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11. Report on the Renegotiation Act of 1951 (H. Doc. 322)

12. Cross-References within the Internal Revenue Code of 1954 as of Jan. 1, 1962

13. Summary of the Revenue Bill of 1962 As It Passed the House (H.R. 10650)

14. Digest of Testimony Presented and Statements Submitted to the Committee on Finance with Respect to H. R. 10650

15. (Conf.) Supplemental Digest of Testimony Presented and Statements Submitted to the Committee on Finance with Respect to Foreign Income Tax Sections of H. R. 10650

16. Analysis of Section 19 of H. R. 10650 Withholding on Dividends and Interest

17. (Conf.) Suggestions for Amendments to H. R. 10650

18. Summary of Revenue Bill of 1962 As Reported by the Senate Committee on Finance (H. R. 10650)

19. Summary of Senate Amendments to H. R. 10650

20. Summary of the Provisions of the Self-Employed Individuals Tax Retirement Act of 1962 (H. R. 10)

COMPARISON OF EXISTING LAW WITH PRESIDENT'S PROPOSALS ON TAXATION OF INCOME FROM FOREIGN SUBSIDIARIES

PREPARED FOR

THE COMMITTEE ON WAYS AND MEANS

U.S. HOUSE OF REPRESENTATIVES

BY THE

STAFF OF THE JOINT COMMITTEE ON INTERNAL REVENUE TAXATION

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COMPARISON OF EXISTING LAW WITH PRESIDENT'S PROPOSALS ON TAXATION OF INCOME FROM FOREIGN SUBSIDIARIES

I. OPERATING SUBSIDIARIES

(a) *Existing law*

If an American corporation uses a 100 percent owned foreign subsidiary organized in country X to actually conduct an active merchandising, service, or manufacturing business in that country, the income produced by the subsidiary is not subject to any U.S. tax until the time it is actually distributed to the parent corporation. The rule is the same whether the subsidiary is in a developed or an underdeveloped country.

(b) *President's proposal*

The President's suggestion would make a distinction between developed and underdeveloped countries. (Generally speaking, the developed countries are the countries in Western Europe and Japan and Australia.) In underdeveloped countries the existing rule of law would not be changed.

In the case of developed countries, all income earned by the foreign subsidiary would be taxed to the parent as if it had been fully distributed. Thus, the total foreign and American tax would, in general, tend to be the same as if an unincorporated branch of the American corporation were used instead of a foreign subsidiary. The total income tax burden (foreign and American) on income produced by business activity outside the country would never be lower than the tax burden on similar income produced by activity in the United States. In the case of a foreign country having a substantially lower corporate income tax rate than the United States, the income produced by an American-owned foreign subsidiary might well be subjected to a substantially greater tax burden than the income produced by its competitors. To illustrate: If the developed country in question had a tax rate of 30 percent, this is all that a competitor corporation (not owned by Americans) would pay until dividends were distributed. On the other hand, the tax paid on the income produced by a corporation which was a subsidiary of an American corporation, plus the tax paid by its parent, would tend to be 52 percent of the income earned in all cases with or without a dividend distribution.

II. FOREIGN "BASE COMPANY"

A "base company" is a corporation organized in some foreign country (such as Venezuela, Panama, or Switzerland) which is a subsidiary of an American corporation and which exists to hold the stock of a number of operating corporations in other foreign countries (for example, Brazil, Mexico, Argentina, etc.). One of the purposes of a base company is to permit money to be taken out of a business operation in one foreign country to be used or reinvested in a business operation in another foreign country without ever passing the funds through the United States. (Of course, the country selected for the incorporation of a base company is one which imposes little or no tax on the income of such a company.)

(*a*) *Existing law*

Under existing law the income of a foreign base company is not taxed to the American parent until an actual dividend distribution is made. However, at the present time the Commissioner of Internal Revenue tries to discourage the formation of such companies by denying section 367 clearance at the time they are incorporated. Such clearance is necessary in order to make the incorporation tax free under section 351 (relating to tax-free incorporations). Without the clearance, capital gains is recognized on the transfer of property to a newly formed foreign corporation. The Commissioner's action is based on the view that the primary purpose for the creation of a base company is to take earnings out of one country and reinvest them in another without passing these earnings through the U.S. tax mill.

(*b*) *President's proposal*

It is proposed that in all cases all of the income of a foreign base company be taxed to the parent corporation as if it were distributed. It is suggested this rule be applied without regard to whether operations are conducted in developed or in underdeveloped countries and without regard to whether the earnings are accumulated or reinvested. The President's proposal characterizes every base company as a "tax haven."

III. NATURE OF A "TAX HAVEN"

In the President's message it is suggested that) without regard to whether the country of incorporation is developed or underdeveloped), the income from corporations which are considered "tax havens" be taxed as if it were immediately distributed. As has already been indicated, all foreign "base companies" are considered "tax havens." In addition, corporations in certain other activities, such as, for instance, the sale of insurance on lives or property in the United States, would be considered "tax havens." Generally speaking, corporations engaged in the active conduct of an actual merchandising or manufacturing business in the country of their incorporation would not be considered "tax havens."

The expression "tax haven" is intended to cover the situations formerly spoken of as areas of "abuse." Of course, there are many possible views as to whether and to what extent the deferment of the U.S. tax on income earned abroad by a foreign subsidiary is an "abuse." However, one common view is that this deferment is not an abuse if (1) the income results from the actual and active conduct of a trade or business in the foreign country in which the subsidiary is incorporated, and (2) the income is not used in a country other than that in which it was earned. Under this view, the use of a foreign company for purely ministerial functions, such as those performed by a so-called base company, is considered an abuse if it results in the payment of less U.S. income taxes. However, another view is that there is no abuse as long as the income earned is not brought into the United States, and is instead employed in active businesses anywhere outside the United States. Under this second view, the use of a base company would not be considered an abuse as long as all earnings were used in active businesses abroad.

It is apparent that the President's suggestion that the income of an actual operating subsidiary should be viewed as immediately distributed is not based on any view that investing in a business abroad is an "abuse." It is instead based on the view that income from a business activity by an American corporation should be subject to the full American tax even if the activity takes place outside the United States (without, of course, changing the rule that this tax may be satisfied in whole or in part with a credit for taxes paid to a foreign country). An exception is made for the special situation in underdeveloped countries.

IV. TAXATION OF UNDISTRIBUTED EARNINGS OF A FOREIGN CORPORATION TO U.S. SHAREHOLDER

(*a*) *Existing law*

Under existing law, except in the very special case of a "foreign personal holding company," the American shareholders of a foreign corporation are taxed on the earnings of the foreign corporation only when these earnings are actually distributed.

(*b*) *President's proposal*

It is proposed to tax the earnings of foreign corporations to the shareholders whether or not they are distributed. In certain cases the shareholders would be taxed even if they owned only 10 percent of the foreign corporation.

(*c*) *Constitutional problem in connection with the proposal*

In 1920 the Supreme Court decided in the famous case of *Eisner* v. *Macomber* (252 U.S. 189 (1920)) that Congress did not have power to levy an income tax where a stockholder received a stock dividend in shares identical to those formerly held by him in exact proportion to his former stockholdings. In the opinion the Court said in part:

> The essential and controlling fact is that the stockholder has received nothing out of the company's assets for his separate use and benefit; on the contrary, every dollar of his original investment, together with whatever accretions and accumulations have resulted from employment of his money and that of the other stockholders in the business of the company, still remains the property of the company, and subject to business risks which may result in wiping out the entire investment. Having regard to the very truth of the matter, to substance and not to form, he has received nothing that answers the definition of income within the meaning of the 16th amendment. * * *

Notwithstanding the decision mentioned above, the present personal holding company statute taxes the undistributed profit of foreign personal holding companies to the shareholders of such companies and this statute has been held valid (*Eder* v. *Commissioner*, 138 F. 2d 27 (C.A. 2, 1943)). However, the foreign personal holding company statute deals with a relatively clear tax evasion area. Thus, there may be some question as to whether all the provisions proposed would be within the constitutional powers of Congress.

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