CORPORATE TAXATION: RECENT DEVELOPMENTS
WHICH EASE QUALIFICATION AS A WESTERN HEMISPHERE TRADE CORPORATION

SUBSTANTIAL TAX SAVINGS may be obtained by a domestic corporation\(^1\) which qualifies for the 27% reduction\(^2\) of taxable income granted a

\(^1\) The corporation must be *initiated* and *maintained* as a domestic corporation. A Canadian or Mexican subsidiary may be treated as a domestic corporation for qualification as a Western Hemisphere trade corporation if it was incorporated to comply with the laws of either country, provided it is so treated in the consolidated return of the domestic parent corporation. Int. Rev. Code of 1954, §1504(d); Rev. Rul. 55-372, 1955-1 Cum. Bull. 339. A detailed statement of specific objectives, purposes and geographic areas to be covered is recommended for the charter. Crawford, Western Hemisphere Trade Corporations, 47 Calif. L. Rev. 621, 627-28 (1959).

\(^2\) This percentage reduction originated by relieving Western Hemisphere trade corporations of the 14% surtax imposed in 1942. The actual reduction from taxable income is determined by multiplying net taxable income by a fraction, the numerator being 14% and the denominator being the sum of the normal and the surtax rates for the tax year. Int. Rev. Code of 1954, § 922. Example: 14%/52% = 26.92%.

A corporation which qualifies as a Western Hemisphere trade corporation also may utilize other tax benefits, such as the foreign tax credit (§§ 901-05). A subsidiary may be incorporated to qualify as a WHTC free of the control limitations of § 269 (I.T. 3757, 1945 Cum. Bull. 200), and a Western Hemisphere trade corporation may be included in a consolidated return without the 2% additional tax on its income. (§ 1503(b)). If a subsidiary pays dividends to its parent, the parent may qualify for the dividend received credit (§ 243(a)); and the Western Hemisphere trade corporation may be liquidated under § 332 without a ruling that tax avoidance is not the principal purpose of the liquidation (§ 367). The dividend credit (§ 34) and the exclusion (§ 116) are available to individual stockholders. Foreign corporations and nonresident aliens who invest in Western Hemisphere trade corporations will not be taxed on the dividends or interest because the source of income is outside the United States. (§§ 861, 1441, 1442).

Some tax disadvantages, however, are inherent. A Western Hemisphere trade corporation is subject to the extra tax on accumulated earnings (§ 531) and, if it is classified as a personal holding company (§ 542), to the surtax imposed by § 541. Foreign taxes may accrue due to the source of income being located in another country.

The form for foreign operations must be determined by individual needs. It should not be decided on the basis of present tax advantages alone. However, assuming a foreign income tax rate of 26%, the most favorable for foreign tax credits, the total tax if a foreign subsidiary is employed is 45.24%; 38% if a WHTC is used (42.84% on a parent); and 52% if a U.S. corporation sells to foreign consumers directly. See, Crawford, Western Hemisphere Trade Corporations, 47 Calif. L. Rev. 621 (1959); Crawford, Foreign Tax Planning: Western Hemisphere Trade Corporation, Possessions Corporation, N.Y.U. 17th Inst. on Fed. Tax 369 (1959); Dean, The Current Importance of Western Hemisphere Trade Corporations, N.Y.U. 10th Inst. on Fed. Tax 489 (1952); Hannon, Choice of Business Organization for Latin American Operations.
Western Hemisphere trade corporation (WHTC). To qualify, the corporation must have transacted all of its business within the Western Hemisphere for the tax year. For the three preceding years (or


The net amount of a WHTC’s income that may be received by a parent corporation may be computed by the following formula: income of the subsidiary [.62-.62 (foreign rate of tax on dividends to nonresidents)]. Assuming no foreign tax on dividends to nonresidents, a Western Hemisphere trade corporation provides a lower total tax than the branch or the foreign subsidiary method until the foreign income tax rate exceeds 45%. 2 CASEY, TAX CONTROL 3421, 3423.

Many feel the tax benefit given Western Hemisphere trade corporations is the first and only major tax incentive to foreign commerce. Dean, supra at 490; Flynn, Western Hemisphere Trade Corporations: Quo Vadis?, 12 TAX L. REV. 413 (1957).

Congress has been slow to grant tax incentives to encourage foreign commerce. The 1913 income tax operated on the theory that all U.S. citizens should pay Federal income tax at the full rate. The first relief was granted in 1918 in the form of a credit for foreign taxes paid. In 1922, the China Trade Corporation was introduced which was the first preference given based on a geographical area. A movement had started in 1921 to give benefits similar to the present WHTC benefits to all domestic corporations with 80% of their gross income from outside the United States. Three years later, this movement culminated in relief being granted domestic corporations on income from the United States’ possessions. The next encouragement to foreign trade came in 1926 when income earned outside the U.S. by a citizen who was a bona fide nonresident for more than six months during the tax year was exempted from U.S. income tax. S.M. 5446, V-1 CUM. BULL. 49 (1926). In 1934, a tax credit for foreign taxes paid by a foreign subsidiary was granted the parent corporation and five years later the Pan American Trade Corporation (PATC) was introduced allowing a consolidated return under certain circumstances. The PATC section, however, was repealed in 1940 when consolidated returns were extended to corporations generally.

The Revenue Act of 1940 exempted foreign income from excess profits taxes, and in 1942 the Senate introduced the present WHTC provisions. See, Baker & Hightower, The Western Hemisphere Trade Corporation: A Problem in the Law of Sales, 22 TUL. L. REV. 229, 231-37 (1947); Flynn, id. at 413-16; Surrey, id. at 831-36.

The geographic specifications of § 921 are “countries in North, Central or South America, or in the West Indies. . . .” No comprehensive list of the countries included is available, but the Virgin Islands, Puerto Rico, the Greater Antilles, the Lesser Antilles, the Bahamas, and the islands off the coast of Venezuela, plus numerous islands in the West Indies, are included. Bermuda and the Falkland Islands are not included. I.T. 3990, 1950-1 CUM. BULL. 57. Alaska was an integral part of the United States even before statehood. Rev. Rul. 55-105, 1955-1 CUM. BULL. 94.

A domestic corporation, “all of whose business (other than incidental purchases) is done” in the Western Hemisphere, qualifies under the statute. No time limitation for this requirement is provided by the statute. The Treasury, however, has limited the test period to the tax year. Treas. Reg. § 1.921-1(a)(1) (1958).

The three year test period includes the tax year and the two prior years. The 90% and 95% requirements are met if the average gross income for the test period is from the prescribed sources. Example for the tax year 1961:
portion during which the corporation was in existence), 90% of its gross income must have been from active trade or business, and 95% of its gross income must have been “from sources without the United States.”

Two major problems have impeded utilization of this tax minimizer. The first arises from the necessity of ascertaining whether 95% of gross income is from sources outside the United States. For this determination, the rules developed to determine source of income for foreign corporations and nonresident aliens have been adopted. These rules make a distinction between manufacturers and brokers. Personal property purchased by brokers in the United States and sold in foreign countries produces gross income only from sources without the United States. Manufacturers, however, are required to allocate part of their total foreign gross income to sources within the United States on the theory that the manufacturing process in this country produced part of the gross income. To evade this requirement—which would virtually

<table>
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<th>Years</th>
<th>Gross Income</th>
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<tr>
<td>1959</td>
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<td>$30,000</td>
<td>$28,500</td>
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7 Income from active trade or business does not include income from investments. “The object of the law, obviously, is to prevent a corporation from obtaining the Western Hemisphere trade corporation credit on investment income.” P-H 1953 FED. TAX SERV. ¶ 4686, 16,705. See also I.T. 1785, II-2 CUM. BULL. 258 (1923). A strict enforcement of this active trade or business requirement could severely restrict the use of WHTCs. Dean, supra note 2, at 493.

8 INT. REV. CODE OF 1954, § 921. The present wording of this phrase is identical to the Senate report which introduced the WHTC. S. REP. No. 1631, 77th Cong., 2d Sess. 32 (1942). The wording of the original section was “other than sources within the United States.” Int. Rev. Code of 1939, § 109, added by ch. 619, 56 Stat. 838 (1942).


10 Treas. Reg. § 1.921-1(c) (1958). The purpose of this determination for foreign corporations and nonresident aliens is to subject as much income as possible to United States income taxes. Although the same phraseology is used in the WHTC requirements, the motivating purpose is to give a tax benefit by excluding income. Tepper & Lotterman, The Federal Tax Inducements to Western Hemisphere Trade, 31 CORNELL L.Q. 205, 211 (1945).


12 INT. REV. CODE OF 1954, § 863(b)(2). The formula set forth by the Treasury allocates income whose source is only partly without the United States on two bases. One half of the gross income to be allocated less expenses, losses and other properly allocable deductions is apportioned on the comparative basis that the taxpayer's property
preclude a manufacturer from qualifying as a WHTC—wholly owned subsidiaries have been formed to sell the manufacturer's products outside the United States but within the Western Hemisphere. WHTC subsidiaries have also been formed by non-manufacturers to handle that portion of their business occurring in the Western Hemisphere and outside the United States, isolating such business so that the 95% source of income requirement is met. Thus, utilization of a subsidiary solves the allocation problem of the manufacturer and provides a tax saving device for others doing any business which will qualify.

Although the use of a subsidiary circumvents the manufacturers' allocation problem, the geographic location of source of income must be determined. Title passage is the classic approach, and the Treasury accepts the title passage test except where title is retained by the seller solely to avoid taxes. In such cases the Treasury applies a "substance of the sale" test which considers the geographic location of important aspects of the transaction to locate the source of income. This excep-

within the United States bears to his total property. The other half is apportioned on the ratio that gross sales within the United States bear to total gross sales. The total allocated to United States sources must not exceed 5% of total gross sales if the corporation is to qualify. Treas. Reg. § 1.863-3(b)(2) Example (2)(ii) (1958).

18 The use of subsidiaries has become a major pattern of operation. Surrey, supra note 2, at 838.

The use of subsidiaries introduces the new problem of allocation of income among controlled entities to prevent evasion or to properly reflect income. (§ 482). This problem, it would appear, may be easily avoided by a true operational separation and "arm's length" purchases, allowing a manufacturing profit to the parent-producer. See, Davis v. United States, 282 F.2d 623 (10th Cir. 1960); Treas. Reg. § 1.863-3(b)(2) Example (1) (1958); Rev. Rul. 15, 1953-1 CUM. BULL. 141; Crawford, Foreign Tax Planning: Western Hemisphere Trade Corporation, Possessions Corporation, N.Y.U. 17TH INST. OF FED. TAX 369, 381-83; Kline, The Western Hemisphere Trade Corporation and the Boggs Bill, 38 TAXES 413 (1960). But, for a successful attack based on agency, see Kaspare Cohn Co., 35 B.T.A. 646 (1937).


10 Prior to 1930, the Treasury accepted title passage as the sole test for determining source of income. In that year the substance of the sale test was adopted by the Treasury because of a misinterpretation of the Compañía case, supra note 14, I.T. 2549, IX-2 CUM. BULL. 360 (1930); G.C.M. 2594, IX-2 CUM. BULL. 354 (1930). After a seventeen year struggle between the courts and the Treasury, the Treasury acquiesced in the East Coast Oil Co. case, supra note 14, and accepted, as a general rule, title passage as the primary test. An exception was entered, however, reserving the substance of the sale test where tax avoidance is the primary purpose of the sale. G.C.M. 25131, 1947-2 CUM. BULL. 85. This exception has been sharply criticized on the bases
tion creates a serious problem for corporations desiring to qualify as a WHTC.

The second major impediment to utilization of the WHTC device stems from the Treasury’s attempt to require capital investment in the source of income country. To foster this requirement the Treasury has promulgated an economic penetration test which is applied independently of either the title passage or the substance of the sale test. The announced requirement of this economic penetration test is substantial commercial activity in the source country on a continuing basis. However, its primary purpose appears to be to require foreign investment, thus severely restricting the use of the WHTC provision.16

In the first cases17 testing wholly owned subsidiaries incorporated to serve as WHTCs, the Court of Claims and the Tax Court recently held that the subsidiaries in question qualified as WHTCs. In both cases the subsidiaries had carefully worded their correspondence and contracts to provide that the beneficial interest, risk of loss and insurance rights in the property remained with the domestic seller until delivery in the foreign country. One of the corporations had a small sales force outside the United States,18 but neither corporation had invested in physical facilities in the foreign country. The Government contended that foreign investment was a prerequisite to qualification and that the substance of the sale test should be imposed to determine source of income

that Congress created the WHTC to induce tax minimization and that the Treasury fostered this minimization by relieving WHTCs of the tax avoidance control limitations of § 269. Dean, supra note 2, at 49. Another criticism is that the exception is founded on dictum in the Balanovski case, supra note 14. Crawford, Foreign Tax Planning: Western Hemisphere Trade Corporation, Possessions Corporation, N.Y.U. 17TH INST. ON FED. TAX 369, 378 (1959). For a comparison of the title passage and the substance of the sale tests, see note 20 infra.

16 Crawford, Foreign Tax Planning: Western Hemisphere Trade Corporation, Possessions Corporation, N.Y.U. 17TH INST. ON FED. TAX 369, 379-80 (1959). The Boggs Bill, H.R. No. 5, 86th Congress, which proposed to amend the INT. REV. CODE of 1954 to encourage private investment abroad, included in its original proposals tax incentives similar to those granted WHTCs for all domestic corporations meeting the source of income and active trade or business requirements from any area outside the United States. Wender, An Analysis of Some of the Limitations on the Base for U.S. Taxation of Foreign Income and Foreign Corporations, HOUSE WAYS AND MEANS COMM., 86th Cong., 1st Sess., COMPRENDIUM OF PAPERS ON BROADENING THE TAX BASE 2171 (Comm. Print 1959). One authority contends that the Service has confused Congress’ intent to encourage foreign trade by giving the WHTC tax incentives with its intent in the Boggs Bill which is to stimulate foreign investment. Kline, supra note 13, at 413.


18 Barber-Greene Americas, Inc., supra note 17.
because the sellers’ motive in retaining title was tax avoidance. Both courts held that foreign investment was not necessary and that title passage was the preferred test since the sellers’ retention of title was not prompted solely by tax avoidance, but also by sound commercial reasons. Thus, a corporation need not have foreign investment to qualify as a Western Hemisphere trade corporation, but its intent to have title pass outside the United States must be carefully expressed.

While the title passage concept provided a sound result in the instant cases, it is questionable whether that test best effectuates the policy of the WHTC provisions. The announced reason for granting tax relief to WHTCs was to alleviate the competitive inequality resulting from domestic corporations’ being taxed on foreign income when it was earned, while European corporations were not taxed on foreign income until it was returned to the country of incorporation. It was anticipated that this tax advantage would also result in increased

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29 The reasons justifying title retention expounded in the instant cases were the need for control by the seller to protect his interest due to the general unrest in foreign countries and the availability of domestic insurance which would pay any losses in U.S. currency.

20 Title passage developed with the law of sales and is based on a concept of superificial delivery. The presumptions which have developed around title passage tend to create a false certainty in the law. See generally, Latty, *Sales and Title and the Proposed Code*, 16 LAW & CONTEMP. PROB. 3 (1951); Llewelyn, *Across Sales on Horseback*, 52 HARV. L. REV. 725 (1939); Wender, *supra* note 16, at 2178. The time and place of title passage is governed by the intent of the parties which in turn is determined objectively by their expressions and conduct and other surrounding circumstances. E.g., Ronrico Corp., 44 B.T.A. 1130 (1941). The items used to determine intent under the UNIFORM SALES ACT § 18(2), are “terms of the contract, the conduct of the parties, usages of trade and the circumstances of the case.” Where express intent cannot be determined, certain presumptions have been codified. UNIFORM SALES ACT § 19.

Under the substance of the sale test, “all factors of the transaction, such as negotiations, execution of the agreement, location of the property, and the place of payment” are considered to determine the geographic source of income. G.C.M. 25131, 1947-2 CUM. BULL. 85. Thus, in ascertaining intent for the title passage test it seems that most of the factors which would be considered under the substance of the sale test are considered. The only true difference, therefore, in using one of these tests rather than the other is the label used in the decision.

21 S. REP. NO. 1631, 77th Cong., 2d Sess. 32 (1942). However, Professor Blough’s testimony during hearings concerning the 1954 Code indicates that the benefits were given for political reasons. *Hearings Before the Subcommittee on Tax Policy of the Joint Committee on the Economic Report*, 84th Cong., 1st Sess. 624 (1955). Representatives of International Telephone and Telegraph Co. and Patino Mines and Enterprises of Bolivia were present at the hearings in 1942 which resulted in the original WHTC proposal. *Hearings Before the Senate Committee on Finance on the Revenue Act of 1942*, 77th Cong., 2d Sess. 1204-10, 2273-76 (1942). For a full discussion, see Surrey, *supra* note 2, at 830-36.

foreign trade.23 Neither the title passage nor the substance of the sale test considers these policies.

Today, more than ever, increased exports by domestic manufacturers should be encouraged. Unemployment and overcapitalization problems could be partially relieved by encouraging domestic corporations dealing in foreign commerce to retain their domestic situs.24 The competitive equalizer given a WHTC helps provide such encouragement,25 but predictability of source of income is crucial under existing law. To facilitate predictability, an economic reality test26 that encompasses the basic reasons for the granted benefits is desirable.27 If American products are flowing out of the United States and into foreign countries in the Western Hemisphere in exchange for funds, the source of income requirement should be deemed satisfied for purposes of qualification as a WHTC.28 However, until the title passage test is overthrown, corporations desiring to qualify must be meticulous in expressing their intent that title is to pass outside the United States.

23 American Food Prods. Corp., 28 T.C. 14 (1957); Baker & Hightower, supra note 3, at 413.
24 Furthermore, the present gold problem emphatically points to our need for exports. In 1945, Tepper & Lotterman, in urging a liberal attitude toward WHTCs, pointed out the urgent need for increasing exports to create jobs for returning servicemen and to assure stability in the period following the post war boom. Tepper & Lotterman, supra note 10, at 206.
27 Using a test which is based on the policy underlying the granted benefits more nearly comports with the modern philosophy of the Uniform Commercial Code, which discards the title passage concept and substitutes rules designed to resolve the individual problems rather than applying one test to solve all sales problems. These rules are tailored to provide socially desirable results in accord with the expectations of the business community. See generally, Latty, supra note 20; Llewelyn, supra note 20.
28 The proposed test received recent approval in Electrical Export Corp. v. United States, 290 F.2d 923 (Ct. Cl. 1961) and is supported in Tepper & Lotterman, supra note 10, at 220. For other suggested solutions and criticism of this test, see Surrey & Warren, The Income Tax Project of the American Law Institute: Partnerships, Corporations, Sale of a Corporate Business, Trusts and Estates, Foreign Income and Foreign Taxpayers, 66 Harv. L. Rev. 1161, 1201 (1953); Note, 69 Harv. L. Rev. 567 (1956). The Tax Court rejected this test in American Food Prods. Corp., 28 T.C. 14 (1957). Compare its language in Barber-Greene Americas, Inc., 35 T.C. 365 (Nov. 30, 1960): "The reality and substance of the petitioners' transactions is that the goods sold were for use in foreign places and the funds to pay for the goods were derived from foreign places."