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1. Cross-References within the Internal Revenue Code of 1954 as of January 1, 1961

2. Suggested Methods of Liberalizing Depreciation

3. Refunds and Credits of Internal Revenue Taxes for the Fiscal Year Ended June 30, 1959

4. Comparison of Existing Law with President's Proposals on Taxation of Income from Foreign Subsidiaries

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9. General Explanation of Committee Discussion Draft of Revenue Bill of 1961

10. Federal Excise-Tax Data

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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)

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

# TAX EFFECTS OF CONDUCTING FOREIGN BUSINESS THROUGH FOREIGN CORPORATIONS

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PREPARED FOR THE USE

OF THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

BY THE

STAFF OF THE

JOINT COMMITTEE ON INTERNAL REVENUE TAXATION

JULY 21, 1961

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## LETTER OF SUBMITTAL

CONGRESS OF THE UNITED STATES,
JOINT COMMITTEE ON INTERNAL REVENUE TAXATION,
*Washington, D.C., July 21, 1961.*

Hon. HARRY F. BYRD,
*Chairman, Committee on Finance,*
*U.S. Senate,*
*Washington, D.C.*

DEAR SENATOR BYRD: In accordance with your request, the staff of the Joint Committee on Internal Revenue Taxation has prepared a report on the tax effects of conducting foreign business through foreign corporations.

We have endeavored to collect as much factual material as was available and have consulted with the Treasury Department; Mr. Henry Taylor, former Ambassador to Switzerland; and various industry groups.

Respectfully submitted.

COLIN F. STAM, *Chief of Staff.*

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# TAX EFFECTS OF CONDUCTING FOREIGN BUSINESS THROUGH FOREIGN CORPORATIONS

## Introduction

This study, which has been prepared for the Committee on Finance, sets forth in section I certain statistics with respect to the organization of new foreign subsidiaries in which U.S. shareholders have an interest and which are located in various countries of the world, with emphasis on Switzerland. Section II briefly discusses the various commercial and tax reasons for conducting a foreign business through a subsidiary corporation organized under the laws of one or another foreign country. Section III of the report discusses some of the various types of foreign operations and the rules of present law applicable to those operations. Section IV deals with situations in which a foreign subsidiary is organized in one country but operates in one or more foreign countries. Section V discusses the abuses which do or may occur under present law.

For purposes of preparing this study, materials were collected primarily from the Office of International Operations (OIO), Internal Revenue Service; the recent hearings before the Committee on Ways and Means (May 3–June 9, 1961), relating to the President's tax message; and from various industry groups.

Attached to this report, as appendixes, are:

(A) The portion of the President's tax message relating to the elimination of the tax-deferral privilege;

(B) The Secretary of the Treasury's statement to the Committee on Ways and Means relating to the elimination of the tax-deferral privilege;

(C) The memorandum of the Commissioner of Internal Revenue, dated June 22, 1961, addressed to the Assistant Secretary of the Treasury;

(D) A letter from the Under Secretary of Commerce to the chairman of the Committee on Ways and Means, dated June 22, 1961, relating to imports and exports of foreign subsidiaries;

(E) Table I, relating to the number of foreign subsidiaries organized in 1960 and 1961 based on information returns (form 959); and

Table II, relating to subsidiaries organized in Switzerland during the period September 1, 1959, to December 1960.

## I. Extent of Growth of Foreign Subsidiaries

Sources of information with respect to the number of foreign subsidiaries which are owned or controlled by U.S. shareholders are limited. At the outset it should be noted that, first, the staff was unable to locate any source of information which lists the total number of all foreign subsidiaries owned or controlled by U.S. shareholders in the various countries of the world. Second, there is some question whether the corporations listed in the various tables encompass all corporations that were organized during the periods named. Third, the information which is available does not show the percentage of ownership by U.S. interests of the foreign subsidiaries. Fourth, and perhaps the most important, it cannot be concluded on the basis of these statistics alone whether the foreign subsidiary is an actual operating company serving a useful business purpose, or whether the foreign subsidiary is an artificial arrangement designed solely for the purpose of minimizing U.S. tax liability.

In appendix E, table I sets forth by country and by type of operation the number of foreign subsidiaries organized by U.S. shareholders during the period January 1, 1960, through May 31, 1961. This information was obtained from summaries prepared by the Office of International Operations in the Internal Revenue Service from information furnished to that Office by taxpayers, as required by section 6046 of the Internal Revenue Code of 1954. That section requires each U.S. citizen or resident who was an officer or director, and each U.S. shareholder owning directly or indirectly 5 percent or more in value of the stock then outstanding at any time within 60 days after the creation or organization, or reorganization of any foreign corporation, to make a return pursuant to regulations prescribed by the Secretary. It should be noted that the Internal Revenue Service has estimated that only about 2,950 information returns required by section 6046 or its predecessor have been received by the Service since 1937 with respect to foreign corporations. However, the Commissioner of Internal Revenue has stated (see appendix C): "It has been estimated there are probably as many as 20,000 foreign corporations controlled by U.S. shareholders." As indicated above, the percentage of ownership by U.S. shareholders of the foreign subsidiary is not known.

Table I shows that 531 foreign subsidiaries were organized in 52 foreign countries during the period January 1, 1960, through May 31, 1961. It can be seen from that chart that there is a concentration of newly formed foreign subsidiaries in four countries, namely, the Bahamas (45), Canada (48), Panama (45), and Switzerland (71). Other areas of lesser concentration are France (27), Germany (21), Mexico (16), and United Kingdom (26).

Table II in appendix E lists only those foreign subsidiaries located in Switzerland which have been definitely identified by the Internal Revenue Service as being owned or controlled by U.S. shareholders and which were organized in Switzerland in the 15-month period indicated. It must be emphasized again at this point that the information furnished did not indicate the percentage of ownership by U.S. shareholders; nor did the information state the type of activity in which the company was engaged. Thus, it could not be determined from this data alone whether the company was an operating company serving a useful business purpose or whether it was an artificial arrangement.

The data from which table II was prepared showed that there was a concentration of newly formed Swiss subsidiaries in 3 cantons, namely, Geneva (63), Zug (56), and Zurich (36). There may be many reasons for locating a corporation in any one of these three cantons. It may be noted, however, that the canton of Zug is a small, remote canton in which there is substantially no business activity but which has made a drive through tax-exemption laws, to attract "domiciliary" companies. A Swiss domiciliary company is one which has a Swiss corporate charter, but which does not have an office or place of business in Switzerland and which does not carry on business in Switzerland.

It is difficult to determine the extent to which any one particular type of business has used foreign corporations to conduct foreign activities. However, the Office of International Operations has submitted the statistics in the table below which show the number of insurance companies registered as Bahamian corporations and which are believed to be partly owned by U.S. shareholders. This table may be significant if the companies are engaged in an arrangement whereby profits actually earned by a U.S. insurance company on U.S. business are siphoned off, by means of reinsurance contracts, to a foreign insurance company which is a subsdiary of the U.S. insurance company or a related corporation.

*Insurance companies registered in Nassau, Bahama Islands, as Bahamian corporations believed to be partly owned by U.S. interests*

| Period | *Number of companies* |
|---|---|
| 1955 | 1 |
| 1958 | 1 |
| 1959 | 20 |
| Jan. 1–Mar. 24, 1960 | 10 |
| Total | 32 |

## II. Reasons for Organizing a Foreign Subsidiary

It can be seen from the previous section of this report that many foreign corporations are being organized by U.S. interests. The question then arises: Why does a U.S. corporation conduct some or all of its foreign operations through one or more corporations organized under the laws of a foreign country, rather than directly or through its branch in the foreign country, and why does it choose one foreign country rather than another in which to organize its subsidiary. There are a multitude of possible reasons, which may be grouped into those based upon tax considerations and those involving commercial or other reasons.

(1) *Commercial and other reasons.*—Sometimes it is necessary, if a U.S. corporation is to sell its products or otherwise operate in a foreign country, to organize a foreign subsidiary under the laws of that country, perhaps with part of the stock owned by nationals of that country. The commercial laws, tariffs and import restrictions, currency laws, or the attitude of government officials or the public generally, may make it advisable and necessary to conduct operations by a corporation organized under the laws of the foreign country rather than through direct sales or through a branch of the U.S. corporation. For example, one large U.S. company refused to organize a manufacturing-assembling corporation under the laws of Brazil, with the result that tariff and other restrictions have made it impractical to sell any of its products in Brazil. Subsequently, it organized a manufacturing-assembling corporation under the laws of Argentina, with the result that it now sells large quantities of semi-

finished parts, and some unrelated finished products, to, or with the aid of, its Argentine subsidiary.

In the event a U.S. corporation decides to organize an international foreign subsidiary which it expects will operate in many foreign countries, there are a multitude of factors which must be weighed to determine the country in which to establish its headquarters. Many of these factors are similar to those which may have induced the parent corporation to establish its headquarters in one or another city in the United States. Among the things to be considered are the political and economic stability of the country, the stability of its currency and the availability of foreign exchange, the accessibility of the country to major markets or sources of supply, transportation and communication facilities, banking facilities, language difficulties, the availability of foreign personnel skilled in international trade and various techniques, and the availability of housing and other facilities for its American employees. Location in a country which affords favorable access to the Common Market (France, Italy, West Germany, Belgium, The Netherlands, and Luxembourg) or to the European Free Trade Area (Great Britain, Denmark, Sweden, Norway, Switzerland, Austria, and Portugal), or both, is of considerable importance.

(2) *Tax considerations.*—Traditionally, the United States has imposed its income tax upon all the income of any corporation organized under the laws of any of the States or the District of Columbia, whether such income was derived from sources within the United States or from sources outside the United States. Thus, if a U.S. corporation operates in one or more foreign countries (1) directly through its own salesmen, or through independent foreign importers or distributing agents; (2) through a branch in the foreign country; or (3) through a subsidiary organized under the laws of one of the States but operating abroad, it must pay income taxes on the foreign source income as it is earned, at the rate of 52 percent (of the income in excess of $25,000). (If the subsidiary is a Western Hemisphere trade corporation, the tax will be at the rate of 38 percent (of the income in excess of $25,000).) Most foreign countries impose income taxes on the income earned by a U.S. corporation within the country. In that event, the foreign tax so paid will be, in general, a credit against the U.S. tax. Thus, in most cases, whether the tax imposed by the foreign country is at a low or at a high rate, the aggregate taxes paid, to the United States and to the foreign country, will be 52 percent (on income above $25,000).

On the other hand, if a foreign corporation, even though owned or controlled by U.S. shareholders, earns its income from sources outside the United States, it will not be subject to U.S. income taxes but will pay an income tax, if any, only to the foreign country or countries in which it operates. Its income will, however, be subject to U.S. income taxes (imposed on the U.S. stockholders) when and if it is brought back to the United States as dividends or in some other fashion. When the income is returned as dividends to a U.S. parent corporation, it will be then taxed at the full corporation rates (ordinarily 52 percent). In this case there is a credit against the U.S. tax of that part of any foreign tax previously paid which relates to the dividend received by the U.S. parent corporation. In the ordinary case, therefore, the tax ultimately paid to the United States with respect to the foreign income of a foreign corporation is likely to be substantially the same as the tax which would have been paid immediately if the foreign operations had been conducted directly, through a branch, or through a subsidiary U.S. corporation.

This ultimate tax may be deferred for only a short period of time, or it may be deferred indefinitely for so long as the foreign subsidiary retains its existence. If the income is retained in the foreign subsidiary until it is liquidated by its U.S. parent corporation, the tax will ordinarily be at the lower capital gains rate of 25 percent generally imposed on the liquidation of any corporation rather than at the rate of 52 percent. Similarly, if the parent corporation sells the stock of its foreign subsidiary, the gain will be taxed at the ordinary capital gains rates even though this gain may be largely attributable to the previously untaxed foreign income.

It is difficult to evaluate the effects of the deferral of U.S. taxes generally, either on the taxpayers involved or on the revenue of the Government. Clearly, however, the longer the deferral period and the higher the rate of return on the amount deferred, the greater will be the value of this deferral of U.S. tax. Also, it is clear that the value of deferring U.S. taxes is greater when there is no foreign tax or where the foreign tax is small, and becomes less valuable, or nonexistent, if the foreign tax rate is high.

In view of the numerous and varied considerations, tax and otherwise, which may have induced a U.S. corporation to organize a foreign subsidiary, it is difficult to determine or even to infer, whether, or to what extent, deferral of U.S. income taxes motivated the creation of the foreign subsidiary.

## III. Various Types of Foreign Operations as Affected by Present Law

As pointed out in the previous section of this report, by conducting its foreign operations through a corporation organized under the laws of a foreign country an American parent corporation can postpone the tax on income earned by the foreign subsidiary until that income is returned to the U.S. parent as dividends or otherwise. The question then is: What is a foreign corporation and under what circumstances is its income not subject to U.S. income tax.

Under present law, a foreign corporation is defined as one which is not created or organized in the United States or under the laws of the United States, any State or the District of Columbia. As this has been interpreted by the Treasury Department over the past 40 years, if a corporation is organized under the laws of a foreign country, unless it is a mere sham with little or no real activities, it is a foreign corporation. This is so even if its technical incorporating stockholders are agents of a U.S. corporation or U.S. citizens; if its capital comes from a U.S. corporation or citizens; if its directors, officers, and even most or all of its employees are U.S. citizens; if it is directed and managed from an office in New York or some other city in the United States and its principal books and records are kept there; if most of its funds are on deposit in U.S. banks; and if its entire activity is the sale of goods purchased or produced by a U.S. corporation or the collection and servicing of royalties, rents, interest, or dividends due a U.S. corporation or citizen.

Sections 881 and 882 of the 1954 code provide that a foreign corporation is taxable only on income from sources within the United States. Thus, if the income of a foreign corporation is entirely from sources without the United States, it is not subject to U.S. income tax on that income. Sections 861, 862, and 863 of the code give the rules for determining whether income is derived from within or without the United States. These rules are general, and their application to specific circumstances must be determined by reference to Treasury regulations and rulings and to court decisions. As applied to specific circumstances they are explained more fully in the discussion of various types of foreign corporations and operations in subsequent parts of this section of this report.

In general, as they apply to foreign corporations, they may be summarized as follows:

1. The income from the sale of personal property (merchandise in general, including securities, except real estate) which was bought in the United States and sold outside the United States is entirely income from foreign sources, not from sources "within the United States." Conversely, if the foreign corporation buys goods outside the United States and sells them in the United States, the entire income is from U.S. sources. However, if the sale is made outside the United States the entire income is foreign-source income, even though the buyers are U.S. corporations or citizens and the goods are to be used in the United States. If a foreign corporation itself manufactures goods in the United States and sells them abroad the income is partly from sources within and partly from sources "without the United States." However, if a domestic parent corporation manufactures the goods and sells them (whether within or without the United States) to the foreign subsidiary corporation, which sells them abroad, the entire income of the foreign corporation from those transactions (not the domestic manufacturer's income) is foreign-source income. Income from the manufacture or purchase of goods in one foreign country and their sale in another foreign country is, of course, entirely foreign-source income.

2. Income from the sale of real estate located outside the United States is foreign-source income.

3. Income from rentals of property located outside the United States, and royalties for the use outside the United States of patents, copyrights, trademarks, formulas, etc., is foreign-source income, even though the device, book, formula, etc., was created in the United States.

4. Income from personal services performed outside the United States is foreign-source income.

5. Interest on bank deposits held in the United States by a foreign corporation is foreign-source income if the recipient is not engaged in business in the United States.

6. In general, dividends from a foreign corporation constitute foreign-source income.

Described below are various ways in which foreign corporations operate and the way in which the source rules apply to those operations.

(*a*) Everyone would agree that a corporation which conducts all of its operations in a foreign country, using raw materials derived from that foreign country or some other foreign country and selling its products or services entirely to buyers within that country, derives all of its income from sources without the United States. Such a company might be a public utility supplying electric power, gas, or transportation to the people of a foreign country.

(*b*) A corporation engaged in large-scale retail or wholesale operations throughout the United States may decide to do the same thing in one or more foreign countries through retail or wholesale outlets of a foreign subsidiary. Some or all of the goods sold by these foreign outlets may be bought in the United States from U.S. producers. Present law provides that the personal property bought in the United States and sold outside the United States generates income wholly from sources outside the United States.

(*c*) Frequently, an Amerian manufacturing corporation sells in the United States finished or semifinished products to a subsidiary organized under the laws of a foreign country. In this case with respect to the foreign subsidiary the source rule is the same as in (*b*) above; that is, the purchase in this country of goods which are sold in the foreign country creates only income from sources without the United States. A problem here is the correct allocation of income between the manufacturing parent and the selling subsidiary.

(*d*) The operations of a foreign subsidiary of a domestic parent corporation may be the reverse of the situation described in (*b*) above; that is, it may buy goods in a foreign country for sale to its U.S. parent corporation for use or resale in the United States. Present law provides that if personal property is purchased outside the United States and sold within the United States, the entire profit is income from U.S. sources. Of course, if both the purchase and the sale are made in a foreign country, however, the income is wholly from sources without the United States. To avoid the characterization of the income as income from sources within the United States, therefore, the foreign subsidiary will ordinarily arrange to pass title to the goods bought by its American parent in a foreign country. The courts have held that the place where goods are sold is the place where title passes, (not the bare legal title but the beneficial ownership and the risk of loss).

(*e*) Instead of purchasing from independent foreign suppliers goods to be sold to its U.S. parent corporation, in some cases the foreign subsidiary may manufacture parts or completed products which are sold to its American parent for distribution in the United States. In such a case present law provides that if the sale is made within the United States, the income must be apportioned between that derived from manufacturing, which would be foreign income, and that derived from the sale, which would be income from U.S. sources. However, as in (*d*) above, the foreign corporation will ordinarily avoid the characterization of any part of the income as income from U.S. sources by passing title to the goods it has produced to its American parent in some place outside of the United States.

(*f*) Where goods are bought or produced in the United States by a U.S. corporation to be sold to foreign customers, for any of several commercial reasons it may be necessary for the U.S. corporation to make the sale directly to the foreign buyer rather than to make the sale in this country to a foreign subsidiary which will then sell the goods to the foreign customer. In such a case the entire income will be taxable to the U.S. corporation, since a domestic corporation is taxable on both the income from U.S. sources and the income from sources outside the United States. However, a foreign subsidiary may be employed by the American parent corporation as a selling agent and, therefore, the commissions paid by the American corporation to the foreign corporation will be a deductible expense and thus reduce the income attributable to the U.S. parent. The commissions earned by such a foreign subsidiary are, of course, foreign source income, since the services are performed outside the United States. A problem here is to determine realistically what portion of the total profits should be allocated to the foreign subsidiary as a commission for selling the goods in foreign countries.

(*g*) Instead of manufacturing and selling their products abroad directly or through wholly owned foreign subsidiaries, in many cases American corporations find it more desirable to license independent foreign corporations to manufacture and sell their products abroad. For the use of the U.S. corporation's trademarks, patents, formulas, and processes, the independent foreign firms agree to make the product under stipulated standards and to sell the product in the foreign countries under stipulated conditions. Typically, the American corporation not only transfers to the licensee the right to use patents, trademarks, etc., but continually provides information and services.

For example, a U.S. manufacturer of shirts recently licensed an Argentine manufacturer to produce and sell its shirts in Argentina. The American corporation transferred to the licensee the right to use its patents, trademarks, and technical information, including a huge manual giving detailed directions for the most efficient method of performing each process in making a shirt. In addition, the American corporation agreed to keep the Argentine licensee continually supplied with its latest patterns, fashion information, technical developments, advertising material, etc. Moreover, engineers of the American corporation assisted the licensee in selecting machinery and equipment, and trained technical employees of the licensee in the operation of the machines. In this case the Argentine licensee will pay a fee of 5 percent of its receipts from selling the shirts in Argentina.[1] In this case it appears that part of this fee is a royalty for the use of patents, trademarks, etc.; part is a payment in the nature of a royalty for the use of the "know-how" embodied in the production manual; part is a purchase price for items supplied by the American corporation such as patterns, advertising material, etc.; and part is payment for services rendered by technicians of the American corporation.

Some American corporations have many such foreign licensees. It is stated, for example, that one U.S. corporation has over 400 license agreements with foreign manufacturers of its products and received more than $2,900,000 in royalties and fees from those licensees last year.

Present law treats as income from sources outside the United States payments for the use of patents, copyrights, etc., outside the United States. But, as in the example given, if the domestic corporation which owns the patents, copyrights, etc., obtains this income directly from its licensees, it is immediately taxable because it must pay taxes on its income from whatever source derived.

[1] Wall Street Journal, June 14, 1961.

Two courses are open to the American corporation if it wishes to have a part of such income treated as income from foreign sources: (1) It may sell the right to exploit the patents, copyrights, formulas, etc., in a designated area to a foreign subsidiary which then enters into an agreement with the foreign licensee. The gain from this sale to the foreign subsidiary will be income of the American parent corporation; however, the royalties and fees derived from the patents, etc., will be the income of the foreign subsidiary, and since the fees are for the use of the patents, etc., in foreign countries, the income is from sources without the United States. (2) Alternatively, the American corporation may retain its ownership of the patents, etc., and receive the fees paid by the foreign licensee. However, it may employ a foreign subsidiary corporation as its selling, collecting, and servicing agent, paying the foreign corporation commissions for such services. A problem here is the determination of realistic commissions to the foreign subsidiary.

## IV. Subsidiaries Operating in Countries Other Than Those in Which They Are Organized

For a great variety of reasons, some based upon tax considerations, some not, it is often desirable to have a foreign corporation incorporated in a country other than that in which it transacts its principal business. Just as, in this country, it may be desirable for a corporation to be incorporated in Delaware, maintain its principal offices in New York, and conduct its principal operations in, say, Michigan or Ohio, so it may be desirable for a corporation to be organized in Switzerland, Panama, the Bahamas, etc., but conduct its operations in another foreign country. A foreign corporation may, for example, partially manufacture and assemble the products of an American corporation in West Germany, but may be incorporated in Switzerland and may conduct its selling operations in Switzerland (or in another foreign country), in which case, the relatively high German income tax will apply only to the manufacturing profits; whereas a relatively low Swiss tax will apply to the profit from marketing. Such a corporation, which is organized by an American parent corporation in one foreign country for the purposes of conducting operations in third countries, is frequently referred to as a "base company."

American corporations with large exports to foreign countries may, in many cases, defer the tax on export profits by organizing corporations in the countries of destination. These foreign subsidiaries take title to the goods in the United States so that the margin between the price of the goods in the United States and the price of the goods in the foreign country is obtained, as foreign source income, by the foreign subsidiary. However, there are many countries, notably Great Britain, France, and West Germany, which impose income taxes roughly equivalent to those imposed by the United States, and there are other countries where the income tax is 40 percent or more. In such cases, the effect of paying income tax to the foreign country would be the same as paying an income tax to the United States. To avoid such taxes, a subsidiary may be organized in one of the "tax-haven" countries, say, Panama. The Panamanian corporation then buys the goods at, say, $90 per item from the U.S. manufacturer, taking title in the United States, and sells the goods for, say, $100 to an independent distributor in the foreign country, passing title there, or at an intervening port of call. Although Panama imposes income taxes with rates rising to 34 percent on income earned within Panama, it imposes no tax on gains from purchases and sales made outside Panama. Thus, the export profit is not taxed when it is earned, by either the United States, the country of destination, or Panama.

Instead of having many foreign subsidiary corporations, one in each foreign country or in groups of countries, many American parent corporations have one large international subsidiary which does all or most of its foreign business. Such a subsidiary company may buy the products of the U.S. parent corporation and sell those products throughout the world, either directly, by local branches, or by foreign corporations which are its subsidiaries. Or it may make sales, purchases, and perform other types of services on a commission basis, thus acting as the agent for the U.S. parent corporation. Or it may be a mere holding company, holding the stock of a great many subsidiary companies each of which deals directly with the parent company. Or the international company may do all these things.

Such an arrangement provides very substantial tax advantages, by greatly extending the period during which the U.S. tax on foreign income is deferred. Where there are several foreign subsidiary corporations, if the profits of one are to be used by another these profits must, in general, be returned to the U.S. parent corporation as taxable dividends before they can be transferred to another foreign subsidiary.[2] But in the case of a huge international organization, whether it is a buy-sell corporation, a sales agency corporation, a mere holding company, or any combination of those, profits derived in one country can be shifted for use in another country without the payment of any tax by the U.S. parent corporation. The U.S. tax on foreign income may thus be deferred not only during the growth period of one foreign enterprise but during the growth period of the entire foreign operation in all foreign countries.

The operations of such a large-scale international foreign subsidiary may be illustrated by the following description of the organization and operation of two actual international corporations which are subsidiaries of large American corporations.

Corporation A is a foreign corporation organized under the laws of Switzerland and with its headquarters in Geneva. It buys finished products, and components of the finished products, from the U.S. corporation and from one or another of several manufacturing foreign subsidiaries of the parent corporation. It sells these products all over the world, directly, through branches in many foreign countries, and, in some cases where foreign laws make it necessary, through wholly owned or partially owned foreign corporations which manufacture or assemble products similar to those manufactured by the U.S. corporation. Not only does it sell the products manufactured by the U.S. parent corporation and its foreign subsidiary manufacturing corporations, but it buys in foreign countries certain raw materials and sells these to the U.S. parent corporation or to the foreign manufacturing subsidiaries of that corporation. Also, it gives technical assistance, not only in the field of sales but in the field of engineering and production techniques and general management, to

[2] One foreign subsidiary can lend money to another foreign subsidiary, but sometimes in such cases the Internal Revenue Service will view such loans as, in effect, dividends to the parent.

the foreign manufacturing subsidiaries of the parent corporation, and to its own manufacturing or assembling foreign subsidiaries.

The international corporation employs directly hundreds of persons—managers, technicians, production experts, marketing experts, advertising experts, financial and credit experts, salesmen, etc. (and indirectly employs thousands of persons in the foreign corporations which are its subsidiaries). Hundreds of these persons are in the headquarters office in Geneva, others are in one of the three regional headquarters which distribute the products in Europe, the sterling area countries, and the rest of the world. Many of the employees, while normally attached to one or another headquarters office, are continually visiting the firm's distribution centers in foreign countries. Representatives of this company state that they are meticulous in determining proper prices which the international company pays for the manufactured products of the parent U.S. corporation and the manufactured products of the parent's foreign subsidiaries, and the prices the international corporation charges the U.S. parent corporation for raw materials it purchases, so that there is a realistic apportionment of income among the various entities.

Corporation B is engaged in the manufacture and sale of various types of machines and equipment which are sold to companies in the United States and in many foreign countries for use in conducting their operations and not for resale to consumers. It set up an international foreign subsidiary corporation as a "marketing machine especially designed and staffed to sell in foreign fields."

This international subsidiary established its headquarters in a country which has no income tax. Its choice of a site for its headquarters was determined not only by tax considerations but also from the facts that this city is close to many of its principal foreign markets, has superior transportation and communication facilities, and is a good place in which to work and live.

The international corporation performs five functions: (1) It is the general sales agent with respect to the export of finished products and parts from the U.S. parent corporation to its subsidiaries and licensees, and to many independent distributors, in practically all the countries of the free world; (2) it similarly is the general sales agent with respect to sales made by the parent corporation's foreign manufacturing subsidiaries to licensees and independent distributors; (3) it performs top-level management supervision of the foreign manufacturing subsidiaries of the parent corporation, with respect to type of products, marketing opportunities, general operational and financial efficiency, etc.; (4) it selects, supervises, and assists with technical "know-how," licensees in many foreign countries which manufacture machines and equipment similar to those produced by the parent corporation under patents, trademarks, etc., developed by the parent corporation; (5) it finances, by loans, the foreign manufacturing subsidiaries of the U.S. parent corporation.

The international corporation has about 50 employees, most of whom are more or less constantly traveling in various parts of the world. Some of these are executives, highly skilled in the fields of technology, marketing, management, etc.; others are fieldmen skilled in dealing with the technical and marketing problems of the licensees and independent distributors all over the free world.

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For its services the international corporation receives commissions and fees. Representatives of the U.S. parent corporation state that the commissions it receives as a general sales agent are "on the basis of those currently charged in the United States for similar services by independent selling agents for similar manufacturing companies" and that its "management fees were fixed after ascertainment of the charges of independent companies for similar managerial service."

Representatives of this corporation concede that the organization of the international subsidiary was to obtain "a greater immediate cash flow resulting from tax deferral which could be used to finance the expansion of overseas business."

It is evident that there are many advantages to the methods employed by corporations such as A and B in conducting their foreign operations. First, not only are U.S. taxes deferred, but foreign taxes are avoided, reduced, or postponed, thus reducing the impact of foreign tax credits on U.S. taxes. Second, not only can profits from one foreign country be reinvested in another foreign country without the payment of U.S. income taxes, but information, skills, and techniques developed in one foreign country can be used in others. Their headquarters (usually in Switzerland or some other low-tax European country) provides a central location, available employees with skills in international operations and ability to speak several languages, ready convertibility of money, internationally minded banks, insurance companies, etc.

## V. Abuses Under Present Law Involving the Use of Foreign Subsidiaries

Section III of this report describes the various ways in which foreign corporations operate and the ways in which present source rules would apply to those operations. This section describes the abuses or problems involving the correct allocation of income that may be incurred in each of these various types of operations.

With respect to the operation described in section III(a) there is no problem with respect to the proper allocation of income, since purchases and production, as well as sales, all occur in the foreign country.

With respect to the operations described in section III(b), which involves the purchase by a foreign subsidiary of goods from independent suppliers in the United States and their sale at wholesale or retail in a foreign country, expenses which actually pertain to the U.S. operations of the foreign subsidiary may be attributed to the parent corporation, with the result that the stated income of the U.S. parent corporation is less than it actually is and the stated income of the foreign subsidiary is greater than it actually is. Frequently, the parent corporation will buy large quantities of goods for its own needs and for the needs of its foreign subsidiary. The parent corporation, acting as the agent of its foreign subsidiary, or employees of the parent corporation acting independently, may be the agents of the foreign subsidiary in the purchasing operations. In such cases, unless there is a careful allocation not only of the direct expenses but of overhead expenses, the expenses which ought to be charged to the foreign subsidiary will be charged to the parent corporation.

In the type of operation described in section III(c), the foreign subsidiary buys directly from its parent semifinished or finished products manufactured by the U.S. parent corporation. In this case there is no distortion of income if the U.S. parent charges a realistic price to its foreign subsidiary. In the case of finished products, such a realistic price would ordinarily be that which the U.S. parent corporation charges independent buyers in this country. In the case of semimanufactured items, however, ordinarily no such sales are made to any purchaser except the foreign subsidiary. Therefore, by inadvertence or by design, an unrealistically low price for these semifinished items may be charged, with the result that the income of the American producer is understated and the income of the foreign subsidiary is overstated. Two examples are as follows: (1) Corporation X organized a foreign subsidiary which bought most of its goods from its domestic parent. The parent charged its foreign subsidiary prices which involved a gross profit of 3 percent to the corporation. However, on sales of similar goods to independent buyers the parent corporation realized a gross profit of 25 percent. Through this improper pricing net profits of about $150,000 were shifted to the foreign subsidiary in a period of 2 years. (2) Corporation Y sold manufactured component parts to its foreign subsidiary at a markup of 5 percent above cost. The usual markup with respect to sales to unrelated customers ranged from 35 to 40 percent above cost. By this preferential pricing income in the amount of $320,000, involving an income tax of approximately $159,000, was shifted from the U.S. parent corporation to its foreign subsidiary in a period of 2 years.

In section III(d) there was discussed a foreign subsidiary whose function is to buy in foreign countries various materials for use by the American parent corporation in this country. Here, also, the price which the foreign subsidiary charges its American parent should be, in general, equivalent to the price which a foreign exporter would charge under similar circumstances. Here, also, by inadvertence or by design, prices charged by the foreign subsidiary to the American parent may be unrealistically high, with the result that the stated income of the foreign subsidiary is higher than it actually is and the stated income of the American parent is less than it actually is.

In section III(e) there was described a foreign subsidiary which manufactures for its American parent parts or finished products which it then sells to the American parent corporation for distribution in the United States. As in the case where the American parent manufactures goods to be sold to the foreign subsidiary, it is frequently difficult to determine what a realistic price should be with respect to semifinished items manufactured by foreign subsidiaries. To the extent that the foreign subsidiary charges a disproportionately high price, its income will be unrealistically high and the income of the American parent will be unrealistically low.

The type of operation described in section III(f) involves a foreign subsidiary which was organized and employed by its American parent corporation as its selling agent and receives commissions for its services from the American parent corporation. As indicated, these commissions earned by the foreign subsidiary are foreign-source income, since they are reimbursement for services performed outside the United States. For various reasons, the commission income of the foreign selling subsidiary may be overstated, and the income of the domestic parent corporation understated because of excessive commissions being paid to the foreign subsidiary. In these cases it is very difficult for the Government to determine realistically the value of the services performed by the foreign subsidiary and, hence, very difficult to determine the portion of the total profits which should be allocated as a commission. To the extent that the income of the foreign selling subsidiary is overstated, taxes which ought to be obtained immediately, based on the income of the parent corporation, are deferred until the income of the foreign subsidiary is returned to the United States.

Section III(g) describes the operations of a foreign subsidiary with the function of licensing independent foreign enterprises to use patents, trademarks, formulas, technical procedures, etc., developed by the U.S. parent corporation. The American parent may sell the right to exploit these patents, etc., in one or more foreign countries to its foreign subsidiary corporation. It is evident that unless a realistic amount is paid by the foreign subsidiary corporation to the American parent for the right to exploit patents, etc., the income obtained by the foreign subsidiary as fees from licenses in various foreign countries will be disproportionately high compared to the income which the American corporation derived from the sale of the right to use these patents, etc., to its foreign subsidiary. One extreme illustration of a distortion of income is illustrated by the fact that an American parent corporation charged its foreign subsidiary $22 for the right to use patents, trademarks, etc., in various foreign countries. During the first full year after this transfer, the foreign subsidiary obtained gross royalties and fees from foreign licenses in the amount of $1,500,000.

Where instead of selling the right to exploit patents, trademarks, etc., to the foreign subsidiary the American parent retains the rights to receive royalties, fees, etc., but employs its foreign subsidiary as a selling, collection, and servicing agent with respect to foreign licenses, paying the foreign subsidiary commissions for such services, it is clear that by paying larger amounts for the services than would normally be paid, income which should be obtained by the American parent corporation will be diverted to the foreign subsidiary corporation.

As an example of how one large U.S. corporation diverted income which should have been attributable to itself to its foreign international subsidiary, the following example is significant. Corporation C has annual sales (including the domestic and foreign sales of its subsidary corporations) of over $200 million, and it has over 10,000 stockholders. The U.S. parent corporation, its U.S. subsidiaries, and a few foreign subsidiary corporations manufacture capital goods—relatively large and high-priced items of equipment and supplies used by the buyers in their operations and not for resale to consumers. Their foreign customers, in many countries, are usually corporations, often very large corporations. Ordinarily these foreign customers deal, directly or indirectly, with the producing corporations in the United States (or with the foreign manufacturing subsidiaries), and usually prefer to take title to the goods in the United States or in the foreign country where the items are manufactured.

The parent corporation organized an international subsidiary under the laws of Liechtenstein which, nominally at least, performs the marketing operations throughout the world (except in the United States and Canada) for the parent corporation and its U.S. and foreign manufacturing subsidiaries. The Liechtenstein corporation also performs, nominally, various services with respect to the many foreign licensees of the parent—collecting royalties and fees, transmitting technical information and assistance, etc. But since Vaduz, Liechtenstein (a city of about 60,000 population) is not deemed a "respectable" address, there is another subsidiary of the parent company which is organized under the laws of Switzerland and has an office there. This company does not act as a principal, but is merely the agent of the Liechtenstein corporation, providing, for a small fee, an office and the handling of correspondence, records, advertising materials, etc. Liechtenstein does not have an income tax, so that the profits of the Liechtenstein corporation are free from tax until they are transmitted as dividends to the U.S. parent corporation. Switzerland and its cantons impose income taxes on income earned in Switzerland, but since the services performed by the Swiss subsidiary are only those which a few employees perform in a small office, and since the fee paid by the Liechtenstein corporation for those office services is only slightly more than the cost of the services, the taxes paid to Switzerland and its cantons is negligible.

Although it employs few, if any, salesmen, and the sales of the products of the U.S. parent company or its U.S. subsidiaries are either made directly by the U.S. companies or by independent foreign distributors, the Liechtenstein company receives a commission of 15 percent of the selling price, out of which it pays 5 percent to the independent foreign distributors. For its services (whatever those may be) in dealing with foreign licensees and collecting royalties and fees for the use of the U.S. corporations' patents, formulas, trademarks, and "know-how" the Liechtenstein corporation receives 80 percent of the royalties and fees.

It is evident that the profits thus allocated to the Liechtenstein corporation are grossly disproportionate to the real value of what little work that corporation does. In fact, among themselves, officers of the parent corporation have admitted that the Liechtenstein corporation is nothing more than a tax device, and that it has no real substance. They have directed subordinates to so handle correspondence, sales documents, etc., as to make it appear that the Liechtenstein corporation is a functioning, commercial organization, even though, in actuality, transactions are handled as if there were no such foreign company.

As indicated above with respect to the C corporation, in many cases the abuse resulting from the use of a foreign subsidiary consists in the fact that the foreign subsidiary has little, if any, substance and does not, in fact, function as an operating commercial corporation. These arrangements may be illustrated with respect to Panamanian corporations, although the same practice may, and no doubt does, exist with respect to subsidiaries organized under the laws of any of the other so-called tax-haven countries. Various arrangements are as follows:

(*a*) In some cases it appears that all export transactions originate in the offices of the American parent in the United States except the signature of one person who is an officer of the Panamanian corporation. All the persons who transact the export business remain employees of the U.S. parent corporation, the operations of the Panamanian corporation thus involving merely the issuance of proper documents transferring title to and from that corporation. (*b*) In other cases all the operations are substantially the same as if the American corporation were directly exporting its goods, except that persons who conduct the transactions, while still located in the offices of the parent corporation, are employees of the Panamanian corporation. (*c*) Yet another very common type of operation involves the employment by the Panamanian corporation of a so-called Panamanian management company, of which there are several with offices both in Panama and the United States. Such a management corporation will, for a fee, perform in Panama accounting, clerical, and legal services as may be required, or it will—in Panama—take care of the transfer of title to and from the Panamanian corporation, as well as handling correspondence and accounts. An editorial comment by one of the tax services is illuminating. It says "this service is 'worth the price of admission,' since it shows that your company is truly an operating entity in Panama—not merely a 'paper' company." (*d*) Instead of hiring an outside management company in Panama, the Panamanian subsidiary may itself employ a few persons in Panama to keep accounts, handle documents, etc. (*e*) Alternatively, there may be an actual selling operation, with headquarters and numerous employees in Panama, but with selling agents all over the world. Even though there is a substantial management operation in Panama, the Panamanian government will levy no income tax so long as the actual buying and selling, collection or servicing is done in other countries.

*Special abuse situations involving the use of foreign corporations*

A. Use of a foreign corporation to defer taxes on the profits of insurance companies may be illustrated by two examples:

(1) Corporation I is a U.S. casualty insurance company. It established a foreign subsidiary insurance company in Liechtenstein and reinsured a substantial part of its risks with this foreign subsidiary corporation. Although the risks involved were on property located in the United States and the policyholders paid the premiums to the U.S. corporation, the reinsurance contracts were negotiated abroad and the underwriting gain on this reinsurance was deemed to be from sources outside the United States. By paying premiums to the foreign reinsurer which were disproportionate to the risks assumed by that foreign subsidiary, a disproportionate part of the underwriting gain was attributed to the foreign subsidiary insurance company.

(2) A much more complex arrangement is as follows: Corporation F is a finance company making installment loans, and in conjunction with these loans it requires the borrower to take out insurance upon his life for the period of the loan. It places this insurance with an independent U.S. insurance company, the premiums paid to that company being equivalent to those normally charged for this type of insurance. By a collateral arrangement with this independent U.S. company, however, it is stipulated that the U.S. company will reinsure a large portion of the business it obtains from the finance company with insurance company G, organized under the laws of the Bahamas. This company, by prior arrangement, reinsures this business with another insurance company organized under the laws of Bermuda, insurance company H. The stock of the latter company is entirely owned by the finance company, corporation F. By this arrangement a large proportion of the underwriting profits from the large bulk of insurance originating with the finance company is deferred until insurance company H transfers dividends to its stockholder, the finance

company, corporation F. Thus, not only is the tax on this income deferred, but corporation F obtains a deduction for the premium which generated this income.

B. Two families, citizens of the United States, owned all of the stock of a U.S. corporation, a manufacturing company, which we will call the M corporation. The A family owned 75 percent of the stock and the B family owned 25 percent. Prior to 1950 the M corporation sold its products in foreign countries by direct sales, made by occasional traveling salesmen or through independent agents in the foreign countries. In 1950 a Panamanian corporation was organized, the stockholders of this corporation being the members of the A family to the extent of 75 percent and the members of the B family to the extent of 25 percent. The M corporation appointed the Panamanian corporation its exclusive sales representative in foreign countries and paid the Panamanian corporation commissions of 10 percent on the price of goods sold for delivery in the foreign countries. During its existence of about 8 years the commissions paid to the Panamanian corporation amounted to about $6 million. When the head of the A family died in 1958, the Panamanian corporation was liquidated and the accumulated earnings were distributed to the two families, upon which they paid capital gains taxes. Prior to the organization of the Panamanian corporation the M corporation paid its independent agents in foreign countries commissions of 5 percent on the sales made by them in the foreign country. After the Panamanian corporation was liquidated, the M corporation again conducted its foreign business through such independent agents and again paid them commissions of 5 percent.

C. Eleven individuals, citizens of the United States, formed a corporation under the laws of Panama for the purpose of engaging in the purchase and sale of stocks of U.S. corporations through the medium of the New York Stock Exchange and similar exchanges. Under present law (secs. 881 and 871), a foreign corporation which has no office or place of business in the United States is not subject to U.S. income taxes on gains derived from the sale of U.S. stocks or securities through U.S. brokers. The taxes which these 11 persons would have had to pay on their stock transactions were deferred until the Panamanian corporation was ultimately liquidated. Since there were 11 stockholders of the Panamanian corporation, that corporation was not a "foreign personal holding company" within the meaning of present law, since such a corporation is defined as one in which not more than 5 persons own 50 percent of the stock of the corporation, and in this corporation any 5 stockholders own less than 46 percent of the stock.

D. As has been previously explained, although the income of a foreign subsidiary is not subject to U.S. income taxes when it is earned, an equivalent U.S. tax will ordinarily apply to this income when it is returned to the U.S. parent corporations as dividends. To avoid this tax and, nevertheless, to obtain the use of the income accumulated by its foreign subsidiary, the U.S. parent may borrow from its foreign subsidiary the amounts which would otherwise be paid to it in dividends. Although the Internal Revenue Service will ordinarily question the bona fides of such intercorporation loans, if the loan is for a fixed period, payable in all events, with a reasonable rate of interest which is in fact paid by the parent corporation, and the parent corporation has ample funds with which to pay the loan, it may be difficult or impossible for the Internal Revenue Service to view the loan as a disguised dividend. If the transaction is accepted as a loan, there are two tax advantages: (1) The U.S. parent has the use of funds without paying a tax, and (2) the taxable income of the U.S. parent corporation is reduced by a deduction of interest paid to the foreign subsidiary corporation. Although a withholding tax of 30 percent must be paid upon this interest, that tax is less than the 52 percent tax advantage obtained by the parent corporation.

# APPENDIXES

A. Portion of the President's tax message relating to the elimination of the tax-deferral privilege.
B. Statement of the Secretary of the Treasury before the Committee on Ways and Means relating to the elimination of the tax-deferral privilege.
C. Memorandum of Commissioner of Internal Revenue dated June 22, 1961, addressed to Assistant Secretary of the Treasury relating to administrative difficulties and tax-haven devices.
D. Letter from Under Secretary of Commerce addressed to chairman, Committee on Ways and Means, dated June 22, 1961, relating to imports and exports of foreign subsidiaries.
E. Chart I—Number of foreign subsidiaries organized in 1960 and 1961 based on information returns (form 959).
   Chart II—Subsidiaries organized in Switzerland during the period September 1, 1959, to December, 1960.

## Appendix A

## Portion of the President's Tax Message Relating to the Elimination of the Tax-Deferral Privilege

### III. TAX TREATMENT OF FOREIGN INCOME

Changing economic conditions at home and abroad, the desire to achieve greater equity in taxation, and the strains which have developed in our balance-of-payments position in the last few years, compel us to examine critically certain features of our tax system which, in conjunction with the tax system of other countries, consistently favor U.S. private investment abroad compared with investment in our own economy.

1. *Elimination of tax deferral privileges in developed countries and "tax haven" deferral privileges in all countries.*—Profits earned abroad by American firms operating through foreign subsidiaries are, under present tax laws, subject to U.S. tax only when they are returned to the parent company in the form of dividends. In some cases this tax deferral has made possible indefinite postponement of the U.S. tax; and, in those countries where income taxes are lower than in the United States, the ability to defer the payment of U.S. tax by retaining income in the subsidiary companies provides a tax advantage for companies operating through oversea subsidiaries that is not available to companies operating solely in the United States. Many American investors properly made use of this deferral in the conduct of their foreign investment. Though changing conditions now make continuance of the privilege undesirable, such change of policy implies no criticism of the investors who so utilize this privilege.

The undesirability of continuing deferral is underscored where deferral has served as a shelter for tax escape through the unjustifiable use of tax havens such as Switzerland. Recently more and more enterprises organized abroad by American firms have arranged their



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corporate structures—aided by artificial arrangements between parent and subsidiary regarding intercompany pricing, the transfer of patent licensing rights, the shifting of management fees, and similar practices which maximize the accumulation of profits in the tax haven—so as to exploit the multiplicity of foreign tax systems and international agreements in order to reduce sharply or eliminate completely their tax liabilities both at home and abroad.

To the extent that these tax havens and other tax deferral privileges result in U.S. firms investing or locating abroad largely for tax reasons, the efficient allocation of international resources is upset, the initial drain on our already adverse balance of payments is never fully compensated, and profits are retained and reinvested abroad which would otherwise be invested in the United States. *Certainly since the postwar reconstruction of Europe and Japan has been completed, there are no longer foreign policy reasons for providing tax incentives for foreign investment in the economically advanced countries.*

If we are seeking to curb tax havens, if we recognize that the stimulus of tax deferral is no longer needed for investment in the developed countries, and if we are to emphasize investment in this country in order to stimulate our economy and our plant modernization, as well as ease our balance-of-payments deficit, we *can no longer afford existing tax treatment of foreign income.*

*I therefore recommend that legislation be adopted which would, after a two-step transitional period, tax each year American corporations on their current share of the undistributed profits realized in that year by subsidiary corporations organized in economically advanced countries.* This current taxation would also apply to individual shareholders of closely held corporations in those countries. Since income taxes paid abroad are properly a credit against the U.S. income tax, this would subject the income from such business activities to essentially the same tax rates as business activities conducted in the United States. To permit firms to adjust their operations to this change, I also recommend that this result be achieved in equal steps over a 2-year period, under which only one-half of the profits would be affected during 1962. Where the foreign taxes paid have been close to the U.S. rates, the impact of this change would be small.

This proposal will maintain U.S. investment in the developed countries at the level justified by market forces. American enterprise abroad will continue to compete with foreign firms. With their access to capital markets at home and abroad, their advanced technical know-how, their energy, resourcefulness, and many other advantages, American firms will continue to occupy their rightful place in the markets of the world. While the rate of expansion of some American business operations abroad may be reduced through the withdrawal of tax deferral, such reduction would be consistent with the efficient distribution of capital resources in the world, our balance of payments needs, and fairness to competing firms located in our own country.

*At the same time, I recommend that tax deferral be continued for income from investment in the developing economies.* The free world has a strong obligation to assist in the development of these economies, and private investment has an important contribution to make. Continued income tax deferral for these areas will be helpful in this respect. In addition, the proposed elimination of income tax deferral on U.S. earnings in industrialized countries should enhance the relative attraction of investment in the less developed countries.

On the other hand, I *recommend elimination of the "tax haven" device anywhere in the world*, even in the underdeveloped countries, through the elimination of tax deferral privileges for those forms of activities, such as trading, licensing, insurance, and others, that typically seek out tax haven methods of operation. *There is no valid reason to permit their remaining untaxed regardless of the country in which they are located.*

## Appendix B

### Statement of the Secretary of the Treasury Before the Committee on Ways and Means Relating to the Elimination of the Tax-Deferral Privilege

#### II. EQUAL TAXATION OF FOREIGN INVESTMENT INCOME

The President in his tax message has cited the strains in our balance of payments position as one of the factors which have led us to reexamine our tax treatment of foreign income. Earlier, in his balance of payments message, the President made it clear that our concern relates to the *preferential* treatment of foreign investment income, tax treatment that has favored U.S. private investment abroad compared with investment in our own country. There is no thought of penalizing private investment abroad which rests upon genuine production or market advantages.

*Role of tax deferral*

The most important feature of our tax system giving preferential treatment to U.S. investment abroad is the privilege of deferring U.S. income tax on the earnings derived through foreign subsidiaries until those earnings are distributed as dividends. The lower the rate of of foreign income tax, the more significant is this privilege of tax deferral.

*Comparison of tax rates applicable to income derived in selected foreign countries under alternative assumptions concerning form of organization*

[In percent]

| Assumptions | Belgium | Denmark | France | Germany | Italy | Netherlands | Sweden | United Kingdom |
|---|---|---|---|---|---|---|---|---|
| 1. Corporation organized by U.S. parent in country where all operations are conducted and all profits are retained by subsidiary | [1] 28.5 | [2] 44.0 | 50.0 | [3] 51.0 | [4] 31 | 47 | 40 | [5] 53.5 |
| 2. Corporation organized in country where manufacturing is conducted as a subsidiary of a U.S.-owned Swiss parent; parent makes sales and derives half the total profits, and receives dividends from the subsidiary [6] | 29.1 | 28.5 | 31.5 | 32.9 | 22 | 30 | 28 | 32.0 |

[1] Taxes paid in the previous year are deductible in every case, thus lowering the effective tax burden. Assuming 100-percent distributions each year, this latter adjustment reduces the 40-percent nominal Belgian tax rate to 28.5 percent.

[2] Because of a special deduction measured by a percentage of capital stock outstanding and allowed to all Danish corporations, the rate may be reduced as low as 22 percent. The average rate for most corporations is 36 percent.

[3] The German corporate rate of 51 percent is reduced to approximately 22 percent if all profits are distributed. This tax plus the creditable portion of the capital tax would amount to a total combined rate of approximately 37 percent.

[4] Includes some allowance for excess profits imposed at the rate of 15 percent on profits in excess of 6 percent of capital plus certain allowable reserves.

[5] Taking into account the increase announced in the 1961–62 budget message.

[6] The Swiss Federal tax rate is 8 percent. In addition, income taxes are also imposed in varying degrees by the Cantons. However, substantial tax concessions may be granted by the Cantons. In the Canton of Geneva, for instance, the granting of such concessions would result in an aggregate tax rate of 15 percent, or 13 percent taking into account the fact that taxes paid in the preceding year are allowed as a deduction. Foreign source dividends are not taxable in Switzerland.

I have here a table showing in the first line of figures the statutory income tax rates imposed by various industrialized countries in Europe. It shows a range of rates from 28½ percent in Belgium to 31 percent in Italy, 51 percent in Germany and 53.5 percent in the United Kingdom. If one were to take into account variations in the methods of computing taxable income, the range of effective rates would be somewhat lower, but similar adjustments would have to be made for U.S. tax rates, and for present purposes the statutory rates would seem to be the appropriate ones to use. As you can see, in most of these countries, and particularly those countries which are our more important competitors, the tax rates are substantially at the same level as the U.S. corporation income tax. Tax deferral with respect to profits earned in these countries does not, of course, have any material effect on U.S.-owned firms. (See table, p. 22.)

However, to the extent that business operations are conducted in countries with lower tax rates, there is considerable leeway for deferring U.S. tax. With a foreign tax rate of 28½ percent, for example, a company can defer U.S. tax payments equal to 23½ percent of total pretax profits. It thus can through deferral retain nearly an extra dollar out of every four that it earns.

These statutory rates, however, do not give adequate weight to the variety of arrangements that have been made by American firms in their foreign operations which may bring down rather substantially the rates of tax imposed on income from their foreign operations. Thus, an American company operating in West Germany through a German subsidiary will be subject to tax there at the West German income tax rate of 51 percent, and hence it cannot benefit significantly from U.S. tax deferral. However, to the extent that the profits of the German subsidiary can be diverted from the sweep of the German tax system, a lower tax on profits can be attained. And this is precisely what is achieved through a proliferation of corporate entities in tax haven countries, like Switzerland.

The tax haven companies are given the right to license patents developed by their parent organizations or sister corporations. They supply the services of technicians of their corporate affiliates to firms in various other countries. They acquire the distribution rights of products manufactured by their affiliates. The transfer of these various activities to tax haven entities means a transfer of income to them. Since the income taxes in these tax haven countries are very low or nonexistent with respect to income derived outside their own borders, the result of these arrangements is to bring about a substantial reduction in tax on the total income derived from the foreign operations. Switzerland, for example, has a Federal income tax ranging from 3 to 8 percent. While local income taxes vary widely, there are opportunities for the negotiation of tax liability to the Cantons. With U.S. tax deferral operating simultaneously, tax payments overall can be and often are very substantially reduced.

If $100 of income of a German subsidiary can be segmented so that $50 is attributed to the entity in Germany and $50 attributed to a selling entity in Switzerland, half the profit would be subject to the 51 percent German tax rate but the other half would be subject to a Swiss national tax of only 8 percent. The overall rate of tax would thus be reduced to less than 30 percent. The table I last referred to shows on the second line the aggregate income tax in cases where manufacturing subsidiaries are organized in various European countries but which effect their sales through a Swiss sales corporation so that taxable profits are divided equally between the country of manufacture and Switzerland. As a consequence of such arrangements, and taking into account withholding taxes on dividends transferred from the manufacturing company to the Swiss sales company, the resulting tax rates range from about 22 to 33 percent.

The reductions in tax that can be achieved through the use of tax-haven operations assume that the incomes attributed to the tax-haven companies are fair and reasonable. But the problem is compounded by the fact that incomes are often allocated to tax-haven companies which are not economically justifiable. U.S. companies frequently attribute a disproportionate share of profits to the trading, licensing, and servicing companies established in tax-haven countries—a practice that is extremely difficult if not impossible for the Internal Revenue Service to police effectively.

This is not simply a question of allocating the profits of foreign operations to tax haven countries. It is a problem that significantly affects U.S. taxation of domestic profits. The technique that is used for diverting profits from one company to another among European affiliates is also used to divert income from U.S. companies to foreign affiliates. Income that would normally be taxable by the United States is thrown into tax haven companies with the object of obtaining tax deferral. This is done, for example, by placing in a Swiss or Panamanian corporation the activities of the export division of a U.S. manufacturing enterprise. A very substantial volume of exports is required merely to offset the loss in foreign exchange which the retention abroad of export profits entails.

The recent growth of U.S. subsidiaries in tax haven countries—and Switzerland and Panama are but two examples—suggests that their importance as a means of tax reduction and avoidance will rapidly increase if the deferral privilege is continued. An examination of the public records in Switzerland alone indicates that there are more than 500 firms there which can be identified as being owned by U.S. interests. About 170 of these were created in the year ending March 31, 1961. U.S. officials on the spot are of the opinion that in addition to these firms there are a substantial number of other U.S.-owned firms in Switzerland which cannot be readily identified as such on the basis of the presently available data. Increasingly, U.S. manufacturing subsidiaries operating elsewhere in Europe are being linked to subsidiaries in the tax haven countries. Parenthetically, I might note that the information returns filed by U.S. shareholders or officers of foreign corporations indicate that there are only 92 U.S.-owned corporations in Switzerland all told. There is little doubt that these information returns are inadequate and incomplete. The tightened requirements for filing information returns on new foreign corporations which were adopted by the Congress last year will doubtless give us more accurate information in the future.

*Proposal regarding advanced countries and tax haven operations*

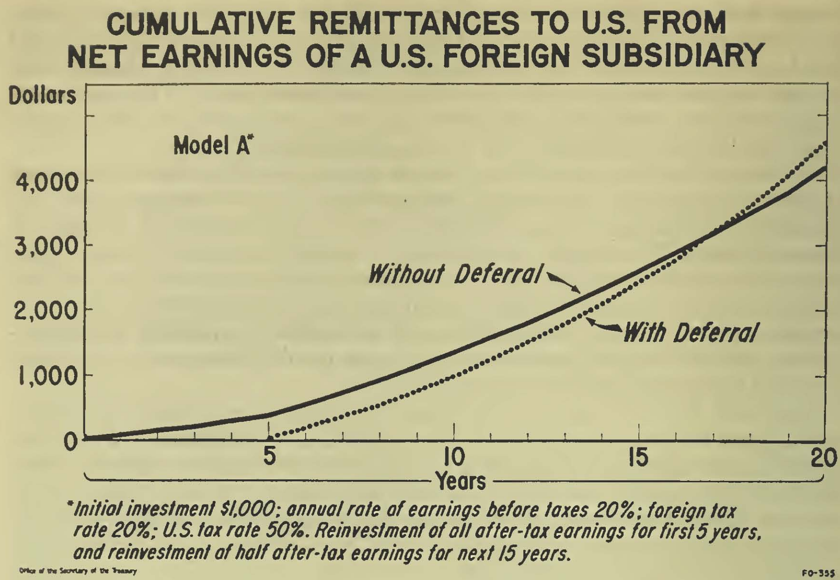
To avoid artificial encouragement to investment in other advanced countries as compared with investment in the United States, we propose that American corporations be fully taxed each year on their current share in the undistributed profits realized by subsidiary corporations organized in economically advanced countries. This change in the method of taxation should be achieved over 2 years, with only half of the profits affected in 1962. Deferral of tax would also be eliminated for individual shareholders controlling closely held foreign corporations in the industrialized countries. The proposed change will not alter the principle that companies may credit income taxes paid abroad against U.S. income tax liability.

In view of the national objective of aiding the development of less advanced countries, we do not propose the same change in the tax treatment of income from investments in less developed countries. Tax deferral will continue to apply with respect to operations in those areas, except that we propose to eliminate deferral in the case of tax haven companies even in the less industrialized countries. For this purpose, a tax haven company would be defined generally as one receiving more than 20 percent of its gross profit from sources outside the country in which it is created.

This test would reach such typical tax haven activities as export and import companies, licensing companies, and insurance companies. However, the general test would be qualified so as not to affect manufacturing companies operating in less developed regions which must look to more than one country for their markets. Other possible areas of exception may be considered in the light of forthcoming testimony before this committee.

While it is difficult to estimate quantitatively by how much tax deferral has contributed to the balance-of-payment deficit, it has surely been a significant factor. Particularly when it is enhanced by the resort to tax havens, tax deferral has given artificial encouragement to foreign investment and has acted as a deterrent to the repatriation of dividend income. Deferral thus adversely affects our balance-of-payments position by increasing payments and reducing receipts. For the 4 years 1957 through 1960, the U.S. capital outflow to Western European subsidiaries amounted to $1.7 billion, raising the total investment in these subsidiaries to $6.2 billion at the end of 1960. Earnings from these subsidiaries in the same period were $2.4 billion, of which $1.1 billion were reinvested abroad and $1.3 billion were remitted to the United States in dividends. On balance, the outflow for the 4-year period exceeded dividend remittances by $400 million. Much the same picture applies to Canada. The capital outflow in the same 4 years amounted to $1.3 billion, bringing our investment there to $9.3 billion. Earnings were $2.4 billion, but $1.3 billion were reinvested and only $1.1 billion were remitted in dividends. Thus, capital outflow exceeded dividend remittances by $200 million.

It is true that deferral causes U.S. assets abroad to rise more rapidly than they would otherwise, so that dividend remittances would also tend to rise over a long span of years. But the time span is apt to be very long. The attached chart shows how the tax deferral privilege can result in a slower remittance of earnings from investment in a foreign subsidiary, as compared with a situation in which the deferral privilege did not exist. Suppose an investment of $1,000 in a foreign subsidiary that yields 20 percent a year before taxes, and that the foreign tax rate is 20 percent. Suppose also that the subsidiary reinvests all of its after-tax earnings for 5 years; and then for the next 15 years reinvests half its profits and remits half its profits to the United States as dividends.




*Without the deferral privilege*, as the solid line shows, the company would immediately begin to remit funds for U.S. tax payments on its earnings.

*With the deferral privilege*, as the dotted line shows, the company reinvests the funds it would otherwise have remitted for U.S. tax payments and it remits nothing for the first 5 years. The greater amount of reinvestment results in a more rapid growth of its net worth, and increases its earnings and remittances, once they begin. Nevertheless, it will be 17 years before cumulative remittances to the United States *equal* those that would have occurred if the deferral privilege had not existed. On the chart this point is reached where the curves cross.

Actually, this is an optimistic example since it assumes that with the deferral privilege the subsidiary will begin remitting *half* of its after-foreign-tax earnings from the sixth year on. In practice, the existence of the deferral privilege may lead it to remit a considerably lower portion of its profits and thus prolong further the time when the two curves cross.

Today our situation is such that we must look first to the more immediate balance-of-payments results. Last fall, as you know, our balance-of-payments position led to a crisis which threatened the stability of the dollar and therefore jeopardized the economic health of the entire free world. Although returning confidence has given a temporary reprieve, it is important that we act to prevent a recurrence of last fall's situation. We must improve our balance-of-payments position. Eliminating the deferral privilege will help us to do so.

It may be estimated, although very roughly, that the elimination of the deferral privilege for subsidiaries in advanced countries and for tax haven operations in all countries would improve our balance-of-payments position by as much as $390 million per annum. This estimate includes the increase in remittances for U.S. taxpayments on foreign earnings, as well as increased dividend remittances and a lower level of capital outflow than would occur if the present privilege were continued.

I have heard it said that elimination of tax deferral such as we propose will not help our balance of payments. Some people even go so far as to claim that it will injure our payments position. In my opinion this view is utterly erroneous. I would cite in support of my opinion that of the responsible financial leaders of Europe. In mid-January, during the height of our balance-of-payments difficulties, the Finance Ministers of the six Common Market countries met and discussed the U.S. balance-of-payments position. They were good enough to give us the general tenor of their thinking. In particular, the Ministers informed us of their unanimous belief that the United States would be justified in discontinuing the fiscal incentives which encouraged the nonremittance of profits made in Europe. This viewpoint from countries which have an interest in attracting and keeping U.S. investment is strong confirmation of our own judgment regarding the adverse impact of the deferral privilege on our balance of payments.

While relief for the balance of payments is an important reason for discontinuing tax deferral, it is not the only one. There exists, in addition, an important issue of equity which has a significant bearing on domestic employment and production, as well as an indirect bearing on our balance-of-payments position. With the present deferral privilege, an American firm contemplating a new investment and finding cost and market conditions comparable at home and abroad is impelled toward the investment opportunity overseas. This is so because it would thereafter be able to finance expansion on the basis of an interest-free loan from the U.S. Treasury, repayable at the option of the borrower. Tax deferral, after all, is just such a loan.

This issue of equity is sometimes presented in reverse; namely, that the withdrawal of the deferral privilege would be unfair because it would change the rules on which companies have already based major investment decisions. This argument seems to me to be very questionable. During the postwar period, the promotion of private foreign investment in both advanced and less developed countries was in the public interest. Times have changed, and the need to stimulate investment in advanced countries no longer exists. Hence, there can be no proper claim that preferential treatment should be continued merely to perpetuate a private gain. This change, moreover, cannot severely injure companies already abroad, for a change in the timing of income tax liability will not normally turn a profit into a loss. At most, it may slow the growth of companies abroad or make the financing of growth somewhat more expensive. To alleviate possible problems, our proposal would remove the tax deferral privilege in two steps.

It is sometimes contended that if U.S. firms are to compete successfully abroad they must enjoy as favorable a tax treatment as their foreign competitors. I believe that this argument has been overly stressed. A difference in tax rates, I said before, should not handicap companies producing abroad, although it may slow the rate of expansion. But even if this argument were fully valid, it could not be a decisive objection to our proposal. As long as the tax systems of various countries differ—and I venture to predict that this will be the case for years to come—we must make a firm choice. Either we tax the foreign income of U.S. companies at U.S. tax rates and credit income taxes paid abroad, thereby eliminating the tax factor in the U.S. investor's choice between domestic and foreign investment; or we permit foreign income to be taxed at the rates applicable abroad, thereby removing the impact, if any, which tax rate differences may have on the competitive position of the American investor abroad. Both types of neutrality cannot be achieved at once. I believe that reasons of tax equity as well as reasons of economic policy clearly dictate that in the case of investment in other industrialized countries we should give priority to tax neutrality in the choice between investment here and investment abroad.

## Appendix C

### Memorandum of Commissioner of Internal Revenue Dated June 22, 1961, Addressed to the Assistant Secretary of the Treasury Relating to Administrative Difficulties and Tax-Haven Abuses

U.S. Treasury Department,
Internal Revenue Service,
*Washington, D.C., June 22, 1961.*

Memorandum for: Hon. Stanley S. Surrey, Assistant Secretary.
Subject: Problems in the administration of the revenue laws relating to the taxation of foreign income.

This is in response to your request for information concerning the administrative problems of the Service in connection with the taxation of foreign income.

In recent years the number of foreign corporations owned directly or indirectly by U.S. shareholders has increased rapidly. It has been estimated there are probably as many as 20,000 foreign corporations controlled by U.S. shareholders. In addition, large numbers of partnerships, trusts, and other businesses have been formed by U.S. taxpayers.

While many of these entities were organized for real business purposes, some have been organized for the sole purpose of avoiding the payment of U.S. taxes that would otherwise be due. The tremendous increase in the number of foreign entities organized has created a number of administrative problems for the Service. The principal problems discussed in this memorandum relate to:

(1) Identification of taxpayers engaged in foreign operations.
(2) Foreign subsidiaries with little or no business activities.
(3) Allocation of income and expense.
(4) Intercompany loans.
(5) Organization and liquidation of foreign corporations for purpose of tax advantage.

*Identification of taxpayers engaged in foreign operations*

Since 1937, the Service has received information returns (forms 959) required by section 6046 of the code reporting the organization or other information with respect to only 2,950 foreign corporations. Information regarding the organization of thousands of other foreign corporations owned by U.S. shareholders has not been filed. This has been due to (1) foreign attorneys who organize foreign corporations for U.S. shareholders are not subject to the jurisdiction of the U.S. laws, and (2) the provisions of section 6046 under which prior to September 14, 1960, domestic attorneys were not required to disclose such information since it constituted privileged communication between attorney and client.

The information which was received over the years at the time the corporations were organized is currently of questionable value. Some of the corporations have been liquidated; the officers, directors, and shareholders of others have been changed or were originally merely nominees and the real parties in interest were not identified. The identification problem created by the failure of persons to file information returns with respect to thousands of foreign corporations and the outdated information contained in those that were filed is further aggravated by the fact that foreign corporations do not file information forms 966, 1096, 1099, and 1099L relating to distributions of dividends and distributions in liquidations to U.S. shareholders.

Section 6046 was amended, effective September 14, 1960. This amendment required U.S. citizens who are officers, directors, or shareholders of the foreign corporation to file information returns rather than to have such information furnished by the persons who organized the corporation as was the case prior to September 14, 1960. Under this amendment filing compliance has improved, but the Service is still not advised of the acquisition or disposition of stock by a U.S. shareholder in a foreign corporation where such action occurred more than 60 days after the foreign corporation was organized or reorganized.

Consequently, where nominees organize a foreign corporation which is later transferred to the real owners of the enterprise who are U.S. citizens or residents, there is no record of the new ownership available to us. There is no obligation to file information on transfers of interest in a foreign corporation from one individual to another, even though such transfers involve all or a controlling share of the stock in the foreign corporation.

Although information is not required of individuals concerning their interests in foreign corporations, except when such corporations are organized, there is a requirement that domestic corporations file information annually on their interests in foreign corporations. Last year Congress enacted a new section 6038 of the Internal Revenue Code which was effective with respect to taxable years beginning after December 31, 1960. The regulations under this section require domestic corporations to file an information report (form 2952) disclosing interests in controlled foreign corporations. It is necessary to furnish this information as a condition to obtaining full foreign tax credit. While much useful information will be obtained under the provisions of section 6038, it will be limited to those cases in which the domestic corporation controls more than 50 percent of the stock of the foreign corporation and, further, the requirement does not include all foreign subsidiaries. Moreover, if all subsidiaries are located in countries which impose no taxes that would be creditable, there is no effective civil penalty for failure to file form 2952. This is because the penalty is only to reduce creditable taxes by 10 percent. As a result, it is possible some corporations with all subsidiaries in tax-haven countries would not file the form even though the Service might assert criminal sanctions for such failure.

Therefore, even though provision has been made for the filing of much information regarding foreign corporations, such information is incomplete and of very limited use because:

(1) Many thousands of returns under old section 6046 have not been filed and those filed under the new version of that section are of no use if there have been changes in the shareholders;

(2) Section 6038 information which will not be received until 1962, applies only to corporations with more than 50 percent ownership, and does not include all foreign corporations owned directly or indirectly by the domestic corporation; and

(3) No provision has been made for submitting information with respect to unincorporated entities such as partnerships trusts, and other businesses formed abroad by U.S. taxpayers.

It is obvious that the Internal Revenue Code does not provide the Service with the source data it really needs to effectively develop a sound enforcement program in the international area. Because of the absence of official information in the past, the Service has had to rely on collateral sources of information. These are often fragmentary, unreliable, and difficult to corroborate.

*Foreign subsidiaries with little or no business activities*

Many domestic corporations form foreign subsidiaries in tax-haven countries solely for the purpose of avoiding U.S. income tax liabilities. In such situations the actual business activities continue to be carried out by the domestic parent, but bookkeeping entries are made in such a manner as to indicate that the activities are those of the subsidiary.

Because of such practices, whenever the Service encounters a situation involving the use of a foreign subsidiary by a domestic taxpayer, we must first determine whether the foreign corporation has real substance. Such a determination can only be made by going beyond the books of account and obtaining information regarding the actual methods of business operations in each case.

If we determine that the foreign subsidiary has no substance, but is merely a shell, we attempt to disregard its existence and to tax its purported earnings to the parent corporation. However, courts have disregarded the corporate entity only in unusual cases. For example, they have done so where it was shown that the corporation was a mere agent for its owners or where the businesses of the separate entities were so commingled as to constitute a single business enterprise.

It is the position of the Service that in order for a foreign subsidiary to be recognized as a separate entity from its parent for tax purposes, it must be engaged in some industrial, commercial, or other business activity. Escaping taxation is not such a business activity. Recognizing the foregoing principle, sophisticated taxpayers attempt to protect the subsidiary's tax status by arranging for the subsidiaries to perform minimal activities.

The line of distinction between a sham operation and a legally recognizable operation is very narrow. This gives rise to many difficult problems in the discovery and development of factual information especially when the information which the Service needs is within the intimate knowledge and possession of uncooperative shareholders or shareholders who are not residents of the United States.

The following case presented the problem to the Service of deciding whether or not the foreign corporation was a sham and demonstrates the practical difficulties we face.

In 1947 a Canadian citizen (owner of a Canadian manufacturing plant and a U.S. distributing corporation) organized a Panamanian corporation in conjunction with an American citizen. Prior to 1947 the Canadian manufacturing company sold its product to U.S. customers through the related U.S. corporation or other U.S. corporations. After the formation of the Panamanian corporation, the Canadian product was first sold to the Panamanian corporation which in turn transferred the product to U.S. customers. Sales prices and title passage were arranged so as to eliminate virtually all United States and Canadian income taxes. This was done by setting prices slightly above cost for sales by the Canadian company to the Panamanian company which in turn sold at abnormally high prices to the U.S. corporation. Thus, almost all profits from the sale of the products were transferred to the Panamanian company. There were no Panamanian taxes due on these profits since Panamanian taxes are only imposed when actual business activities are carried on in that country.

The Service learned from third parties of the activities of the Panamanian corporation within the United States and a search was made for a U.S. tax return. No corporate income tax return was discovered, but a form 959 disclosing the names of the organizers of the Panamanian corporation was found.

The person who organized the Panamanian corporation informed the Service that the foreign corporation did not carry on a trade or business within the United States, that the company had no gross income from sources within the United States, and that the foreign entity was not required to file a U.S. tax return.

It was necessary to locate and interview numerous U.S. customers of the Panamanian corporation to establish that the management, the employees, the banking and numerous other activities of the foreign entity were carried on continuously for a number of years within the United States. On the basis of this information, the Service concluded that the foreign entity was in fact a resident foreign corporation and not a mere sham, that it was carrying on a trade or business within the United States and that a return was due.

The Service was able, with the information obtained, to require the organizers of the foreign corporation to submit sworn statements regarding their interests in the foreign corporation. The sworn statements identified the true owners of the "bearer" shares issued by the Panamanian corporation and established that the management, control, and operations of the company in the United States was sufficient to provide the Service with authority to seek the production of the books and records of the foreign entity. "Bearer" shares are corporate shares which may be transferred without identification of the owners. However, the Panamanian corporation refused to supply the Service with the requested records and it became necessary for the Service to seek the aid of the courts in the enforcement of a summons issued for the production of the records.

After litigation, a court order was issued requiring the foreign entity to produce its records, thereby providing the Service with sufficient information and evidence to support a proposed deficiency in excess of $4,500,000 in U.S. taxes and penalties. However, it took the Service 2 years from the time the examination was started to obtain sufficient information to make this decision. During this time, 7 months of intensive examination effort was required.

*Allocation of income and expense*

The provisions of section 482 of the code relating to the allocation of income and expenses are applicable to transactions between related taxpayers or entities. The transactions between related domestic and foreign entities cause extreme administrative difficulties and these transactions include all normal business activities connected with the export of capital, goods, and services from the United States as well as the import of capital, goods, and services into the United States.

The most difficult problem in applying the provisions of code section 482 in an examination involving foreign entities is that of obtaining factual and useful information relating to the foreign operations and activities. This requires a high degree of cooperation on the part of the domestic taxpayer which is usually not received. The problem becomes more acute if the foreign subsidiary maintains its records in the foreign country. For instance, Swiss subsidiaries create a problem in obtaining information. This problem is magnified in Switzerland since that country has very stringent economic espionage laws, and in two recent cases domestic corporations have hidden the operation of the Swiss subsidiary behind the cloak of the Swiss laws. This applies in countries such as Panama which has recently adopted banking secrecy laws.

Furthermore, because the income of a foreign corporation not doing business in the United States is not taxable here, the domestic parent of such a corporation maintained, in a recent case, that our tax laws do not reach to the foreign operating company and questioned our right to any information regarding it. Generally, complete and acceptable data is obtained only through intensive interrogation and repetitive questioning of the corporation's tax representative by the agent. This is a time-consuming operation and the domestic corporations give the information reluctantly and in piecemeal fashion.

If the earnings of such corporations were made taxable whether or not repatriated, this attitude would have no substance and would require disclosure on the part of the parent especially in a case where the foreign corporation is 100 percent owned. Admittedly, if stockholders who are not citizens of the United States should hold a substantial interest, they might still raise this objection. But certainly if the domestic interests actually control the foreign entity, the argument still seems to be without substance.

The financial statements in two recent cases were obtained only after numerous requests by the agent and in one case a summons was issued to obtain the statements. In another case some very valuable correspondence between a Swiss attorney, who is the managing director of the Swiss corporation, and the domestic corporation was claimed as privileged communication. In both cases the books and records maintained in Switzerland were not made available for our examination. Both of these cases involved large publicly held corporations. Our limited knowledge and the reluctance of taxpayers to volunteer information regarding foreign activities hinders us in obtaining material facts. The questions about the foreign corporation must be specific and narrow requiring only a very simple statement of fact as an answer. The taxpayer's personnel refuse to answer broad and sweeping questions on the advice of counsel since no "fishing" question will be answered. This restricted questioning technique leaves much to be desired since our agents in the first place do not have the internal operating knowledge about the corporations to ask the specific question.

In the examination of a domestic taxpayer involving related domestic entities, the Service can secure the books and records, minute books, internal audit reports, correspondence files, contract files, stock transfer books, and other files and related accounting information maintained by both entities. The parties concerned, their employees and third parties are available to give testimony and evidence.

This is true even in the case of the most uncooperative resident taxpayer since the records and information are available in the United States and, by use of the summons provisions of the code and application of good audit techniques, we are able to develop the information required to conclude our audit.

The situation is just the opposite with respect to related foreign entities when their records and operations are located outside the United States. The Service is without authority to apply the provisions of the Internal Revenue Code beyond the borders of the United States, its territories, and possessions. Both the State Department and the foreign country must approve our sending an agent to foreign soil. In some countries with which we have tax treaties the foreign tax authorities will cooperate in specific cases to see that records, information, and evidence are made available so the Service can complete an investigation. However, in other instances local laws prevent the country from cooperating with us, whether there is a tax treaty or not, to the extent required by our investigation. Therefore, with respect to such countries, they normally decline admission to our agent or admit him but do not assist in securing the records, information, and evidence necessary to complete the investigation. Without the cooperation of the tax authorities of the foreign country our chances of examining books and records, securing the cooperation of the officers, employees, and third parties in developing testimony and admissible evidence are minimal. The effectiveness and results of the audit of a domestic taxpayer with foreign affiliates, therefore, rests to a large extent upon the cooperativeness of the taxpayer who has a pecuniary interest in the outcome and is not inclined to volunteer information adverse to his position.

Since we can ordinarily examine only one side of the case when foreign affiliates are involved, we are severely limited in our chances of adequately developing all of the facts necessary to prevent diversion of income to a foreign entity. The underlying information and facts with respect to the relationships, purchases, sales, expensing, licensing, and other arrangements are matters peculiarly with the knowledge and control of the domestic taxpayer and its foreign affiliates. An investigation involving 482 is complex when only domestics are involved, but when the foreign affiliate enters the picture and we cannot examine the affiliate's records to ascertain the type and source of its income our problem is magnified many times. Indeed, it will be impossible to identify many cases of income diversion since there will be no leads or information in the domestic taxpayer's records.

Even when cases have been identified involving transactions between related companies which involve questionable pricing practices and it is clear that section 482 should be invoked, difficulties in applying the section are encountered. The most useful, and least troublesome, technique for allocating information between the related companies is to find transactions involving similar products entered into by unrelated firms. Frequently this is not feasible because of wide differentiation in detail of products that serve the same purpose. In some cases firms have sought to make use of the arm's length pricing so as to escape any adjustment under section 482. They may make sales in small amounts to unrelated enterprises at low prices which could then be used as justification for the low price charged their foreign affiliate. Sometimes they may purchase products at high prices to justify high prices paid to their related enterprises abroad.

The Service has many section 482 examinations in process involving foreign affiliates, and typical questionable items include:

(1) Pricing of sales and purchases of products.
(2) Pricing of equipment transfers.
(3) Allocation of operating expenses.
(4) Use of patents, copyright, trademarks, and formula.
(5) Services: Engineering and other professions.
(6) Financing charges.

The examining agent must check into all of the above items and others when a domestic has foreign affiliates to assure there is no diversion of income. This is a time-consuming process and is becoming worse with the creation of each additional foreign affiliate. Hundreds of domestic taxpayers have 10 or more foreign affiliates and one is known to have over 250. As stated earlier, there may be as many as 20,000 foreign corporations controlled by U.S. shareholders. Proper enforcement of section 482 could involve the time and effort of most of our revenue agent staff and practically all of our agents with highest skills if the foreign entity situation continues to grow.

The development of the facts and evidence to make determination involving the above items involves the use of initiative, imagination, discretion, judgment, and the application of expert knowledge and skills which could be beyond the abilities of the journeyman revenue agent who is an accountant trained in tax law.

Incidental difficulties in connection with information from foreign sources are that it frequently is presented in a foreign language and requires translation, and our agents cannot be familiar with the laws of foreign countries. Accordingly, we cannot be sure that they interpret the information received to assure a proper determination of income.

We are assigning our agents with the highest skills to these time-consuming audits, and this can only result in reducing the total number of cases to be audited by the Service in its planned audit program.

It is quite obvious that the Service is compelled to devote endless man-hours in the application of section 482 in cases involving foreign subsidiaries. Upon completion of these time-consuming and laborious examinations, there still remains an amount of income the Service must recognize as income of the foreign corporation. These frequently large amounts are not subject to U.S. tax.

*Intercompany loans*

Large accumulations of foreign earnings are returned to the United States by domestic shareholders without incurring liability for tax on dividends by the device of borrowing from their wholly owned foreign subsidiaries. Moreover, the domestic shareholders exercise such a degree of control over the finances of their foreign subsidiaries that they are able to use such earnings for investment and reinvestment in any foreign country without payment of U.S. tax.

That is, the domestic companies direct the operations of the foreign corporations to such an extent that they can shift earnings from one to another through loans or use the earnings of one to create still another foreign corporation. Thus, the earnings are treated as income of the domestic but are not repatriated before doing so. On the other hand a domestic corporation which does not resort to devices of this kind but which desires to establish itself in a foreign country or expand its foreign operations would be required to use taxpaid earnings for the purpose.

Shareholder and intercompany loans involving foreign corporations may be divided into two broad categories:

(1) Loans to or from the shareholder and controlled foreign corporations;

(2) Loans between related foreign corporations controlled by the same shareholder.

Both categories may involve either individual or corporate shareholders and regardless of the nature of the shareholder the problems are essentially the same. That is,

(1) Ascertaining the existence of a loan;

(2) Establishing the fact that a loan is between related entities;

(3) Establishing a fair rate of interest for use of funds.

Our examinations indicate that loans from controlled foreign corporations to both individual and corporate U.S. taxpayers have materially increased during recent years.

The general practice is to employ a foreign base corporation located in a tax-haven treaty country, such as Switzerland, for purposes of shareholder and intercompany loans. Typical examples follow:

(1) In a case now under examination the sole stockholder of a domestic corporation which controls 100 percent of a foreign corporation obtained non-interest-bearing loans totaling $2 million from the foreign corporation over a period of 3 years. The transactions are not recorded on the books of the domestic corporation and the sole stockholder does not maintain a set of books.

The tax savings of this arrangement to the domestic corporation exceeds $1 million (subject to any foreign tax credit) due to its failure to report a dividend from the foreign corporation.

The tax savings to the sole stockholder would depend upon his other income and the earned surplus of the domestic corporation available for dividends but could approximate $450,000 for each of the 3 years.

In our audit of the returns of the stockholder and the domestic corporation, our problem is to ascertain the existence of the loan.

The stockholder has no books and the transaction is not reflected on the books of the domestic corporation. Our success in locating the transaction, therefore, depends upon the agent observing that the individual stockholder has large unaccounted for resources available or securing leading information from the foreign corporation's records or detailed financial statements of the foreign corporation. The returns of the stockholder and the domestic corporation did not reflect any evidence of this arrangement, and they were not initially selected for examination. However, because of information received from other sources, they were later assigned for examination.

(2) A domestic corporation arranges to borrow $1 million from its 100 percent controlled Swiss subsidiary with interest at 6 percent. The Swiss corporation remits the proceeds of the loan to the parent through an established Swiss bank which is also designated to collect the interest and principal payments on the loan. The parent records the loan on its books as payable to the Swiss bank and makes annual interest payments of $60,000 to the bank which are claimed as deductions on the parent's return. The tax savings to the domestic corporation from this arrangement would be $31,200. The withholding tax on the interest paid to the Swiss corporation would be $3,000. The potential tax deficiency against the corporation is $520,000 subject to offset by any foreign tax credit and disallowance of the current tax saving for interest paid. This tax deficiency arises as a result of establishing that the loan was in fact the payment of a constructive dividend.

In the audit of this return the difficulty is ascertaining that the loan is from a controlled Swiss corporation, instead of the Swiss bank. The only way the Service could detect this transaction or ascertain that the loan is from a controlled Swiss corporation would be to audit the Swiss corporation's books or obtain detailed financial statements which might disclose the parent's name. This fact cannot be ascertained by contact with the Swiss bank because the Swiss secrecy laws do not permit banks to disclose principals in such transactions.

These examples clearly demonstrate the difficulties created by the Service having access only to the books and records of one party to foreign transactions. They also demonstrate the means by which foreign earnings may be used by domestic shareholders without subjecting them to U.S. taxation.

*Organization and liquidation of foreign corporation for purpose of tax advantage*

Income diverted to tax-haven subsidiaries by the methods described above is often brought back to the United States by the domestic parent by liquidation of these subsidiaries. The domestic parent through its complete control of the subsidiary can cause its liquidation at such time and manner to obtain maximum tax advantages. The highest applicable rate in such situations is 25 percent, the capital gains rate, and in some cases the payment of any taxes upon the proceeds of the liquidation may be indefinitely postponed.

The liquidation provisions of the code are particularly attractive to companies organized in tax havens to carry out relatively short-term projects. Such companies can accumulate their earnings virtually untaxed, then distribute them to the domestic parent upon liquidation.

Not satisfied with these benefits, some domestic companies artificially inflate the earnings of the subsidiary. To the extent they are successful in doing so, such amounts escape ordinary tax rates and are returned at no more than the capital gains rates.

In a recent case, a corporation was formed to construct a housing project. Although the U.S. shareholders performed all the required architectural and engineering services, they received no compensation from the foreign corporation. As soon as the project was completed, the foreign corporation liquidated, and approximately half a million dollars was distributed to the U.S. taxpayers as liquidation dividends subject to the capital gains rates. A substantial portion of the foreign corporation's profits was attributable to the services performed by the U.S. taxpayers. Therefore, to the extent of the value of their services, ordinary income was converted to capital gains.

*Conclusion*

We are clearly handicapped in our administration by the failure of the law to require disclosure of the interests of U.S. citizens in certain types of foreign activity. Moreover, the discovery of information regarding the activities of foreign entities is hampered by the domestic taxpayer's resistance on the ground that disclosures are not required in connection with the determination of their tax liabilities. This is especially true where foreign subsidiaries have little or no business activity and in cases involving allocation of income and expense under section 482.

Also, the limitations on our audit capacity do not permit the examination of all cases where international activities are carried on with the result that many cases escape detection. This is aggravated by the necessity to employ our agents with the highest skills on these very difficult and time-consuming examinations. Absent voluntary and full cooperation by domestic taxpayers in making full disclosure of foreign activities, the Service will continue to be handicapped in this foreign aspect of enforcement under present law.

Mortimer W. Caplin, *Commissioner*.

## Principal Patterns of Avoidance by U.S. Corporate Taxpayers in Foreign Tax Haven Activities

### I. DESCRIPTION AND SCOPE OF ANALYSIS

Basically this analysis was made from a review of approximately 135 case reports describing various types of foreign activities used to avoid U.S. income taxes. While some of the reported cases have been closed, the vast majority are still in process.

From an income tax audit standpoint the raising of issues in connection with foreign activities is just beginning to emerge. Our source material is therefore quite limited and cannot be considered as a firm base for projecting the overall picture. Nevertheless, the relatively small number of case reports does illustrate the type of operations which are becoming more and more prevalent.

One other factor which should be noted is that the reports deal almost exclusively with situations in which the foreign entity is a subsidiary of a domestic company. While we believe that individuals have formed foreign companies or otherwise arranged to take advantage of the tax haven situation, we do not have factual information in sufficient quantity to outline the patterns of these activities.

## II. CATEGORIES OF TAX AVOIDANCE DEVICES

### *A. Cases in which income is diverted to a foreign subsidiary which engages in no real activity abroad*

These cases involve the establishment of one or more subsidiaries in tax haven countries for the ostensible purpose of engaging in foreign business activities. Typical of these situations is the establishment of foreign corporations to buy raw materials abroad to sell solely to its domestic parent or to sell the parent's products abroad. In these cases the subsidiaries are shell corporations with legal existence but do not perform any real economic function. Often they do not have any operating employees nor any physical assets. The parent company's operations remain the same in substance with the employees of the parent performing all the necessary functions of the tax haven subsidiary. However, the books of the foreign subsidiary are kept in such a manner to create the illusion that it is actually engaged in business operations.

There are many variations of the situations described above. One of the most common is the establishment of a tax haven subsidiary to take over income producing intangible assets such as patent rights and secret processes. These valuable assets are transferred from the parent to the subsidiary for only nominal consideration although they may have been developed by the parent by substantial tax deductible research expenditures. The subsidiary then relicenses these rights to other foreign corporations. In the cases described in this section all activities in connection with the sale of the licensing rights are conducted by the parent's employees and by the use of its facilities.

The result of the arrangements described above and the numerous variations, which are limited only by the imagination of the taxpayers involved, is the diversion of income from the U.S. parent company to the entire extent of the subsidiary's profits.

### *B. Cases in which foreign subsidiaries are organized to carry on the same type of business activity previously conducted by the domestic parent*

1. *Intercompany transactions conducted in the same fashion as with unrelated companies.*—Through a change in legal form a domestic company can achieve a material reduction of its income subject to U.S. income taxes. This is accomplished by forming a tax haven company which then carries on the foreign activities of the U.S. parent. Foreign branches or agencies, whose income was formerly includible in the income of the parent, continue to operate as in the past, but are placed under the jurisdiction of the tax haven company.

In some cases business functions of the parent are duplicated by the foreign subsidiary. Thus, there are two selling and buying organizations, one engaging in domestic business and the other in foreign business with respect to the same products. Under present law the profits of the foreign subsidiary are not subject to U.S. income taxes unless the subsidiary's income is repatriated, that is, brought back into the United States. Even when repatriation of the earnings occurs, it is often arranged in such a manner that the tax impact on the earnings of the subsidiary is less than if it were taxed in the year earned.

2. *Diversion of income through improper pricing arrangements.*—In many instances, questionable intercompany pricing and expense allocation practices result in the foreign company's receiving a greater portion of the income than it actually earned. This is the most prevalent abuse because of the simplicity of its arrangement. A parent may buy from or sell to its wholly owned foreign subsidiaries at prices which will result in the lowest possible tax liability to the affiliated group. Since the U.S. tax rate is substantially higher than that in the tax haven countries, profits are artificially shifted abroad. In many cases the domestic parent sells to its foreign subsidiaries at prices lower than the fair market value, or purchases from them at inflated prices. In extreme cases sales are made to the tax haven subsidiary below actual cost to the parent. As a result, the foreign subsidiary has abnormally high profits and the parent company's profits decline accordingly.

Conversely, in some cases the parent buys products from its subsidiaries at excessive prices, and the result is the same as that described above.

3. *Diversion through transfer of valuable income-producing assets.*—Frequently the domestic parent transfers valuable income-producing assets to its tax haven subsidiaries. These situations are distinguished from the situations described in II A above, since the assets are in reality transferred and the subsidiary engages in actual business operations. The most common assets transferred are licensing rights. Also, investments in foreign subsidiaries are transferred to tax haven holding companies. The income these assets produced for the parent in past years is thus shifted to the tax haven subsidiary.

4. *Diversion of income through improper expensing.*—While the foreign subsidiaries in this category engage in real activity, they often receive managerial and technical advice and other services from their domestic parents at no cost or at less than a fair charge. This misallocation results in an increase in a subsidiary's net earning and a corresponding reduction of its parent's taxable income.

*C. Cases in which financial arrangements are made to place funds of foreign subsidiaries at the disposal of the domestic parent without being subjected to U.S. income taxes*

In some cases the profits accumulated by the foreign affiliates are loaned to the domestic parent at no interest or at low-interest rates. In this way the parent obtains the use of the affiliates' earnings without incurring U.S. income taxes on repatriating these funds. In other cases the domestic parent corporation makes loans to its tax haven subsidiaries without charging interest on the money borrowed to lend to the subsidiary. In either event, the net effect is a reduction of the taxes paid to the United States.

*D. Miscellaneous*

1. *Foreign mutual funds.*—Such funds are organized in foreign countries upon payment of a small annual fee. The books and records and assets, etc., of the fund are kept in the United States. The fund invests in foreign securities and as planned pays no cash dividends to the U.S. shareholders. Thus, their investment grows untaxed and the increment can be obtained when desired at capital gain rates. Alternatively, the fund will invest in U.S. securities and be subject to only the statutory or treaty rate of withholding on dividends.

2. *Transportation.*—U.S. taxpayers place their ships and aircraft under foreign registry in tax haven countries and the income derived from the operation of such ships and aircraft is not subject to U.S. taxes.

3. *Reinsurance.*—This is a comparatively new avoidance device primarily involving life insurance which installment buyers are required to purchase to insure payment of their obligations. In these cases insurance is placed by a domestic loan company with an unrelated domestic insurance company. The latter has agreed to reinsure the policy with a tax haven company controlled by the stockholders of the loan company. In this way most of the underwriting profits are siphoned off to the tax haven company to avoid payment of U.S. income taxes.

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## Appendix D

### Letter From Under Secretary of Commerce Addressed to Chairman, Committee on Ways and Means, Relating to Imports and Exports of Foreign Subsidiaries

The Under Secretary of Commerce,
*Washington, D.C., June 22, 1961.*

Hon. Wilbur D. Mills,
*Chairman, Committee on Ways and Means,*
*House of Representatives, Washington, D.C.*

Dear Mr. Chairman: In the course of my testimony before the House Ways and Means Committee on May 5, 1961, on the subject of proposed revisions of the method of taxing U.S. firms on the income of their foreign subsidiaries, your committee requested statistics on three matters: (1) exports from the United States to foreign subsidiary companies; (2) imports to the United States from foreign subsidiary companies; (3) financing provided by subsidiaries in developed countries to subsidiaries in underdeveloped countries.

Since there was no up-to-date information on these points, our Office of Business Economics undertook a special survey, the results of which are summarized below. Questionnaires were sent to 200 representative U.S. manufacturing companies with plants and other facilities abroad. Usable responses were received from 155 companies, whose foreign investment, in the aggregate, accounts for at least 80 percent of all U.S. manufacturing investments abroad.

*(1) Exports from the United States to foreign subsidiary companies*

Companies covered in the survey reported that their manufacturing subsidiaries abroad purchased $1.6 billion of goods from the United States in 1960, and $1.4 billion in 1959. In addition, foreign trading subsidiaries purchased $0.6 billion of U.S. goods in 1960 and $0.4 billion in 1959. Further exports from the United States were effected by the foreign subsidiaries on a commission basis, amounting to over $0.4 billion in 1960 and over $0.3 billion in 1959.

These figures are given in table 1, showing the areas to which shipments were made. This table also provides a comparison of these exports with total exports from the United States, and with an adjusted export total from which certain items, mainly foodstuffs, raw materials, and civilian aircraft, have been eliminated, since they are not likely to have any counterpart in the exports to this group of subsidiaries.

Exports to the foreign subsidiaries are understated to the extent there are certain companies not included, all industries are not covered, and some respondents stated they could only give figures for their own shipments to the foreign subsidiaries, so that other purchases here were left out. On the other hand, there could be some overstatement to the extent there were intercompany sales abroad, although efforts were made to reduce this possibility.

In the aggregate, it appears that in 1960 roughly one-fifth of the adjusted export total was associated with the foreign subsidiaries of these manufacturing firms. These subsidiaries also shared substantially in the rise in exports to Europe in 1960, as economic activity in that area continued upward.

A comparison of the data supplied in this special survey with data collected from other sources, indicates that, in the aggregate, goods purchased in the United States amount to roughly 20 percent of the total materials used by the foreign subsidiaries in their manufacturing operations abroad. The proportion is higher than average in Latin America and Canada, roughly 50 percent and 25 percent, respectively, and probably less than 10 percent in Europe.

The manufacturing subsidiaries abroad reported imports of $129 million of capital equipment from the United States in 1960, compared with about half that much in 1959. Canada and Europe each accounted for about one-third of the 1960 total. A number of reporters were not able to segregate exports of capital equipment from other exports, so that the total for equipment is comparatively incomplete.

*We believe these results indicate that the foreign subsidiaries do provide an important channel for U.S. exports, both for their own use in producing goods abroad for resale, and as an aid in developing sales from the United States to other consumers abroad.* The increase in export to manufacturing subsidiaries from 1959 to 1960 was not more, however, than in total comparable exports. This applies to all areas together, as well as to Europe. Exports to trading subsidiaries abroad seem to have increased somewhat faster than total exports.

It must be realized, however, that the net effect of the establishment of these foreign subsidiaries on our export trade can not be actually measured, since it is not possible to know how our export trade would have developed in the absence of these subsidiaries. It may well be that these exports are not additional to the U.S. total because a foreign company rather than a subsidiary might have purchased the same goods from the United States.

(2) *Imports to the United States from foreign subsidiary companies*

The companies covered in the special survey reported exports from their foreign subsidiaries to the United States totaling nearly $500 million in 1960, down from about $600 million in 1959. Certain of these imports are relatively crude materials, such as paper and pulp from Canada or meat products from Latin America and Australia. If these are eliminated, total imports are reduced to about $300 million in 1960. These figures are shown in table 2.

Manufacturing subsidiaries abroad shipped about $200 million of goods to the United States in 1960, after the eliminations noted above.

The largest amount came from Canada; less than $100 million came from Europe. The major change from 1959 to 1960 was the sharp decline of imports from Europe, resulting from lower automobile shipments. Automobiles and parts make up more than half of the reported imports from European manufacturing subsidiaries.

Although the coverage of imports in the special survey is less complete than the amounts reported for 1957 in the comprehensive census, U.S. Business Investments in Foreign Countries, the data for Europe indicate that there has not been a significant change in shipments from European manufacturing subsidiaries in the 1957–60 period.

(3) *Financing provided by subsidiaries in developed countries to subsidiaries in underdeveloped countries.*

Companies who were able to supply data on the flow of capital between their foreign subsidiaries reported a total flow of $118 million in 1960, up from $70 million in 1959. These flows consisted of long-term capital investments plus changes in advances and other working capital supplied in the year to subsidiaries in all areas of the world, both developed and underdeveloped.

The flow from European subsidiaries to subsidiaries in Latin America and other underdeveloped areas was about $25 million in 1960, mainly originating in Swiss subsidiaries. In addition, Canadian subsidiaries provided about $10 million to subsidiaries in less developed countries. The 1960 flow from Europe was $3 million higher than the 1959 equivalent.

Flows within some of the areas were substantial. For instance, *there was a flow of $32 million in 1960 from subsidiaries in some European countries. to subsidiaries in other European countries.* In Latin America *about $21 million passed through Panamanian subsidiaries to operating subsidiaries in other Latin American countries.*

It is difficult to appraise the significance of these figures, since they cover only subsidiaries of manufacturing companies, and often involve intricate corporate structures. However, the total estimated direct-investment capital outflow from the United States to manufacturing affiliates in the underdeveloped countries in 1959 was only $77 million, and $63 million of this was to Latin America. By comparison, therefore, the transfers of funds among the foreign subsidiaries appear to be a sizable portion of total financing.

Additional data were collected in this survey on the amounts of royalties, license fees, technical and engineering fees, management fees, and other service fees paid back to the United States from the foreign subsidiaries. The total for 1960 was $165 million, of which $148 million came directly from the manufacturing subsidiaries. An additional $25 million was reported as paid to the United States as fees and payments for service on business developed abroad by the foreign subsidiaries. This amount was derived almost entirely from trading subsidiaries.

Of the $165 million mentioned above, over *$70 million came from Europe, and $40 million from Canada.*

In summary, the results of this survey show that a considerable share of U.S. exports is channeled through, or developed by, the foreign subsidiaries of U.S. manufacturing firms; exports to manufacturing subsidiaries developed from 1959 to 1960 in about the same proportion as comparable total exports, while exports through trading subsidiaries showed a sharp rise; the foreign subsidiaries supply a rather small share of total U.S. imports of manufactured goods; the subsidiaries pay each year a substantial amount of royalties and fees to the United States; and transfers of funds from developed to less developed countries, although not of great magnitude, appear to account for a sizable part of the overall investment by U.S. companies in manufacturing in the less developed countries.

It should be emphasized that these data are not intended to cover all the effects of the subsidiaries' operations. In particular, figures are not given for dividends, interest, or branch profits received, reinvested earnings, or capital outflows from the United States, since these data are regularly collected and published as aggregates for all U.S. companies investing abroad.

It must also be understood that we have no way of determining what effect the withdrawal or the continuance of the tax deferral privilege would have on the above figures whether relative to flow of exports or investment funds.

Sincerely yours,

EDWARD GUDEMAN,
*Under Secretary of Commerce.*

TABLE 1.—*U.S. exports, total and selected commodities, by area, related to exports to, or developed by, foreign subsidiary companies, 1959 and 1960*

[In millions of dollars]

| | Total | | Canada | | Latin American Republics | | Western Europe | | Other countries and unallocated | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 1959 | 1960 | 1959 | 1960 | 1959 | 1960 | 1959 | 1960 | 1959 | 1960 |
| Total, exports, excluding "special category" | 15, 837 | 18, 785 | 3, 728 | 3, 699 | 3, 515 | 3, 455 | 4, 320 | 6, 095 | 4, 274 | 5, 536 |
| Less: Foodstuffs and beverages | 2, 409 | 2, 619 | 301 | 321 | 388 | 355 | 947 | 841 | 773 | 1, 102 |
| Animals and products, inedible | 298 | 320 | 43 | 38 | 32 | 27 | 141 | 150 | 82 | 105 |
| Oilseeds and crude vegetable oils | 425 | 485 | 43 | 49 | 10 | 11 | 233 | 270 | 139 | 155 |
| Tobacco and manufactures | 441 | 476 | 3 | 4 | 39 | 27 | 277 | 323 | 122 | 122 |
| Cotton unmanufactured | 452 | 988 | 20 | 46 | 12 | 15 | 202 | 478 | 218 | 449 |
| Nonmetallic minerals | 1, 099 | 1, 108 | 337 | 298 | 188 | 175 | 327 | 330 | 247 | 305 |
| Iron and steelmaking raw materials, chiefly scrap | 202 | 305 | 50 | 66 | 15 | 16 | 21 | 84 | 116 | 139 |
| Civilian aircraft | 159 | 551 | 11 | 41 | 31 | 50 | 49 | 375 | 68 | 85 |
| Relief shipments | 110 | 129 | (1) | (1) | 11 | 15 | 36 | 40 | 63 | 74 |
| Reexports | 181 | 197 | 82 | 75 | 18 | 24 | 64 | 78 | 17 | 20 |
| Adjusted exports | 10, 061 | 11, 607 | 2, 838 | 2, 761 | 2, 771 | 2, 740 | 2, 023 | 3, 126 | 2, 429 | 2, 980 |
| Exports from the United States to foreign subsidiaries, total | 1, 824 | 2, 232 | 793 | 790 | 513 | 594 | 275 | 509 | 244 | 339 |
| Manufacturing subsidiaries | 1, 429 | 1, 625 | 736 | 732 | 301 | 334 | 174 | 265 | 217 | 293 |
| Trading subsidiaries | 381 | 599 | 55 | 57 | 204 | 257 | 96 | 240 | 27 | 46 |
| Other subsidiaries | 14 | 9 | 1 | 1 | 8 | 4 | 5 | 3 | (1) | (1) |
| Exports developed by foreign subsidiaries on a commission basis | 359 | 447 | 15 | 15 | 176 | 171 | 113 | 203 | 55 | 57 |
| Manufacturing subsidiaries | 143 | 170 | 13 | 14 | 94 | 100 | 21 | 26 | 15 | 30 |
| Trading subsidiaries | 216 | 277 | 2 | 2 | 82 | 71 | 92 | 177 | 40 | 27 |
| Other subsidiaries | (1) | (1) | (1) | (1) | (1) | (1) | | | | |
| Total exports to, or developed by, foreign subsidiaries | 2, 183 | 2, 679 | 808 | 805 | 689 | 765 | 388 | 712 | 299 | 396 |
| Manufacturing subsidiaries | 1, 572 | 1, 795 | 749 | 746 | 395 | 434 | 195 | 291 | 232 | 323 |
| Trading subsidiaries | 597 | 876 | 57 | 59 | 286 | 328 | 188 | 417 | 67 | 73 |
| Other subsidiaries | 14 | 9 | 1 | 1 | 8 | 4 | 5 | 3 | (1) | (1) |

[1] Less than $500,000.

NOTE.—The data for foreign subsidiaries cover only those included in special survey. Detail may not add to totals due to rounding.

Source: U.S. Department of Commerce, Office of Business Economics.

TABLE 2.—*Imports into the United States from foreign subsidiary companies, 1959 and 1960*

[In millions of dollars]

| | Total | | Canada | | Latin American Republics | | Western Europe | | Other countries and unallocated | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 1959 | 1960 | 1959 | 1960 | 1959 | 1960 | 1959 | 1960 | 1959 | 1960 |
| Total imports from U.S. subsidiaries abroad | 592 | 475 | 226 | 243 | 73 | 71 | 212 | 96 | 81 | 65 |
| Includes paper, pulp, and foodstuffs | 170 | 166 | 107 | 119 | 25 | 16 | ------ | ------ | 38 | 31 |
| Other imports | 422 | 309 | 119 | 124 | 48 | 55 | 212 | 96 | 43 | 34 |
| Imports from manufacturing subsidiaries | 498 | 379 | 219 | 236 | 31 | 20 | 208 | 90 | 40 | 33 |
| Includes paper, pulp, and foodstuffs | 170 | 166 | 107 | 119 | 25 | 16 | ------ | ------ | 38 | 31 |
| Other imports | 328 | 213 | 112 | 117 | 6 | 4 | 208 | 90 | 2 | 2 |
| Imports from trading and other subsidiaries | 94 | 96 | 7 | 7 | 42 | 51 | 4 | 6 | 41 | 32 |

NOTE.—The data for foreign subsidiaries cover only those included in special survey.

Source: U.S. Department of Commerce, Office of Business Economics.

## Appendix E

### Table I

*Number of foreign subsidiaries organized in 1960 and 1961 based on information returns (form 959)*

| Country | Number of companies reporting | 1960 | 1961 | Other years |
|---|---|---|---|---|
| 1. Antigua, West Indies: Real estate | 1 | 1 | | |
| 2. Algeria: Oil | 1 | 1 | | |
| 3. Argentina: | | | | |
| Sales | 1 | | 1 | |
| Manufacturing | 4 | 3 | 1 | |
| Oil | 3 | 3 | | |
| Engineering | 2 | 2 | | |
| Unknown | 2 | 2 | | |
| Total | 12 | 10 | 2 | |
| 4. Australia: | | | | |
| Finance | 1 | 1 | | |
| Oil | 1 | | 1 | |
| Manufacturing | 2 | 1 | 1 | |
| Investment | 1 | | 1 | |
| Shoe repair | 1 | 1 | | |
| Unknown | 4 | 2 | 2 | |
| Total | 10 | 5 | 5 | |
| 5. Austria: Bowling | 1 | 1 | | |
| 6. Bahamas: | | | | |
| Manufacturing | 2 | 2 | | |
| Insurance | 10 | 7 | | 3 (1959) |
| Reinsurance | 2 | 2 | | |
| Sales | 4 | 3 | 1 | |
| Real estate | 5 | 4 | | 1 (1959) |
| Trade | 2 | 2 | | |
| Construction | 1 | 1 | | |
| Financing | 1 | | 1 | |
| Equipment renting | 1 | | | 1 (1959) |
| Oil | 1 | | 1 | |
| Circus | 1 | | 1 | |
| Leasing | 1 | 1 | | |
| Banking | 2 | 1 | 1 | |
| Export | 1 | 1 | | |
| Investment | 2 | 1 | 1 | |
| Trust | 2 | 1 | 1 | |
| Patents | 1 | 1 | | |
| Publisher | 1 | 1 | | |
| Mining | 1 | 1 | | |
| Yacht club | 1 | 1 | | |
| Agent | 1 | | | 1 (1958) |
| Unknown | 12 | 5 | 3 | 1 (1955)<br>1 (1958)<br>2 (1959) |
| Total | 55 | 35 | 10 | 10 |
| 7. Belgium: | | | | |
| Manufacturing | 4 | 3 | | 1 (1959) |
| Sales | 3 | 2 | 1 | |
| Oil | 1 | 1 | | |
| Shoe service | 2 | | 1 | 1 (1957) |
| Total | 10 | 6 | 2 | 2 |
| 8. Bermuda: | | | | |
| Insurance | 1 | 1 | | |
| Reinsurance | 1 | 1 | | |
| Sales | 1 | 1 | | |
| Investment | 2 | 1 | | 1 (1959) |
| Shipping | 3 | | 1 | 2 (1959) |
| Unknown | 3 | 1 | 1 | 1 (1957) |
| Total | 11 | 5 | 2 | 4 |

*Number of foreign subsidiaries organized in 1960 and 1961 based on information returns (form 959)*—Continued

| Country | Number of companies reporting | 1960 | 1961 | Other years |
|---|---|---|---|---|
| 9. Brazil: | | | | |
| Import | 1 | | 1 | |
| Manufacturing | 2 | 2 | | |
| Construction | 1 | 1 | | |
| Sales | 1 | | 1 | |
| Mining service | 1 | | 1 | |
| Engineering | 1 | | 1 | |
| Unknown | 7 | 5 | 1 | 1 (1954) |
| Total | 14 | 8 | 5 | 1 |
| 10. British Honduras: Manufacturing | 1 | | 1 | |
| 11. British West Indies: Real estate | 1 | 1 | | |
| 12. Canada: | | | | |
| Drilling | 1 | | 1 | |
| Manufacturing | 10 | 9 | | 1 (1959) |
| Trade | 3 | 3 | | |
| Timber | 2 | 1 | 1 | |
| Oil | 3 | 1 | 2 | |
| Holding | 2 | 1 | | 1 (1959) |
| Mining | 2 | 2 | | |
| Petroleum | 1 | | 1 | |
| Service | 3 | 1 | 2 | |
| Engineering | 1 | 1 | | |
| Construction | 1 | 1 | | |
| Mineral | 1 | | 1 | |
| Investment | 2 | 2 | | |
| Flowers | 1 | 1 | | |
| Finance | 1 | 1 | | |
| Printing | 1 | 1 | | |
| Building | 1 | 1 | | |
| Advertising | 1 | 1 | | |
| Gymnasium system | 1 | 1 | | |
| Import and export | 1 | | 1 | |
| Sales | 8 | 1 | 2 | 4 (1959)<br>1 (1954) |
| Unknown | 10 | 6 | 2 | 1 (unknown)<br>1 (1959) |
| Total | 57 | 35 | 13 | 9 |
| 13. Chile: Oil | 1 | 1 | | |
| 14. Colombia: | | | | |
| Manufacturing | 5 | 3 | 2 | |
| Insurance | 1 | | 1 | |
| Sales | 1 | | | 1 (1955) |
| Unknown | 2 | 2 | | |
| Total | 9 | 5 | 3 | 1 |
| 15. Denmark: Sales | 1 | | 1 | |
| 16. Ecuador: Manufacturing | 1 | 1 | | |
| 17. El Salvador: Oil | 1 | 1 | | |
| 18. Finland: Manufacturing | 1 | | 1 | |
| 19. France: | | | | |
| Engineering | 1 | 1 | | |
| Manufacturing | 12 | 8 | 4 | |
| Sales | 5 | 1 | 4 | |
| Trade | 3 | | 3 | |
| Construction | 2 | 1 | 1 | |
| Investment | 1 | 1 | | |
| Shoe repair | 1 | | | 1 (1958) |
| Publishing | 1 | | 1 | |
| Unknown | 3 | 2 | | 1 (unknown) |
| Total | 29 | 14 | 13 | 2 |
| 20. Germany: | | | | |
| Shipping | 1 | 1 | | |
| Manufacturing | 10 | 8 | 2 | |
| Insurance | 1 | 1 | | |
| Service | 2 | 2 | | |
| Construction | 2 | 2 | | |
| Sales | 3 | 2 | 1 | |
| Trade | 1 | 1 | | |
| Shoe repair | 1 | | | 1 (1959) |
| Unknown | 1 | 1 | | |
| Total | 22 | 18 | 3 | 1 |

*Number of foreign subsidiaries organized in 1960 and 1961 based on information returns (form 959)*—Continued

| Country | Number of companies reporting | 1960 | 1961 | Other years |
|---|---|---|---|---|
| 21. Ghana: Unknown | 1 | 1 | | |
| 22. Holland: | | | | |
| Trade | 1 | | 1 | |
| Finance | 1 | 1 | | |
| Manufacturing | 1 | 1 | | |
| Shoe repair | 1 | | | 1 (1959) |
| Total | 4 | 2 | 1 | 1 |
| 23. Hong Kong: | | | | |
| Construction | 1 | 1 | | |
| Trade | 2 | 2 | | |
| Manufacturing | 1 | 1 | | |
| Total | 4 | 4 | | |
| 24. India: Manufacturing | 4 | 4 | | |
| 25. Ireland: Manufacturing | 1 | | 1 | |
| 26. Israel: Hotel | 1 | 1 | | |
| 27. Italy: | | | | |
| Manufacturing | 7 | 5 | 2 | |
| Engineering | 2 | 2 | | |
| Sales | 2 | 2 | | |
| Finance | 1 | 1 | | |
| Trade | 2 | 1 | 1 | |
| Real estate | 1 | 1 | | |
| Shoe repair | 1 | 1 | | |
| Unknown | 1 | 1 | | |
| Total | 17 | 14 | 3 | |
| 28. Jamaica: | | | | |
| Manufacturing | 1 | | 1 | |
| Trade | 1 | 1 | | |
| Total | 2 | 1 | 1 | |
| 29. Japan: | | | | |
| Sales | 1 | | 1 | |
| Manufacturing | 10 | 8 | 2 | |
| Chemicals | 1 | 1 | | |
| Service | 1 | | 1 | |
| Advertising | 1 | 1 | | |
| Total | 14 | 10 | 4 | |
| 30. Liberia: | | | | |
| Construction | 2 | 2 | | |
| Shipping | 2 | 1 | 1 | |
| Finance | 1 | | 1 | |
| Service | 1 | | 1 | |
| Total | 6 | 3 | 3 | |
| 31. Liechtenstein: | | | | |
| Sales | 1 | | 1 | |
| Insurance | 2 | 2 | | |
| Reinsurance | 2 | 1 | | 1 (1959) |
| Manufacturing | 2 | 1 | | 1 (1958) |
| Management | 1 | | 1 | |
| Construction | 1 | 1 | | |
| Arts | 1 | 1 | | |
| Total | 10 | 6 | 2 | 2 |
| 32. Luxembourg: | | | | |
| Banking | 1 | 1 | | |
| Manufacturing | 1 | 1 | | |
| Holding | 1 | 1 | | |
| Shoe repair | 1 | 1 | | |
| Total | 4 | 4 | | |

*Number of foreign subsidiaries organized in 1960 and 1961 based on information returns (form 959)*—Continued

| Country | Number of companies reporting | 1960 | 1961 | Other years |
|---|---|---|---|---|
| 33. Mexico: | | | | |
| Trade | 2 | | 2 | |
| Manufacturing | 3 | 3 | | |
| Sales | 5 | 3 | | 1 (1959)<br>1 (1947) |
| Car rentals | 1 | 1 | | |
| Language school | 1 | 1 | | |
| Construction | 2 | 1 | 1 | |
| Unknown | 4 | 4 | | |
| Total | 18 | 13 | 3 | 2 |
| 34. Netherlands: | | | | |
| Service | 1 | 1 | | |
| Manufacturing | 3 | 1 | 2 | |
| Publisher | 1 | 1 | | |
| Real estate | 1 | | 1 | |
| Sales | 1 | | 1 | |
| Construction | 1 | | | 1 (1959) |
| Unknown | 1 | 1 | | |
| Total | 9 | 4 | 4 | 1 |
| 35. Netherlands Antilles: | | | | |
| Sales | 1 | 1 | | |
| Investment | 2 | | 1 | 1 (1956) |
| Motion picture | 1 | 1 | | |
| TV films | 1 | | 1 | |
| Hotel | 1 | | 1 | |
| Total | 6 | 2 | 3 | 1 |
| 36. Pakistan: Manufacturing | 2 | 2 | | |
| 37. Panama: | | | | |
| Service | 2 | | 2 | |
| Sales | 4 | 4 | | |
| Investment | 4 | 4 | | |
| Trade | 6 | 3 | 2 | 1 (1957) |
| Construction | 3 | 2 | 1 | |
| Ship repair | 2 | 1 | 1 | |
| Holding | 1 | 1 | | |
| Real estate | 1 | 1 | | |
| Shipping | 1 | 1 | | |
| Roads | 1 | | 1 | |
| Import | 2 | 2 | | |
| Contracting | 1 | 1 | | |
| Oil | 3 | 2 | 1 | |
| Manufacturing | 2 | 2 | | |
| Geophysical operations | 1 | 1 | | |
| Cattle | 1 | | 1 | |
| Securities | 1 | 1 | | |
| Unknown | 10 | 8 | 2 | |
| Total | 46 | 34 | 11 | 1 |
| 38. Peru: | | | | |
| Manufacturing | 2 | 2 | | |
| Sales | 1 | 1 | | |
| Mining | 1 | 1 | | |
| Unknown | 2 | 1 | 1 | |
| Total | 6 | 5 | 1 | |
| 39. Philippines: Trade | 1 | | 1 | |
| 40. Puerto Rico: | | | | |
| Service | 1 | | 1 | |
| Manufacturing | 2 | 2 | | |
| Sales | 4 | 1 | | 3 (1957) |
| Radio station | 1 | | 1 | |
| Unknown | 1 | | 1 | |
| Total | 9 | 3 | 3 | 3 |
| 41. Sierra Leone: Process fish | 1 | 1 | | |
| 42. South Africa: | | | | |
| Manufacturing | 2 | 1 | 1 | |
| Construction | 1 | 1 | | |
| Shoe repair | 1 | 1 | | |
| Total | 4 | 3 | 1 | |

*Number of foreign subsidiaries organized in 1960 and 1961 based on information returns (form 959)*—Continued

| Country | Number of companies reporting | 1960 | 1961 | Other years |
|---|---|---|---|---|
| 43. Southern Rhodesia: | | | | |
| Engineering | 1 | 1 | | |
| Unknown | 1 | 1 | | |
| Total | 2 | 2 | | |
| 44. Spain: Sales | 1 | | 1 | |
| 45. Sweden: | | | | |
| Shoe repair | 1 | 1 | | |
| Manufacturing | 1 | | 1 | |
| Total | 2 | 1 | 1 | |
| 46. Switzerland: | | | | |
| Export | 1 | | 1 | |
| Sales | 12 | 9 | 3 | |
| Manufacturing | 8 | 4 | 4 | |
| Investment | 2 | 2 | | |
| Trade | 9 | 7 | 2 | |
| Patents | 5 | 5 | | |
| Service | 2 | 1 | 1 | |
| Financial | 1 | 1 | | |
| Motion pictures | 3 | 3 | | |
| Real estate | 1 | 1 | | |
| Management | 1 | | 1 | |
| Shipping | 1 | 1 | | |
| Broker | 1 | 1 | | |
| Oil | 1 | 1 | | |
| Holding | 1 | | 1 | |
| Technical and commercial advice | 1 | 1 | | |
| Bowling alley | 2 | 1 | 1 | |
| Restaurant | 1 | 1 | | |
| Leasing equipment | 1 | 1 | | |
| Unknown | 11 | 8 | 3 | |
| Insurance | 2 | | | 2 (1959) |
| Shoe repair | 1 | | | 1 (1959) |
| Sales | 8 | 2 | 4 | 1 (1958)<br>1 (1959) |
| Total | 76 | 50 | 21 | 5 |
| 47. Taiwan: Fruitgrower | 1 | 1 | | |
| 48. Thailand: Manufacturing | 1 | | 1 | |
| 49. Trinidad: Manufacturing | 1 | 1 | | |
| 50. Tunisia: Unknown | 1 | 1 | | |
| 51. United Kingdom: | | | | |
| Manufacturing | 11 | 7 | 4 | |
| Finance | 2 | 2 | | |
| Construction | 3 | 1 | | 1 (1956)<br>1 (1957) |
| Sales | 2 | 2 | | |
| Service | 1 | 1 | | |
| Television | 1 | 1 | | |
| Nominee service | 1 | 1 | | |
| Electronics | 1 | 1 | | |
| Shoe repair | 1 | | | 1 (1959) |
| Import-export | 1 | | 1 | |
| Unknown | 5 | 3 | 2 | |
| Total | 29 | 19 | 7 | 3 |
| 52. Venezuela: | | | | |
| Gas | 3 | 3 | | |
| Manufacturing | 1 | 1 | | |
| Investment | 1 | 1 | | |
| Construction | 1 | 1 | | |
| Sales | 2 | | | 1 (1958)<br>1 (1959) |
| Total | 8 | 6 | | 2 |
| Grand total | 531 | 346 | 134 | 51 |

TABLE II

*Subsidiaries organized in Switzerland during the period Sept. 1, 1959, to December 1960*

| Period | Number of companies |
|---|---|
| (1) Sept. 1, 1959–Mar. 31, 1960 | 90 |
| (2) May 1960 | 11 |
| (3) June 1960 | 13 |
| (4) July 1960 | 17 |
| (5) August 1960 | 18 |
| (6) September 1960 | 17 |
| (7) October 1960 | 22 |
| (8) November 1960 | 16 |
| (9) December 1960 | 13 |
| Total | 217 |

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