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AMENDING THE INTERNAL REVENUE CODE OF 1954 TO EXEMPT FROM TAX INCOME DERIVED BY A FOREIGN CENTRAL BANK OF ISSUE FROM OBLIGATIONS OF THE UNITED STATES

APRIL 13, 1961.—Ordered to be printed

Mr. BYRD of Virginia, from the Committee on Finance, submitted the following

REPORT

[To accompany H.R. 5189]

The Committee on Finance, to whom was referred the bill (H.R. 5189) to amend the Internal Revenue Code of 1954 to exempt from tax income derived by a foreign central bank of issue from obligations of the United States, having considered the same, report favorably thereon with amendments and recommend that the bill as amended do pass.

PURPOSE OF BILL

The House-passed bill provides an exemption from tax for income derived by a foreign central bank of issue from U.S. Government obligations, but only if the obligations are not held for, or used in connection with, commercial banking functions or other commercial activities. This exemption is to be effective with respect to income received in taxable years beginning after 1960.

This exemption will accord foreign central banks of issue which are separately incorporated the same exemption with respect to holdings of U.S. Government obligations as now exists where these obligations are held directly by the foreign government itself. Interest on U.S. bank deposits held by persons not engaged in trade or business in the United States already are free of tax as also are bankers' acceptances held by foreign central banks of issue.

The President of the United States has requested this legislation as one of various desirable steps intended to improve this country's ability to defend its gold reserves. A similar proposal was made by the administration last year but there was not sufficient time for its consideration by Congress. It is anticipated that the bill will have a negligible effect on revenues.

PURPOSE OF COMMITTEE AMENDMENTS

The Committee on Finance added to the House-passed bill an amendment to extend to May 15, 1961, the period in which the spouse of a shareholder in a small business corporation may consent to an election not to be taxed as a corporation. The title of the bill was appropriately amended also.

Under subchapter S, certain small business corporations were permitted to elect not to be taxed as a corporation. The Treasury Department has taken the position that in the case of an election under this section in a community property State, both husband and wife must make the election. In many situations in community property States, the husband operating as a small business corporation made the election but did not have his wife sign the document. Such elections the Treasury now holds are invalid, and as the elections had to be signed within a specified time, the period has expired in which the wife and the husband may now perfect the election. The amendment adopted by the Committee on Finance permits the spouse not signing the election additional time to sign the election. The extended date for perfecting such election is May 15, 1961.

If this amendment is not adopted, many small businessmen in community property States will not be able to take advantage of subchapter S, permitting certain small business corporations not to be taxable as corporations. The amendment only applies where a timely election in the first instance was made by one of the spouses.

GENERAL STATEMENT ON BILL

Under present law (sec. 881 of the Internal Revenue Code) foreign corporations not engaged in a trade or business in the United States generally are subject to a flat 30-percent tax (collected by withholding at the source) on amounts received from sources within the United States in the form of interest, dividends, rents, salaries, and other fixed or determinable amounts. There are, however, several exceptions to this general rule. The principal ones with respect to interest are specified below. First, there is no tax on interest on bank deposits. Also, there is no tax on interest received from resident alien individuals, resident foreign corporations, or domestic corporations where less than 20 percent of the recipient's gross income for the past 3-year period is derived from sources within the United States. Other exceptions to the rules specified above exist in many of the tax treaties the United States has entered into with 21 different foreign countries. Five of these treaties on a reciprocal basis provide for reduced rates of taxation on interest and 10 provide for outright exemption of interest. Of the five providing for reduced rates, a rate of 15 percent is specified in four cases and a rate of 5 percent in the other case.

Still another exception to the general rule described above exists in the case of foreign governments and international organizations of which the United States is a member. Present law (sec. 892) provides that these governments or organizations are completely exempt from tax in the case of income earned from sources within the United States. In addition, present law exempts from tax income derived from bankers' acceptances but only in the case of holdings by foreign central banks of issue. A "foreign central bank of issue" is defined under existing regulations as a bank which is by law or government

sanction the principal authority, other than the government itself, issuing instruments intended to circulate as currency. Such a bank is generally the custodian of the banking reserve of the country.

This bill is concerned with the tax treatment of interest on U.S. Government obligations received by these foreign central banks of issue where these banks are not a part of the foreign government itself but instead are separately incorporated and in some cases are not wholly owned by the government. Many of them, for example, organize their central banking somewhat along the lines of our Federal Reserve System. Foreign central banks have increasingly acquired dollar assets as a part of their monetary reserves. These usually take the form of bank deposits, bankers' acceptances, or Treasury bills. As noted above, the United States imposes no tax on this bank deposit interest or on income from bankers' acceptances held by foreign central banks of issue. However, a tax may be imposed with respect to holdings of Treasury bills or other U.S. obligations if the central bank of issue is not a part of the foreign government itself.

Prior to 1946 the Internal Revenue Service held that a foreign corporation which was wholly owned by a foreign government was exempt from tax on income from sources within the United States under the provision exempting foreign governments (sec. 892 of present law). In 1946 the Service reversed its position (I.T. 3789) and held that the tax exemption for a foreign government did not apply to a separate corporation. This reversal of position was based upon the disapproval by the Joint Committee on Internal Revenue Taxation of a tax refund to a corporation incorporated under the laws of the State of New York, the stock of which was wholly owned by a foreign government and which was engaged in commercial activities in this country. The joint committee believed that the exemption from tax for foreign governments did not extend to separate corporations, which may be engaging in commercial activities, even though they are wholly owned by a foreign government. In 1955 the Internal Revenue Service held that the Commonwealth Bank of Australia was entitled to tax exemption as a part of the Australian Government. It was wholly owned by that Government and similar in its functions to our Federal Reserve banks. Upon review of the bank's claim for refund the staff of the Joint Committee on Internal Revenue Taxation disagreed with the position of the Service and recommended that the claim be rejected on the theory that the bank was a separate entity from the Australian Government. It took the position that an entity with the attributes of an ordinary domestic corporation should not be considered a part of a foreign government. As a result, the Service revoked its ruling. However, because of fiscal repercussions anticipated in connection with a shift in U.S. investments of foreign central banks, the revocation of the ruling was suspended after consultations between the staff of the joint committee and representatives of the Treasury Department to the extent such a bank is not engaged in commercial activities.

This bill settles the problem described above by providing an exemption from income tax for income derived by foreign central banks of issue from obligations of the United States unless the obligations are held for, or used in connection with, the conduct of commercial banking functions or any other commercial activity. It applies to income received in taxable years beginning after December 31, 1960, and thus removes any doubt on this problem as to the future.

Your committee believes that this change is desirable because it will provide uniform tax treatment for investments of the reserve funds of various countries in the case of investments in U.S. obligations. It will remove the present distinction which turns on whether or not the central bank operations are carried on through a separate corporation or directly by the foreign government. Thus, countries which organize their foreign central banks as a separate corporation will no longer be subject to U.S. tax with respect to the return on their holdings of U.S. Government obligations.

Also, in the case of these foreign central banks, this bill is desirable because it will remove a distinction between the treatment provided for income from bank deposits and bankers' acceptances on the one hand and U.S. Government obligations on the other. Thus, no longer will a preference be provided these foreign central banks for their holdings of deposits or bankers' acceptances on the grounds that the return is free of U.S. tax, while the return from Treasury bills or other U.S. Government obligations may be subject to tax.

Of particular importance at the present time is the improved effect that this change can be expected to have on the gold reserves of the United States. This is illustrated by the events of the last year when large volumes of funds seeking short-term investments flowed out of the United States because of temporary higher interest rates in foreign countries. Under these conditions the foreign governments where the funds were invested tended to acquire dollar assets as a result of these investments, in order to maintain the strength of the dollar as required by their International Monetary Fund commitments. Once these dollar balances are acquired, they can be converted by the foreign banking authority into gold or into other dollar assets such as bank accounts, bankers' acceptances, or Treasury bills. Conversion of these balances into gold, of course, increases the drain upon the old reserves of the United States. On the other hand, deposits in U.S. banks, purchases of bankers' acceptances, or purchases of the U.S. Treasury bills do not have this adverse effect. The present tax which may be imposed upon investments in U.S. obligations, however, tends to discourage the purchase of Treasury bills and, therefore, increases the likelihood of conversion into gold.

The exemption provided by the bill will not discriminate against domestic private enterprise because it is limited to U.S. Government obligations held by foreign banks in connection with their central banking functions and is not available in the case of balances held for commercial banking activities or any other commercial activities.

The revenue effect of this proposal is expected to be negligible. It is believed that this will be true because foreign central banks of issue, where the tax is presently applicable, now tend not to hold their reserves in U.S. Government obligations but instead to hold them in gold or in dollar assets, income from which is exempt, such as bank accounts or bankers' acceptances.

CHANGES IN EXISTING LAW

In compliance with subsection 4 of rule XXIX of the Standing Rules of the Senate, changes in existing law made by the bill are shown as follows (existing law proposed to be omitted is enclosed in black brackets; new matter is printed in italic; existing law in which no change is proposed is shown in roman):

INTERNAL REVENUE CODE OF 1954

CHAPTER 1—NORMAL TAXES AND SURTAXES

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Subchapter N—Tax Based on Income From Sources Within or Without the United States

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PART II—NONRESIDENT ALIENS AND FOREIGN CORPORATIONS

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Subpart C—Miscellaneous provisions

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SEC. 892. INCOME OF FOREIGN GOVERNMENTS AND OF INTERNATIONAL ORGANIZATIONS.

The income of foreign governments or international organizations received from investments in the United States in stocks, bonds, or other domestic securities, owned by such foreign governments or by international organizations, or from interest on deposits in banks in the United States of moneys belonging to such foreign governments or international organizations, or from any other source within the United States, shall not be included in gross income and shall be exempt from taxation under this subtitle.

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SEC. 894. INCOME EXEMPT UNDER TREATY.

Income of any kind, to the extent required by any treaty obligation of the United States, shall not be included in gross income and shall be exempt from taxation under this subtitle.

SEC. 895. INCOME DERIVED BY A FOREIGN CENTRAL BANK OF ISSUE FROM OBLIGATIONS OF THE UNITED STATES.

Income derived by a foreign central bank of issue from obligations of the United States owned by such foreign central bank of issue shall not be included in gross income and shall be exempt from taxation under this subtitle unless such obligations are held for, or used in connection with the conduct of commercial banking functions or other commercial activities.

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Subchapter S—Election of Certain Small Business Corporations as to Taxable Status

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SEC. 1372. ELECTION BY SMALL BUSINESS CORPORATION.

(a) ELIGIBILITY.—Except as provided in subsection (f), any small business corporation may elect, in accordance with the provisions of this section, not to be subject to the taxes imposed by this chapter. Such election shall be valid only if all persons who are shareholders in such corporation—

(1) on the first day of the first taxable year for which such election is effective, if such election is made on or before such first day, or

(2) on the day on which the election is made, if the election is made after such first day,

consent to such election.

(b) EFFECT.—If a small business corporation makes an election under subsection (a), then—

(1) with respect to the taxable years of the corporation for which such election is in effect, such corporation shall not be subject to the taxes imposed by this chapter and, with respect to such taxable years and all succeeding taxable years, the provisions of section 1377 shall apply to such corporation, and

(2) with respect to the taxable years of a shareholder of such corporation in which or with which the taxable years of the corporation for which such election is in effect end, the provisions of sections 1373, 1374, and 1375 shall apply to such shareholder, and with respect to such taxable years and all succeeding taxable years, the provisions of section 1376 shall apply to such shareholder.

(c) WHERE AND HOW MADE.—

(1) IN GENERAL.—An election under subsection (a) may be made by a small business corporation for any taxable year at any time during the first month of such taxable year, or at any time during the month preceding such first month. Such election shall be made in such manner as the Secretary or his delegate shall prescribe by regulations.

(2) TAXABLE YEARS BEGINNING BEFORE DATE OF ENACTMENT.—An election may be made under subsection (a) by a small business corporation for its first taxable year which begins after December 31, 1957, and on or before the date of the enactment of this subchapter, and ends after such date at any time—

(A) within the 90-day period beginning on the day after the date of the enactment of this subchapter, or

(B) if its taxable year ends within such 90-day period, before the close of such taxable year.

An election may be made pursuant to this paragraph only if the small business corporation has been a small business corporation (as defined in section 1371 (a)) on each day after the date of the enactment of this subchapter and before the day of such election.

(d) YEARS FOR WHICH EFFECTIVE.—An election under subsection (a) shall be effective for the taxable year of the corporation for which it is made and for all succeeding taxable years of the corporation, unless it is terminated, with respect to any such taxable year, under subsection (e).

(e) TERMINATION.—

(1) NEW SHAREHOLDERS.—An election under subsection (a) made by a small business corporation shall terminate if any person who was not a shareholder in such corporation—

(A) on the first day of the first taxable year of the corporation for which the election is effective, if such election is made on or before such first day, or

(B) on the day on which the election is made, if such election is made after such first day,

becomes a shareholder in such corporation and does not consent to such election within such time as the Secretary or his delegate shall prescribe by regulations. Such termination shall be effective for the taxable year of the corporation in which such person becomes a shareholder in the corporation and for all succeeding taxable years of the corporation.

(2) REVOCATION.—An election under subsection (a) made by a small business corporation may be revoked by it for any taxable year of the corporation after the first taxable year for which the election is effective. An election may be revoked only if all persons who are shareholders in the corporation on the day on which the revocation is made consent to the revocation. A revocation under this paragraph shall be effective—

(A) for the taxable year in which made, if made before the close of the first month of such taxable year,

(B) for the taxable year following the taxable year in which made, if made after the close of such first month,

and for all succeeding taxable years of the corporation. Such revocation shall be made in such manner as the Secretary or his delegate shall prescribe by regulations.

(3) CEASES TO BE SMALL BUSINESS CORPORATION.—An election under subsection (a) made by a small business corporation shall terminate if at any time—

(A) after the first day of the first taxable year of the corporation for which the election is effective, if such election is made on or before such first day, or

(B) after the day on which the election is made, if such election is made after such first day,

the corporation ceases to be a small business corporation (as defined in section 1371 (a)). Such termination shall be effective for the taxable year of the corporation in which the corporation ceases to be a small business corporation and for all succeeding taxable years of the corporation.

(4) FOREIGN INCOME.—An election under subsection (a) made by a small business corporation shall terminate if for any taxable year of the corporation for which the election is in effect, such corporation derives more than 80 percent of its gross receipts from sources outside the United States. Such termination shall be effective for the taxable year of the corporation in which it derives more than 80 percent of its gross receipts from sources outside the United States, and for all succeeding taxable years of the corporation.

(5) PERSONAL HOLDING COMPANY INCOME.—An election under subsection (a) made by a small business corporation shall terminate if, for any taxable year of the corporation for which the election is in effect, such corporation has gross receipts more than 20 percent

of which is derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities (gross receipts from such sales or exchanges being taken into account for purposes of this paragraph only to the extent of gains therefrom). Such termination shall be effective for the taxable year of the corporation in which it has gross receipts of such amount, and for all succeeding taxable years of the corporation.

(f) ELECTION AFTER TERMINATION.—If a small business corporation has made an election under subsection (a) and if such election has been terminated or revoked under subsection (e), such corporation (and any successor corporation) shall not be eligible to make an election under subsection (a) for any taxable year prior to its fifth taxable year which begins after the first taxable year for which such termination or revocation is effective, unless the Secretary or his delegate consents to such election.

(g) *SHAREHOLDERS IN COMMUNITY PROPERTY STATES.—In the case of a shareholder in a community property State whose spouse has filed a timely consent to an election under subsection (a), the consent of such shareholder to such election shall also be considered timely filed if it is filed on or before May 15, 1961, or the last day prescribed for making such election, whichever is the later.*

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