended to each article, interpretations are certain to be more uniform than are those associated with older bilateral arrangements. Nor is it too optimistic to believe that these recommendations will also have a harmonizing effect on the shape of national tax laws.

(d) Illustrative effect of harmonization on American enterprises.—Harmonization will, of course, tend to simplify the problems of those foreigners, such as American enterprises, who wish to do business in the Common Market. It will also reduce the significance of tax factors in making a choice of locale. But it may also have an adverse effect in some instances. Illustrative is the problem associated with taxes on inter-corporate dividends.

As indicated in the country-by-country survey in PART I, most
countries exempt intercorporate dividends from tax if both parent and subsidiary are residents. Even the withholding tax, if any, has been neutralized in that circumstance. Except in France and the Netherlands, however, such exemptions are not granted if the subsidiary is a nonresident corporation. Harmonization of the tax laws will certainly lead to the adoption of general exemptions in this circumstance. But the result may directly affect only the member nations; in effect, outside countries, such as the United States, may be prejudiced. This may make it desirable for an American company to have "sister" subsidiaries in the member nations. While the deemed-paid credit provisions in the American Internal Revenue Code may give adequate relief from double taxation, it may still be useful to transfer the shares of the "sister" subsidiaries to a European holding company situated within the Common Market, i.e., in a country which will not impose an income tax on incoming dividends nor, in compliance with a bilateral tax treaty with the United States, withhold tax when these are ultimately remitted to the American parent. And if this organizational structure is ultimately to be established, it may be desirable to make the necessary transfers before one encounters the knotty capital gains problem which would arise on transferring the shares to the holding company, as explained more fully in Section G of PART III.

SECTION B. FUTURE AMERICAN TAXATION OF FOREIGN INCOME

(a) Chronology of the past: A guide to the future.—An abbreviated chronology of the past will contribute markedly to the identification of possible statutory changes which are most likely to receive serious consideration by those responsible for fixing the American tax reaction to foreign income. Indeed, that so much of the present tax pattern reaches so far back into the past during which heavy foreign investments have been made—thus giving rise to a "vested right" type of psychology, is the most serious, and perhaps meritorious, obstacle confronting any major attempt at overall revision.

For 47 years, American industry has acted on the assumption that, through use of a foreign subsidiary, American taxation of foreign income could be deferred until such income was remitted as a dividend to the States.² For that same period of time, form has

² The United States has never tried to reach more than is now reached by I.R.C., § 882(b), except in the case of foreign personal holding companies. See I.R.C., § 551.
counted for much; *timing-wise*, American tax incidence on the for-

eign income of branches could not be so deferred. The effect, solely

by reference to this differential, has been that one arrangement en-

joyed an interest free loan of taxes denied to the other.

For a slightly shorter, but, nevertheless, a very long period—42

years, the total ultimate two-country tax on foreign income of Amer-

can owned or controlled enterprises has been less in one frequently

recurring circumstance than the tax borne by domestically earned in-

come. This has been so whenever (a) foreign operations were con-
ducted through a foreign subsidiary, (b) the foreign country im-

posed an income tax, but (c) at a lower effective rate than that of

the United States. American concepts, relating to gross income and

the deemed-paid credit, combined to make it possible for foreign

income in that circumstance to enjoy both a deduction and a sub-

stantial credit for foreign income taxes; as a result, the ultimate

total two-country effective rate on foreign income earned by an

American parent's subsidiary could be as low as 45.24%, compared

with 52% on domestically earned income. And because of the pecu-

liar workings of the two concepts, American companies with sub-

sidiaries in nations which imposed a 26% tax on the operating unit

fared better, tax-wise, than those companies which situated the unit

in countries which imposed 39% or 13% effective rates, or for that

matter 0 or 52% rates.

For 18 years, another possible difference in ultimate total tax

costs has turned on whether foreign operations were conducted by

the parent's own subsidiary, or through sub-subsidiaries, the differ-

eence here being attributable to the peculiar way in which the deemed-

paid credit works at the two-tier foreign level as distinguished from

the one-tier level. Under the best of circumstances, the total effec-

tive rate under the two-tier or sub-subsidiary foreign arrangement

could drop as low as 40.18%, contrasted with 45.24% in the best

possible circumstance under the one-tier foreign arrangement.

Again for that same period, the amount of American tax, stand-
ing alone, has differed by reference to the place where foreign in-

come was earned. During World War II, when American trade was

necessarily confined in major proportions to its own hemisphere, en-


---

4 Discussed more fully in PART III, Section C, Subsection 1, *supra*.
5 Statement of Jay W. Glasman, Assistant to the Secretary of the Treasury, Hearings

on H.R. 10859 and 10860, House Committee on Ways and Means, 86th Cong., 2d Sess.

(1960) p. 3.
6 Originated by Rev. Act of 1942, § 131(f) (2), now as revised, I.R.C., § 902(b).
7 See note 5, *supra*, at 4. Discussed more fully in PART III, Section E, Subsection 2,

*supra*. 
actment of what is now a special deduction with respect to foreign income earned by a domestic corporation in that hemisphere—the aim being to make American companies more competitive with international businesses which are based in Europe, has meant that the business activity of American companies in, say, South America could enjoy more favorable tax treatment than American activity carried on in Europe. Assuming branch operations in both cases, the differential in American tax amounts to 14 percentage points, i.e., 38% as against 52%.

For 34 years, the concept underlying the difference in American taxes on that kind of domestic and foreign income most frequently associated with individuals (earned income) has been out of harmony with one of the most significant concepts underlying the American tax differential on corporate domestic and foreign income. An American citizen who works abroad while a resident there for American tax purposes will never pay U.S. taxes on his foreign earned income even though the applicable foreign tax is substantially lower than would be the American tax, and this immunity may be enjoyed though the nonresident citizen ultimately remits a substantial part of his earnings to the States. By way of contrast, an American corporation’s foreign income, even when earned by a foreign (i.e., nonresident) subsidiary, will always be taxed upon remission to the States as a dividend, assuming, of course, that the foreign income tax was not so high as to wipe out American tax liability through operation of the credit provision.

From the above, as well as from the focus of recent congressional inquiries, it appears that two different two-part problems are most likely to attract the attention of future sessions of Congress. The first involves the question of whether foreign income should enjoy a lower total effective tax rate than domestically earned income, and if there is to be such a differential, to what extent should it turn on the matter of form. The second concerns the extent to which the American tax should be deferred until foreign income is remitted to the United States, as well as the complementary question of whether form should also make a difference here. While the degree and direction of congressional concern with respect to these two basic problems will be considered under separate sub-topics below, other questions which only recently have been resolved by Congress should be noted here.

9 I.R.C., §§ 921 and 922.
10 I.R.C., § 911(a), discussed more fully in PART V, Section C, supra, originated with Rev. Act of 1926, § 213(b)(14).
In late 1960, Congress sought in three different respects to minimize the significance of differences which had previously turned on the form of organization. First, it authorized even those American corporations which operated abroad through “sister” facilities to elect to submit their foreign tax credit to an “overall” limitation, rather than to the previously applicable “per-country” limitation. Because of the way the per-country limitation itself had been construed, other forms of organization—such as foreign holding company arrangements—had always enjoyed the averaging effect associated with the overall limitation. While this new legislation did whittle down the effect of a difference which previously had turned solely on form, certain practical differences, as noted elsewhere, do remain. Second, Congress also adopted legislation which clearly established the right of the government to obtain from domestic parents certain types of information relative to their foreign subsidiaries and sub-subsidiaries, which information the Treasury had always had the clear right to obtain with reference to foreign branches. In this same connection, it also extended to stockholders, officers, and directors a responsibility to file information returns with reference to the creation or reorganization of foreign corporations with which they were associated. Third and finally, it also extended the 85% dividends received deduction to American parent corporations with respect to dividends paid by a foreign corporation out of earnings and profits accumulated by the foreign facility at an earlier time when it was actually incorporated in the United States, i.e., before the enterprise was converted into a foreign corporation through a tax-free reorganization.

(b) Prospect for reduction in American taxes re income earned in the Common Market.—As a practical matter, it seems unlikely, in the foreseeable future, that the present ultimate American

12 A detailed discussion of the per-country limitation appears in Subsection 1 of Section C, PART III, supra.
13 Discussed more fully in Sections F and G, PART III, supra.
14 Id.
15 Pub. Law 86-780, 86th Cong., 2d Sess. (1960), adding a new § 6038 to the Code, the old § 6038 being renumbered § 6039. Included in that which must be submitted is information regarding accumulated profits, balance sheets, and certain inter-company transactions.
16 Pub. Law 86-780, 86th Cong., 2d Sess. (1960), amending I.R.C., § 6046. Formerly, only those who advised with reference to the creation or reorganization of foreign corporations had to furnish such information. This proved to be relatively ineffective, because attorneys apparently felt their advice was protected by the attorney-client relationship.
In the past, the United States has tried three of the four ways by which the ultimate American tax on foreign income could be reduced to a point below that borne by domestic income. The first, a reduction in rates for domestic Western Hemisphere Trade Corporations, gave way to the second, a deduction of equivalent proportions for the same beneficiary. Policy makers in the Treasury Department have made it abundantly clear that they oppose extension of this type of benefit to investment operations even in under-developed foreign countries, to say nothing of extending such to the more industrialized communities of Western Europe.

Spokesmen for the Department start from the premise that rate discrimination between foreign and domestic income cannot be justified on grounds of tax policy; it must be justified, if at all, by reference to the requirements of foreign economic policy—a matter dictated in the end by foreign political policy. And while clearly interested in an expansion of investments in the under-developed part of the world, they have expressed doubt as to whether rate reduction for income from those less fortunate areas would actually constitute a significant incentive, facilitating expansion of American investments in those areas. As to the highly developed parts of the world, additional “special stimulus” of this type was not thought, in any event, to be a requisite of America’s foreign economic policy. Coupled with the foregoing philosophy was a banker’s point of view, to the effect that the Treasury was not prepared to accept the annual revenue loss of $200,000,000 which would follow extension of the Western Hemisphere Trade Corporation concept to the rest of the world.

Perhaps it was these same considerations, plus Treasury opposition, that led appropriate congressional committees to eliminate from bills pending in the 1960 session any extension of the Western Hemisphere Corporation tax reduction formula.

---

19 I.R.C., § 921. Indeed, for a short time a credit was also involved, Rev. Act of 1950, § 121(c) amending I.R.C. (1939), § 15(a).
20 Letter from the Secretary of the Treasury to the Chairman of the House Committee on Ways and Means, May 6, 1959, in '59 Vol. 6 CCH para. 6469. See also note 5, supra.
21 Ibid.
22 Ibid.
23 See Secretary Anderson’s letter, note 20, supra.
24 Note 20, supra.
25 § 4 of the originally proposed Foreign Investment Incentive Tax Act of 1959
On the other hand, the President as well as the Treasury have indicated agreement in principle with a third method of reducing taxes on foreign income, i.e., the so-called "tax-sparing" arrangement. Under present American law, a reduction by a foreign country of its own tax rates is advantageous to an American company only as long as its profits are reinvested in that country, and this only if the business is conducted through a foreign subsidiary; otherwise, in terms of ultimate effect, it serves only to reduce the credit which the American company would otherwise apply against its American tax liability. The so-called tax-sparing principle would allow a credit for income taxes specifically waived by a foreign country as an inducement to investment. While the Treasury agrees that the American tax pattern should not always have a negative effect on the desire of a foreign country to make special reductions in its own tax load as a means to attract American capital, the Treasury is not prepared to accept any such program on "an unlimited and unilateral basis." In other words, it believes that tax-sparing "should be implemented on a selective basis either by treaties or by negotiated agreements authorized by statute." This is probably another way of saying, inter alia, that the program should not be extended to the industrialized Common Market even in the unlikely event that area manifested an interest in the kind of tax sacrifice and local discrimination which such a program envisages; instead the focal point would be on the under-developed parts of the world, with the tax-sparing principle applied there only to the extent and in the manner deemed to be in accordance with the requirements of American economic policy. In the face of these considerations and Treasury opposition, here too congressional committees eliminated from pending bills of the 1960 session any reference to the tax-sparing principle.

As previously indicated, a fourth method by which foreign income will actually enjoy an effective rate advantage over domestic income relates to the combined effect of the gross income and deemed-paid credit concepts, wherein income earned through a foreign subsidiary
arrangement in effect enjoys both a deduction and a substantial credit for foreign income taxes.\textsuperscript{30} The fact that a similar rate advantage is not available to branch operations obviously indicates considerable stress on form. Also, the fact that the ultimate preference available to a foreign subsidiary's foreign income springs from the operation of the gross income and credit concepts, rather than via a uniform rate reduction, means that the degree of preference will in fact depend "upon and fluctuate with the level and changes in tax rates abroad on a country-by-country basis."\textsuperscript{31} For these reasons, the Treasury has publicly recognized that if preference is to be given because—according to its underlying premise—of the requirements of America's foreign economic policy, "it would appear more sound and equitable that it be granted on a uniform and predictable basis."\textsuperscript{32} Looking at the matter solely in terms of tax principles, the Treasury thought (1) that the combined deduction and credit which the subsidiary arrangement enjoyed with reference to foreign income could not be defended, and (2) that it would be more appropriate to "gross up" the parent's dividend by the amount of foreign income taxes, a full credit then being allowed for those same taxes, assuming a distribution of all of the foreign profit. In other words, laying aside the question of possible differences in timing, the foreign income of branch and subsidiary arrangements should be taxed alike in terms of ultimate effect. But at this point the Treasury found itself in a dilemma.

On the one hand, the Treasury fully recognized that adoption of the "gross up" arrangement, without a compensating rate reduction for subsidiary operations, would result in a $46,000,000 tax increase\textsuperscript{33} with respect to the latter through elimination of a preference which such arrangements had enjoyed for 42 years. On the other hand, extension of any such wholesale rate reduction to branches would constitute an additional inroad (1) on its underlying philosophy, namely, that preference for foreign income, over domestic income, could be justified only by reference to the needs of foreign economic policy, (2) on its factual premise, namely, a doubt that rate reduction would really stimulate foreign investments in any significant sense, and (3) on its conclusion that, in any event,

\textsuperscript{30} There are those who deny that this is a "fair" way of describing the effect. Statement of Clayton E. Turney, representing the National Foreign Trade Council, Inc., Hearings on H.R. 10859 and 10860, House Committee on Ways and Means, 86th Cong., 2d Sess. (1960) p. 31 at 32.

\textsuperscript{31} Note 5, supra, at 8.

\textsuperscript{32} Ibid.

\textsuperscript{33} Id. at 7.
investments in industrialized foreign markets did not need a further special stimulus. Nor was the Treasury prepared to accept the revenue loss which extension of a rate reduction to branches would involve. In this connection, to be wholly fair to the "vested right" psychology of subsidiary arrangements in the sense of avoiding prejudice to any, it would have been necessary to effect a reduction equal to the maximum advantage presently enjoyed by any such arrangements, namely, by those in relatively low income tax countries.

While the House Ways and Means Committee indicated at one point that it was prepared to adopt the "gross up" formula so as to put branches and subsidiaries on a par,\(^\text{34}\) reconsideration leading to additional hearings in April, 1960 has led the committee to withhold, to date, reporting out a bill which would have accomplished that end.\(^\text{35}\) Indeed, in at least one sense it has moved in the opposite direction in that it has reported out a bill\(^\text{36}\) which is actually designed to enhance the feasibility of resorting to the advantageous multiple tier sub-subsidiary arrangement, this being the setting in which the combined exclusion and credit have the most exaggerated effect.

In this latter connection, the deemed-paid credit, when first extended twenty-eight years ago to embrace a sub-subsidiary's foreign taxes, was available only if the top tier foreign subsidiary owned "all the voting stock (except qualifying shares)" of the sub-subsidiary.\(^\text{37}\) Eight years later, in 1950, business urged that the Point 4 Program would be furthered if Congress relaxed all of the ownership requirements associated with the deemed-paid credit.\(^\text{38}\) Reduction in the proportionate interest which the parent had to hold in the top tier foreign subsidiary, to 10%,\(^\text{39}\) was accompanied by reducing to 50% the interest which that subsidiary had to hold in a sub-subsidiary,\(^\text{40}\) the overall aim being to accommodate those cases where ownership of the subsidiary and sub-subsidiary was divided for any number of reasons, including requirements of foreign law.\(^\text{41}\) Indeed, it was then asserted that the 50% limitation at the second tier level was retained only for administrative rea-

\(^{\text{34}}\) For a statement regarding the sequence of events, see note 5, supra, at 4.


\(^{\text{37}}\) Rev. Act of 1942, § 131(f) (2).


\(^{\text{39}}\) Rev. Act of 1951, § 332(a), now I.R.C., § 902(a).

\(^{\text{40}}\) Rev. Act of 1951, § 332(b), now I.R.C., § 902(b).

the general belief being expressed that the amount of ultimate dividends received by the parent would be affected by foreign income taxes irrespective of the proportion of ownership. In late 1960, the House committee reported out a bill which would downgrade the required ownership at the second tier level to 20%, arguing again that divided ownership cases should be accommodated subject only to limitations geared to administrative feasibility which now, it believed, would be "fully" provided for by a 20% standard. While the House itself approved the proposal, the Senate did not have an opportunity to act on the matter in the 1960 session. The support which the proposal enjoyed in the House suggests, however, that the matter is almost certain to be considered again in the 1961 session.

(c) Prospect for a consistent pattern re deferral of American tax on foreign income.—As also noted in sub-topic (a), supra, the most striking and practical difference between an operation conducted through a foreign subsidiary and that handled by a branch involves the opportunity, in the case of the former only, to defer American taxes on foreign income until such income is remitted to the States.

Support for deferral in the case of foreign subsidiaries rests essentially on the notion that only in this way will American controlled foreign operations be placed on a competitive basis with foreign controlled enterprises with which they compete. It has also been said that the deferral should terminate when dividends are distributed to the parent at which time the foreign profits enter the domestic market.

The same general theory is obviously just as applicable to a branch operation as to a foreign subsidiary. Even the Treasury has acknowledged that the stress placed on form by existing law is hard to justify on the merits though, of course, the problem itself cannot be dealt with separate and apart from such intimately related matters as the difference between the applicable direct and deemed-paid credit provisions. Nevertheless, the Treasury has opposed

42 The character of the administrative difficulties and the reasons why 50% became the magic number were not discussed.
43 Note 41, supra.
48 Id. at 2.
49 See Secretary's letter, note 20, supra.
wholesale extension of the deferral privilege to branch operations in general, noting that the revenue loss would run between $300,000,000 and $500,000,000, and would amount at least to $100,000,000 even if export situations were denied the privilege. On the other hand, the Treasury has voiced approval of a more limited solution to the differential, namely, allowance of the deferral privilege to a new type of domestic tax entity, to be called a "foreign business corporation," the business activities of which would be centralized in the under-developed nations.

The House Committee on Ways and Means was not originally content, however, with so limited an approach. H.R. 5, as approved by that committee in the current session, would have extended the deferral privilege to an electing domestic corporation (then to be known as a "foreign business corporation" or FBC) without limitation by reference to the place from which its foreign source income was derived.

That committee apparently believed its more sweeping approach would in fact accomplish in large measure the Treasury’s aim of expanding investments in under-developed areas; for the most part, those were the areas, according to the committee, “where the tax rates are lower than those in the United States, and it is only to the extent that the taxes on the same income are lower in the foreign countries that deferral of U.S. tax results in any benefit.” Nevertheless, the bill encountered very rough sledding in the House itself. Concern was expressed, for example, that adoption of the bill would further stimulate American industry to produce in other countries products now produced by American labor in the United States, thus eliminating American jobs. In the end, the House committee was forced to make a substantial concession; from the floor of the House, it proposed an amendment limiting the application of the new concept to FBC’s doing business in “less developed countries,” a concept defined specifically, inter alia, to exclude most of Western Europe, including all Common Market nations, and such other developed countries as Canada and Japan. The House then passed the amended bill by a scant three vote margin. In view

---

50 Ibid.
51 Ibid.
52 Ibid.
53 Note 47, supra.
54 Id. at 2.
57 Ibid. See also proposed § 951(e)(2) of H.R. 5, 86th Cong., 2d Sess. (1960) as transmitted to the Senate.
of that narrow margin and of the fact that the Senate Finance Com-
mittee has not yet indicated its own views with reference to the
total problem, it is not worthwhile here to do more than indicate the
main highlights of the House approved bill.

The House committee itself originally contemplated applying
five limitations as conditions for qualification as an FBC. Some of
these, as well as other restrictions bearing only on the amount which
could be deferred—as distinguished from the question of qualifica-
tion itself, were originally intended by the committee to be limita-
tions on either indirect or direct American activity of such a corpora-
tion. When the committee capitulated to the demand that the bill
be limited to less developed countries, the previously mentioned
limitations were re-designed as restrictions on indirect or direct
activity outside of the less developed countries, as distinguished
from activity solely within the United States.

The five limitations, as re-designed, follow.

(1) Certain types of corporations which already enjoy some
significant type of special tax benefit or treatment would be ren-
dered ineligible, including tax-exempt organizations, China Trade
Act corporations, regulated investment companies, personal hold-
ing companies, life insurance companies, unincorporated busi-
ness enterprises taxed as corporations under § 1361, and corpora-
tions electing to have their income taxed to shareholders under
Subchapter S. 58

(2) In order to facilitate the Treasury's determination of
whether a corporation qualifies as an FBC and has complied with
the requirements of other tax laws, the corporation, as a condi-
tion to qualification, would have to furnish the Treasury such in-
formation as may be necessary with reference to any year which
is affected by, or affects, the election. 59

(3) While an otherwise qualified domestic corporation would
not in any event enjoy deferral with respect to income "from
sources without less developed countries," qualification of the
corporation as an FBC would also carry with it a requirement
that its income be almost exclusively from foreign operations, i.e.,
90% or more of its gross income must be from sources within less
developed countries. 60 By way of contrast, deferral of the Amer-

57 Life insurance companies were excluded until the matter could be given further
58 Proposed § 951 (a) (4).
59 Proposed § 951 (a) (5).
60 Proposed § 952 (a) (r) (A).
61 Proposed § 951 (a) (r).
TAXATION
ican tax on a foreign subsidiary's foreign profit is not lost even if it derives substantial income from American sources.

(4) Qualification would also be denied if the corporation derived more than 10% of its gross income from the sale of any articles for ultimate use, consumption, or disposition in the United States.62 This limitation rests on a notion which is not applied to foreign subsidiaries, namely, that deferral even with respect to a company's foreign source profit is unwarranted if a significant part of its products are "in competition with domestically produced or extracted products where this tax deferral is not available." 63

(5) In order to "restrict the benefits of tax deferral largely to an active business enterprise or to a corporation receiving income from such a corporation," 64 qualification was also made dependent upon a requirement that 90% or more of the corporation's gross income be from some combination of three specified classes of income: 65 (a) income from the active conduct of a trade or business; (b) dividends or other income from a qualified payor corporation, i.e., from a corporation in which the FBC itself held a 10% stock ownership and which met substantially the same qualifications as the FBC itself; 66 and (c) compensation for technical, managerial, engineering, construction, scientific, or like services performed in less developed countries and for the right to use, in less developed countries, patents, copyrights, secret processes and formulas, goodwill, trademarks, trade brands, franchises, and other like properties. A royalty from patents, etc., but not income from services rendered abroad, is closely akin in many circumstances to passive income as distinguished from that derived from the active conduct of a trade or business. Accordingly, except where it does involve such active conduct or is income other than dividends from a qualified payor corporation, the royalty income could not be taken into account in meeting the 90% test to the extent it exceeds 25% of the corporation's gross income.67 Illustratively, if all of the corporation's income would have qualified under the 90% test except for the fact that 45% was derived from royalties, the corporation would not qualify,

62 Proposed § 951(a)(3).
63 Note 47, supra, at 4.
64 Id. at 3. Italics added.
65 Proposed § 951(a)(2).
66 The dividend must be out of earnings and profits of such a corporation when it was a qualified payor corporation or would have been except for the 10% stock ownership requirement.
for only 80% of its gross would be deemed to satisfy the 90% requirement.

Other limitations, while not conditions to qualification, would also be imposed as a means of denying deferral to the extent foreign income was actually attributable to business activity in other than less developed countries. To appreciate the significance of the device which would be utilized to this end, one must understand the difference between the ultimate tax treatment of a domestic FBC and that currently associated with foreign profits earned by a foreign subsidiary.

Whereas the United States taxes the latter’s profit only to the domestic parent, and then only to the extent of dividends received—with an appropriate credit for foreign income taxes, the proposal regarding an FBC contemplates that it will be the taxable entity, the timing to coincide with any actual or constructive distribution, and if to a parent, the latter would normally enjoy what is equivalent to a 100% dividends received deduction. Loans from an FBC to a parent holding 10% or more stock ownership would be deemed, illustratively, a constructive distribution, the theory being that the parent “has effectively achieved the withdrawal of the funds from the foreign operation and made them available for its own operations.”

Moreover, in keeping with the previously stated purpose of denying deferral to the extent foreign income was actually attributable to business activity in other than the less developed countries, a formula, involving the ratio of investments and payroll in the less developed countries to total investments and payroll wherever located, is to be applied to the active trade or business income from less developed countries for the purpose of denying deferral to that portion actually attributable to activity based elsewhere. In determining the ratio, the significance of inventory would be neutralized; the investment factor would include only real property and tangible personal property (other than inventory) of a type ordinary and necessary to the operation of the business, all such property being

---

68 Proposed § 952.
68 Proposed §§ 953 and 954. “Distribution” would include redemptions and liquidations.
70 § 2 (b) of H.R. 5 would amend I.R.C., § 243 to this effect.
71 Proposed § 954 (d).
72 Note 47, supra, at 12. However, loans from a subsidiary to an FBC will not result immediately in a U.S. tax though it will increase the FBC’s reinvested foreign income. Proposed § 954 (d).
73 Proposed § 954 (b).
valued for this purpose by reference to the adjusted basis. The payroll factor, geared also to ordinary and necessary items, would be given double weight. But only one-half of the product resulting from multiplication of the ratio by active business income from less developed countries would be deemed constructively distributed, but not—according to a de minimus rule—if the factors outside the less developed countries are less than 10%.

When the taxpayer is engaged in two or more separate trades or businesses, the ratio would be applied separately, provided the trades or businesses are "clearly and distinctly separate." 74

Also deemed constructively distributed from foreign income otherwise previously or currently deferred ("reinvested foreign income account") are those amounts invested in so-called "prohibited property," 75 another notion which is inapplicable to the more free-wheeling ordinary foreign subsidiary type of arrangement. The aim of this restriction is to limit deferral to those cases where the funds are being used in active foreign operations, i.e., to deny deferral to the extent the funds (1) have been diverted, directly or indirectly, to operations outside of less well developed countries, or (2) with certain exceptions, have been converted into mere investments, whether foreign or American. The description of the prohibited class is accomplished by identifying nonprohibited properties, which would include the following: (1) tangible or intangible property which is ordinary and necessary for carrying on a trade or business, but only where 90% of the total income for the current or preceding year is derived from less developed countries; (2) securities of a "qualified payor corporation" or of another 10% owned FBC (including one not qualifying for the current year, provided it has elected FBC treatment); (3) bonds, etc., of foreign governments not in excess of 15% of the corporation's earnings and profits accumulated since 1960; (4) bonds, etc., of the United States; (5) money; (6) bank deposits; and (7) loans to a parent holding 10% stock ownership. Loans were excluded from the prohibited class because of the previously described separate treatment applicable to them. 76

Wholly apart from the action of the House in restricting the benefits of this bill to those enterprises doing business in the "less developed countries," it appears from the foregoing that the oppor-

74 Note 47, supra, at 11.
75 Proposed § 954(c).
76 Note 47, supra, at 11.
tunity to defer American tax through an FBC would suffer from restrictions not applicable to an ordinary foreign subsidiary arrangement. There will also be a difference between the two arrangements in the ultimate amount of American tax if the FBC must "gross up" the amount includible by adding the applicable amount of foreign taxes, a full credit then being allowed for the latter, while a foreign subsidiary arrangement remains free of the "gross up" requirement, thus enjoying what is tantamount to a deduction and a substantial credit for the foreign tax.

While H.R. 5 (the proposed FBC legislation), as originally approved by the House committee, called for the application of a "gross up" requirement in both cases, that notion, as applied to ordinary foreign subsidiary arrangements, was carved out for special consideration in the separate legislation mentioned in sub-topic (b) above. An ultimate difference between the two would survive if, on the one hand, that special bill should fail of adoption and, on the other, the House committee continued to insist, as it did in the original version of H.R. 5, that deferral for an FBC should not "decrease the ultimate level of combined foreign and U.S. tax on . . . foreign income of these domestic corporations below the level of taxation generally applicable to other domestic corporations operating abroad through branches." However, in the final House debate regarding H.R. 5 (FBC legislation), its sponsor noted that the House committee had not yet resolved the separate "gross up" question as it related to foreign subsidiaries and proceeded to suggest that the committee felt that "whatever is done should apply across the board. . . ."

Laying aside the ultimate result with reference to that question, there may be some companies which would prefer an FBC arrangement, using either branches abroad or using the FBC as a holding company to own stock in qualified foreign subsidiaries. In the absence of special mitigation, those with foreign interests otherwise presently organized might have encountered a tax at the point when interests are reshuffled so as to make use of an FBC. With reference to companies interested in converting foreign subsidiary operations into branches of an FBC, H.R. 5 takes account of the prospect that the Treasury, by reliance on § 367, might have called for recognition of gain when business property of the foreign subsidiary is transferred to an FBC. The bill specifically neutralizes § 367 in this case, provided substantially all of the property of the foreign sub-

\*\* Id. at 2.
sidiary is so transferred. But in such case, the accumulated earnings and profits of the foreign subsidiary pass into the reinvested foreign income account (deferred income account) of the FBC and would, upon distribution, be taxed to it.\textsuperscript{78} It was not thought that nonrecognition should be enjoyed and deferral obtained with reference to increments which took place in the value of inventory while held in the United States prior to the transfer. Accordingly, H.R. 5 would add a new section to the Code calling for inclusion in gross income of any gain realized when such property is transferred to an FBC or to a foreign subsidiary.\textsuperscript{79}

Under certain conditions, H.R. 5 also neutralizes §367 in that instance where an FBC is converted into a holding company through transfer of "foreign business property" to a foreign subsidiary.\textsuperscript{80} But this will be so only if the FBC (holding company) owns 80% of the voting stock as well as 80% of all other classes of stock in the subsidiary. Moreover, the foreign subsidiary must be a "qualified payor corporation," i.e., it must in general meet the standards otherwise applicable to the FBC itself. Illustratively, its income must be derived, to the extent of 90%, from less developed countries. Again, 90% or more of its income must be derived from articles which are not imported into the United States.

Finally, but only in a fairly limited type of case, H.R. 5 would also neutralize the possibility, under §1491, that the Treasury might apply an excise tax in that instance where an FBC transfers stock in one foreign subsidiary to another, thereby creating a three-tier chain.\textsuperscript{81} The tax will not be applied if (1) the transferor satisfies the previously described control test, (2) the subsidiary, the stock of which is transferred, measures up to the previously described "qualified payor corporation" as to the transferor for the 3 preceding taxable years, and for the first subsequent taxable year, (a) will be such as to the transferee, and (b) will derive 50% or more of its gross income from less developed countries and from the active conduct of a trade or business.

\textsuperscript{78} § 3(a).
\textsuperscript{79} § 3(c) proposes addition of a new §78 to the Code.
\textsuperscript{80} Proposed § 367(c). Under certain conditions, §2(d) of H.R. 5 would also immunize an F.B.C. from the personal holding company provisions by amending I.R.C., § 543.
\textsuperscript{81} § 3(b).
Baker, "Foreign Holding Companies and Foreign Tax Credit," 34 Taxes 746 (1956).
Barlow and Wender, Foreign Investment and Taxation (Prentice-Hall, 1955).
Belgian System of Taxation in Its Relation to Corporations (Min¬
istry of Foreign Affairs, 1959).
Bergmann, "International Double Taxation," 22 Taxes 362
(1944).
Bermans, "Aliens and the Federal Tax Law," 40 Marquette Law
Bernstein, "Why Do U.S. Producers Make Films Abroad? Taxes
Big, but Not Only Reason," 9 Journal of Taxation 156
(1958).
Birnberg, "Contemporary International Monetary Problems and
International Trade," 1959 University of Illinois Law Forum
328.
Bloch and Heilemann, "International Tax Relations [Symposium
article on world organization]", 55 Yale Law Journal 1158
(1946).
Bowman, "Overseas Trading Corporation," 1957 Journal of Busi-
ness Law 268.
Brainerd, "Computing Foreign-Tax Credit Made Easy; Subsidiary
(1957).
Brainerd, "Foreign Holding Company—When Should a Company
Brainerd, "United States Income Taxation of the Foreign Holding
Brainerd and White, "When Is It Advantageous to Take Foreign
Earnings as Royalty, Not Dividend?" 10 Journal of Taxation
33 (1959).
Braun, "United States—Netherlands Tax Treaty to Prevent Double
Taxation," 34 Taxes 143 (1956).
Bronheim, "Overseas Trade Corporations—a United Kingdom Ex-
Brudno, "Tax Considerations in Selecting a Form of Business Or-
ganization," Southwestern Legal Foundation, An Institute on
Brudno, "Tax Considerations in Selecting a Form of Foreign
(1959).
Brudno, "United States Taxation of Income from Abroad," South-
western Legal Foundation, An Institute on Private Invest-
ments Abroad, p. 5 (1959).
Bulletin for International Fiscal Documentation, International
Bureau of Fiscal Documentation (Amsterdam, Netherlands,
bi-monthly).
Calvert, "Pension Problems of Overseas Employees," Southwestern
Legal Foundation, an Institute for Private Investments
Carroll, "Development of International Tax Law in the Amer-
icas," 8 Law and Contemporary Problems 793 (1941).
BIBLIOGRAPHY OF TAX MATERIALS


Carroll, “Tax Conventions With the Netherlands and Denmark,” 26 Taxes 1026 (1948).


Crockett, “Relative Advantages of Operating in Canada Through a Branch, Domestic Subsidiary, or Canadian Subsidiary,” 5 American University Tax Institute 509 (1953).


* Hereafter abbreviated as N.Y.I.


Diamond, Foreign Tax and Tax Trade Briefs (Fallon Law Book Company, 1951).


Doggett, “Taxability of Payment Received by Non-Resident Alien Author From Domestic Publisher for Literary Property,” 6 Washington and Lee Law Review 116 (1949).


Grant, “Interest Assessments on Foreign Tax Credit Adjustments,” 24 Taxes 470 (1946).
Hepworth, Reporting Foreign Operations (Bureau of Business Research, School of Business Administration, University of Michigan, 1956).


International Bureau of Fiscal Documentation, Annual Reports (Amsterdam, Netherlands).


Irell and Stone, "Tax Exemption of Foreign Profits Determined by 'Source' of Income," 1959 University of Southern California Tax Institute 333.


Lefebvre and Lefebvre, Summary of Taxation in France (Bureau d'Études fiscales Francis Lefebvre, Paris, 1959).
Phillips, United States Taxation of Nonresident Aliens and Foreign Corporations (Carswell Co., 1952).
Pratesi, "Western Hemisphere Trade Corporations," 5 American University Tax Institute 527 (1953).
BIBLIOGRAPHY OF TAX MATERIALS 643

Slonim, "Aliens, Taxes, and 'Engaged in trade or business within the United States,'" 5 N.Y.I. 398 (1947).
Stone, Irell and, "Tax Exemption of Foreign Profits Determined by 'Source' of Income," 1959 University of Southern California Tax Institute 333.
BIBLIOGRAPHY OF TAX MATERIALS


Washburn, “The Tax Trials of P. G. Wodehouse and Sax Rohmer, Including a Discussion, of the Liability to United States Taxes of Nonresident Alien Authors—Section 211(a)(1),” 10 N.Y.I. 213 (1952).
Wender, “Doing Business Abroad in Corporate Form,” 9 Tax Institute of Southern California 139 (1957).
Wender, Barlow and, Foreign Investment and Taxation (Prentice-Hall, 1955).