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TAXATION-PROPOSED CHANGES IN THE TAX TREATMENT OF FOREIGN INCOME

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TAXATION—PROPOSED CHANGES IN THE TAX TREATMENT OF FOREIGN INCOME—The United States has the power to tax the income of its citizens and domestic corporations even though that income is earned in a foreign country.[1] When it is recognized that income derived abroad generally incurs tax liabilities to foreign governments as well, it immediately becomes apparent that the American businessman doing business abroad may, absent some sort of relief provisions, easily be the victim of double taxation. Relief has taken a number of

[1] Cook v. Tait, 265 U.S. 47, 44 S.Ct. 444 (1924). Cf. United States v. Bennett, 232 U.S. 299, 34 S.Ct. 433 (1914), upholding the power of Congress to tax property outside the United States.

forms. Income derived by American corporations in certain geographical areas is under proper circumstances wholly or partly exempt from federal income taxation. Thus, citizens and corporations which derive the bulk of their income from sources within a possession of the United States enjoy complete exemption, except as to income earned in this country.[2] China Trade Act corporations have long been accorded similar treatment.[3] Since 1942, Western Hemisphere Trade corporations have been exempt from the corporate surtax, now 14%.[4] Within recent years, multiple taxation treaties with individual foreign governments have served to reduce the burden in some areas.[5] In general, however, relief is obtained in the form of a tax credit for income taxes paid to other countries.[6] In the case of the individual American citizen, no tax is imposed on income earned while a bona fide resident abroad.[7] As might be expected, such heterogeneous provisions have not resulted in complete tax equality. In addition, amendments aimed to curb abuse have not always confined themselves to their target.

With this government's increased emphasis on the rehabilitation and economic development of foreign countries, as manifested by the so-called Point Four program,[8] attention has been focused on the propriety of revising the tax treatment of foreign earned income so as to encourage operations abroad by American business. In his statement before the House Ways and Means Committee on February 3, 1950, Secretary Snyder made certain proposals relative to the treatment of foreign income.[9] These proposals will be discussed briefly in this comment.

[2] I.R.C. §251. For the interesting origin of this section, see James, "The Taxation of Business Income from Foreign Sources," 13 UNIV. CHI. L. REV. 229 at 240 (1946).

[3] I.R.C. §261. See Berdon, "Memorandum on China Trade Act Corporations," 24 TAXES 251 (1946).

[4] I.R.C. §15(b). The conditions which must be satisfied to be termed a "Western Hemisphere Trade Corporation" are found in I.R.C. §109.

[5] For an analysis of existing and pending United States income tax treaties, see Gilpin and Wells, "International Double Taxation of Income: Its Problems and Remedies," 28 TAXES 9 (1950); Wasserman and Tucker, "The U.S. Tax Treaty Program," 2 NAT. TAX J. 33 (1949).

[6] The provisions are found in I.R.C. §131.

[7] I.R.C. §116.

[8] The text of President Truman's 1949 inaugural address espousing this program may be found in N.Y. TIMES, Jan. 21, 1949, p. 4, col. 2. For an excellent discussion of the program, see Mackey and Smith, "Private Capital Under the 'Point Four' Program," 38 GEO. L. J. 32 (1949).

[9] The statement is published in CCH STANDARD FEDERAL TAX REPORTS, Vol. XXXVII, No. 9, Feb. 8, 1950. The italicized proposals which follow are taken from p. 13.

A. *Foreign Tax Credit*

Credit for foreign income taxes was first provided for in the Revenue Act of 1918.[10] The act set no limit as to the amount of credit which could be claimed. Thus, a domestic corporation with a foreign branch had no reason to be concerned with the amount of the tax imposed by the country in which its branch was located, unless of course it was so great as to surpass the tax normally imposed by the United States on the total income, foreign and domestic, of the company. Congressional dissatisfaction[11] with this dollar-for-dollar credit which could wipe out the tax properly attributable to income derived from sources within the United States was expressed by the passage of the "over-all limitation" in 1921.[12] In effect, it provided that the total foreign income tax credit could not exceed the product obtained by applying the domestic tax rate to the total foreign income. It was still possible, however, to obtain full credit for taxes paid to a country with a rate higher than the United States rate if the excess tax paid could be credited against the earnings of another branch in a country with a low income tax or no tax at all. For example, suppose that in a year when the federal tax rate on corporate earnings was 12% a corporation derived taxable income of $200,000 from domestic sources, the income from branch operations in country *A* with an effective tax rate of 24% was $100,000, and a branch in country *B* with no income tax netted $100,000. The domestic tax on the total income of $400,000 at the 12% rate would be $48,000. Since one-half of this income was derived from foreign operations, a maximum foreign tax credit of $24,000, or the total amount of tax paid to country *A* with the 24% rate, would be allowed.

In 1932, the "per-country" limitation was added.[13] The effect of this provision was to apply the domestic rate limitation to the tax credit available for taxes paid to each country individually before applying the "over-all" limitation. A domestic corporation with branches in only one foreign country was of course not affected by the additional

[10] 40 Stat. L. 1073 and 1080 (1918). Prior to this act, foreign taxes were deducted from gross income in computing net income. Congress recognized that a "severe burden" still remained. H. Rep. 767, 65th Cong., 2d sess. (1918) found in INT. REV. BUL., 1939-1 CUM. BUL. (Part 2) 86 at 93.

[11] See S. Rep. 275, 67th Cong., 1st sess. (1921) found in INT. REV. BUL., 1931-1 CUM. BUL. (Part 2) 181 at 193.

[12] 42 Stat. L. 258 (1921). The limitation is now contained in I.R.C. §131(b)(2).

[13] 47 Stat. L. 211 (1932). This limitation is now contained in I.R.C. §131(b)(1).

limitation. The domestic taxpayer in the example set out in the last paragraph, however, would lose one-half of his credit since the "per-country" limitation would limit his credit for taxes paid to country *A* to $12,000, 12% of $100,000. This effect is no doubt justifiable. There seems to be no reason for the United States to absorb the taxes imposed by a foreign country at a rate in excess of the domestic rate merely because another country or countries in which branches are located choose to tax at a lower rate.[14]

It would seem that the evil which Congress saw in 1921 and again in 1932 could arise only when a foreign country imposes a tax on the income of foreign branches at a rate in excess of our domestic rate. The "per-country" limitation standing by itself is a sufficient remedy. This does not mean that the "over-all" limitation is now impotent. Its imposition may subject to multiple taxation a taxpayer who operates branches in two or more foreign countries, none of which has a tax rate in excess of our own. Suppose that the tax rates in country *A* and country *B* are the same as the tax rate in the United States and that, instead of earning $100,000 in country *B*, operations resulted in a loss of that amount. The "per-country" limitation would permit a credit for taxes paid to country *A*, but the "over-all" limitation would prevent it because total net foreign income is zero. While the loss incurred by the branch in country *B* can be deducted[15] and the tax paid to country *A* can, in this case be taken as a *deduction*,[16] the over-all tax impact on the corporation is greater than it would have been if all operations were confined to the United States or to country *A*.

Secretary Snyder stated, *"Foreign investment would also be encouraged by the liberalization of the foreign tax credit in the cases where losses in one foreign country offset profits in another."*

The possibilities of suffering a loss in a newly established foreign branch are sufficiently great without regard to tax consequences, and businessmen rightly maintain that unhappy profit experience in one country should not deprive them of the credit for taxes paid in another.[17] So long as the "per-country" limitation is in effect, there

[14] See H. Rep. 708, 72d Cong., 1st sess. (1932) found in INT. REV. BUL., 1939-1 CUM. BUL. (Part 2) 457 at 473.

[15] I.R.C. §23(f).

[16] I.R.C. §23(c). This deduction may be taken only when no foreign tax credit is claimed. I.R.C. §23(c)(1)(C).

[17] See Shere, "Taxation of American Business Abroad," 7 INST. FED. TAX. 812 at 817 (1949).

would seem to be no reason to continue to apply the "over-all" limitation.[18]

The United States does not tax the income of a foreign corporation earned in a foreign country, even though it is a wholly owned subsidiary of a domestic corporation, until this income is distributed to its American stockholders in the form of dividends. In addition, upon receipt of dividends from its controlled foreign subsidiary, the domestic corporation is deemed to have paid the foreign tax on the accumulated profits out of which the dividend was paid, and is allowed a tax credit, subject to the two limitations already discussed.[19] Since 1942, this credit has extended to taxes paid by a wholly-owned foreign subsidiary of the foreign subsidiary.[20] In order to claim either of these credits, however, the domestic corporation must own a majority of the voting stock of the foreign corporation.

Secretary Snyder has proposed that *"to facilitate joint ventures abroad and to meet the requirements or desires of foreign countries for local participation in these ventures, we should reduce the present ownership requirement for foreign tax credit."*

Participation of foreign capital is desirable from the standpoint of the foreign country, which stands to benefit from the development of its resources and the education of its businessmen, and from the standpoint of the American businessman because it helps to achieve a more receptive attitude toward the business. Under the present majority control requirement, foreign ownership of one-half or more of the stock would result in the loss of the entire credit to the American owners.

The deterrent effect of the majority requirement on joint ventures abroad is at once apparent. If two or more domestic corporations join in the organization of a foreign corporation, the corporation owning a majority of the stock would receive credit while the owners of the minority of the stock would receive none. Furthermore, if two domestic corporations owned the foreign corporation equally, neither would receive a credit for foreign taxes paid.

Clearly, the majority requirement should be abandoned. It is not so clear, however, just what requirement should be substituted. Others

[18] One writer has termed this limitation "but little short of barbaric." Keesling, "The Importance of Citizenship, Residence, and Domicile in Federal Income Taxation," 31 CALIF. L. REV. 283 at 299 (1943).
[19] I.R.C. §131(f)(1).
[20] 56 Stat. L. 858 (1942), I.R.C. §131(f)(2).

have proposed that the stock ownership requirement should merely be reduced to 20%.[21] The Secretary's use of the word "reduce" might indicate that only some such percentage reduction was suggested; however, the supporting exhibit proposed that "the majority control test be abandoned so that the credit will be available to *all* owners of a foreign enterprise."[22] This would mean that an individual who owned shares of stock in a foreign corporation would be allowed a tax credit equal to, in many cases, the total amount of his ordinary federal income tax on the dividends received, thus being placed in a better position than a taxpayer with a corresponding investment in American business. Our policy favoring expansion of foreign investment would not seem to justify such unequal treatment of individual investors. Perhaps a better requirement would be that any *corporate* owner regardless of the amount of stock owned should be entitled to a credit.

B. *Undistributed Income of Foreign Branches*

As already pointed out, the earnings of a foreign subsidiary become taxable in the hands of its American stockholders only when distributed to them as dividends. On the other hand, profits of a foreign branch of a domestic corporation are taxed as earned whether returned to this country or not. From a tax standpoint, there are two advantages to foreign operations through a subsidiary. While losses incurred by a foreign branch can be carried forward only two years,[23] losses incurred by a foreign subsidiary can be carried forward indefinitely. A more important advantage to the corporation operating through a subsidiary is encountered when expansion of foreign operations is undertaken in an area where the tax rate is much lower than that in the United States. The corporation operating through a foreign branch has only the profits remaining after taxes at the United States rate have been taken out while the foreign subsidiary has to pay only the foreign taxes.[24] This difference in tax treatment is of less importance as the foreign tax rate approaches the domestic rate, disappearing entirely when the foreign country imposes taxes at the United States rate. However, even foreign

21 Allan and Coggan, "Tax Planning for Foreign Trade," 3 TAX L. REV. 23 at 58 (1947).

22 CCH STANDARD FEDERAL TAX REPORTS, Vol. XXXVII, No. 9, Feb. 8, 1950, at 29. Italics added.

23 I.R.C. §122. In his statement before the House Ways and Means Committee, Secretary Snyder recommended a five-year carryover with a one-year carryback. CCH STANDARD FEDERAL TAX REPORTS, Vol. XXXVII, No. 9, Feb. 8, 1950, at 13.

24 Nor need the foreign subsidiary concern itself with the possibility of a surtax on improperly accumulated surplus under I.R.C. §102.

countries with a higher rate are often willing to make special tax concessions when profits are reinvested within their borders. These concessions are lost in the case of branch operations by a compensating decrease in the foreign tax credit.

With these considerations in mind, it was proposed that *"foreign branch operations should be placed on an equal footing with foreign subsidiaries by allowing postponement of tax on their income until it is returned to the United States."*

Apparently strict parallel treatment of subsidiaries and branches is not contemplated. This would require the disallowance of net losses by branches until liquidation of the foreign undertaking. In discussing some of the factors which enter into a decision to operate a foreign branch despite the advantages of a subsidiary, the accompanying exhibit points out that losses from branches may be deducted from income derived from United States sources.[25] The suggestion that foreign branches might be allowed to defer tax payments until the income is returned to this country without losing the advantage of the loss deduction is not a new one[26] and, in view of the current government policy, may be proper; however, it seems that some consideration should be given to putting branch and subsidiary operations on an equal footing as regards the deduction of losses as well as the postponement of tax.

The decision as to the type of foreign operation is at best extremely difficult. A change in the law so as to eliminate *all* consideration of federal tax consequences from this decision would seem to be highly desirable.

C. *Income Earned Abroad by Individuals*

Under proper circumstances, individual citizens are exempt from tax on income earned through personal service abroad regardless of the amount of foreign tax imposed. Prior to the 1942 amendments, the only requirement was that the citizen be outside of the United States for more than six months of the taxable year.[27] Because of the abuses of this provision, the first draft of the Act of 1942 repealed the provision and offered no substitute.[28] In restoring the provision, the Senate Finance Committee required "residence in a foreign country

[25] CCH STANDARD FEDERAL TAX REPORTS, Vol. XXXVII, No. 9, Feb. 8, 1950, at 28.
[26] Shere, "Taxation of American Business Abroad," 7 INST. FED. TAX. 812 at 827 (1949).
[27] I.T. 3424, INT. REV. BUL., 1940-2 CUM. BUL. 119.
[28] H. Rep. 2333 at 50, 77th Cong., 2d sess. (1942).

or countries during the entire taxable year."[29] At the same time, a new section was added which provided that a citizen who resumes American residence after at least two years foreign residence is exempt from tax on the income earned abroad during the taxable year of return.[30]

Thus, an individual who leaves the United States to establish a bona fide residence abroad in the middle of a taxable year gets no exemption until the beginning of the next year. Furthermore, it is possible to reside abroad for a period just short of two years without being entitled to any exemption. That the foreign residence provision, enacted in its present form to close a tax loophole, should dictate the time of departure of citizens entering upon a period of foreign service seems absurd.

Secretary Snyder's proposal is as follows: *"We should remove discouragement to Americans participating in these activities by making the present exemption on their earnings applicable to the entire period they reside abroad once they have established a bona fide residence."*

The accompanying exhibit makes it clear that a bona fide residence abroad for one year would still be required in order to attain an exempt status.[31] Once that status is acquired, however, the taxpayer would be entitled to a refund of the tax paid on the income earned during the first part-year. Thus, abuses in the nature of those practiced before 1942 should be prevented. At the same time, personnel problems of businesses operating abroad would be lessened; and government revenue would be decreased little if at all.

D. *Conclusion*

It has been suggested that foreign income should be completely exempt from United States taxes.[32] Clearly, as the tax rate of foreign countries approaches that of the United States, the revenue result under the present system approaches that of complete exemption, leaving only the job of tax administration and auditing. On the other hand, announcement of a total tax exemption on foreign earned income would certainly shake the public confidence in the equity and fairness of our

[29] S. Rep. 1631 at 54, 77th Cong., 2d sess. (1942). I.R.C. §116(a).

[30] I.R.C. §116(b).

[31] CCH STANDARD FEDERAL TAX REPORTS, Vol. XXXVII, No. 9, Feb. 8, 1950, at 30. For a discussion of the tests applied to determine whether there has been a bona fide residence abroad, see Stream, "Earned Income From Foreign Sources," 26 TAXES 714 (1948).

[32] TAX COMMITTEE OF THE NATIONAL FOREIGN TRADE COUNCIL, REPORT ON REGIME OF TAX RELIEF FOR DOMESTIC TAXPAYERS OPERATING ARBOAD 18 (1947).

tax system. It would seem that the present system of taxing foreign earned income, with the granting of foreign tax credit, should be retained. At the same time, in light of the goals of the Point Four program, the minor adjustments recommended by the Secretary of the Treasury should be adopted.

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