REVENUE ACT OF 1962

HEARINGS

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

EIGHTY-SEVENTH CONGRESS

SECOND SESSION

ON

H.R. 10650

AN ACT TO AMEND THE REVENUE ACT OF 1954 TO PROVIDE A CREDIT FOR INVESTMENT IN CERTAIN DEPRECIABLE PROPERTY, TO ELIMINATE CERTAIN DEFECTS AND INEQUITIES, AND FOR OTHER PURPOSES

APRIL 24 AND 25, 1962

PART 6

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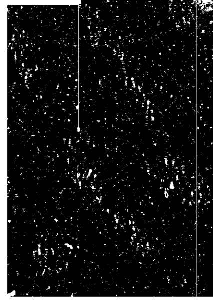

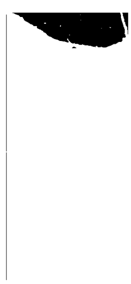

REVENUE ACT OF 1962

TUESDAY, APRIL 24, 1962

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, D.C.

The committee met, pursuant to recess, at 10 a.m., in room 2221, New Senate Office Building, Senator Harry F. Byrd (chairman) presiding.

Present: Senators Byrd, Kerr, Smathers, Douglas, Talmadge, McCarthy, Williams, and Curtis.

Also present: Elizabeth B. Springer, committee clerk; and Colin F. Stam and L. N. Woodward of the Joint Committee on Internal Revenue Taxation.

The CHAIRMAN. The committee will come to order.

The first witness is Mr. Randolph W. Thrower of the American Bar Association.

Senator TALMADGE. Mr. Chairman, may I say Mr. Thrower is a constituent of mine and friend, and it is a pleasure indeed to welcome him to this committee.

Mr. THROWER. Thank you, Senator.

The CHAIRMAN. You may proceed, sir.

STATEMENT OF RANDOLPH W. THROWER, CHAIRMAN, SECTION OF TAXATION, AMERICAN BAR ASSOCIATION; ACCOMPANIED BY RICHARD H. APPERT, CHAIRMAN, COMMITTEE ON TAXATION OF FOREIGN INCOME, AMERICAN BAR ASSOCIATION, AND ARTHUR B. WILLIS, CHAIRMAN, SPECIAL COMMITTEE ON EXTENSION OF WITHHOLDING ON DIVIDENDS AND INTEREST

Mr. THROWER. May name is Randolph W. Thrower; my address is 1500 First National Bank Building, Atlanta, Ga. I am appearing here on behalf of the American Bar Association in my capacity as chairman of the section on taxation of that association.

With your permission I would like to have here with me two of the committee chairmen of the section. On my right is Richard H. Appert of the firm of White & Case of New York City, who is the chairman of our committee on taxation of foreign income, and on my left is Mr. Arthur B. Willis of the firm of Willis, MacCracken & Butler of Los Angeles, Calif., who is chairman of our section's special committee on extension of withholding on dividends and interest.

Each has directed an intensive study of certain portions of the bill under consideration and can be of assistance in answering questions in these areas.

By way of preface, I should explain that as to the greater part of the bill before you we have not undertaken to arrive at any categorical position for or against any particular segment of the bill but have felt that greater assistance might be rendered to your committee by providing as much information as possible not only on technical drafting problems but also on the practical application of these provisions.

Our general authority from the American Bar on the bill is to provide technical advice and assistance. When the bill was before the Ways and Means Committee we submitted detailed memorandums and held extended conferences with the staff of the joint committee on most of the sections of the bill. We are today submitting additional memorandums to your committee on certain sections of H.R. 10650 as passed by the House.

With that introduction I will now cover briefly some of the more consequential of the positions we have taken.

WITHHOLDING

As to withholding, in the spring of 1961 our special committee on extension of withholding taxes initiated an exhaustive study of the proposals for withholding on dividends and interest and for a system of taxpayer account numbers for purposes of automatic data processing, which system is often referred to as ADP.

Our committee's report, which was formally adopted by the section of taxation and the house of delegates of the ABA, and has been submitted to your committee, gave an enthusiastic endorsement to ADP but expressed grave misgivings about the desirability at that time of introducing an involved and intricate system of withholding on dividends and interest.

I might say that the study of that committee has been continued throughout the past year. Our misgivings have not been dispelled but in some respects have grown.

We do not minimize the importance of closing the gap on the underreporting of income but, rather than a program to close the gap on dividends and a portion of interest such as is being proposed, we would prefer to see a major coordinated effort using automatic data processing directed at the entire gap of $20 to $25 billion.

While we do not categorically oppose withholding on dividends and interest, we would favor it if, and only if, all other reasonable measures, which we are suggesting, have been tried and have failed and this should be found to be the only way to close the gap on interest and dividends within a reasonable time.

We feel, however, that the following combination of measures will have a significant impact on underreporting in this area and should be given a fair trial before withholding is instituted:

First. The use by the Internal Revenue Service of automatic data processing, with the taxpayer account number system. The delay of the House bill for a full year and the acceleration of the automatic data processing program makes this factor more significant than it was when the committee first reached this conclusion.

Although automatic data processing should be a very effective enforcement tool permitting the collection of unreported dividends and interest at less cost to the Service, perhaps an even greater contribution

to be made by automatic data processing in this area will be through increasing the degree of voluntary compliance by many taxpayers large and small in the reporting of dividends and interest.

The second factor is the program of better taxpayer education inspired by the Service and participated in by the payers of dividends and interest, and by many other groups, including the American Bar Association.

Third. The proposed reduction of the information return requirements on interest from $600 to a level of around $100, which is suggested in our report.

It seems apparent to us that the foregoing measures would go far to close the gap on the underreporting of dividends and interest. Certainly this would seem true as to all but the very small amounts of dividends and interest.

The complaint may be made, however, that tax on the very small payments cannot be collected despite taxpayer education and strict enforcement using automatic processing. This leads to the conclusion that the merit of this whole intricate process depends to a large extent upon its justification as a means of withholding on the small interest and dividend accounts. But it is the small withholdings from millions of small accounts that, in our opinion, will create the greatest confusion and the greatest cost, both to the Government and to the payor. We are very much alarmed at the problems which will arise from the withholding of close to $5 billion from several hundred million payment items each year with no receipt or report to the payee and no accounting to the Government of the amount withheld from any particular taxpayer.

Refunds and credits will necessarily be made largely on faith. The system is one that will produce a staggering number of errors in returns and claims and will invite many frauds.

Furthermore, the redtape involved in claiming exemptions or filing claims for refund will cause many people of low income through ignorance or frustration to ignore the whole thing, thus converting withholding into a gross receipts tax of 20 percent. If these withholding procedures should be enacted by Congress and if there arises the confusion which we fear, we are concerned that the failure of the program would be prejudicial to the public good will on which our self-assessment system depends for success and, through being associated with the automatic data processing program, might also seriously handicap the public acceptance of that program.

TRAVEL AND ENTERTAINMENT EXPENSE

We are filing with you a report prepared by our special committee on travel and entertainment expense, headed by Mark H. Johnson of the firm of Rabkin & Johnson, New York City. That committee was appointed early last fall. Our report is dated January 24, 1962, and it antedates, of course, the report by the Ways and Means Committee, but as you will note it indicates approval of much of the substance of the bill passed by the House, and it probably initiated some suggestions which were incorporated in that bill.

We are also filing additional written comments on the bill as passed by the House. There are only a few remarks which I will add.

First, we have favored the elimination or restriction of the so-called Cohan rule under which taxpayers have supported partial deductions with the most general kind of testimony. The present draft and report, however, swings too far in the other direction in denying the efficacy of oral testimony which is specific, clear, reasonable, and unimpeached. Establishing arbitrary rules of evidence often leads to unnecessary controversy and unintended hardships, and we would like to see this aspect corrected.

Second, to require that expenses of entertainment be "directly related to the active conduct of the taxpayer's trade or business" is not objectionable insofar as this implements the basic rule that such expenses must be essentially for business purposes rather than essentially personal expenses with only a minor business aspect. To this extent, we think writing this into the code as is proposed in the legislation will have a very salutary effect, but we raise the question, does the House bill and House committee report, read together, go beyond this, and if they do go beyond this, how far beyond this do they go?

What, for example, is the purpose for a number of the exceptions under section 274(d), particularly the exception for entertainment under circumstances "conducive to a business discussion"?

For example, must a taxpayer entertaining customers or prospects at a supper club show a closer relationship to his business than his competitor entertaining similar prospects and customers at a downtown luncheon club?

Is there a difference in the test of deductibility or merely a different inference of fact affecting the rules of evidence? Is it intended that one who provides the entertainment at the luncheon club will have a more liberal rule than exists under the present law. We think the act, as amplified by the report, is ambiguous in this respect.

Furthermore, the House presumably does not propose to disallow entertainment for business goodwill, where the business interest is clear and dominant, since it rejected this provision of the discussion draft. We think this particular point is ambiguous under the bill and should be clarified.

Moreover, the bill apparently is not intended to confine the deductions for business entertainment, recreation or amusement of customers or prospects to those occasions where business is discussed, but this is not clear, and we fear that unless these points are clarified a great deal of controversy and uncertainty will be spawned, and this will increase rather than decrease the difficulties of administering this particular portion of the Internal Revenue Code. In view of all the attention given to this subject it would be disappointing for it to be left in this State. We would like to add we think this subject deserves the continued attention of this committee, and we would like to see it reviewed from time to time to ascertain whether or not the provisions as adopted and as enforced are adequately meeting the problems that all of us recognize in this area.

FOREIGN INCOME

As to foreign income, the proposals for the taxation of foreign income constitute in total a very ambitious program. The statutory language in these provisions itself consumes approximately half of the

total bill and some of the important segments of this present bill were not in the discussion draft of 1961 but apparently were only recently drafted.

Moreover, the amount of available information on the nature, volume and economic significance of the foreign transactions touched by the House bill is now admittedly limited and incomplete. Under these circumstances, we would recommend that the Congress move cautiously in this area on the theory that it would be better at first to fall a little short than to go much too far.

.Our principal concern, that is as to the specific provisions, specific sections in the foreign income area, have been directed toward the provision of section 13, changing the rules as to the taxation of the income of foreign corporations.

We seriously question whether this section should be enacted before the Treasury has had a chance to correct abuses under existing law, especially if implemented by some of the proposed sections on foreign income other than section 13, with the assistance of the new information provisions under which it is receiving detailed information as to foreign operations for the first time this year.

We feel that there are serious constitutional problems involved in the proposed approach, particularly to the extent that it would tax undistributed income of foreign corporations to stockholders who, in fact, do not have effective control of the income, and may in fact never receive that income.

Moreover, constitutional questions aside, it seems patently unfair and unjust to tax anyone on income which he has not received and which is not within his control.

Our committee has found many instances of what it considers technical defects in the bill and we would suggest, at the least, a very careful screening to correct these defects before passage. This is not to criticize the draftsmen of the House bill but, as you gentlemen know, with respect to any new tax legislation that is extensive and complicated it is always extremely difficult to eliminate the "bugs."

We hope that the memorandum prepared by our committee on taxation of foreign income will be helpful in this regard. I should add that representatives of this committee, as well as of our other committees, concerned with other sections of the bill, would certainly be very happy to confer with the members of the staff of the Joint Committee on Internal Revenue Taxation if that should seem desirable.

APPEARANCES WITH RESPECT TO LEGISLATION

We are pleased to see within the bill a provision for the deduction of business expenses legitimately incurred in making presentations before legislative bodies.

In 1958, one of my predecessors, Lee I. Park of the firm of Hamel, Morgan, Park & Saunders of Washington, D.C., testified before the Ways and Means Committee in support of an American Bar Association recommendation to this effect.

Our recommendation was confined to expenses incurred in connection with appearances before, or submission of statements to, committees of Congress or of any State or local legislative body.

Such presentations, on the one hand, are often essential to the economic livelihood of a business, and, on the other hand, they provide information that is often valuable to the legislators in making their decisions. Where the presentation is for the benefit of the business, and is not personal, we see no policy that would be served by disallowing the deduction of such legitimate business expenses.

Entertainment expenses and the expense of public campaigns would not be includible and thus these areas of possible abuse would not be involved.

The provisions of the House bill, I do need to point out, expand somewhat upon the American Bar Association recommendation but are not inconsistent with its basic premises. The American Bar proposal is limited to presentations to committees of Congress or local bodies having legislative powers, while the House bill also covers presentations to individual legislators and presentations to or by organizations of which the taxpayer is a member.

In closing I would like to summarize the memorandums which we have today submitted to your commitee, which are replete with technical suggestions, and to request that they be included in the record of these hearings.

The CHAIRMAN. Without objection.

Senator KERR. Mr. Chairman, may I ask a question?

Does that mean they will be printed in the hearings or included in the files and filed with the hearings?

The CHAIRMAN. It has been customary—are they very extensive in length, Mr. Thrower?

Senator KERR. There they are, beginning with that book.

The CHAIRMAN. Could you reduce that part of it, that is put a part of it in the record and file the rest? I see you have a pamphlet here with a good many pages in it.

Mr. THROWER. Well, the particular pamphlet there is on the subject of the proposed withholding with respect to dividends and interest. I would say that I think it does contain material that will be of considerable interest, of considerable pertinent interest. I don't want to impose on you.

The CHAIRMAN. I will ask the staff to go over it and we will insert all that we think is essential to your statement at the end of your testimony.

Mr. THROWER. Thank you, sir.

These are:

(1) Report on extension of withholding taxes, approved by the House of Delegates of the American Bar Association on August 9, 1961, supplemented by comments recently prepared on the provisions of section 19 of H.R. 10650.

(2) Report of the special committee on travel and entertainment expenses, dated January 24, 1962, supplemented by comments recently prepared on the provisions of section 4 of H.R. 10650.

(3) Comments assembled by our committee on taxation of foreign income on the provisions of H.R. 10650 dealing with taxation of foreign income; namely, sections 5, 6, 7, 9, 11, 12, 13, 15, 16, 20, and 21.

(4) Comments assembled by our committee on depreciation and amortization on the provisions of sections 2 and 14.

(5) Comments assembled by our committee on general income tax problems on the provisions of section 3.

(6) Comments assembled by our committee on estate and gift taxes on the provisions of section 18.

Finally, let me emphasize that the memorandums entitled "Comments" are merely collections of opinions of individual members and do not represent committee action and certainly not action of the section of taxation and the American Bar Association.

(The material referred to appears following Mr. Thrower's testimony.)

The CHAIRMAN. I want to commend you and congratulate you on making a very clear analysis, especially of withholding.

As I understand it, you think that the withholding of tax on dividends and interest should await the operation of the automatic data processing in an effort to collect an amount estimated at $20 to $25 billion, which is a gap allegedly.

I want to ask this question: The Internal Revenue and the Treasury state they now collect 92 percent of dividends. Is it your belief that this withholding system will collect more than 92 percent in view of the errors which you think will occur in the refunding? As stated on top of page 5, of your prepared statement—

> This system is one that will produce a staggering number of errors in returns and claims and will invite many frauds.

I was wondering if your investigation had gone to the point that you could say with any certainty that a larger percent of dividends would be collected by the withholding than is now being collected?

Mr. THROWER. Senator, may I refer that question to Mr. Willis here, who, as I stated, is the chairman of our special committee in this field, and while I could undertake to answer it, I think he has the figures much better at hand than I would have.

The CHAIRMAN. Of course, we should take into consideration the cost of making these refunds; the cost of withholding on the part of the individual companies, and the expense of the Government in checking on this complicated system they have.

Mr. WILLIS. Senator, we attempted to compare the relative efficiencies and relative costs as to the Treasury Department of the two concepts: (1) of the automatic data processing without withholding, and (2) the withholding implemented by the automatic data processing.

Mr. Caplin stated in his speech before the Section on Taxation of the New York State Bar Association that use of automatic data processing would require lowering the interest floor on reporting to $10 and this would add approximately 150 million form 1099's to the amounts they have to process which would bring up to a total of 250 million the form 1099's that would be processed. Mr. Caplin said this would cost the Government $5.5 million a year.

This figures out to a cost of $2.25 for processing 100 form 1099's and since there would be an increase of 150 million forms there would be an increase in cost of $3,300,000 in the processing if the reporting requirement were reduced to $10.

This does not take into account the savings possible in doing what we were told by Mr. Smith, Assistant Commissioner of Internal Revenue, is already being done on wages and is being contemplated on divi-

dends and interest. This is obtaining magnetic tapes from the dividends payors and interest, which would be processed in lieu of form 1099, into the Treasury Department's ADP system.

If this can be expanded in the form that the Service contemplates, it will save most of the cost of processing and will assure greater accuracy. Using magnetic tape provided by payors, the information goes from one machine to another without intervention of human effort.

I am confident the information made available to us because of time, the increase in input, would not have this $5.5 million in cost of input because so much would be done with magnetic tape with the intervention of practically no human in between.

The CHAIRMAN. Your investigation hasn't gone far enough to say whether or not, considering the cost and all other items relating thereto, that the net return to the Government would be more than 92 percent which is the collection now on dividends? I am not speaking of interest but of dividends.

Mr. WILLIS. I am confident it will be more than 92 percent, I am confident it will be more than 92 percent either with withholding supplemented by ADP or ADP without withholding.

The CHAIRMAN. But you haven't got any figure.

Mr. WILLIS. I think it is impossible to get that.

May I point out something, though, that comes up in connection with the efficiency of ADP and the relative costs.

One of the points made by the Treasury Department and Internal Revenue Service is that with ADP without withholding it would be possible to collect approximately one-fourth of the estimated tax payable on the present unreported amount of dividend and interest income.

With withholding, implemented by ADP they estimate it will be possible to collect about 75 percent.

Further, the Treasury estimates that the costs of ADP without withholding, because of the enforcement, the followup would be very tremendous, something like $21.3 million.

We met with representatives of the Treasury Department, the Internal Revenue Service, and the joint committee in December 1960, when our committee was trying to obtain background information with respect to the problem of withholding.

We were told at that time that the ADP machinery that the Treasury Department had ordered was completely capable of matching the information returns with the individual income tax returns and then printing automatically a letter that would go out to the taxpayer saying, in effect:

DEAR MR. JONES: You reported $135 in dividends. Information returns that we have indicate that you received $250. If this is correct you owe additional tax of $35.10 plus interest computed to such and such a date of $1.35. If you are in agreement with the figures that we have, please send your check for this amount, including interest, along with the enclosed prepunched card.

Now, in the great number of cases it is probable where there has been an omission that there will be no need for correspondence. The taxpayer upon receipt of this printed communication from the machine itself will agree with the deficiency, enclose his check, and thus close the matter and not be required to have an audit, as such.

Now, no one can guess in what number of cases this will be done automatically with virtually no human being involved in it, everything being done by machine.

It would seem reasonable to expect, since we already are well acquainted with the process of paying bills along with prepunched cards, that the great proportion of the deficiencies resulting from understatements of dividends and interest will be paid without the necessity of an actual audit. I would contemplate this letter would state at the time it went out that—

This letter does not constitute an audit of your return and your return may be subject to audit later on.

We were further informed that the machine has the capability of being set to any degree of difference that the Internal Revenue Service determines.

For example, the Service might determine that a differential of less than $25 was not worth going after. So the machine would only print out letters where there was a difference between the amount reported and the total shown on the information returns of more than $25 or that could be set at whatever figure the Service determined from experience was appropriate.

Now, the feasibility of this seems to be pretty well buttressed by an article by Mr. Stanley Surrey, assistant to the Secretary of the Treasury, appearing in the current issue of the Tax Law Review for January 1962, issue.

Mr. Surrey is talking about billing procedure and not matching information returns with tax returns and then sending out a bill, but I believe what he says there would be equally applicable.

With your permission——

The CHAIRMAN. Let me ask you another question.

Mr. WILLIS. Yes, sir.

The CHAIRMAN. Let us assume that the automatic data processing becomes operative, which it will in time. I am an enthusiast of the numbering system. I had the privilege of handling the bill on the floor of the Senate. I was authorized then by the Treasury to say that this bill would bring in additional taxes to the extent of $5 billion a year.

Now, assuming that the automatic data processing is in operation a year from now, wouldn't that be much more effective in collecting taxes at less expense than the withholding plan?

Mr. WILLIS. Senator Byrd, after a careful analysis we think it would be much more efficient. There would be fewer complications. There would be a collection of close to the total amount.

The CHAIRMAN. There would be much less hardship on individuals with small incomes. Allegedly they will get refunds every quarter.

Mr. WILLIS. This is correct, if they file claims.

The CHAIRMAN. It is my opinion that is going to be impossible to do in an effective manner, because the income fluctuates in different quarters. At the end of the year the entire year must be checked to determine whether the refunds were excessive.

Mr. WILLIS. I understand, though, that can be done on a spot check basis.

The CHAIRMAN. When do you think this numbering system could get into operation?

Mr. WILLIS. Well, the numbering system will be in operation January 1, 1963, under the legislation. I understand that the latest word from Mr. Caplin is that the automatic data processing will be in full operation throughout the United States as of January 1, 1965.

The CHAIRMAN. But it is your opinion, as I understand it, that the numbering system would be more effective in collecting a larger amount of taxes and likewise imposing less hardship than the withholding plan?

Mr. WILLIS. Senator Byrd, we will have the numbering system either way, and they also plan under withholding to use the automatic data processing to check up——

The CHAIRMAN. Our objective, though, is to collect the taxes. That is the only justification for withholding. What I want to know is your opinion as to whether the numbering system will be more effective than the withholding plan.

Mr. WILLIS. I believe it will be more effective, less bothersome to the payees, the payors, and the U.S. Government, the Internal Revenue Service; yes, sir.

The CHAIRMAN. I think our Government owes a responsibility to the millions of taxpayers to make the collection of such taxes as simple as can be done, bearing in mind always that we should make everyone pay their share of taxes.

What I am trying to get clear in my mind is whether the plan for automatic data processing, even if it is deferred for a year from now; wouldn't it be a much fairer operation than the withholding plan, whether it is connected with the numbering plan or not.

Mr. THROWER. Senator, let me summarize our position with respect to that: We are quite enthusiastic about the automatic data processing system. We believe that with proper enforcement it can do the job. We think it should be given a trial.

We would not favor the introduction of a withholding system unless and until it is found that automatic data processing has not been successful. We think it will be successful in closing the largest part of this gap.

The CHAIRMAN. You think there would be a good deal of fraud in these refunds. The Chair has the same belief about it because, as you say, it must be practically determined largely on faith.

Mr. THROWER. A combination of fraud and error.

The CHAIRMAN. That will produce a lot of complications.

Now the interest, of course, is another matter. It is my belief that there is considerably more evasion in payment of taxes on interest than there is on dividends.

Mr. WILLIS. The statistics show that, Senator.

The CHAIRMAN. All dividends are reported to the Internal Revenue Department by every corporation that pays a dividend. The Internal Revenue Service has that data to go on now. If we would enact a law rquiring that all interest should be reported likewise, such as the interest on bank deposits or buildings and loans, and so forth, I should think that would be helpful in collecting the taxes on interest.

Mr. THROWER. I think it could be done by regulation.

The CHAIRMAN. If this numbering plan works as they claim it will, it certainly ought to be able to consolidate the income from both interest and dividends received by a given individual, thereby determining whether any dividends or interest income is being ommitted.

Have you given any thought to the fact of putting a severe penalty on those who fail to report dividends and interest?

Mr. WILLIS. We have given consideration to that. We feel it probably would be inappropriate to try to do it at this time. As further information is developed, if there is not a substantial improvement in compliance because of the fear of automatic data processing which we feel will follow, then consideration at that time might be given to penalizing the negligent taxpayer.

Of course, we already have in the law a 5-percent negligence penalty provision. At any time it was felt there was a negligently prepared return there could be a 5-percent penalty under the law.

The CHAIRMAN. Now, the complications of withholding the tax on interest are considerably greater than on dividends, is that right?

Mr. WILLIS. Yes, sir.

But we feel these problems of unreported interest are going to be solved over a period of time. We developed information in our committee that the commercial banks could report down to $150 of interest payments and only pick up 15 percent of the total accounts that they had.

Unfortunately, the statistics they had did not break at the $100 mark which is the figure that we happen to have used in our report. But we believe it would be possible, starting next year, to reduce the interest reporting level to somewhere between $100 and $150, and thereafter to reduce it over a period of years as the banks and other interest payers get into the electronic machinery era as the dividend payors already have done.

The CHAIRMAN. You approve of these withholding exemptions in the House bill.

Doesn't that complicate the plan very much?

Mr. WILLIS. I think that it does. When we get into an area of having exemptions and refunds, and then have some interest subject to withholding and some not subject to withholding, we have many complications.

One of the complications that disturbs me a great deal is a complication on the return to be prepared by the individual.

Take the case of the simplest individual tax return form. This is form 1040A, the card form, which you can use if you don't have more more than $10,000 of income and not more than $200 from sources other than wages subject to withholding.

For 1959 there were 915,000, out of some 18 million returns, reporting "other income." Presumably most of that was dividend and interest income.

I have great admiration for the ingenuity of the forms division of the Service but I frankly don't see how it would be possible to continue to use the card form in a situation where you have these various combinations of interest subject to withholding, interest not subject to withholding, exemptions, refunds, grossing up and all of that. I think that everybody who has any amount of dividends and interest will be required to report on form 1040 and no matter how diligently the form experts work in simplifying form 1040 and instructions, it is going to be quite complicated.

The CHAIRMAN. One more question: What is the opinion of the bar association on the investment tax credit?

Mr. THROWER. Senator, we have not undertaken to take a categorical position either for or against the credit, we have supplied comments which go to the technical provisions. We did give consideration to it. Of course, we found the views divided among those that I spoke to. There were a good many among those that I spoke to who opposed it but their reasons for opposing it were so varied and some were conditional, so we felt that the opinions would not be of great value.

The CHAIRMAN. As I read your statement, the strongest disapproval that you have given any part of this bill is the withholding, and that is because of its complications and the difficulty of operating under it, is that a fact?

Mr. THROWER. We have been authorized by the American Bar Association, after considerable study, to take the position that we have indicated here on withholding, so that we have taken a stronger position.

I might indicate, Senator, with respect to the investment credit, as a matter of general principle, there are some aspects of that which concern us to the extent it introduces into the Internal Revenue Code any nonrevenue provisions.

We believe that the acceptance of the Internal Revenue Code by the public generally depends upon its maintaining a kind of objectivity or integrity.

We think that is lost to some extent as nonrevenue provisions are introduced.

People take great issue with the way in which Congress might spend money. While people dislike paying taxes, they don't take issue to the same extent with the way that taxes are being raised.

If political and social provisions that are of a nonrevenue nature are introduced into the code, then we bring the code into a controversial area where at any one time you may have a great number of the populace opposed, and thus we think it would lose its aspect of objectivity and integrity, and that would, of course, be adverse to the interests of the Service, to the Treasury, and to the Government.

As an abstract proposition of long-range significance, we think this principle is quite important. We have felt within our own section a great many pressures, more pressures than in the past, to go to the code for an answer to every problem. We have had great pressures to approve credit for higher education, great pressure to approve credit for fallout shelters.

I noticed the other day the recommendation to provide credit for campaign contributions.

This is a credit to stimulate investment. Each of the objectives may be excellent, but we feel that each of these steps is a step in the wrong direction so far as the maintenance of the integrity of the Internal Revenue Code.

I certainly would not want to defend every provision that is now in the code. We think this could stand substantial modification but we think this is a step in the wrong direction.

The CHAIRMAN. Do you regard this tax credit as a subsidy?

Senator KERR. What was the question?

The CHAIRMAN. The question is whether the witness regards the investment tax credit as a subsidy; in other words, whether he regards

it as a stimulation, a bonus, so to speak, for a business to do a certain thing in order to receive the credit.

Mr. THROWER. I think I would; yes.

As I understand it, it is a reimbursement to certain taxpayers for certain costs of equipment that they incur, and in that sense I think it is a subsidy.

The CHAIRMAN. It only applies to certain taxpayers. It is not universal like most of the taxes. To that extent, it would seem to me to be a departure from, just as you have stated, the fundamental principles of taxation on income for the purpose of operating the Government.

In other words, it is another "gimmick" in an already very complicated tax system. Isn't that right?

Mr. THROWER. What I intended to say, I would hesitate to call it a "gimmick," though I have heard that term used frequently.

The CHAIRMAN. Would you prefer a subsidy or would you prefer a "gimmick"? [Laughter.]

Senator KERR. Do you mean as a designation of what this is or as a recipient?

The CHAIRMAN. Those of us who call it a subsidy have been severely chastised by those who deny it is a subsidy. Well, it is either a subsidy or it is a bonus. It gives a special tax reduction to a taxpayer who does a specific thing.

Mr. THROWER. It does seem to us to be a kind of appropriation that is written into the tax bill and not a revenue measure, as with the other credits that I spoke of.

The CHAIRMAN. To show the fallacy of the investment tax credits proposal it is retroactive to January 1 and thereby gives tax relief amounting to about $600 to $700 million to those companies that couldn't have been influenced by the tax credit because they started their modernization perhaps the 1st of January. They had no information then that this tax credit would be adopted by Congress and, therefore, it was not an incentive. It would be a windfall, wouldn't it, to those concerns that would receive it, covering expenditures that were made prior to the passage of this bill? I understand it amounts to about $600 or $700 million; is that your understanding?

Mr. THROWER. I think that taxpayers have been encouraged to go ahead and make their investment and not wait on the bill to the extent that they were led by that to make their investment——

The CHAIRMAN. There is still a Congress left in this country.

Mr. THROWER. That is right.

The CHAIRMAN. I don't believe the businessmen are going to take a statement made by the administration in power—I am not referring to the present administration, but any of them—that they recommend a certain thing and then a businessman goes ahead on the assumption that it is certain to be enacted.

Mr. THROWER. That is true, Senator. They were likewise encouraged last year to make the investment and not wait for the passage of the bill.

The CHAIRMAN. The investment credits as recommended last year were very much more extensive than under this bill.

Mr. THROWER. That is right.

The CHAIRMAN. They included the buildings, and to be logical about it if you give an investment credit at all, it should include buildings, because many industries cannot modernize unless they put up new buildings.

So this is just the beginning of this special treatment and this $1,400 million is a reduction in taxes which falls heavily on all the taxpayers. It may be necessary to increase other tax brackets if we ever are to balance the budget again. I am not certain we are going to balance it. But if we ever balance the budget again and give relief to this group of taxpayers, then we will have to increase taxes on other taxpayers to make up that loss; is that correct?

Mr. THROWER. Senator, if this were an appropriation bill we would not presume to be here testifying on it; that is, if what you had referred to as a subsidy were given by direct appropriations, we would not consider ourselves specially prepared to testify upon it.

The CHAIRMAN. But I understood you to say a few moments ago, you consider this in the nature of an appropriation.

Mr. THROWER. That is correct.

And we would as a matter of principle think indirect appropriations of things of this sort should not be in the internal revenue bill.

The CHAIRMAN. We also must remember that all of these things of this character in the nature of a subsidy, whether it is actually a subsidy or not, whatever it may be, grow and grow.

I have been here 29 years and I have seen them start little and they get bigger and bigger and bigger and they are never repealed. It may be thought possible—sometimes that if a corporation receives a subsidy that then they can increase wages and not increase the price of the product they sell.

That might be possible some day.

Senator Kerr?

Senator KERR. I am quite interested in the discussion you have just had.

The CHAIRMAN. I didn't want to offend you by calling it a subsidy, but I thought it was a good point to start from anyway.

Senator KERR. The great chairman of this committee could not possibly offend me. I have respect and affection for him and admiration, and I am so aware of his great integrity that there would be no possibility of offense.

Certainly men can disagree either as to what something is or what the significance of it is without thereby offending each other.

The CHAIRMAN. I haven't been offended at all.

Senator KERR. Nor have I.

The CHAIRMAN. Let's shake hands. [Laughter.]

Senator KERR. I thought the significance was the question, and I didn't know whether you answered it or acquiesced in an answer, or either, asking if a tax reduction to certain taxpayers who do certain things is a subsidy.

I understood you to say that you interpreted it as an appropriation. Now, we are talking about tax credit in this bill, and I am sure that you are as familiar with it and understand it as well as any witness who has appeared before this committee in these hearings.

I would like for you to just tell the committee whether you regard it as a tax reduction or as a subsidy or as a gimmick or an appropriation or as a lawyer how you interpret it?

Mr. THROWER. Senator, I would interpret it as a tax credit that is dependent upon conditions which are not taken into account in computing gross income or deductions, therefore, as a credit not related to the computation of taxable income.

Senator KERR. You say it is not related to taxable income?

Mr. THROWER. Not related—as I understand the credit, it does not enter into the computation of taxable income.

Senator KERR. That is correct.

Mr. THROWER. It does not reduce the basis of the property which is acquired.

Senator KERR. That is correct.

Mr. THROWER. And, therefore, it is a non-income-tax item or a non-income item. It is simply a provision for the credit or reduction of the taxes that would otherwise be due.

Senator KERR. The credit against or reduction of taxes.

Mr. THROWER. Taxes otherwise due; yes.

Senator KERR. Then would it be a correct statement to say that it does provide a tax reduction for any taxpayer in the United States who complies with it or whose actions conform to the specifications written into it?

Mr. THROWER. Yes.

Senator KERR. Not the slightest question about that, is there?

Mr. THROWER. I would think not; no.

Senator KERR. It is universal in application in that it is applicable to any taxpayer who performs in accordance with the requirements set forth in it in order for that taxpayer to receive that reduction in his taxes.

The CHAIRMAN. Will the Senator yield at that point?

Senator KERR. Yes.

The CHAIRMAN. If there is a loss on the part of the corporation that makes that investment to modernize then there is nothing, they can't get a credit.

So it is not uniform entirely.

Mr. THROWER. What the Senator says is, of course, correct.

Senator KERR. It might not be an implemented credit but it would still be a credit, wouldn't it?

Mr. THROWER. The credit is only against tax that is otherwise due. If the enterprise for which the purchase is made is unsuccessful, and there are losses and the carryover is not made available, then the credit would not be obtainable by——

Senator KERR. Would not be implemented. If it were a subsidy it would be implemented, wouldn't it?

Mr. THROWER. If it were a direct payment without regard to these other conditions, it would.

Senator KERR. If it amounted to a subsidy the corporation doing it would get some benefit from it, wouldn't it, if it were a subsidy?

Mr. THROWER. If it were a direct subsidy, that is right.

Senator KERR. Therefore, instead of the question by the Senator from Virginia producing an answer to prove that it is not a tax reduction, in the judgment of the Senator from Oklahoma, the question and the answer prove that it is not a subsidy because if it were a subsidy the taxpayer would receive it.

As I understand the difference between a subsidy and a tax reduction, on the one hand, a subsidy is something received. A tax reduc-

tion, on the other hand, is a reduction of the amount of taxes that a taxpayer owes.

Would you disagree with that?

Mr. THROWER. Well, that, Senator, seems to me to get in a certain conflict here of semantics.

Senator KERR. Identify the conflict in semantics.

Mr. THROWER. Well, the conflict——

Senator KERR. I speak to you with a great amount of respect for your ability or you couldn't have given the lucid statement your presented here, nor would you be in the position you occupy in the American Bar Association.

Mr. THROWER. Well, this certainly is a very new and novel provision within our particular code.

Senator KERR. When we put a provision——

Mr. THROWER. The terminology that might be applied to it——

Senator KERR. When we put a provision in the code permitting a reduction of taxable income by charitable contributions that was an innovation, wasn't it?

Mr. THROWER. That was allowed as a deduction against income, whether rightly or wrongly——

Senator KERR. I say that was an innovation, wasn't it?

Mr. THROWER. That was an innovation, yes, at the point that it had never been done before.

Senator KERR. It didn't apply to anybody who didn't do it, did it?

Mr. THROWER. That is correct.

Senator KERR. Is that correct?

Mr. THROWER. That would be correct; yes.

Senator KERR. But it did apply to everybody who did do it if they had taxable income?

Mr. THROWER. That is right.

Senator KERR. Not only right, but correct.

Mr. THROWER. Correct.

Senator KERR. Exemptions for dependent children doesn't apply to everybody, does it?

Mr. THROWER. No; it does not.

Senator KERR. It rarely applies to single persons, does it?

Mr. THROWER. Rarely.

Senator KERR. Unless under the laws of the State there is an offspring which has either been willingly acknowledged or unwillingly established. [Laughter.]

Yet it is regarded as a universal application, isn't it, or a law of universal application as nearly so as one could be.

Mr. THROWER. It is applicable to all who meet the conditions of the provisions; yes.

Senator KERR. Well, that is true of the tax credit provision in this bill, isn't it?

Mr. THROWER. It is applicable to all who meet the conditions of the provisions; yes.

Senator KERR. Just as true as the exemption for dependents, just as applicable?

Mr. THROWER. In the sense that I said; yes.

Senator KERR. Well, on the basis that in either case the law or the benefit applies to anyone whose situation meets the requirements of the law for the benefit to accrue?

Mr. THROWER. Well, yes.

Senator KERR. Is that correct?

Mr. THROWER. I think that it is evident; yes.

Senator KERR. I think it is evident. Do you think it is correct?

Mr. THROWER. I think it is evident and correct; yes.

Senator KERR. You are not only an expert lawyer but an adroit witness. Now, you were speaking about business expenses. That is not universal in application if universal in application would mean that it applied to every taxpayer, is it?

Mr. THROWER. Every taxpayer does not have expenses of that nature; no.

Senator KERR. But any taxpayer who does, gets the benefit of that provision under the law; is that correct?

Mr. THROWER. That is correct; yes. Either the benefit or subject to the limitations.

Senator KERR. I understand. Well, this is subject to limitation. So that the proposed legislation before us or that part of it that provides for a tax credit is just as universal in application as any of the other provisions in the code that we have discussed, isn't it?

Senator KERR. Well, they all apply to a taxpayer who meets the requirements.

Mr. THROWER. They all apply to taxpayers who meet the requirements.

Senator KERR. And neither applies to any taxpayer who does not.

Mr. THROWER. That is true. Some are more limited than others.

Senator KERR. I understand.

Mr. THROWER. The only point I made, undertook to make, was that within the Internal Revenue Code most of the provisions are related to the computation of income or matters related to the computation of income. This is a provision which does not enter into the computation of income.

Senator KERR. Well, when we reduced certain excise taxes from 20 percent to 10 percent, they didn't enter into the computation of income, did they?

Mr. THROWER. Well, that, I think is a—a direct excise tax would not be within the scope of what I was discussing.

Senator KERR. But I am now bringing it into the discussion.

Mr. THROWER. Well, this is a credit against income tax.

Senator KERR. I say, the reduction of an excise tax from 20 percent to 10 percent is not dependent upon the income of the taxpayer nor is it a part of the income tax code, is it?

Mr. THROWER. It is not within the income tax provisions of the code; no.

Senator KERR. Of the code. Yet it was a tax reduction.

Mr. THROWER. It was a reduction of the excise tax; yes.

Senator KERR. Would you call that a tax reduction?

Mr. THROWER. That would be a tax reduction within that area; yes.

Senator KERR. Well, was it a tax reduction?

Mr. THROWER. Yes, definitely.

Senator KERR. Will the proposed tax credit in this law, if enacted, be a tax reduction?

Mr. THROWER. Not in the general sense that we have commonly in the past thought of tax reduction.

Senator KERR. You mean not similar to other——

Mr. THROWER. Not in a——

Senator KERR. You mean it will be dissimilar to other tax reductions?

Mr. THROWER. That is right.

Senator KERR. But will it be a tax reduction?

Mr. THROWER. It will be a reduction of the obligation of the taxpayer who gets the benefit of it and to that extent it will be a tax reduction.

Senator KERR. Well, that is almost an affirmative answer [laughter] and I appreciate it.

Now, you were talking about the withholding provision of the law. At this point, did the chairman have a definition he wanted to put in the record? I see the dictionary there.

The CHAIRMAN. There is something I would like to put into the record.

We have been talking about reductions on earned income. This is entirely income.

Senator KERR. I was not talking about reduction in earned income.

The CHAIRMAN. You cited a number of things. Take dependent children and all that.

Senator KERR. I did.

The CHAIRMAN. This is not an exemption; it is a tax credit.

Senator KERR. It is a reduction, Mr. Chairman, of taxable income.

The CHAIRMAN. I know it is.

Senator KERR. They get the reduction whether it is against earned income or investments.

The CHAIRMAN. No; you take it off your tax. That is entirely different from making a deduction from your earned income. Here is the definition of subsidy in the dictionary:

> Pecuniary aid directly granted by Government to an individual or commercial enterprise deemed productive of public benefit.

When you take a tax credit after estimating what your tax is, it is entirely different from a tax reduction, because a tax reduction should be taken off of the earned income before your tax is determined; isn't that correct?

Mr. THROWER. Well, within the income tax field, that would be correct; yes.

The CHAIRMAN. I think the dictionary here, with all due consideration to my very learned and distinguished friend——

Senator KERR. I read the same provision into the record the other day.

The CHAIRMAN. Well, nobody questioned it at that time.

Senator KERR. I am not questioning it now.

The CHAIRMAN. Here it is and I think it applies to this case: "pecuniary aid directly granted by Government to an individual or commercial enterprise deemed productive of public benefit."

Now, the basis of investment credit is that it is for public benefit because these industries will be induced to modernize, and that is alleged to be for public benefit. But I will compromise with my distinguished friend and let's call it a gift [laughter]; that is what it is.

Senator KERR. But you see, Mr. Chairman, and, of course, we will carry this on——

The CHAIRMAN. If you want to read the definition of a gift we can locate it in this dictionary.

Senator KERR. We will carry this on, I am sure, after this is over with. The Senator from Oklahoma does not regard this as a grant or as a gift, because a grant or a gift is something which the receiver obtains by acceptance, and that is all the receiver has to do.

The CHAIRMAN. Except this——

Senator KERR. No; in order to get this investment credit they have to do certain things.

If you make a grant to me, all I have to do is to accept it.

The CHAIRMAN. Let me change it now and make it a bonus, if you don't like the word "gift" or "subsidy."

Senator KERR. I like the word "gift." I even like gifts, either as a giver or a givee. It is just a matter of interpretation of the significance of the law, of the language in a bill. Where the taxpayer has to do certain things in order to receive a credit the Senator from Oklahoma does not regard the credit as a grant or a gift or a subsidy but as a reduction in the tax owed by the taxpayer and with reference to which he is able to reduce his taxes by that amount by reason of having performed in accordance with the requirement in the law to entitle him to receive that reduction in his tax liability to his Government.

The Senator from Oklahoma had to make his living at one period in his life practicing law, and although he may not have learned much, he learned that much.

The CHAIRMAN. I regard the Senator from Oklahoma as the best cross-examiner I have ever known and I hope he will never get me on the witness stand. [Laughter.]

Senator KERR. Let's go to withholding, Mr. Witness.

Are you familiar with the way regulated investment companies operate?

Mr. THROWER. May I refer that to Mr. Willis?

Mr. WILLIS. Not specifically. I have some knowledge of it.

Senator KERR. Well, I am going to try to outline what I think is the method of their operation and I do not do so critically. I have sat on this committee and helped write the law under which they operate, and I think it is a reasonable law and a just law, but I want to talk to you about it and ask you a question or two.

You are aware of the fact that a regulated investment company that passes its earnings on through to its owners or stockholders or shareholders or participants, has no tax liability to the Government with reference to those earnings.

Mr. WILLIS. That is right.

Senator KERR. You are familiar with that?

Mr. WILLIS. Yes, sir.

Senator KERR. Are you familiar with the fact that in many cases and maybe most of them, and in my judgment all of them where they are able to do so, they have a contract with the participant or the owner or the beneficiary whereby those earnings are deposited into a depository, ordinarily a bank, in a fund, which, when so deposited under the terms of the agreement between the participant and the company, are deemed to have been distributed to the participant?

Mr. WILLIS. Yes, sir, I am acquainted with that.

Senator KERR. But with reference to which the participant has no right to withdraw?

Mr. WILLIS. Correct.

Senator KERR. So that they are retained there and under that agreement the investment company reinvests it?

Mr. WILLIS. That is correct, sir.

Senator KERR. For the account of its shareholders and that then each shareholder gets his participation in the asset acquired by the reinvestment of that distribution.

Mr. WILLIS. Correct, sir.

Senator KERR. What percentage of those shareholders do you think included in their tax returns the amount of money thus distributed by the investment company by depositing it into a reinvestment fund with reference to which the equitable or actual beneficiary never actually receives it until he either withdraws his entire account or at a certain date he begins to receive a certain amount a month or otherwise terminates his arrangement with the investment company?

Mr. WILLIS. Senator Kerr, I think a very high percent included it for the reason that the investment fund has to get out a notice at the end of the year to tell the total amount of the distribution, the amount subject to ordinary income tax and the amount of capital gain. Thus the shareholders receive a specific notice as to the amounts they have received during the year.

While it is only surmise, I would surmise that most of the recipients of those notices have reported the correct amounts in their tax returns.

Senator KERR. You think most of them do?

Mr. WILLIS. Yes, sir, I do.

Senator KERR. Are you familiar with the fact that a very large percent of savings accounts, both in savings banks and commercial banks, are handled in such a way that periodically the bank credits the savings account of the depositor with the interest earned and that the depositor is notified of it or aware of it only by reason of the fact that when he receives his statement at such times as the statements are furnished to the depositors, in which, if he examined it carefully he will find that his account now reflects what he put in it plus the earnings that have been deposited to him.

Mr. WILLIS. I am acquainted with this practice; yes, sir.

Senator KERR. And that the same is true of building and loan associations and the commercial banks advertise the advantages of the saver depositing funds and letting the income be added to the principal so that the earnings are compounded, and thereby the account caused to grow at a relatively faster or accelerated rate.

Mr. WILLIS. The Senator states it very accurately, yes, sir.

Senator KERR. The Senator from Oklahoma was talking to a very dear friend of his the other day, who is the managing officer of one of Oklahoma's fine banking institutions, and the conversation along this line took place.

He said, "You know, I think this withholding tax is going to produce an astonishing amount of revenue." This gentleman is not only one of the best bankers in Oklahoma, he is one of the best lawyers in Oklahoma.

He said, "Every member of my family and my wife's family, and our in-laws have savings accounts. We have as good an income tax consultant as there is in our area." He said, "After this issue was brought up and was brought about by the suggestion that a withhold-

ing tax be legislated, I went back and checked to see if the earnings credited to the accounts of the members of my family had been included in their tax returns, income tax returns, and," he said, "to my amazement I found out they had not been."

He said, "I immediately visited our tax consultant to revise current and previous tax returns to show those earnings."

He said, "It certainly was an astonishing experience, but," he said, "I understood how easily it happened because of the fact that it was income we were unaware of, we never saw, and just accumulated to us and inadvertently had not been included in our returns."

Would you say that that was a rare occurrence or would you say it might be possible that that was an occurrence of some degree of frequency?

Mr. WILLIS. I think it is an occurrence with some degree of frequency. I think there are a large number of people who have been credited with interest on their savings accounts or their savings and loan accounts which they have not thought of at the time of preparing their tax return and have not included in their taxable income.

I might mention we have talked to quite a few bankers and corresponded with bankers and this is a matter that is beginning to concern them entirely aside from the taxation aspect.

Some banks have estimated that as to 25 percent of their savings accounts depositors no longer have accurate addresses and are not sure how to communicate with their depositors. They are becoming aware of the fact this is poor public relations and quite a few of them have indicated they think they are going to get around to the practice——

Senator KERR. Get what?

Mr. WILLIS. Get around to the practice of sending out an annual statement to the depositor telling him the balance in his account, how much he was credited with interest. They will do this as a matter of customer relationships, and also keeping their customers' addresses up to date. We would hope, with the automatic data processing, and the amount required to be reported eventually reduced to a level perhaps comparable to the $10 level for dividends, which I think some day will be feasible, there will be a much higher level of reporting interest income credited on accounts in banks and savings and loan institutions.

Senator KERR. A witness appeared here the other day representing a certain group of regulated investment companies. In fact he not only represented the group but he was the managing head of what he said was one of the very large ones.

He said the passage of this withholding tax would destroy the integrity of their arrangement with their participants by reason of the fact that they would then not be able to meet their commitments to their participants which they can do only by compounding all of the revenue received by their participants and adding it to the principal of their asset or estate or account.

The Senator from Oklahoma was rather astonished at that statement because it made it quite plain to him, to me, as to the situation that exists there, that evidently his company, and I would presume those that he represented, was such, that the success of their relationship with their shareholders and their ability to do what they had

assured their shareholders they would do and could do for them, depended upon their shareholders paying their income tax on their earnings out of their funds if they paid them at all, out of money other than the earnings which that particular investment generated.

I wondered if it wasn't entirely possible that the millions of people participating in these investment funds, apparently the most of whom do not get their earnings in the form of actual cash distributions received, in many instances, and maybe a very high percentage of the instances, would be unaware of the fact that they had that taxable income.

Mr. WILLIS. Senator, I think in the case of the participants in the plan you speak of, they would receive notices from the company at the end of the year, because they have, as I mentioned, the two classes of income that must be broken down so they can promptly report them on their tax returns.

Senator KERR. Well, you know the participants in farm cooperatives get their notices but they don't pay any tax on it.

Mr. WILLIS. I am acquainted with the figures which tend to show that, sir.

Senator KERR. Don't you think that if we pass a law whereby a farm cooperative withholds 20 percent of the amount credited to the participant and transmits it to the Government against the tax liability of that participating farmer, whether it exists or not, that it would be equitable to provide the same treatment for the participant in an investment fund?

Mr. WILLIS. Senator, I am not well acquainted with cooperatives. As I understand it, under the proposed bill the same treatment would be accorded to the participants in the cooperative as the stockholders in a mutual investment fund.

There would be the same withholding.

Senator KERR. Well, don't you think if we are going to apply that principle to the farmer who is a member of the co-op, that we ought to apply it to the town man who is a member of the group in an investment fund venture?

Mr. WILLIS. You mean one of these investment clubs, not the regulated investments?

Senator KERR. I am talking about the regulated investment companies.

Mr. WILLIS. I think the same thing is applied, Senator. I think there is a 20-percent withholding there, too, on their dividend payments.

Senator KERR. There is in this provision.

Mr. WILLIS. Yes, sir. In the proposed law.

Senator KERR. But as I understand your position you are opposed to the withholding feature of this law.

Mr. WILLIS. Yes, sir.

Senator KERR. Are you opposed to the provision that withholds 20 percent of the amount of the credit certificates issued by farm co-ops to farmers?

Mr. WILLIS. I think it is just as unnecessary there as it is in the case of the withholding on the dividends and interest, yes, sir.

Senator KERR. In other words, you would be just as much opposed to that provision of the law as you are to the other?

Mr. WILLIS. Yes, sir.

Senator KERR. Thank you, very much.

The CHAIRMAN. Senator Williams?

Senator WILLIAMS. Mr. Thrower, I think most of us are in agreement that no doubt there are a substantial number of savings accounts upon which interest is allowed to accumulate and credited back to the account and which, in turn, is not reported as taxable income by the depositor.

However, can you imagine many situations existing where bankers themselves are not aware of the fact that the interest which is credited back to their own accounts or to that of their families would not be taxable?

Would not most bankers realize that interest is a taxable part of their income?

Mr. THROWER. I would think that most bankers would realize that.

Senator WILLIAMS. It would be hard to realize many situations where there would be lack of knowledge on the part of the depositor that his interest which was credited back to his account was not properly supposed to be included in his taxable income?

Mr. THROWER. I would think that would be right, yes.

Senator WILLIAMS. Now, in connection with the investment credit, I don't want to get involved in a discussion between two very able lawyers. I, as a layman, certainly know better than that.

However, I have been reading with interest here comments on a report which has been submitted, as I understand it, by your group to the staff of the committee for study. It is entitled "Comments on Sections 2 and 14." And as I understand it these comments represent the comments of different members of your organization but which have not been boiled down, you might say, to be included in your statement which you presented to our committee today.

Mr. THROWER. That is right.

Within the limited time we had available we undertook to distribute the House bill, and the House report as widely as possible, among the several committees that would be interested and concerned and would have a responsibility.

This would extend to several hundred members of the tax section.

We have compiled their comments, and they are represented in these reports that are headed "Comments." Those are not representations by the committee as such, but simply an individual member. They certainly——

Senator KERR. You made it very clear they were not the position of the American Bar Association, didn't you?

Mr. THROWER. That is right.

Well, I intended to; yes. They are individual comments.

Senator WILLIAMS. That is my understanding, they are the comments of the individual members of the American Bar Association.

Mr. THROWER. That is right.

Senator WILLIAMS. I noticed some of these comments are rather significant.

I am reading from comments on section 2. I am quoting this particular member of your organization:

> I am completely opposed to the investment credit provision. It provides selective rate reduction for a limited group of taxpayers and is an outright subsidy.

At least that member of your organization thought this was an outright subsidy.

Commenting, he said:

It is extremely unfair to the taxpayer who made an investment in depreciable property last year or the year before, and he does not qualify for the credit this year.

The CHAIRMAN. Will the Senator from Delaware yield for just one moment?

Senator WILLIAMS. Yes.

The CHAIRMAN. As I remember the representative of the CIO called it a subsidy.

Senator WILLIAMS. It's been called subsidy, as I understand it, by several others.

Senator KERR. Will the Senator yield?

Senator WILLIAMS. Oh, yes.

Senator KERR. Would the chairman ask the staff to notify both the man who made that comment and the representative of the CIO of the chairman's approval of their comment?

The CHAIRMAN. They indicated the chairman's approval at the time. I mentioned the fact that the U.S. Chamber of Commerce was opposed to this, I won't call it a subsidy.

Senator KERR. I noticed you put them on the bottom of the totem pole.

The CHAIRMAN. I used the word "gimmick." The National Association of Manufacturers is opposed to it. The CIO and AFL is opposed to it, and the American Farm Bureau is opposed to it, and the Farmers Union is opposed to it.

Senator WILLIAMS. I would like to continue. There were other members of your organizations who were likewise opposed to it. I would like to read the comments of this member of your organization:

The provision for the so-called investment credit is so basically wrong in principle that it seems next to useless to attempt to achieve any technical improvement. I start with an unreserved endorsement of the minority report printed on pages B-5 through B-14 in House Report No. 1447 to accompany H.R. 10650.

Reading again, I find that another member of your organization has this to say:

The question is whether either approach would have the desired effect so as to warrant selectivity and subsidy.

So we find the word "subsidy" drawn all through these comments of the various members of your organization. So I don't think there is too much of a difference of opinion or too much exception can be taken to the point that there are many people who have considered this investment credit proposal and have termed it a "subsidy."

Senator KERR. You know a lot of people thought the world was level until Columbus proved otherwise.

Senator WILLIAMS. That is correct.

Senator KERR. The compounding of error never created accuracy. [Laughter.]

Senator WILLIAMS. The Senator from Delaware had one other statement here:

If one were to advocate that the amount of investment credit would be deducted from basis we merely create another problem. In terms of subsidy it would mean there was only a question of degree.

Senator KERR. That was not the statement of the Senator from Oklahoma.

Senator WILLIAMS. No, no; it is a statement of the members of this profession of attorneys. As a layman——

Senator KERR. Of attorneys.

Senator WILLIAMS. I understand the members of the American Bar Association are attorneys. I understand the Senator from Oklahoma is an attorney.

Senator KERR. I am an attorney, I am not a member of the American Bar Association.

Senator WILLIAMS. No; but I am quoting from a most respected profession of men who have told us laymen that this is a subsidy. And I understand that the witness before us likewise has agreed that this is in effect a subsidy. [Laughter.]

I have no further questions, Mr. Chairman.

Senator KERR. There is another answer provided for you, Mr. Witness, but you are not bound by it. You can state your own conclusions.

Senator WILLIAMS. I will ask the witness this question. In answer to the question from the chairman of the committee, did you not likewise agree that this was a subsidy?

Mr. THROWER. With your leave, Senator, if I may at this point I would like to stand on the record. [Laughter.]

The CHAIRMAN. That is a good witness.

Senator Douglas?

Senator DOUGLAS. I would like to ask Mr. Thrower this question: It is quite evident that you prefer automatic data processing to withholding for the collection of taxes on dividends and interest.

Do you favor the replacement of withholding or automatic data processing on the collection of wages and salaries?

Mr. THROWER. We do not; no.

Senator DOUGLAS. You do not?

Mr. THROWER. We do not; no.

Senator DOUGLAS. You favor withholding for wages and salaries.

Well now, if automatic data processing is superior to withholding for the collection of taxes on dividends and interest, why is it not superior for the collection of taxes on wages and salaries.

Mr. THROWER. May I again ask the chairman of our committee——

Senator DOUGLAS. Yes; I would be much interested in the answer to that question.

Mr. THROWER (continuing). To comment on that.

Mr. WILLIS. Senator, I think there are several differences.

In the case of withholding on wages for most part you have one employer. It is possible to have personal exemptions recognized so that in the ordinary case the withholding is going to about equal the tax liability.

In the second place, the wage earner usually has nothing but his wage with which to pay taxes. The person receiving dividends or interest income has his stock, bond, or bank account available to the tax collector, so if he does not report and the service catches up with him, there is the capital available. The wage earner does not have this capital available.

Senator DOUGLAS. May I answer that?

Mr. WILLIS. Yes, sir.

Senator DOUGLAS. The record shows that about 25 percent of dividend and interest payments taken together escape taxation, whereas the percentage of wages and salaries which escape taxation is relatively small, it is something in the order of 3 percent.

Mr. WILLIS. That is correct, sir. The percentage in the case of dividends where we have adequate information returns filed now is in the area of 7 or 8 percent.

This is the percentage of dividends escaping taxation that should be taxed.

Senator DOUGLAS. Yes; but I mean if you take dividend and interest together it is approximately 25 percent.

Mr. WILLIS. This is correct. The big gap is in the interest area.

Senator DOUGLAS. I understand.

Mr. WILLIS. And the withholding would not close all of this because there will not be withholding on all of the interest that is paid.

Senator DOUGLAS. Now the withholding system was applied to wages and salaries, as I understand it, in approximately 1942.

Mr. WILLIS. That is correct, sir.

Senator DOUGLAS. Before the electronic computing machines had come into existence. Now, they are in existence. Why not scrap withholding for wages and salaries and substitute automatic data processing for them?

Mr. WILLIS. I think that there are reasons why we should not do that. We then would have to require all wage earners to file declarations of estimated tax, which is done by people who have a substantial amount of other income now.

The most efficient way in the case of the wage earner is to deduct his tax from the source, as it is paid. There is a different problem in the case of the wage earner than the recipient of dividends or interest.

Senator DOUGLAS. Why is that not the most efficient way of collecting taxes from those receiving dividends and interest.

Mr. WILLIS. Because there is the capital available to insure the payment of the tax in the case of the dividend and interest. There is not the capital available in the case of the employees.

Senator DOUGLAS. The record shows that 25 percent of dividend and interest escapes taxation year after year after year.

Mr. WILLIS. Senator, I am convinced that with the proper utilization of automatic data processing it is going to be possible to close that gap to a negligible amount. I think it would be possible to close it more than the amount indicated in table 10 of Mr. Dillon's exhibit 2 with the use of withholding.

Senator DOUGLAS. If you have such confidence in automatic data processing why not apply it to wages and salaries?

Mr. WILLIS. We have dissimilar situations because we cannot give reflection reasonably in the dividend and interest area to the marital status and the number of dependents, for example.

In the case of dividends and interest, there either has to be a total exemption or no exemption. Everybody seems agreed this is the only practical way of working the exemption system in the case of dividends and interest.

Senator DOUGLAS. You are aware of the fact, are you not, that there are some 37 million cases of overwithholding in the case of wages and salaries, are you not?

Mr. WILLIS. The total figure—yes, sir; it is around that.

Senator DOUGLAS. Approximately 60 percent on those who earn wages and salaries have more taxes withheld from them than they ultimately owe.

Mr. WILLIS. This is correct, Senator.

Senator DOUGLAS. Is not this a severe hardship that they experience?

Mr. WILLIS. I wish we had more complete statistics with respect to this area. I confess that I was somewhat concerned as I reviewed the available figures. If we knew not just what the average refund is, which incidentally amounts to about $125, but what the median refund was, we would get a much better idea. If the great bulk of these refunds are in the area of $5 or $10, and then we have a relatively few large refunds to bring the average up to $125, I would feel it is not a very severe problem.

If, in fact, the median refund gets close to $125, then I think a study should be made to ascertain the reason for this. There may be several reasons: A person who is employed may lose his employment. He may have seasonable unemployment. He may have unexpected medical expenses.

Senator, I am expressing personally my personal viewpoint and not at all the viewpoint of the American Bar Association, but I would feel if the statistics showed there was much excess withholding on wages because of these conditions that cannot be reflected in the rates of withholding, that consideration should be given to intra-annual refunds in the case of withholding on wages.

I think it is only fair that it should be done in that case where there are these factors that cannot be considered in the rates of withholding.

Senator DOUGLAS. You propose quarterly refunds then in wages and salaries comparable to the quarterly refunds provided in the present bill?

Mr. WILLIS. I don't know whether it would be necessary to have it quarterly or not, Senator.

Senator DOUGLAS. Would you attempt to have it quarterly to attempt to make the treatment parallel?

Mr. WILLIS. Perhaps it should be quarterly. But certainly the man who has lost his job or has had unexpected medical expenses and because of the overwithholding should get his tax more promptly than at the end of the year.

Senator DOUGLAS. Aren't you subjecting yourself to the criticism that you are giving more favorable treatment to the recipients of dividends and interest than to recipients of wages and salaries, because you approve of withholding in the case of those receiving wages and salaries, but disapprove of it in the case of those receiving dividends and interest? Why should you have inequality of treatment between two classes? I am not saying that wages and salaries are more honorific than dividends and interest. I am not maintaining that, although at one time the Internal Revenue Code did give them better treatment. I am merely saying, are they not equal, of equal value?

Mr. WILLIS. Yes; I think they are of equal value.

Senator DOUGLAS. Why should you give a dollar of dividend and interest favored treatment as compared to a dollar of wages and salaries?

Mr. WILLIS. The recipient of dividends and interest, who is going to be in a tax bracket is required to file a declaration of estimated taxes paid at least on a quarterly return, so the tax is paid quarterly on his declaration of estimated tax liability.

Senator DOUGLAS. But the withholding on wages and salaries is each week.

Mr. WILLIS. This is true. So there is that loss of time. But I think that in the case of wages and salaries this is truly a benefit as the easy way of paying the tax.

Senator DOUGLAS. Why would it not be a benefit in the case of dividend and interest? Let's assume that people who receive dividends and interest are law-abiding citizens who want to pay their taxes. This enables them to pay their taxes as they go along instead of waiting until the end of the year to pay it. This was the great reason why withholding was imposed in the case of wages and salaries at the outbreak of World War II.

Mr. WILLIS. Yes, sir.

Senator DOUGLAS. It makes that easier for them instead of throwing this strain upon them. They don't have to remember as much. They don't have to draw down their account as much at the end of the year, but can use the pay-as-you-go principle which was said to be a great improvement in the tax system when it was first introduced 20 years ago. Why not have pay as you go for everyone?

Mr. WILLIS. I think we do have pay as you go through the declaration of estimated tax.

Senator DOUGLAS. The record shows that the estimated income is not equal to the actual income in the case of dividends and interest and also not equal to actual income in the case of independent businesses and professional people who get their income directly from the public, without going through the intermediate receiving corporation.

Mr. WILLIS. Senator, as I remember the statistics the refund because of overpayment on the tax returns about equaled in dollar amount the additional tax to be collected.

There was about an offset on the two. There was substantial amount of refunds, too, arising not only from wage withholding but also the declaration of estimated tax.

So quite a——

Senator DOUGLAS. I don't wish to pursue the subject much further, because I do think that you are laying yourself open to the criticism that you are trying to protect the recipients of dividends and interest to a degree that you do not wish to protect the recipients of wages and salaries.

May I ask a question about the——

Mr. THROWER. Senator, if I may comment on that particular statement before we leave it.

Senator DOUGLAS. Yes.

Mr. THROWER. Because I would not want there to be any question about our position.

We don't feel that because withholding is deemed by us to be efficient in aiding the collection of one particular type of income that there is any intent to discriminate if we conclude that it is not efficient in undertaking to collect another type of income, and that is simply our position——

Senator DOUGLAS. You haven't tried it yet.

Mr. THROWER. Of the basic facts.

Senator DOUGLAS. And the same predictions were made by less influential people when the withholding tax was proposed for wages and salaries. It was said to be administratively cumbersome and could not be worked out.

I believe that after a year or two, the bugs were eliminated and the system has gone along very well. The percentage of evasion is relatively slight. The percentage of refunds is extremely high, much greater, I would think, than would be the case of dividends and interest, because the average income of recipients of dividend and interest is appreciably above the average income of those of wages and salaries.

Are you not exaggerating the administrative difficulties?

Mr. THROWER. Well, of course, our representations in our report will have to speak for themselves. But in the one instance you are dealing with payments that may for a year total or average two or three thousand dollars or more, where there is a receipt given to the payee and there is a report and accounting to the Federal Government.

On the other hand, you are dealing with many hundreds of millions of accounts that may be less than, payment items that may be less than $10, maybe 40 cents, 60 cents, with no reporting or accounting in either direction, and our conclusion is not that the income should not be collected, but simply that this particular technique, we think, is not an efficient way to correct the problem of underreporting.

Senator DOUGLAS. May I ask a question about entertainment expenditures which you touch upon?

I take it that you believe that the language under section 274(d) and possibly also (b) is too indefinite, and would be subject to a great zone of uncertainty which would hamper its administration, is that correct?

Mr. THROWER. We think that is true; yes.

Senator DOUGLAS. Wouldn't this be true of any qualitative tests? These are primarily qualitative tests.

For instance, it says business meals under (d) of a type generally considered to be conducive to a business discussion. This involves the comparative merits of a businessman's lunch and an elaborate dinner at the 21 Club or other place of entertainment, the degree to which attendance at "My Fair Lady" or the "Follies," if the "Follies" are still going, would be conducive to operation of businesses.

Mr. THROWER. Well, as to the first, Senator, we would think that the meeting at midday should meet the same tests as the meeting in the evening.

Senator DOUGLAS. You mean that it should require the evening entertainment to be of the same simple characteristic which is ordinarily attendant upon a noon luncheon?

Mr. THROWER. Well, the test, I intended to refer to was the test that it be directly related or attributable to the business or the production of income or whatever the words may be.

Senator DOUGLAS. You find fault with that because you say it is subject to a great zone of uncertainty as to how it is to be interpreted.

Mr. THROWER. Well, would it mean, for example, as to the meeting at midday, that you need not show that it is related, directly related to the conduct of a business?

Senator DOUGLAS. Wouldn't it be simpler if you imposed quantative tests?

Mr. THROWER. Well, I think——

Senator DOUGLAS. Say that a luncheon check was in excess of $5, that would be—that this would be excessive or an evening dinner in excess of $10.

Mr. THROWER. Well, Senator, I think when you attempt to take the complex, varied operations of all different kinds of business, and state them in an arbitrary formula you are producing more problems than you are removing.

Senator DOUGLAS. But you are finding fault with the present definition because these are qualitative terms.

Mr. THROWER. I don't think I intended to do that. I say, the import of my remarks as I intended it, was that there simply are some ambiguities in here which seem evident to us, and that they can be clarified and should be clarified.

Whatever the rule may be, is it intended that entertainment for goodwill be allowed or not allowed? Now that is an important issue.

Senator DOUGLAS. Remember the expression, "Liberty, liberty, what crimes are committed in thy name."

Can it not be now said, "Goodwill, goodwill, what crimes are committed in your name"?

Mr. THROWER. My first statement is that it should be clearly stated one way or the other.

Senator DOUGLAS. Would you favor a provision that entertainment for the purposes of goodwill would not be tax exempt?

Mr. THROWER. It would not be a question of tax exemption. I would say that if the entertainment is for the benefit of a business and is a business expense, as a general proposition we think that business expenses that are legitimate, that is, are not illegal or immoral or against public policy, should be deducted.

Senator DOUGLAS. What would you say about the case of the mortician who spent $5,000 entertaining people on his yacht in Florida and justified it on the ground that it was a business expense to attract future customers, and was successful in maintaining his claim.

Mr. THROWER. As an internal revenue agent, I would find it hard to maintain that position.

Senator DOUGLAS. Well, he was successful in maintaining his claim.

Mr. THROWER. The regulations have required a showing that the expense be attributable——

Senator DOUGLAS. He was building up goodwill on the part of those who would die in the future whose heirs might wish to have this gentleman bury him.

Senator KERR. What he was doing was in order that they might have their heirs bury them.

Senator DOUGLAS. I don't think there was any homicide.

Senator KERR. Not at all, not at all, but I would think that his entertainment of prospective customers might be with reference to the business they would be paying for rather than the business for which their heirs would pay.

Senator DOUGLAS. All right.

Mr. THROWER. Senator, we think there has prevailed very widely and unfortunately a feeling that any expense in this area if it had a very remote business relationship could be deductible.

Senator DOUGLAS. You think there have been abuses?

Mr. THROWER. There is no question about that.

Our feeling is that they, under the present law should not have been allowed.

Senator DOUGLAS. Would trips to Europe to enhance one's professional capabilities? Would that be a proper expense?

Mr. THROWER. We will always have judgment questions whatever the rule may be and that involves——

Senator DOUGLAS. I merely ask your judgment. Is an expense to go to Europe, to go to a meeting of a trade or professional association, a proper deductible item?

Mr. THROWER. Well, I think that if it involved a meeting with foreign businessmen very much interested in the problems——

Senator DOUGLAS. No. I mean a professional association.

Mr. THROWER. I thought you referred to it as a trade association.

Senator DOUGLAS. I was trying to be polite. Let us say professional association.

Senator KERR. A lawyer going over there to an international bar meeting.

Mr. THROWER. Well, there would be a judgment question. I think that it would be the feeling of the American Bar Association that the meeting in London did contribute greatly to the profession, and that those who went to that meeting to participate in that effort were enhancing their own position and enhancing the position of the bar association of both countries.

Senator DOUGLAS. This would include not merely the cost of travel between here and London, but it would include supplementary travel on the Continent?

Mr. THROWER. Well, it certainly would not. It would not include members of families.

Senator DOUGLAS. Did this apply to doctors if the AMA held its meeting in, say, Paris?

Mr. THROWER. I do not think a generalized——

Senator DOUGLAS. If it applies to lawyers that they would enhance their professional skill by going to a meeting of the bar association in London, why would it not enhance the professional skill of doctors by going to a meeting in Paris?

Mr. THROWER. I do not think lawyers could just pick any point on the globe and say, "We want to meet there."

I think the meeting——

Senator DOUGLAS. You prefer London to Paris then? Is it proper to charge up expenses to go to London but not Paris? You mean there may be temptations in Paris which do not exist in London?

Mr. THROWER. Or vice versa.

Senator DOUGLAS. Well, why is it that you say that it is proper to deduct expenditures for London but not for Paris?

Mr. THROWER. I am not undertaking to state a flat position. I did not go on this trip, but I am saying that there was a purpose for the selection of the place of London which was closely related to the aims and purposes of the American Bar Association.

Senator DOUGLAS. British medicine is of a very high order. Antiseptic surgery came from London with Joseph Lister. Would you say it would be proper for the American Medical Association to have its expenditures at a joint meeting in London deducted from income and made nontaxable?

Mr. THROWER. Not simply because there is some relationship, but if it is demonstrable that the purpose of that meeting is to enhance the value of the services of the American Medical Association, then I would think that that would be within——

Senator DOUGLAS. Would this apply in the case of accountants?

Mr. THROWER. What is that?

Senator DOUGLAS. That would apply in the case of accountants?

Mr. THROWER. If they meet a test of that sort, yes.

Senator DOUGLAS. Well, if they meet. Don't you think they would meet this test?

Mr. THROWER. I do not know the facts with respect to the medical association.

Senator DOUGLAS. Why do you think that the travel of the bar association met this test but you are doubtful as to whether the travel of the doctors or of the accountants would meet this test?

Mr. THROWER. Because I know in some detail the reasons for the holding of the American Bar Association meeting in London. I do not know in detail any reasons for the other groups.

Senator DOUGLAS. What about actuaries going to Edinburgh? The Scotch are reputed to be the best actuaries in the world. I always was struck by the fact that most of the American actuaries are of Scotch blood. Do you think that would be a proper deduction?

Mr. THROWER. I simply would not know.

Senator DOUGLAS. Wouldn't you think that American accountants would profit from association with the keenest minds in the actuarial field?

Mr. THROWER. Again, Senator——

Senator DOUGLAS. In other words, you are certain about lawyers, you are not certain about these other professions.

Mr. THROWER. I do not think on the basis of the simple statement of some relationship you could judge the business justification for a trip any place in the world.

Senator DOUGLAS. Are you dubious, then, for instance, about trade associations meeting in Nassau which, I am told, is quite a pleasant place in the wintertime?

Mr. THROWER. I think these are questions of degree, and I am not—not having studied the matter, I do not know where the line is drawn. I do not understand, Senator, that there is any proposal to disallow expenses of attending conventions of one's professional group.

Senator DOUGLAS. Wherever they are?

Mr. THROWER. There is no reference to the limitation of space.

Senator DOUGLAS. But it is a question of whether we should or should not.

As the Senator from Oklahoma and the Senator from Virginia said, Congress is an independent agency and is not confined to the proposals made by the administration.

Mr. THROWER. Well, I do not understand that the proposals made by the House extended any geographical limitation.

Senator DOUGLAS. Nor is the Senate confined to the proposals made by the House.

Mr. THROWER. Consequently, I have not studied that particular thing. I think, as in regard to many of these other questions, it is a matter of degree.

Senator DOUGLAS. Would not the situation be improved if certain quantitative tests and standards were laid down in the bill so that we would not have the vaguenesses of interpretation which can be stretched for one group but applied more rigidly to another group? Aren't you really making an argument for a precise definition of quantitative qualifications?

Mr. THROWER. Senator, as a general proposition, I do not think there is any substitute for judgment in this area. I do think, we do think, that administration will be greatly improved by some of the measures that have been proposed, and it will be simplified.

We have pointed out that we think there are still some ambiguities that will create problems if they are not clarified, as all ambiguities do.

Senator DOUGLAS. May I turn to the question of the taxation of foreign corporations, particularly the controlled foreign corporations, and the subsidiaries of American-owned foreign corporations.

This is a highly complicated subject, and I confess that I certainly am not an expert in the field and, of course, I am not a lawyer.

Am I correct in inferring that one of the differences between the taxation of American corporations at home and the taxation of American-owned corporations abroad is the fact that here at home earnings are taxed as they are made, whereas abroad earnings are taxed only when transmitted back to the United States?

Senator KERR. Would the Senator repeat that question?

Senator DOUGLAS. I did not interrupt the Senator from Oklahoma.

Senator KERR. I was paying very close attention. I did not understand the question. I beg your pardon.

Senator DOUGLAS. Not at all.

Senator KERR. I thought he said "abroad earnings"; I beg your pardon.

Senator DOUGLAS. I will try to restate it for the benefit of the Senator from Oklahoma, who normally has very acute ears and very sharp sense.

Senator KERR. I admit both.

Senator DOUGLAS. I started out, may I remind my colleague, with the statement that I certainly am not an expert in this field, not a lawyer, but seeking enlightment, and I hope the Senator will bear with me in my efforts.

Senator KERR. Will the Senator yield right there?

Senator DOUGLAS. No; I will not.

Do I understand that the main difference between the taxation of the earnings of American corporations incorporated in this country

and the taxation of American-owned foreign corporations differs primarily in this respect:

That the earnings of domestic corporations are taxed annually as made, whereas in the case of foreign corporations the earnings are taxed when they are transmitted back to the United States. But as long as they are held in foreign corporaitons, taxation is deferred. Is that question clear to you?

Mr. THROWER. The question, I think, is clear.

Senator DOUGLAS. Is my understanding correct or erroneous?

Mr. THROWER. Let me ask Mr. Appert, if he will, to comment on that.

Senator DOUGLAS. Yes.

Mr. APPERT. Senator, I think that the net result sometimes amounts to this, although I do not think your statement covers the principle in full. The answer really is that foreign corporations are taxed only on income from U.S. sources, and American corporations are taxed——

Senator DOUGLAS. I am speaking of the difference between American corporations doing business at home and American corporations doing business abroad and/or incorporated abroad.

Mr. APPERT. Well, you have two different results there.

Senator DOUGLAS. Yes.

Mr. APPERT. An American corporation is taxed on income regardless of source, so if it directly operates abroad it is taxed on income as that income is earned.

If the American corporation has a foreign subsidiary, the foreign subsidiary is not taxed at all unless it earns income from U.S. sources.

Senator DOUGLAS. That is the point I want to make. Taxation on the earnings made abroad, will only be taxed when they are sent back to the United States.

Mr. APPERT. They will be taxed in this country.

Senator DOUGLAS. That is correct.

Mr. APPERT. They will be taxed in the country where the company is operating.

Senator DOUGLAS. Suppose a foreign subsidiary of an American corporation is based in the Canton of Zug in Switzerland or in the principality of Liechtenstein, in both of which places, as I understand it, there are no personal income taxes and no corporate income taxes; isn't that correct?

Mr. APPERT. There are no corporate income taxes under certain circumstances.

Senator DOUGLAS. Isn't it true in general that there are no income taxes in Liechtenstein, no corporate income taxes in Zug, and very low personal income taxes in Zug; isn't that true?

Mr. APPERT. At least it is true that certain types of arrangements can be set up so you do not have to pay taxes.

I am not so sure about the precise laws of these countries with respect to corporations which are actively doing business in those countries, so far as they are concerned, but certainly it is true that certain types of income can flow in and not be taxed.

Senator DOUGLAS. Yes.

Now, do you think this is equitable to tax American industry at a higher rate than the earnings of——

Mr. APPERT. It was thought for a time that it was not equitable, and there was a proposal, as you may recall, in the Boggs bill to permit the deferment of tax on the foreign income of American companies that were operated directly abroad. So there is some problem in this area.

You also have jurisdictional problems. How do you tax foreign entities and where do you draw the line?

Senator DOUGLAS. Are you saying such a tax as this would be unconstitutional?

Mr. APPERT. I think it depends, Senator. I certainly think there are grave constitutional problems in section 13 as it is drawn in this bill, which would go so far as to tax an American shareholder who had as little as 10 percent of a foreign corporation.

After all, this bill is drawn so that if 51 percent of the stock is owned by people in this country, although they are completely unrelated, and any one individual has 10 percent either actually owned or attributed to him, he is taxed on his share of the income of the foreign corporation concerned, even though he has no actual control of whether the income is distributed to him or not, and even though it might not be removable from the foreign corporation.

Senator DOUGLAS. Are you speaking of the foreign personal holding company?

Mr. APPERT. No, I am speaking of section 13 which is misnamed, "Controlled Foreign Corporations."

The point there is that this provision is extended far beyond any element of real control, and that is why we object to that section.

Now, when you get into the other area of an actual control, I think there is less of a constitutional problem. You may have some constitutional problems even there, because in this situation the tax is not on the foreign corporation.

We have no jurisdiction to tax it, and we are taxing an American corporation on income that has not yet been its income, or it may be an American individual. This is not limited only to American corporations——

Senator DOUGLAS. I understand.

Mr. APPERT (Continuing). Which own stock in a foreign corporation.

Senator DOUGLAS. There is a very real question as to a movie actor who goes abroad, gets high income, establishes residence abroad, and still holds American citizenship, there is a very real question as to whether he should be exempt from paying taxes.

Mr. APPERT. Senator, this is another question. It does not tie in with section 13.

Senator DOUGLAS. But it is the same thing. The question is whether you should give more favorable tax treatment to American corporations and individuals living or doing business abroad than you give to corresponding corporations and individuals doing business and living here at home.

What justification is there for this?

Mr. APPERT. Well, Senator, so far as the proposal to limit the exemption on income earned by individuals abroad is concerned, we have voiced no objection to that. We feel that is entirely a matter of policy, a question of weighing the necessity of giving some tax incentive—I think this might be a term which the Senator from Oklahoma

might be interested in using, as an answer to this colloquy that went on before.

Senator DOUGLAS. Come to the point, please.

Mr. APPERT. A tax incentive may be what we are talking about here.

Senator DOUGLAS. You mean you favor using the taxing system to encourage investment abroad?

Mr. APPERT. Well, we are skipping now back and forth from the individual earning problem to the foreign corporation problem.

Senator DOUGLAS. I am talking about the corporate tax now. You agree with us on individuals. I am talking about the corporation. You favor giving favorable tax treatment to companies investing abroad as compared with companies investing at home?

Mr. APPERT. This is not a question of favorable tax treatment to companies investing abroad as against investing at home. It is a question of whether you tax foreign corporations or you do not.

Senator DOUGLAS. These foreign corporations that I referred to are American subsidiaries of American companies.

Mr. APPERT. Not in every instances where they are hit by this bill.

Senator DOUGLAS. Well, would you favor this where they were subsidiaries of American corporations?

Mr. APPERT. I think there is a stronger case if you limit the application of section 13 to a wholly owned subsidiary of an American corporation.

Senator DOUGLAS. Or a predominantly owned subsidiary.

Mr. APPERT. Or a controlled, actually controlled, subsidiary. I think you have a much better case for that than you have in this broadgaged——

Senator DOUGLAS. Would you approve of it?

Mr. APPERT. I have reservations about it.

Senator DOUGLAS. I see.

Mr. APPERT. I have reservations about it.

Senator DOUGLAS. I thought we were about to get agreement on it. So you are not in favor of even that?

Mr. APPERT. I think there is much less of a problem when you confine this to the wholly owned subsidiaries. But then you get into the question of, Do we want to discriminate from a competitive standpoint in taxing a wholly owned subsidiary one way and taxing something which is not quite wholly owned a different way?

So I do not think I can say without reservation that I approve of taxation of a wholly owned subsidiary either. I think it is grossly unfair and probably unconstitutional to tax something that is not controlled directly by the shareholders.

But when you get to the other area I do not think you have quite the same constitutional problem. But I think there are a lot of policy questions that militate against taxation of this.

Senator DOUGLAS. I am a very simple man with a very simple and rudimentary mind on these things. I want to come back to the basic question. Should you give tax advantages to the investment of American capital abroad which are not given to the investment of American capital at home?

Mr. APPERT. Well, you get these advantages only because the foreign companies in which this income—the foreign countries in which this income is generated have more favorable tax rates than ours. If

they do not, there is not any tax advantage. You are paying foreign taxes that are——

Senator DOUGLAS. Yes; but I pointed out that there are tax havens abroad which do not exist at home, and I can give other examples: There are two other cantons in Switzerland, I think, in addition to Zug, which have virtually no taxation of either corporate or personal income.

There are tax havens in the Western Hemisphere, notably the Bahamas and certain other places which we are trying to locate.

Mr. APPERT. I do not think, Senator——

Senator DOUGLAS. I believe Morocco is a tax haven also.

Mr. APPERT. I do not believe, Senator, there is any question about the fact that there are abuses in this area, and that legislation to cure abuses, if necessary, should be enacted. I think a great many of the abuses can be remedied under existing law. I think section 482, even as it now stands, without any amendment, permitting the reallocation of income between affiliated companies can do away with a lot of the abuses.

In other words, in any situation where what is really the income of an American company is diverted and made to look like the income of a foreign corporation from foreign sources by transactions that are not at arm's length, it can be reached here. Anything that is a real diversion of income can be reached.

I think methods could be arrived at for taxing unreasonable accumulations, taking away the incentive to accumulate, and distribute ultimately at capital gains rates.

Senator DOUGLAS. Would you apply a qualitative test to that?

Mr. APPERT. I think you can apply the same quantitative test on that——

Senator DOUGLAS. Are you opposed to using quantitative tests?

Mr. APPERT. I do not understand what you mean by quantitative tests.

Senator DOUGLAS. I mean, as I did referring to entertainment.

Mr. APPERT. If you mean the statute should set down a definite dollar amount and so forth, I would be inclined to oppose it. I think the test of reasonableness that we apply to the penalty surtax on unreasonable accumulations of domestic corporations can be applied in this other area.

Senator DOUGLAS. Why do you think Congress gave this more favorable treatment to American capital invested abroad than American capital invested at home? Have you gone into the history of that?

Mr. APPERT. This is a natural growth. It is not a question really of anything being given. It is a question of——

Senator DOUGLAS. Accorded. Strike the word "given." Why did Congress accord?

Mr. APPERT. It was a question of basic jurisdiction to tax.

Senator DOUGLAS. You think that was it?

Mr. APPERT. I think so.

Senator DOUGLAS. Or was it granted in the belief that it was important to build up Western Europe?

Mr. APPERT. No; I do not think so.

Senator DOUGLAS. I think if you will go into the history of the act, it is said one will find that one of the reasons for the passage of these provisions was the belief that after the war Western Europe needed to be built up, American capital should go there, and so forth. I want to correct my statement. I am told that is not correct.

Mr. APPERT. This has been something that is historic so long as the income tax provisions have been in effect. In fact, this thought that you had just expressed has come to you from some place else. There has been a lot of talk to that effect, and it is one of the disturbing things about this.

Senator DOUGLAS. I am glad to have the record corrected on this point.

Mr. APPERT. It is spoken of as a grant. It was not.

Senator DOUGLAS. Whether this would be the reason for the origin, it has certainly been an argument which has been advanced to justify its continuance. Do you think that in the case of Western Europe they are so retarded as to deserve this inducement to American investment?

Mr. APPERT. Well, I am not so sure that it is a question of inducement. It is a question of competition abroad.

Senator DOUGLAS. I have heard people argue at previous sessions of this committee that you should not eliminate this because we do need to build up the prosperity of Western Europe.

Mr. APPERT. Well, I am not so sure that that should be the sole test here.

Senator DOUGLAS. Are you certain that it should not be?

Mr. APPERT. Well, let me put it this way: I think the real question is whether it is to the advantage of the United States to encourage a participation by U.S. citizens in worldwide investment or are they going to be handicapped by less favorable tax rules in this country than other countries impose on the investments of their nationals.

Senator DOUGLAS. Does this mean that we should let Zug, Liechtenstein, and Nassau set the pace for the American taxation?

Mr. APPERT. Well, in a sense, yes; in a sense, yes, because what often happens here is that these countries, the incorporations in the so-called tax haven countries, are used not to avoid American taxes but to avoid local taxes in other countries.

You have royalties that flow from, say, a German corporation to a Swiss company which reduce the taxable income in Germany, and then are not taxed in Switzerland.

Now, to the extent that these things are successful in reducing these foreign taxes, it means that more is ultimately brought home to this country to be taxed. So I am not at all sure that these things are bad from the American standpoint.

What we can do, I think, is to take some means of seeing that there is not an undue delay in getting them back, an unreasonable accumulation abroad.

Senator DOUGLAS. How would you define "undue" and "unreasonable"?

Mr. APPERT. Well, it is a question of—the same test we use today in determining whether the income of a corporation is accumulated beyond the reasonable needs of the business, and if you have just a pure

holding company that is just accumulating funds in a Swiss bank you have a pretty clear case that it is an unreasonable accumulation.

Senator DOUGLAS. Of course, that accumulation of funds can be in a numbered account which you cannot identify.

Mr. APPERT. Well, I think that that difficulty will largely be overcome by these new information requirements. Numbered account or not, the responsibility is being put upon American controlling corporations to divulge the transactions with their foreign affiliates and between the foreign affiliates. So that I think from now on the Treasury will have——

Senator DOUGLAS. Will our law supersede the Swiss law?

Mr. APPERT. Well, you do not go to the Swiss bank. You get the American owner of this and ask him what he has put in. You do not have to find out.

Senator DOUGLAS. Is he given sanctuary under Swiss law?

Mr. APPERT. I am sorry, I did not understand.

Senator DOUGLAS. Can he claim sanctuary under Swiss law?

Mr. APPERT. I can't see how an American can claim sanctuary under Swiss law with respect to what he has abroad.

Senator DOUGLAS. You still have doubts as to the constitutionality of these provisions?

Mr. APPERT. Of section 13 as written, I most certainly do.

Senator DOUGLAS. Are you acquainted with the existing law dealing with foreign personal holding companies?

Mr. APPERT. Yes, Senator, I am.

Senator DOUGLAS. Doesn't that provide for the taxation of income as earned?

Mr. APPERT. It provides for the taxation of the undistributed income as if it were a dividend to the shareholders.

Senator DOUGLAS. Are you aware that has been held constitutional by the circuit court of the second circuit?

Mr. APPERT. Indirectly it was. It has never been passed on by the U.S. Supreme Court.

Senator DOUGLAS. I know, but never carried on appeal to the Supreme Court.

Mr. APPERT. That is correct.

Senator DOUGLAS. The decision, as I understand it, in the second circuit was that this taxation was constitutional.

Mr. APPERT. I might even mention, Senator, that the taxpayer in that case did not even question the constitutionality in his brief. He said in his brief that he did not question the constitutionality of the foreign personal holding company provisions.

What he was questioning was the constitutionality of taxing under the foreign personal holding company provisions income that was blocked in one of the South American countries. I cannot remember at this moment which one.

Senator DOUGLAS. Is it not true that the controlling opinion in dealing with this law is that the tax is constitutional?

Mr. APPERT. Well, it is the only opinion—there are only two opinions, one in the *Eder* case in the second circuit which, I think, must be construed as passing on the constitutionality of the law because a fortiori if it is constitutional to tax blocked personal holding company income to the shareholders——

Senator DOUGLAS. You are exactly right.

Mr. APPERT. A fortiori I think you can tax unblocked income of the corporation to the shareholders. So that case stands for the proposition. It has not been passed on by the U.S. Supreme Court.

Senator DOUGLAS. No appeal was taken.

Mr. APPERT. And no appeal was taken, that is correct.

As I said, the taxpayer did not even question the constitutionality of the section, so it really has not been litigated.

Senator DOUGLAS. I think it was litigated. Is not the decision of the circuit court presumptive evidence until it is overruled that such a tax is constitutional? I had always assumed that if a circuit court passed on a question of constitutionality in a case, decided it favorably, that in the absence of it being overruled by the Supreme Court this could be presumed to be the constitutional law of the land.

Mr. APPERT. My only point is that the decision was reached without anybody really arguing that the foreign personal holding company provisions were unconstitutional.

Senator DOUGLAS. Don't you think this creates a very strong presumption in favor of the constitutionality?

Mr. APPERT. I do; and I think there is quite a difference here.

Senator DOUGLAS. Would you pardon a person who is not a lawyer saying that he somewhat doubts the constitutional arguments of the lawyers in this matter?

Mr. APPERT. Well, you have ignored the point that I am making, though. In the foreign personal holding company provisions you have dealt with an individual; in every case where that has been up you have dealt with an individual or a small family group that actually had control of this corporation. You are dealing with a corporation that is an incorporated pocketbook in the sense of merely holding securities in other corporations and not transacting business and having a real business purpose in that sense. I think there is quite a distinction between those two situations.

I am not at all sure that even the foreign personal holding company provisions would be upheld as constitutional against some individual shareholder who was not at all related to the controlling shareholders and had no connection with the determination of whether dividends are distributed or not.

Senator DOUGLAS. The only way to find out is to try it; isn't that correct?

Mr. APPERT. That is correct. It has not been done; I merely point out it has never been done. It has never been tested.

Senator DOUGLAS. The presumptions of the Circuit Court are that it would be constitutional.

Mr. APPERT. I am not sure about that, Senator, because the case before it dealt with a family group that did control it. I do not think you have much of a question about the U.S. Supreme Court being willing to attribute to a family group the characteristics of a single taxpayer, and that is what——

Senator DOUGLAS. Yet wholly owned subsidiaries abroad would be subject to taxation on earnings as made, would they not, constitutionally?

Mr. APPERT. I think that probably the court would hold those constitutional. There is a dicta——

Senator DOUGLAS. Or where 51 percent of the stock was owned.

Mr. APPERT. There is a dicta to that effect in the *National Grocery Company* case. There the Court, the Supreme Court of the United States, was dealing with the question of the propriety of putting a penalty tax on the corporation for failing to distribute earnings to the stockholders.

In the course of the decision the Court remarked that the single individual stockholder could, if Congress made the law that way, be taxed on the earnings of the corporation. This was dicta. It was not the point up for consideration by the Court.

But I think it is a strong indication, along with the decision in the *Eder* case, that the Court would probably uphold as constitutional a tax where there is real control.

Senator DOUGLAS. I want to point out that this opinion of yours is quite different from the brief, the statement submitted by a representative of the American Bar Association, which rather threw the weight on the constitutional question against the probable constitutionality of such a measure.

Now you are saying that the case of wholly owned subsidiaries or subsidiaries where an American corporation owns a controlling interest or exercises a controlling interest, that the presumption would be in favor of constitutionality.

Mr. THROWER. What brief was that to which you were referring?

Senator DOUGLAS. Well, excuse me, testimony, your testimony. I thought that the weight of your testimony was that such tax would be of very doubtful constitutionality.

Mr. THROWER. I was referring in my testimony, Senator, to—specifically to—the minority stockholder not related to the controlling group, and I believe that would be perfectly consistent with what Mr. Appert has just said.

Senator DOUGLAS. Isn't it true that in section 13 we are dealing with 51 percent U.S. ownership, 10 percent individual or corporate ownership, and isn't this controlled?

Mr. APPERT. I do not believe it is. I think that is one of the main difficulties with the section.

Senator DOUGLAS. Fifty-one percent U.S. ownership is not controlled?

Mr. APPERT. Fifty-one percent in any one individual or any one individual or corporation which may be regarded for tax purposes as a single person is control. Fifty-one percent scattered widely over the United States is not control, and the bill hits both.

Senator DOUGLAS. Would you say that the Ford Motor Co. of England would be subject to section 13 as it is now drafted?

Mr. APPERT. I am not quite familiar with the stockownership in that corporation.

Senator DOUGLAS. I believe the Ford Co. of the United States owns a majority of the stock in the Ford Co. of England.

Mr. APPERT. Well, that would certainly be hit by section 13.

Senator DOUGLAS. And you think it should be?

Mr. APPERT. As I say, I am not quite sure—well, do you ask me do I think it should be, or do I think it could be constitutional? I told you——

Senator DOUGLAS. Let us first say or ask, could it be constitutional?

Mr. APPERT. As I said before on that point, there has been no clear-cut decision. I think there are indications that the Supreme Court would hold it constitutional if there was actual control.

Senator DOUGLAS. Do you think it should be?

Mr. APPERT. So far as whether it should be, I have misgivings as to whether we should discriminate where you have a foreign operation, a foreign corporation, and income being generated abroad; as to whether the foreign corporation, just because it is controlled here, should be treated differently than the foreign corporation that is not controlled here when the two have to compete with each other.

Senator DOUGLAS. If I may turn to this challenge to the investment credit through taxation which Mr. Thrower laid down. As I understood it, he said that income of corporation taxes should not be used to stimulate one form of consumption or investment as compared to others.

Did I understand that correctly, that the tax system should be neutral in a sense on purposes for consumption or investment?

Mr. THROWER. I intended to say as a matter of general principle we felt that it was in the public interest that nonrevenue matters not be brought into the Internal Revenue Code.

Senator DOUGLAS. It is precisely on this point that I have been skeptical of the investment credit, and I wanted to hear more argument on it.

I tend to be skeptical of investment credit on just this one point.

Let me ask you this: Do you favor then the repeal of the 4-percent dividend tax credit which permits the deduction from taxes of 4 percent of dividends received?

Mr. THROWER. Well, I would think that it would have to be said with respect to that, Senator, that that is related to proper income determination and taxing.

Senator DOUGLAS. Oh, no, no; it is not.

Mr. THROWER. If I may refer back, I think the initial proposal was made in recognition of the fact that there was a double taxation of corporate earnings to the extent that they were distributed in this country. For those corporations that were in a 52-percent bracket, where taxes were paid on a dollar of earnings, and where they, as corporations, were encouraged to and did distribute a substantial part of the remaining portion of the dollar, say, up to 70 or 80 percent, and that was taxed again to the individual recipients, the portion of the total dollar of corporate earnings taken in taxes was extremely high, particularly in relation to what other industrial countries were doing, and it was recognized that there should be some alleviation of that.

I think the initial proposal was substantially more.

Senator DOUGLAS. So far as other countries are concerned, I think you will find that virtually all the countries, with the possible exception of one, have a rate of taxation on corporate profits of approximately 50 percent, approximately the same as ours, and, in general, the rates of individual income taxation in most of these countries are either equal to or in excess of our own.

Mr. THROWER. I think that——

Senator DOUGLAS. So that I think an examination of the comparative tax structures rules that argument out.

Mr. THROWER. Well, I think it could be briefed, Senator, and if it would be helpful, we certainly would be happy to submit a memorandum on that, that corporate earnings to the extent that they are distributed are generally not taxed in the other industrial countries as high as they are here.

For example, in England, I believe, that the credit there is given to the corporation when it distributes. I am not really prepared on this, but that is my recollection, and we could, if you wish, give you a memorandum on that.

I would say as to that my real answer was that the credit is related to proper income taxing and determination. Whether you have it, or whether it is good or whether it is bad, it still is related as compared to these other things that are not related.

(The following was later received for the record:)

MEMORANDUM—TAXATION OF DISTRIBUTED CORPORATE EARNINGS BY LEADING FOREIGN INDUSTRIAL COUNTRIES

In the summary tabulations below it should be noted that the British avoid double taxation of dividends in a substantial measure by requiring the dividend recipient to "gross up" the dividend and by permitting a credit for the standard tax paid by the corporation (38¾ percent).

The West Germans avoid double taxation in a substantial measure by a difference in tax rates on undistributed profits and distributed profits.

The Canadian and the Japanese permit liberal credits to the individual taxpayer on dividend income.

The French have lower individual rates, but do not seek directly to avoid double taxation.

UNITED KINGDOM

On individuals:

The standard tax graduates from about 8½ percent on the first $168 to 38¾ percent over $1,008.

The surtax graduates from 10 percent on the first $5,600 to 50 percent over $42,000.

On corporations: The standard tax is 38¾ percent; the profits tax is 15 percent, or a total of 53¾ percent.

On dividends to resident shareholders: The individual "grosses up" the dividend and takes credit for the amount of the standard tax paid by the corporation. Thus, there is only one tax at standard tax levels.

Dividends are taxable for surtax purposes to the individual. The corporation, however, may have profits tax relief on distributions to reduce the double tax.

WEST GERMANY

On individuals: Tax is 20 percent on first $2,000; 53 percent over $27,500.

On corporations: Tax on undistributed profits is 51 percent; tax on distributed profits is 15 percent.

On dividends to resident shareholders: The effect of system is that shareholder reports the dividend: which has been taxed at 15 percent by the corporation.

CANADA

On individuals: Tax is 11 percent on first $1,000 to 80 percent over $400,000.

On corporations: Tax is 21 percent on first $35,000; 50 percent over $35,000.

On dividends to resident shareholders: Tax on dividends is 15 percent but taxpayers are given a 20-percent credit on dividends received.

JAPAN

On individuals: Tax is 10 percent on first $138.50 to 70 percent over $138,500.

On corporations: Tax is 8 percent on $1,400, 10 percent on $1,400 to $2,800, 12 percent over $2,800; also 33 percent up to $5,600, 38 percent over $5,600, or a total of 50 percent over $5,600.

On dividends to resident shareholders: Taxpayers are given a 20-percent credit on dividends received.

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FRANCE

On individuals: Tax is 5 percent on first $444 up to 65 percent over $12,210.
On corporations: Tax is 50 percent.

Senator DOUGLAS. All right. Let us turn to another facet of the same principle.

You favor the existing, the provision in the House bill, on lobbying expenses. This encourages, of course, expenditures on lobbying.

Would you say that this violated the principle of integrity of the tax structure in encouraging one set of expenditures?

Mr. THROWER. Senator, to the extent that the expenditure constitutes a legitimate business deduction we would think that it ought to enter into the computation of what the tax will be upon the income of that business.

Senator DOUGLAS. That begs the question.

Mr. THROWER. The initial ABA proposal, of course, was in the presentations to committees of legislative bodies. But I do not think that is in any way inconsistent with the principle I stated. We would think if it is a legitimate business expense directly related to the conduct of the business, like other expenses, it should be deducted, unless it is against public policy in some way. The activities covered within our recommendation, and I think within the recommendation of the House or the House bill, would not be against public policy.

Senator DOUGLAS. Do you think then that H.R. 10, which your association has sponsored, violates the principles of the neutrality of the tax system which regards certain types of expenditures more favorably as compared to others. Does not this encourage voluntary purchasing of insurance, of annuities by independent professionals and businessmen by giving them tax favors which are not accorded to others?

Mr. THROWER. If we were discussing pension and profit-sharing plans from the very initiation there might, I think, be merit in your suggestion.

While I am not prepared to state the case of the bar association on H.R. 10, as it should be stated, I do think that one of the primary supports for the proposal is that there is a discrimination against the professional man who cannot incorporate, and against others in similar positions, that others have gotten relief from very high rates through such things as pension and profit-sharing plans, capital gains and the like, and that it is the rare individual, and frequently the professional, who really pays surtax rates on all of his earned income.

Senator DOUGLAS. In other words, since this privilege has been given to the employees of corporations it should be accorded to the independent professional.

Mr. THROWER. I think that basically would be one of the reasons.

Senator DOUGLAS. If this is true, should it not also be accorded to employees of companies which do not have retirement plans?

Mr. THROWER. Well, I had not given consideration to that.

Senator DOUGLAS. We have got to give consideration to it, the Members of Congress.

Mr. THROWER. Well, as I say, I did not come prepared to discuss that.

Senator DOUGLAS. Your association, with the American Medical Association, have been the two strongest groups in advocating H.R. 10, which was passed out of this committee, which was reported out of

this committee, which is now before the Senate, after having passed the House, and which is trembling on the verge of enactment.

You do not wish to pass judgment as to whether this should be extended to employees of companies which do not have retirement plans but who may wish to take out voluntarily policies?

Mr. THROWER. I have not seen any analysis of such a proposal or really given any consideration to it, and I could not comment on it.

Senator DOUGLAS. Mr. Thrower, we have got to give consideration to this.

Mr. THROWER. Well, I am sure that the group within our association that is more closely identified with this proposal and familiar with it would be happy to submit something with respect to that to you.

Senator DOUGLAS. I would be much interested in any statement they make.

Would you say that the recipients of benefits under the railway retirement system should have their compulsory contributions exempted from taxation?

Mr. THROWER. Well, I am simply not prepared to extend into that.

Senator DOUGLAS. What about civil service, people on civil service?

Mr. THROWER. I would have to make the same comment as to that.

Senator DOUGLAS. Or those under social security?

Mr. THROWER. Well——

Senator DOUGLAS. What about savings for education, the education of one's children? Is retirement any more socially beneficial than the development of the natural abilities of one's sons and daughters?

Mr. THROWER. Well, I think I introduced the comment you asked for on this particular subject by saying that I think the approach to it might be somewhat different if we were taking up the entire problem from its initiation.

Senator DOUGLAS. You say you would hold the line against the request for having savings for education exempted from taxation; isn't that true? You have refused to endorse that, isn't that true?

Mr. THROWER. We have been urged to endorse it. We have not yet endorsed it.

Senator DOUGLAS. You have not done so, that is right. But you have endorsed exemption for savings by independent professionals to provide retirement benefits in old age.

Mr. THROWER. That has been an outstanding position of the association for many years.

Senator DOUGLAS. Isn't it inconsistent to favor something which benefits you but not to favor something which benefits others? What about savings to purchase a home? Is not homeownership highly important in society? Is not the homeownership one of the physical attributes around which family affection is built?

Mr. THROWER. Well, I do not really understand the question. Certainly the savings for homeownership——

Senator DOUGLAS. Should you not exempt from taxation money spent for the purchase of a home?

Mr. THROWER. I do not think that is proposed, certainly not——

Senator DOUGLAS. Some people are proposing it, yes, indeed.

You have reservations on all these points, and I have them, too. But you do not seem to have reservations on exempting from taxation amounts contributed by lawyers for future pensions. I have reservations on that point, too.

Mr. THROWER. Well, Senator——

Senator DOUGLAS. I have the same reservations about your profession that you have about other professions.

Mr. THROWER. I did not know, Senator, that I had expressed any reservations about any professions. I think I did make it clear——

Senator DOUGLAS. About other occupations.

Mr. THROWER (continuing). That within the broad principle that I stated, if we now faced the question anew as to whether or not pensions and profit-sharing plans should be made available to the corporate employee or the employed nonowner of the unincorporated business, the principle might indicate that it would be a move in the wrong direction to adopt such a plank.

Senator DOUGLAS. That is if we had gone back. I had proposed to this committee that we roll back and repeal those special exemptions for deductions of corporate contributions to pension funds. But, failing that, and I was not successful in that and I think Senator Gore and I were the only two who voted for it, but failing that, would you say you should stop with the independent professional? If you grant it for the independent professional, don't you have to go logically to the employees of companies which do not have plans but who individually want to take out policies, and then the recipients of railway retirement, the recipients of military pensions, the recipients of military service pensions, the recipients of social security, to the savings for homes, to the savings for the education for children and so forth. In the end you wind up with virtually all of the income of the country exempt from taxation except expenditures on consumption of material objects. That is where all these exemptions are leading you.

This is one of the reasons, Mr. Chairman, I am more than skeptical about this investment credit because I think it is a member of the same family, that has helped to disintegrate our whole tax structure.

Mr. THROWER. Senator, you may be interested in this. We have recently appointed a committee, we think it will be a committee of the most able of our members, to make a study of substantive tax reform which, I believe, will go into all these matters, including the matter of rate reduction.

Senator DOUGLAS. I hope you will also go into H.R. 10.

Mr. THROWER. I would think under the present state of the law that it would be evident that many of those who have high individual earnings, and there are professional people within the group, and who are dependent upon those earnings and have none of the corporate benefits, have none of the capital gains benefits, that there is a high degree of discrimination in the sense that they are bearing proportionately a much larger portion of the tax burden than others.

Senator DOUGLAS. Would you favor the repeal, then, of the provisions exempting from taxation corporation contributions to pensions, voluntary corporate contributions to pensions of their employees?

Mr. THROWER. I really am not prepared to take any position. I certainly would not be authorized as a representative of the section of the association to take any position with respect to that.

Senator DOUGLAS. As long as corporate employees are getting it, you think the independent professional should get it?

Mr. THROWER. I do not believe I stated it exactly that way or that I would state it that way exactly.

Senator DOUGLAS. Well, in substance, that is correct?

Mr. THROWER. If it is accepted as a part of our national tax policy, then, I think it is important as to whether some attention——

Senator DOUGLAS. The question is, Should it be exempted?

Mr. THROWER. Then some attention should be given to the problems of the man who is paying a disproportionate part of the tax burden.

Senator DOUGLAS. All right.

What about those who are saving to educate their children?

Mr. THROWER. Well, I am doing that myself, Senator, and I recognize they have a problem. I do not think it is a tax problem, as I have stated previously.

Senator DOUGLAS. I thank you very much.

Senator KERR. Mr. Chairman, may I have a moment?

The CHAIRMAN. Senator Kerr.

Senator KERR. First, I would like to put into the record at this point a release of the U.S. Department of Commerce on reports required on foreign investments and licensing, because I think it throws some light on the question of the reporting requirements for international investors and licensors who are contemplated to be subject to some of the provisions of section 13.

The CHAIRMAN. Without objection.

(The document referred to follows:)

[For immediate release Monday, Apr. 23, 1962, OBE 62-35]

U.S. DEPARTMENT OF COMMERCE, OFFICE OF BUSINESS ECONOMICS

REPORTS REQUIRED ON FOREIGN INVESTMENTS AND LICENSING

New reporting requirements for international investors and licensors were announced today by the Office of Business Economics, U.S. Department of Commerce, in a major effort to improve the data now used in the balance-of-payments accounts.

Under the new regulations, U.S. business firms and others holding substantial interests in foreign firms—generally 10 percent or more of the controlling stock—are required to file regular reports on their intercompany transactions. Similar reports are required of U.S. firms substantially controlled abroad, and a further report must be filed by firms receiving or paying royalties and license fees.

Up to the present, statistics on these international investments, income flows, and licensing operations have been collected on the basis of voluntary reports filed by sample groups of leading firms. The Office of Business Economics of the Commerce Department, which is responsible for the preparation of the balance-of-payments accounts, expects the new mandatory reporting system to strengthen these essential data in three ways: by broadening the coverage, improving the accuracy and timeliness of the reports, and producing new figures on certain types of investments not previously covered.

Underlining the importance of these new reports, the Department noted that U.S. investments abroad are now valued at nearly $37 billion, account for annual capital outflows of $1.6 billion, earn over $3½ billion a year abroad and remit about $3 billion to the United States annually as income, royalties, and fees.

The foreign direct investments in the United States covered by the new reporting system total some $7 billion.

Reports must be filed by those persons or business firms having the type of foreign business investment or foreign control mentioned above, as specified in more detail in the instructions available with the reporting forms. Certain of the forms are quarterly and must be filed beginning with a report for the first quarter of 1962. Other reports are annual, and the first report is to cover the calendar year 1961.

Completed reports are to be filed with the Office of Business Economics, U.S. Department of Commerce, Washington, D.C. Additional information and copies of the regulations and forms may be obtained from that Office or the Commerce Department field offices throughout the United States.

Details of these requirements and the regulations concerning the reports are published in the Federal Register dated April 21, 1962, and are codified in the Code of Federal Regulations under title 15, chapter VIII, part 803.

Senator KERR. Then I would like to say, and I would like for the Senator from Illinois to hear it, that the Senator from Illinois today, when I asked him a question, said not only that he would not yield but that he would not permit interruption and, in justification, stated that "I do not interrupt the Senator from Oklahoma."

On last Friday the Senator from Oklahoma was interrogating a witness in what he regarded as a much less rigorous cross-examination than that conducted by the Senator from Illinois with reference to the witnesses before him today, and the Senator from Illinois did interrupt the Senator from Oklahoma and stated for the record and publicly that he resented the rudeness and the discourtesy of the Senator from Oklahoma in conducting of the cross-examination.

I want to say publicly that I did not resent the Senator from Illinois interrupting me then, nor do I ever resent it, or fear it, but welcome it, because there is no one with whom I would rather clash swords orally than with the Senator from Illinois.

I was just amused and not even resentful when today the Senator from Oklahoma offered what he thought was a much less rugged interruption of the Senator from Illinois, that the Senator from Illinois refused to yield, and stated that he did not interrupt the Senator from Oklahoma and, therefore, would not permit the Senator from Oklahoma to interrupt.

Senator DOUGLAS. Is the Senator from Oklahoma finished?

Senator KERR. No, sir; I have concluded my statement. [Laughter.]

Senator DOUGLAS. It is always difficult to know how to deal with the Senator from Oklahoma.

Senator KERR. That is one of the assets of the Senator from Oklahoma. [Laughter.]

Senator DOUGLAS. At times I try to turn the other cheek. I do not seem to be successful in altering the methods of the Senator from Oklahoma. At other times I strike back in the same manner that the Senator from Oklahoma strikes, although not as effectively or with the same caustic wit as the Senator from Oklahoma possesses. In the present instance, so far as this morning is concerned, I did not interrupt the Senator when he was conducting his lengthy cross-examination, and I know the Senator from Oklahoma is a master of diversionary tactics.

This makes him one of the most formidable people to deal with in the history of the U.S. Senate. One starts a given line of interrogation and the Senator from Oklahoma breaks in and gets the conversation off on an entirely different subject. Not having the same ability as the Senator from Oklahoma, not having his extraordinary capacity, I have to resist these diversionary tactics because I know that if he throws me off balance, it will be very hard to get back again. The Senator from Oklahoma does not suffer from this mental disadvantage which I possess.

Now, if the Senator from Oklahoma wishes to have the conversation of last Friday put in the record, the Senator from Illinois is perfectly

willing to have it done. It was my understanding that it was eliminated from the record with the consent of the Senator from Oklahoma and not at the request of the Senator from Illinois. And then, if it is put in the record, if anyone ever reads the record, they can judge.

I may say that the Senator from Oklahoma said that my cross-examination was rigorous. I hope it was courteous.

I would like to ask Mr. Thrower if he regarded it as courteous?

Mr. THROWER. Indeed so; yes.

Senator DOUGLAS. I did not think that the cross-examination of the Senator from Oklahoma of the banker from North Carolina was courteous. I thought it was extremely discourteous; and I felt, therefore, an obligation to make a protest to protect the witness because we dwell here in sort of a castle as a judge does where a witness cannot answer back and, therefore, I have always felt we should observe restraint, and if any time I err in being discourteous to a witness or insulting to a witness, I want to be called to order, and I will apologize. I did not think I had been this morning.

I am very frank to say I thought the Senator from Oklahoma had been last Thursday, and that is why I objected at the time. I ask that this stay in the record.

Senator KERR. I hope it will, and also the statement which the Senator from Illinois made when I was trying to interrupt. I thought that the record for his benefit should be clarified.

Senator DOUGLAS. I may say to my good friend that I appreciate this kind solicitude that he has for me.

Senator KERR. Then the day has not been wasted. [Laughter.]

Senator DOUGLAS. It is very touching, but I have the same feeling toward it that the Trojans had about the Greeks—beware of the Greeks when they bring gifts. Beware of the Senator from Oklahoma when he comes to your assistance. [Laughter.]

The CHAIRMAN. Senator Curtis.

Senator KERR. Let the record show that the hands were clasped. [Laughter.]

The CHAIRMAN. Senator Curtis.

Mr. THROWER. Senator, may I give to the reporter a list of the documents that I referred to earlier?

The CHAIRMAN. Yes.

Mr. THROWER. There are one or two points we have covered so that it might be helpful to submit a brief comment or extension. May I give that to the reporter when we correct the record?

The CHAIRMAN. You may do so.

Senator Curtis.

Senator CURTIS. I will be very brief. Whether or not the preceding colloquy contributes to our tax problems, history will have to answer that verdict. I am sure it is convincing proof that we have as the chairman of the committee the most patient individual that I in all my life have ever known.

I want to thank the Bar Association Committee on Taxation. Throughout the years you have been very helpful to the committees of Congress.

The hour is late and I will be very brief. I hope I can ask some questions that will not call necessarily for discussion, but there can be brief answers and anything else can be supplied.

Now, do you see a difficult problem in the withholding of interest with respect to the business of life insurance? As soon as an indi-

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vidual takes a policy and pays one premium, interest starts to accumulate and before a very long time passes it is a credit to his policy.

Have you examined this bill as to whether or not there is going to have to be withholding there?

Mr. WILLIS. It is my recollection that there is withholding on the interest that is credited.

Senator CURTIS. And that could be a very few cents, could it not?

Mr. WILLIS. It could be quite a small amount, sir.

Senator CURTIS. I do not know how many millions of people hold life insurance nor how many individual policies. But I have followed these hearings very carefully, and no one has come up with any satisfactory mathematics to my mind that the Treasury is not going to suffer a loss.

Mr. WILLIS. I think the gist of what I said with respect to the automatic data processing letter is to query the validity of the figures used in table 10 of exhibit 2 of Secretary Dillon's testimony which purported to show that there would be a substantial increase in reserve collections under withholding supplemented by ADP; whereas there would only be a recovery of about 25 percent of the tax under ADP without withholding.

I believe that these figures are questionable.

Senator CURTIS. All of those estimates are quite speculative.

Mr. WILLIS. Yes, sir.

Senator CURTIS. There are banks in my State which encourage people to open a savings account with $1; $1 is the corpus, not the interest.

Mr. WILLIS. Yes, sir.

Senator CURTIS. And I just do not believe that such things will be encouraged if we enact such a proposal.

It has been stated that 8 percent of the dividends are not reported, 7 or 8 percent or thereabouts.

Mr. WILLIS. That is correct, sir.

Senator CURTIS. Do you have any proof that that 7 or 8 percent should be subject to taxation?

Mr. WILLIS. No, sir.

Senator CURTIS. You do not know how much of it comes within the $50 exclusion?

Mr. WILLIS. No, sir. This has to be estimated.

Senator CURTIS. Yes. In all probability it does involve taxpayers of modest income. The larger taxpayers are going to be audited, are they not, more often?

Mr. WILLIS. The Treasury Department figures did not indicate that, sir. Under their figures they apparently assumed that the average tax bracket of the omitted dividend is 41 or 42 percent.

Senator CURTIS. But here is the point they overlook. The taxpayer of substantial income, the likelihood of his being audited is much more probable.

Mr. WILLIS. Yes, sir.

Senator CURTIS. The likelihood of his tax return going to show long-term gains and losses in dealing with securities is going to make it impossible for him to ignore dividends that he has received if he has those securities in his tax return which he has named. So, perhaps, much of this 8 percent may be covered by the $50 exclusion which, for a couple, is $100 exclusion, which might run to investments of $1,500 to $2,000.

Now, reference was made to a special penalty for failure to report dividends and interest. If you had a heavier penalty for that failure than to report other income might you run into some constitutional questions?

Mr. WILLIS. Yes, sir; I think you would, and I would hate to see this as a precedent. I am not sure that there is any theoretical difference in the necessity to report income from other sources than in the case of dividends or interest. I think probably the present 5-percent negligence penalty and 50-percent fraud penalty are adequate deterrents if they are applied to situations where they are deserved.

Senator CURTIS. I do not want to take time especially at this hour to rehash all that was said about withholding on wages and salaries. But I remember the debates well, and it was presented as a pay-as-you-go package for the benefit of the taxpayer and his previous year's taxes in the lower brackets were forgiven, and in the larger brackets substantially forgiven in order that he might pay as he goes, and that he might be relieved of digging up substantial sums when his income was derived from wages at the end of the year.

Mr. WILLIS. The Senator is correct.

Senator CURTIS. Have you submitted—and I do not care to go into the details of it now, but to make sure it is in the record or in the hands of the staff—your suggested draft on entertainment expenses? The bar association had a suggested draft on that, did they not?

Mr. THROWER. Our suggestions are in the record. We do not have an entire draft. I think at this point that our differences are relatively minor and can be resolved better through conference with the representatives of the staff, I would think, than attempting to redraft.

Senator CURTIS. I understand that.

Now, in reference to business expenses with respect to appearing before legislative bodies, does that also cover appearing before the executive branch? Various executive branches of the Government have quasi-legislative functions.

Mr. THROWER. I think those are allowed under present law where there are business expenses.

Senator CURTIS. Does the draft in the House bill, or what you propose, cover business expenses where a case is not only taken to committees of Congress but taken to the public?

Mr. THROWER. It does not.

Senator CURTIS. Don't you think it should?

Mr. THROWER. Well, the ABA proposal is more conservative than the House bill, and the House bill does not go so far as to cover the taking of the issue to the public. I think as you move along the line it does become more debatable. I would want to say——

Senator CURTIS. I am now arguing about a local municipality that proposes to take over a business that is now handled by private operation, to make it a municipal affair, and that business faces extinction. But certainly it is a business expense there just the same as it is a business expense to carry fire insurance that they could take their story to the people.

Mr. THROWER. I think we would agree on that; yes.

Senator CURTIS. I do not believe there is an accountant who would say this is not a legitimate business expense, so far as business and accounting practices are concerned. Wouldn't you agree?

Mr. THROWER. I would agree that it would clearly be a necessary expense to the life of that business; yes.

Senator CURTIS. That is all I have.

Now, in reference to H.R. 10, which is not before us——

Mr. WILLIS. Senator Curtis, may I expand an answer to a question you asked me with respect to life insurance interest?

Senator CURTIS. Yes.

Mr. WILLIS. Withholding applies only to interest on amounts held by an insurance company under an agreement to pay interest. The committee report of the Ways and Means Committee stated that this provision includes interest paid with respect to dividends held by an insurance company and interest on the proceeds of insurance policies held by an insurer under an agreement to pay interest thereon. This provision does not apply to amounts which represent the so-called interest element in the case of annuity or installment payments under a life insurance or endowment contract.

Senator CURTIS. Would it apply to the interest that is credited to the policy used either to lessen the amount of the premium or to lessen the number of years——

Mr. WILLIS. I think it does not apply to that as I read the last sentence that I read, I do not think it would apply to the interest portion which is really an offset against the premium cost.

Senator CURTIS. I might say while H.R. 10 is not before us, if you will look at the last hearings we had you will find that I did offer an amendment which was discussed in the hearings to deal with the subject of all people in a limited degree who are outside of a corporate plan whereby they can save for old age.

That is all, Mr. Chairman.

The CHAIRMAN. Thank you very much, Mr. Thrower. You and your associates have made a valuable contribution.

Mr. THROWER. Thank you, Mr. Chairman.

The CHAIRMAN. The committee will recess until 2:30.

(The material submitted by Mr. Thrower follows:)

AMERICAN BAR ASSOCIATION, SECTION OF TAXATION

(Attachments to prepared statement of Randolph W. Thrower, chairman of the section of taxation, before the Committee on Finance, U.S. Senate, April 24, 1962, relative to H.R. 10650)

The attachments are:

(1) "Report on Extension of Withholding Taxes," approved by the house of delegates of the American Bar Association on August 9, 1961, supplemented by comments recently prepared on the provisions of section 19 of H.R. 10650.

(2) "Report of the Special Committee on Travel and Entertainment Expenses," dated January 24, 1962, supplemented by comments recently prepared on the provisions of section 4 of H.R. 10650.

(3) Comments assembled by our committee on taxation of foreign income on the provisions of H.R. 10650 dealing with taxation of foreign income; namely, sections 5, 6, 7, 9, 11, 12, 13, 15, 16, 20, and 21.

(4) Comments assembled by our committee on depreciation and amortization on the provisions of sections 2 and 14.

(5) Comments assembled by our committee on general income tax problems on the provisions of section 3.

(6) Comments assembled by our committee on estate and gift taxes on the provisions of section 18.

The memorandums entitled "Comments" consist of compilations of the views of those members who submitted comments. Nothing herein contained shall be construed as the action of the American Bar Association unless the same shall have been approved by the house of delegates or the board of governors, or of the section of taxation of the American Bar Association unless first approved by the section or its council.

AMERICAN BAR ASSOCIATION

SECTION OF TAXATION

REPORT ON
EXTENSION OF WITHHOLDING TAXES

LEGISLATIVE RECOMMENDATION FOR A
SYSTEM OF TAXPAYER ACCOUNT NUMBERS

ANNUAL MEETING
ST. LOUIS, MISSOURI
August, 1961

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1961–1962

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FOREWORD

The within report and legislative recommendation were prepared after extensive investigation by a special committee of the Section of Taxation of which Arthur B. Willis, Esq., Los Angeles, California, Chairman, and Lee I. Park, Esq., Washington, D. C., Vice-Chairman. The report on extension of withholding taxes and the legislative recommendation on a system of taxpayer account numbers were adopted by the Section of Taxation at its Annual Meeting in St. Louis on August 5, 1961. On August 8, 1961 the report was presented to and adopted by the House of Delegates. The House of Delegates on the same day adopted the legislative recommendation. The legislative recommendation is accompanied by an explanation of the reasons for its adoption.

RANDOLPH W. THROWER
Chairman, Section of Taxation

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WASHINGTON 6, D. C.

REPORT ON EXTENSION OF WITHHOLDING TAXES AND LEGISLATIVE RECOMMENDATION FOR A SYSTEM OF TAXPAYER ACCOUNT NUMBERS

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REPORT ON EXTENSION OF WITHHOLDING TAXES

General Discussion

One of the most significant tax measures before Congress in 1961 is that involving appropriate legislation to obtain better enforcement of the reporting of income from dividends and interest. Without question, the gap in underreporting of various types of income, including dividends and interest is a serious problem. The extent of the underreporting in various categories of income is illustrated in the following estimates furnished to the Ways and Means Committee at its hearings in 1959 (all figures are for 1957 and are after adjustment for estimated legitimate non-reporting because of personal exemptions):

Type of Income	Underreported (in Billions)
Dividends [1]	$ 0.9
Interest [2]	3.5
Salaries and wages [3]	5.5
Business and professional [4]	5.3
Farm operators [5]	2.9
Rent [6]	2.0
Total of above	$20.1

Unless effective steps are taken to close the gap, the careless or dishonest underreporters will continue to shift their fair share of the tax burden to the shoulders of others who report fully all income and pay tax thereon.

Recognizing the interest of all concerned in this problem and the possible extension to dividend and interest payment of the withholding tax concept, in August, 1960, the Section of Taxation established this committee. The committee was instructed to investigate the various areas of problems pertaining to the underreporting of income by taxpayers and possible solutions to the problem. The committee was specifically instructed to submit a report on the advisability of and problems with respect to the extension of withholding of taxes on payments of dividends and interest.

After the appointment of the committee, its first activity was gathering available information concerning the extent of the problem and possible solutions. This included the panel discussions and the papers submitted in connection with the hearings before the Committee on Ways and Means in November and December, 1959, on the subject

[1] Holland, Compendium, page 1399, as revised in Hearings, page 768, and as adjusted in Compendium, pages 1400-1402, and revised in Hearings, pages 767-768.
[2] Holland, Compendium, page 1418, as adjusted at page 1419.
[3] Kahn, Compendium, page 1459, as adjusted in Hearings, page 781.
[4] Kahn, Compendium, page 1449, as adjusted at page 1455.
[5] Kahn, Compendium, page 1449, as adjusted at page 1455.
[6] Pechman, Hearings, page 121; see also page 125.

of broadening the tax bases. Further information was developed from other sources.

The committee made a conscientious effort to approach the problems objectively and without bias. It was agreed from the outset that steps must be taken to close the gap of underreporting of income. The only question was the best way to achieve that objective, having in mind the imminence of automatic data processing and the extent of the burden that the various proposals would impose upon the Internal Revenue Service and upon the payors and payees of dividends and interest.

The comments in this report may be materially affected by the more recent information and statistics which undoubtedly will be developed in the 1961 Congressional hearings.

There may be developments after the submission of this report (such as the introduction of a specific Administration bill on the subject of interest and dividends withholding) which might cause the committee to present, at the 1961 Annual Meeting, specific legislative recommendations. In the absence of any such Administration bill at the time of submission of this report, the committee's legislative recommendations have been confined in this report to the matter of taxpayer account numbers.

1. The Scope and Nature of the Problem

Any estimate of the gap representing improper underreporting of dividends and interest involves many assumptions, and is subject to a very large possible margin of error. Estimates made by different persons may differ substantially. However, the following table of estimated underreporting is taken from relatively recent information prepared by the Tax Analysis Staff of the Office of the Secretary of the Treasury:

Year	Dividend Reporting Gap	Interest Reporting Gap
	(In millions of dollars)	
1955	1,333	
1956	1,091	2,072
1957	851	2,534
1958	917	2,605
1959	940	2,837

Even if these estimates are subject to as much as a 50% margin of error, they still indicate a serious problem of underreporting in those areas.

The Commissioner's Annual Report for the fiscal year ended June 30, 1960, states that there were approximately 116 million Form 1099's and Form 1087's filed with the Internal Revenue Service during the fiscal year ended June 30, 1960. These report payments of dividends in excess of $10, interest in excess of $600, and other types of income such as rents, royalties, etc. The task of manually sorting these information returns and associating them with the returns filed by

the taxpayers has proved to be so massive that in the past the Service has succeeded in carrying through with the matching on only approximately 10% to 17% of the information returns.

Withholding of tax on salaries and wages has been in effect since 1943. Consideration has been given by Congress from time to time in the intervening period to the imposition of the withholding of tax on dividends and interest. Thus far, such legislation has not been adopted because it was believed to be unnecessary and to involve complexities, not present with salaries and wages, which would impose a substantial burden on business and investors.

To insure better taxpayer compliance in this area, a nationwide educational program was undertaken last year by the Treasury Department and the Internal Revenue Service to acquaint taxpayers with the legal requirements for reporting income from these sources. This campaign was conducted with the cooperation of the principal associations of interest and dividend payors and thousands of corporations, banks, and other institutions that make such payments. The analysis by the Service of the statistics of income for 1959 indicates that there was little improvement in 1959 as compared with 1958 in the reporting of dividends and interest. The improved reporting that was generally expected to follow the educational program may not be evident until 1960 or later years. Then again, the errors of estimate that are inherent in the final conclusion about the dividend and interest gaps may have offset some actual improvement for 1959 in reporting attributable to the educational program. As of the date of this report, the problem appears to be of sufficient magnitude to justify further serious consideration.

2. Taxpayer Account Numbers

This committee is taking separate action with a view to obtaining approval of a recommendation that the Congress adopt specific legislation providing for taxpayer account numbers and that such legislation be enacted as expeditiously as possible.

For the reasons set forth in the explanatory statement accompanying such legislative recommendation, the committee believes such legislation is highly desirable for effective utilization of automatic data processing whether or not a system of withholding of tax on dividends and interest is enacted. Even before automatic data processing becomes fully effective, the use of the taxpayer account number will facilitate the manual sorting and matching of information returns with taxpayer returns. During this interim period, taxpayer knowledge of the intended use of the taxpayer account numbers may have the psychological effect of encouraging a greater degree of reporting of income, including dividends and interest, than has been true in the past. Such numbers might well be used to close the gap, not only on dividends and interest, but also on other types of income where the gap is much greater. However, the extent of such effectiveness can be greatly influenced by the Treasury's program for acquiring the necessary automatic data processing equipment and instituting new procedures for the employment of such equipment as an enforcement aid.

3. The Service's Plans for Automatic Data Processing

The Internal Revenue Service plans an automatic data processing center to be located at Martinsburg, West Virginia, served by seven satellite centers located in various regions of the country. Taxpayer returns will be sent to a regional center where the information contained therein will be encoded upon magnetic tape. At the regional center the return will be mathematically verified and audit programs at the local level will be selected and processed on medium sized computers located in each regional center. Duplicate tapes will be forwarded to Martinsburg, West Virginia, where the information contained thereon will be collated with the taxpayer's master account number. Additionally, data from information returns filed with respect to each taxpayer will be inserted in his master account and collated with the other material therein. Ultimately, the taxpayer's complete tax history from the inception of automatic data processing will appear on a portion of magnetic tape located at the Martinsburg center.

Automatic data processing machines process information at extremely high speeds. Thus, the taxpayer's reported income can be matched with his information returns (W-2's, 1099's, 1087's etc.), and any discrepancies will be almost immediately available to the Service for enforcement purposes. In addition, new and accurate statistical information can be developed for use in both enforcement and legislative programs.

4. Basic Issues

The basic issues are:

(1) Would withholding of tax on dividends and interest be desirable when there is effective use of automatic data processing?

(2) If withholding of tax on dividends and interest would not be desirable when automatic data processing is in full operation, is withholding of tax on dividends and interest worthwhile as an interim measure until automatic data processing is in full operation?

(3) If the answer to either (1) or (2) is in the affirmative, what features should be included in the witholding tax system?

4.1 *Withholding of Tax Considered with Automatic Data Processing*

The suggestion has been made (by persons other officials of the Treasury Department) that withholding of tax on payments of dividends and interest is justified to eliminate the time gap on payment of income tax on income from dividends and interest as compared with income from wages, on which tax is now withheld. This does not appear to be sound. The existing statutory plan for current payments based upon declarations of estimated tax was intended to overcome this time gap.

Withholding of tax upon wages involves differing considerations. If a wage earner spends his tax money he may have nothing left with

which to satisfy his obligation for taxes, except his continuing earning capacity, which in turn is subject to additional income taxes, when realized. No similar reason exists in the dividend and interest areas. The recipients of dividends and interest, even though they spend their receipts, still own the underlying capital which produced the income and the Government can resort to this for the collection of its taxes.

It appears doubtful that, once automatic data processing is in full operation, withholding would appreciably reduce administrative costs.

If automatic data processing is used to the fullest extent practicable, it may be questioned whether withholding of tax upon dividends and interest would have sufficient administrative value, as a device for enforcing payment of tax upon income from dividends and interest, to justify the costs of imposition of such a withholding system. This assumes that the minimum requirement of $600 for reporting interest payments would be reduced, when automatic data processing is fully operative, to a level more comparable to the reporting requirement for dividends.

It has been suggested that withholding of tax on dividends and interest is justified to insure collection of tax on amounts that are too small to justify the administrative effort of identifying and collecting deficiencies in underreporting. If these amounts are too small to justify such administrative action, consideration should be given to whether they are too small to justify the burdens that would be imposed by withholding of tax on payors, payees, and the Service. It has never been suggested that there be withholding of tax solely on amounts of dividend and interest payments that are too small to justify administrative follow-up. The imposition of withholding of tax on all payments of dividends and interest in order to insure collection of a tax on the minimum fringe may involve an uneven balance of interests.

4.2 *Withholding of Tax on Dividends and Interest as an Interim Measure*

Automatic data processing will not be fully effective on a nationwide basis until approximately 1967 or 1968. The question accordingly arises as to the necessity for affirmative action prior to that time to close for the intervening years the gap in underreporting of dividends and interest.

One answer, proposed by the President, is to put in effect as of January 1, 1962, a withholding of tax on dividends and interest without issuance of receipts. Whether the problems involved in such a method of withholding of tax on dividends and interest outweigh the gains from the collection of such tax is a matter for serious consideration in the light of the discussion which follows.

5. Withholding Problems in the Dividend Area

There are more than thirty-eight million shareholder accounts in the United States, and the annual dividend payments are estimated to require in excess of one hundred million checks. However, there is a peculiarity in the dividend situation in that a substantial number of large corporations utilize the services of banks as disbursing agents. This narrows to some extent the impact of the problem, and at the same time aggravates the burdens on disbursing agents because they are acting for so many corporations.

For 1958, dividend income was reported in 5,125,813 returns of individuals in a total amount in excess of $9 billion.[7] This does not take into account dividends included in income on Form 1040A, since dividends on this form are not identified as such.[8] There were 41,955,064 returns for 1958 filed on Form 1040,[9] so that dividend income was reported in approximately 1 out of 8 returns.

Dividends in excess of the $50 exclusion were reported in 4,235,017 returns of individuals in a total amount of $8,740 million.[10] In number of returns, about one-half of the returns reporting dividend income had adjusted gross income of under $10,000.[11] In dollars reported, after deduction of the $50 exclusion, approximately one-half of the dividend income was reported by taxpayers with adjusted gross income of less than $25,000.[12] Although average dividends reported after deducting the exclusion were approximately $2,200 ($8,740,560 thousands÷4,235,017 returns),[13] over half of the returns filed reported taxable dividend income of under $400.[14]

5.1 *Payor and Disbursing Agent Considerations*

The disbursing agents who issue dividend checks for many corporations have special problems with respect to the utilization of their mechanical equipment. The committee was not able to ascertain the capabilities of existing equipment to handle additional reporting requirements, and particularly to handle reporting requirements connected with withholding of tax on dividends. Obviously, however, if a *reporting* requirement were imposed in connection with withholding of tax on dividends, both the disbursing agents and the corporations which pay dividends directly to their stockholders would be faced with the problem of changeover to new equipment which would meet the requirements thereby thrust upon them.

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[7] Statistics of Income—Individual Income Tax Returns for 1958 (hereinafter referred to as "Statistics of Income"), page 4, Table B, Column (3).
[8] Statistics of Income, page 4.
[9] Statistics of Income, page 15, Table Q, Column (1).
[10] Statistics of Income, page 30, Table 4, Columns (4) and (5).
[11] Computation from data in Statistics of Income, page 30, Table 4, Column (4).
[12] Computation from data in Statistics of Income, page 30, Table 4, Column (5).
[13] See note (12).
[14] Computation from Statistics of Income, page 44, Table 6, Columns (1), (2), (3), (4) and (5).

5.2 *Payee Considerations*

Because of exemptions, standard deductions, and other such allowances, a withholding system would necessarily involve some excess withholding on dividend receipts in the lower income brackets. This will work a hardship on such recipients (with the exception of special groups such as minors supported by their parents), unless some special provision is made to rectify overwithholding.

Due to the deductions, exemptions and dividend credits allowable under existing law, surprisingly large amounts of dividends may be received, and still have overwithholding at a 20% rate, if the taxpayer's sole income is from dividends. This is illustrated in the following table, which shows the amounts of dividend income where tax payable exactly equals tax withheld at a 20% rate. If the dividend income were any less than the amount indicated, there would be overwithholding.

	Standard Deduction	Deduction of 13% of Adjusted Gross Income [15]
Married couple filing joint return; both over 65; no dependents ...	$24,950	$32,103
Married couple filing joint return; both under 65; no dependents ...	21,950	28,633
Head of houshold with one dependent; under 65..........	16,447	20,153
Single person; over 65; no dependents	13,750	16,116
Single person; under 65; no dependents	12,296	14,384

Figures are not available in the Statistics of Income as to the number of returns reporting only dividend income, so it is impossible to draw any conclusions as to the number of taxpayers in this category who will be subjected to overwithholding on dividends.

Overwithholding on dividends will not exist if there is sufficient taxable income not subject to withholding (or subject, as in the case of wages, to withholding that reflects the standard deduction and any exemptions). Some examples of the break-even point in income subject and not subject to withholding of tax are set forth in Exhibits 1 and 2, attached.

From an administrative standpoint, it is necessary to weigh the desirability of fairness to lower bracket taxpayers against the administrative problems that may be involved in reducing the hardship of overwithholding.

It is not possible to do more than to estimate the category of payees

[15] Ratio of Deductions to Adjusted Gross Income for all taxable returns with Adjusted Gross Income of $25,000 to $50,000; computed from data in Statistics of Income, page 57, Table 10.

who are principally responsible for the underreporting of dividend income. Statistics developed a decade ago indicate that a substantial portion of the underreporting occurs in connection with taxpayers in lower income brackets. Thus, it was estimated that 34.5% of the dividend underreporting for the year 1948 occurred in connection with taxpayers having an income of less than $7,000 a year.

Consideration was given by the committee to the possibility of a personal exemption, similar to that in the case of wages. The problems involved with respect to exemptions from withholding of tax are discussed at Sections 7.5, 7.6 and 7.7, *infra*.

Provision for intra-annual refunds, perhaps on a quarterly basis, would reduce the burden on the low bracket recipients of dividend income. This, however, would multiply the administrative problems of the Service, and such problems would probably be greater without receipts than with receipts. It would also present serious problems for payors if receipts were required. Even without receipts, payors would be faced with problems in connection with the necessity for furnishing information to the payee which the payee could use to support his claim for refund, assuming that such supporting information with respect to intra-annual refunds would be necessary.

The lowering of the withholding rate is one means of reducing the problem of overwithholding, but this, in turn, reduces the effectiveness of the withholding tax as an instrument to insure full reporting of dividend income and to reduce the revenue loss from underreporting.

Consideration might be given to an alternative such as allowing interest on refunds of overwithheld tax on dividends from an earlier date (for example, from June 30 of the year in which the overwithholding occurred). The additional interest on the refund would compensate for the payees' loss of use of the dividend income and the extra interest cost to the Government may be less than the administrative cost in verifying and handling intra-annual refunds.

5.3 *Fiscal Considerations*

The direct cost to the Treasury Department in administering a withholding of tax on dividends necessarily depends upon the nature of the withholding system and the extent to which an attempt is made to alleviate overwithholding by means such as intra-annual refunds. We were advised that in the case of refunds of excess withholding on wages, it is currently costing the Service 34 cents to process each refund, plus 15 cents for each refund check, a total cost of 49 cents per refund. The Service, at the present time, makes approximately 35 million refunds between January 1 and May 31 of each year. No practical estimate can be made of the cost to the Service of handling refunds of excess withholding of tax on dividends.

There is an additional cost to the Treasury Department of withholding in that payors will incur increased expenses with respect to the operation of the withholding system and additional reporting to payees and the Treasury Department. These additional costs will be

deductible in computing the taxable income of the payors, and in most cases the Treasury Department will bear 52% of these additional costs. If the Treasury Department does not require receipts, these additional costs will arise only to the extent the payor is required, or finds it appropriate, to furnish information to the payees at the request of the payee or voluntarily as a matter of good business practice.

The cost to payors is also dependent upon the nature of the withholding system. A gross-up withholding of tax, involving no receipts to payees and no additional reports to the Internal Revenue Service, would involve very little additional cost to payors. However, a system involving receipts to payees might create a large economic and administrative burden on corporations. This cost would be considerably increased if there were an enforcement of the requirement of an annual reporting of dividends paid during the year, rather than the current acceptance of reporting dividends paid on a per dividend basis.

5.4 *Economic Repercussions of Withholding of Tax on Dividends and No Withholding of Tax on Interest*

Mechanically it would appear less difficult to impose tax withholding on dividends than on interest for reasons that will be developed in Section 6 of this report. Therefore, there may be an inclination to impose the withholding of tax on dividends and not to impose a withholding of tax on interest.

It is believed that it would be unwise and inequitable to impose a withholding of tax on dividends and not on investment-type interest. A one-sided withholding might encourage investors to switch from corporate stocks to interest-bearing obligations. Further, the gap of underreporting for 1956 and 1957 appeared to be approximately two to three times as great in the interest field as in the dividend field.

6. Withholding Problems in the Interest Area

There is no centralization of payors of interest in a relatively small group as in the case of dividends. On the contrary, interest payments involve every segment of our economy, from the long-range financing of business enterprises and the United States Treasury to the typical credit transactions wherein the consumer buys merchandise on charge accounts or conditional sales contracts; from the financing of railroad rolling stock to the savings of children in their school thrift programs. There is also a wide spread of taxpayers receiving interest payments. This would range from the small savings account in a bank or savings and loan association to finance companies and lending institutions whose principal business is the earning of interest. It appears to be generally accepted that a large part of the gap in underreporting of interest income arises with respect to small taxpayers receiving relatively small amounts of interest income on government obligations and on deposits in savings accounts in banks or savings and loan associations.

There are attached hereto, as Exhibits 3 and 4, tables recently prepared by the Tax Analysis Staff of the Office of the Secretary of the Treasury which give breakdowns of interest and dividend payments by types for several recent years.

As noted at Section 5.2 in connection with dividend income, surprisingly large amounts of investment-type income may be received and there still may be overwithholding of tax at a 20% rate, if the taxpayer's sole income is from income subject to withholding of tax. This is illustrated in the following table which shows the amount of interest income if interest constitutes the only taxable income where tax payable exactly equals tax withheld at a 20% rate. If the interest income were any less than the amount indicated, there would be overwithholding.

	Standard Deduction	Deduction of 13% of Adjusted Gross Income [16]
Married couple filing joint return; both over 65; no dependents...	$19,000	$24,384
Married couple filing joint return; both under 65; no dependents...	15,400	20,125
Head of houshold with one dependent; under 65...........	12,367	14,847
Single person; over 65; no dependents	10,771	12,192
Single person; under 65; no dependents	8,857	10,063

Figures are not available in the Statistics of Income as to the number of returns reporting only investment-type interest income, so it is impossible to draw any conclusion as to the number of taxpayers in this category who will be subjected to overwithholding on interest.

Overwithholding on interest will not exist if there is sufficient taxable income not subject to withholding (or subject, as in the case of wages, to withholding that reflects the standard deduction and any exemptions). Some examples of the break-even point in interest subject to withholding tax and other income subject to no withholding tax are set forth below (Schedules attached as Exhibits 1 and 2 show more comprehensively the break-even points of income subject and not subject to withholding of tax (i.e., the points at which the tax payable exactly equals the tax withheld at source).):

[16] See footnote (15).

	Standard Deduction	Deduction of 20% of Adjusted Gross Income[17]
Married couple filing joint return; both over 65; no dependents		
1. If taxable income is	$ 1,000	$ 1,000
Adjusted gross income will be	3,778	4,250
There will be overwithholding if—		
Interest subject to withholding is more than	1,000	1,000
Interest not subject to withholding is less than	2,778	3,250
2. If taxable income is	5,000	5,000
Adjusted gross income will be	8,222	9,250
There will be overwithholding if—		
Interest subject to withholding is more than	5,100	5,100
Interest not subject to withholding is less than	3,122	4,150
3. If taxable income is	10,000	10,000
Adjusted gross income will be	13,400	15,500
There will be overwithholding if—		
Interest subject to withholding is more than	11,000	11,000
Interest not subject to withholding is less than	2,400	4,500
4. If taxable income is	15,000	15,000
Adjusted gross income will be	18,400	21,750
There will be overwithholding if—		
Interest subject to withholding is more than	18,100	18,100
Interest not subject to withholding is less than	300	3,650

6.1 *Payor and Disbursing Agent Considerations*

Many of the payor and disbursing agent considerations with respect to withholding of tax on interest are similar to those previously discussed at 5.1 with respect to withholding of tax on dividends. In addition, there are special problems in the interest area which must be considered.

One such is the "back-to-back" interest problem. Thus, a bank may have tax withheld on some of the interest it receives, on loans, and at the same time be paying interest to the Federal Reserve Bank on its own borrowings. Thus, until such time as the interest withheld could be applied against its tax liability, such a financial institution would be placed under an economic handicap. Of course, the individual

[17] Ratio of Deductions to Adjusted Gross Income for all taxable returns with Adjusted Gross Income of less than $10,000; actual figure, computed from data in Statistics of Income, page 57, Table 10, is 19.53%, which was rounded to 20%.

who has tax withheld on interest paid to him may also be put to an economic disadvantage, but the problem may be more serious in the case of a financial institution whose interest income may be in large part offset by interest payments.

Another matter to be considered with respect to withholding of tax on interest is the effect of such withholding on the normal practice of depositors leaving in the bank or savings and loan association the interest earned, thus increasing the depositors' balance. To an appreciable extent, this practice also exists in the dividend area under dividend reinvestment programs sponsored by investment companies and others.

While withholding of tax on dividends would be applicable to all payors, withholding of tax on interest would not be apt to have such wide application. In contrast to dividend transactions which involve only a corporation and its shareholders, borrowings cut across every type of business and personal transaction and the imposition of withholding requirements on every interest transaction would swamp both persons and businesses with paperwork. Such an imposition would also impose almost insoluble administrative problems upon the Service. The delinquent trust accounts would probably rise because of the failure of a payor of a few dollars of interest to remit the withheld amount to the Service. And because of the volume of transactions, most of which would involve small amounts, the cost of enforcement would be disproportionate to the amount collected. This suggests that interest payments made by individuals should be excluded from the requirements of withholding.

In the first instance at least, withholding might preferably be limited to interest on corporate and government obligations, savings accounts and like investments. Presumably there would be withholding on such investment-type interest received by corporations, partnerships and other recipients, as well as by individuals. The exclusion from withholding of other types of interest should not affect collections of tax upon interest adversely and would, at the same time, materially decrease the administrative and enforcement problem existent in this area. It would, however, seem to require separate reporting of withholdable and nonwithholdable interest in the tax return forms of recipients.

6.2 *Payee Considerations*

Payee considerations involve matters previously discussed at Section 5.2 with respect to the overwithholding of tax on dividend payments. In addition, in the case of the savings accounts at a bank or savings and loan association, the payee usually must take affirmative action to determine the amount of interest earned on his deposit. This differs from the dividend situation where the owner of the stock or his nominee receives the dividend check, and therefore has information as to his dividend income durng the year. In the case of the savings account, the interest is credited to the account and the depositor gener-

ally does not know the amount of his interest income until such time as he turns in his passbook for crediting of the interest.

As in the case of withholding of tax on dividends (also discussed at Section 5.2 above), the desirability of fairness to lower bracket taxpayers must be weighed against the administrative problems to the Service and to the payor. These will depend in part upon the nature of the withholding system and the reporting requirements. The additional cost to the Service of administering tax withholding presumably would be a substantial amount, but we know of no basis for a reliable estimate. The same observation would apply to the additional cost to the payors. The increased cost of the payors would reduce taxable income and income tax liability of the payors.

6.3 *Fiscal Considerations*

In addition to the costs to the Service of administering the tax withholding system and the cost to the payors of interest, there would be significant fiscal effects upon obligations of the United States Government if there is to be a reporting requirement by payors. In the absence of such requirement, there may possibly be some effect because of requests for information from payees. The committee was informed in December, 1960, that of $288 billion of interest-bearing obligations, there are $243 billion in the hands of the public. Of the $243 billion, $185 billion are in the form of marketable securities. There are $39 billion of Treasury bills sold at a discount and $25 billion of certificates of indebtedness, most having two interest certificates attached and some only one. Of $42 billion of Treasury notes, about half have coupons and half do not. Of the nonmarketable securities, the bulk is in savings bonds, of which $9 billion are in interest-bearing form. In the case of savings bonds, there are 440 million pieces, aggregating $38 billion.

The committee was also informed in December, 1960, that providing annual information returns with respect to interest paid by the United States Government would be expensive. In the case of some bonds it might be possible to have the withholding done by banks which cash the bonds or the interest coupons. The Treasury Department now pays an average of 12 cents per bond to banks for their services in handling redemptions. If the bank is required to prepare a receipt and an information return, it is estimated this might double the cost.

In December, 1960, we were informed that the additional estimated cost to the Treasury Department of complying, as an issuer of bonds, with a tax withholding system involving receipts might run from $11 million to $25 million a year, depending upon the reporting and receipt requirements of a particular withholding system. These figures do not include the additional cost with respect to registered bonds.

An effective tax withholding system for interest payments would almost certainly have to include interest payments by the United States Government on its outstanding obligations.

7. Facets of Various Withholding Plans

It is obviously necessary to balance the considerations of fairness to taxpayers against the administrative cost to the Service and to the payors of dividends and interest and withholding agents. Any system should be so devised that it would not encourage wholesale dishonesty or errors because of the lack of reasonable verification of claims for refund of overwithholding of tax. On the other hand, if the system becomes enmeshed in too many intricacies it may strangle in its own complexity.

7.1 *Gross-Up with No Receipts*

A plan for withholding of tax ostensibly involving a minimum of administrative complications to the Service, to payors and recipients of dividends and interest is the gross-up plan without receipts to payees. This is the theory of the withholding plan proposed in the President's Tax Message and explained in more detail in the statement of the Secretary of the Treasury. Under this concept there would be withholding of tax at a rate which would permit easy grossing-up. For example, the withholding rate might be at 20%, with the 80% being remitted to the owner of the stock or of the interest-bearing obligation. The recipient would total the amounts he had received as dividends or interest payments and gross-up by adding 25% of the total amount he had actually received, and reporting the sum as his income from dividends and interest. He would then claim a credit in his tax return for the tax withheld in an amount equal to 20% of the total amount reported as dividend and interest income. The payor would remit the tax withheld but make no additional reports to the Internal Revenue Service and would not be required to issue any receipts to the payee.

The introduction of a gross-up concept of reporting dividends and certain interest would present substantial problems of form design, particularly with respect to Forms 1040A and 1040W. The extra gross-up computations may lead to additional errors in returns and difficulties in processing.

The principal objection to this simple approach lies in the absence of any feasible verification of refund claims. Since there would be no receipts, an individual might claim refund based on his contention that he had received $50 or $100 of dividend income, which is not taxable because of his exemptions and deductions, relying on the fact that he is not required to submit receipts or other proof of tax withheld. The Service would have to be prepared for the most part to allow the refund on a "quickie" basis without any attempt at verification. No doubt certain information would be required in the claims for refund, such as listing by payors and amounts the dividends and interest on which there was withholding. It has been suggested that this would tend to inhibit filing of false claims for refund.

Another problem of withholding of tax without receipts is the payee's difficulty in distinguishing in his tax return between interest on which tax has been withheld and interest on which there was no withholding.

This would appear to impose an additional record-keeping burden on small taxpayers.

The proponents of this plan suggest that protection against cheating could be achieved through sample checks in various communities of refund claims for overwithholding on dividends and interest. There would be letters mailed out to the sample selectees requesting specification as to the sources of the dividends and interest payments, and probably a subsequent letter to the alleged sources of these payments requesting verification that such amounts were paid to the taxpayers claiming the refund and that tax in the amount claimed was withheld. This might be done on a very small percentage of the total claims for refund, but considerable publicity would be given to the verification program, and a few criminal actions instituted in a community undertaken for the purpose of publicizing the penalties that might attach to fraudulent claims for refund of taxes alleged to have been overwithheld.

After careful consideration of this plan, serious doubts remain as to the adoption of a system permitting refunds without receipts unless Congress is satisfied that it would not lead to extensive fraudulent or erroneous refund claims against the Government. The committee did not find appealing the "in terrorem" concept that prosecution of a few violators is the proper means to deter others from cheating. If withholding of tax is adopted, it is desirable that the plan include administrative provisions that will assure proper functioning.

Such a plan would be feasible, at best, in a limited number of cases involving relatively small receipts of dividends or of interest subject to withholding from only a few sources. However, to the knowledge of the committee, no realistic estimate has been made of the number of cases of overwithholding which may arise at the proposed 20% rate. Some idea of the minimum figure of overwithholding situations is available from the information that for 1958 dividends were reported on 608,362 nontaxable returns filed by individuals and interest income was reported on 1,215,439 nontaxable returns filed by individuals.[18] There will be a substantial amount of dividend and interest income reported by tax-exempt corporations, charitable trusts, pension and profit-sharing plans, and other tax-exempt institutions. The extent to which overwithholding on dividends and interest paid to these organizations will actually be subject to offset, as suggested in the statement of the Secretary of the Treasury, against social security and wage withholding is in the realm of speculation.

In addition, there is what appears to be an unknown area of possible refunds of overwithholding on taxable returns. As reflected in Exhibits 1 and 2, attached, the dollar size of returns in which there would be overwithholding at the 20% rate is surprisingly large ($32,103 of income solely from dividends in the case of a married couple, both over 65, with no dependents and deductions of 13% of adjusted gross income, which was the national average in 1958 for this bracket; $24,384 of income solely from interest with the balance of the assumed

[18] Statistics of Income, page 30, Table 4, Columns (4) and (6), Line 38.

facts the same). The prospect of withholding of tax on dividends and interest could be approached with greater certainty if more facts were known about the magnitude of the problem, and particularly of intra-annual refunds of overwithholding.

The sizable amounts of dividend and interest income which may produce overwithholding in certain cases (see Exhibits 1 and 2, attached), raise an important question as to the administrative feasibility of properly processing refund claims without receipts. It may be feasible to spot-check refund claims involving a few hundred dollars of dividend and interest income from a small number of payors. It is difficult to contemplate an adequate verification of refund claims where the dividend or interest income runs into the thousands of dollars and may be from 50 to 100 or more sources.

7.2 *Receipts*

If Congress should adopt a tax withholding system for dividends and interest, further consideration should be given to legislation which requires issuance of receipts to payees. In the long range it is believed inevitable that receipts will have to be furnished to the payees on an annual basis, summarizing the total payments to the payee during the year. As a temporary expedient it might be satisfactory to permit receipts to be furnished with respect to each payment so as to ease the burden upon the payor during the transition period, although there may be difficulties in the replacement of lost or mislaid receipts.

Automatic data processing bears upon the necessity of receipts. Without automatic data processing, receipts seem highly desirable for good administration, both from the standpoint of protecting the Treasury from improper claims and from the standpoint of assisting the honest taxpayer by giving him supporting proof of his claim. They may prove invaluable in the processing of claims for refund of tax overwithheld or claims for credit in excess of the tax actually being paid on the reported amount of dividends and interest. With automatic data processing, the receipt system may be less important than it would be at the present time from an administrative standpoint, assuming a lowering of the present $600 minimum for filing of information returns regarding payments of interest.

Realistically, a system starting out with no receipts might well convert itself, in a relatively short time, to a receipts system. It may well be that the Treasury Department, after an initial experience with a no-receipts system, will find that receipts to payees are essential.

Even if the Treasury Department is willing and able to accept a no-receipts system, payees may well demand receipts to assist them in preparing their returns or claims for refund. The demands of the payees for receipts probably will be addressed initially to the payors. If the response is not fast enough and complete enough, Congress may be requested by the payees to enact legislation requiring payors to furnish receipts.

7.3 *Intra-Annual Refunds*

There will be hardships, especially in the first year of the withholding tax, to small bracket taxpayers relying upon income from dividends and interest as a source of livelihood if taxes are overwithheld, and the taxpayer cannot recover the tax overwithheld until after the end of the taxable year. It has been suggested that there might be intra-annual refunds to take care of these cases. The committee gave careful consideration to the problems involved in intra-annual refunds with full sympathy for the problems of the small taxpayer, but the committee concluded that intra-annual refunds would involve serious administrative complications which would have to be balanced against the hardship on payees.

It should be noted that one objection to intra-annual refunds with respect to dividends and interest is that it might establish a precedent for intra-annual refunds on overwithholding of wages. Thus, the administrative problem of making intra-annual refunds could eventually become much greater than that which would flow directly from intra-annual refunds of overwithholding solely in connection with dividends and interest payments.

7.4 *Gross-Up with Receipts*

The gross-up concept, as indicated at 7.1, is indispensable to a withholding plan which does not involve receipts to payees. It has been suggested that the gross-up concept would also be of value, even in a withholding plan which did involve receipts to payees.

The committee concluded that, while there might be some incidental benefits from ease in grossing-up receipts of dividends and interest to determine the total amount of these payments before withholding of tax, on the whole the receipt system sufficiently answered the verification problems so that the gross-up concept was not an essential feature of a withholding plan involving receipts.

7.5 *Total Exemption Certificates for Tax Exempt Institutions*

It has been proposed (by persons other than officials of the Treasury Department) that tax-exempt institutions be permitted to file exemption certificates under the terms of which they would not be subject to withholding on dividends and interest received. From the standpoint of the payor and withholding agent, this would increase the cost because these exempt institutions would have to be flagged and the full amount of any dividend or interest remitted to them. It has been suggested (by persons other than officials of the Treasury Department) that the number of total exemption certificates is sufficiently small to permit this to be done without an additional disproportionate cost burden upon the payor. The committee is informed that, to the extent payors can use automatic or machine processing of withholding, the introduction of an "all or nothing" exemption would not materially alter the system insofar as costs are concerned. The exempt recipients

would, of course, benefit from this because they would not have to wait to receive the refunds and the Service would be spared the mechanical problem of making such refunds.

7.6 *Total Exemption Certificates for Individuals*

The withholding statute might provide for no tax to be withheld on payments of dividends and interest if the payee has filed with the payor a certificate of exemption. It is further assumed that the exemption certificate would be issued only in cases where the payee's exemptions exceeded his expected income from all sources.

There occurred to the committee no serious objections to such exemption certificates, unless the number of such certificates issued was sufficiently large to cause a substantial increase in the payor's handling costs.

7.7 *Partial Exemption Certificates for Individuals*

The committee considered a plan for partial exemption certificates for individuals to be filed in much the same manner as they are with W-2 statements. Such an exemption system would be very costly to payors and withholding agents because of the difference in handling each separate payment in accordance with particular exemption certificates filed by the payee. Unlike wage withholding where there is a personal relationship between the employer and the employee, the corporation shareholder and creditor-debtor relationship is by and large conducted entirely by mail, and the additional correspondence and paperwork involved in securing both proper exemption certificates and a verification with respect to status would be immense. The personal exemption certificate works well with wage withholding where there usually is only one employer. However, the investor may have dividends and interest from several sources, thereby complicating the operation.

7.8 *Payees' Considerations—Interrelationship of Rates, Exemptions and Intra-Annual Refunds*

From the standpoint of the payee, the use of the exemption or the provision for intra-annual refunds are mechanics for alleviating the burden caused by overwithholding. To some extent the same result can be achieved by a lowering of the effective withholding rate. These three mechanics are not mutually exclusive and can be applied either alone or in combination.

7.9 *Administrative Considerations*

From the standpoint of administering a withholding system, the interrelationship of these various facets must be explicitly set forth. It can reasonably be anticipated that there will be many claims for refund filed if intra-annual refunds are permitted. This committee knows of no way effectively to check the validity of these claims without a receipt system.

The advantage to be gained by the use of the gross-up technique, that is, a flat rate and simplicity of determining the gross amount to be reported as income, disappears if personal exemptions are permitted. The use of variable personal exemptions will change the effective withholding rate on each payee, and grossing-up will then be invalid. Similarly, if personal exemptions are permitted, receipts will be necessary to permit both the taxpayer and the Service to know what the effective withholding rate was. Therefore, no personal exemption system can be permitted unless a receipt system is adopted.

Similarly, intra-annual refunds are designed to accomplish the same results as personal exemption certificates. It would seem to increase unnecessarily the paperwork of the payees, payors and the Service to use both of these techniques when one should suffice, and the addition of the second technique would not be economically sound.

If intra-annual refunds are permitted, a simple gross-up will not be valid for a person who has received an intra-annual refund and special provision will have to be made for such person.

8. Additional Problems

There are a number of additional problems which must be solved in the enactment of legislation designed to institute withholding on dividends and interest.

If no receipts are required, the payee will be in the position of having part of his money sent to the United States Government although the payor is not required to furnish any accounting to him annually or periodically. There should be considered a statutory enactment which will require certain payors to account to payees upon demand. It may be that such legislation would be necessary only with respect to United States obligations, such as Series E Bonds. A taxpayer selling or buying stock will ordinarily have the certificate or some record from the broker to show his ownership of the stock. A taxpayer buying or cashing Series E Bonds at a bank, however, may have no record of his ownership, and may be unable to prove to an examining revenue agent his right to a credit or refund.

If there are no receipts, the definition of the payments which are subject to withholding, and the payments which are not, should be very simple and very clear, so as to avoid confusion and error by payees. The definition of a dividend as presently contained in the Internal Revenue Code may be too complicated for purposes of any system of withholding without receipts.

Whether or not there are receipts, there will be special problems in determining how to treat, and who is to obtain the benefits of, the withheld amount in the case of fiduciaries who receive income and make distributions of all or part of their income to beneficiaries, in the case of partnerships, in the case of regulated investment companies, in the case of corporations which have elected to be taxed under Subchapter S, and so forth. All of these areas of the tax law are already quite complicated, and the provision for the treatment of withheld amounts in these cases should be as simple as possible. It might

be undesirable to require a "tracing" of the dividend or interest on which there is withholding.

The present income tax forms are quite complicated. The provisions for withholding may make them even more complex. This will be particularly true if the withholding system does not require receipts, since there will then probably have to be two schedules, one for dividends and interest subject to withholding, and another for dividends and interest not subject to withholding.

The present system for estimated tax returns should be reconsidered so as to coordinate its requirements with the new withholding system.

9. Conclusion

The committee would favor a withholding of tax on dividends and interest, if it were demonstrated to be a practicable way and the only practicable way to close the gap in reporting of dividends and interest within a reasonable time. However, the committee does not favor such withholding unless, after thorough investigation and analysis, it is reasonably apparent that this is necessary.

In making such investigation and analysis the following should be considered:

1. Separation from the balance of the current tax legislation the matter of taxpayer account numbers and sending that through as a separate bill.

   The effective date would be the earliest practicable. Information furnished to the committee is to the effect that a changeover to taxpayer account numbers in the case of a large proportion of dividend payors might be possible by January 1, 1963. The committee has no information as to when interest payors could commence operations with taxpayer account numbers.

2. Reduction of the information return requirements on interest payments.

   A level of around $100 may be more realistic than the present $600 level.

3. If taxpayer account numbers can go into full operation in 1963, a complete collation and matching of information returns with tax returns for that year.

   a. Acceleration of the time schedule for automatic data processing so as to obtain as much assistance as possible from the new electronic equipment.

   b. Communication with a substantial percentage of taxpayers who understate dividend and interest income for 1963 beyond a tolerance set by the Treasury Department.

   c. Examination of the returns for prior years of taxpayers who substantially understate dividend or interest income for 1963. The information developed for 1963 would assist in this operation.

   d. Development of more statistical information from the matching of information returns with tax returns. This infor-

mation would show more accurately than is presently possible how much dividend and interest income is underreported and the brackets of the taxpayers involved. Data should be developed so that there will be information which will make it possible, for example, accurately to estimate the number and amount of refunds because of overwithholding at various alternative rates.

The cost of the matching of all information returns with tax returns will be very large. However, this committee believes that the results would justify a substantial expenditure because: (1) there should be better reporting as the result of public knowledge of the matching program, (2) additional tax will be collected from those whose understatements are revealed by the matching program, and (3) it will provide the data for a more informed determination as to the desirability of a withholding of tax on dividends and interest and its implementation, if determined to be desirable. The above suggestions are directed at all types of underreported income, which for 1957 were estimated to aggregate more than $20 billion.

EXHIBIT 1

WITHHOLDING OF TAX AT 20% ON DIVIDENDS AND INTEREST

ANALYSIS OF POINTS AT WHICH THERE WILL BE AN OVERWITHHOLDING OF TAX UNDER VARIOUS STATED ASSUMPTIONS

(All Computations Assume the Standard Deduction and Do Not Include the Retirement Income Credit)

	Married Couple; Over 65; No Dependents	Married Couple; Under 65; No Dependents	Head of Household; Under 65; 1 Dependent	Single; Over 65; No Dependents	Single; Under 65; No Dependents
1. Income solely from dividends; present law as to exclusion and credit for dividends					
Withholding at 20% will result in overwithholding on any income under.	$24,950	$21,950	$16,447	$13,750	$12,296
2. Income solely from withholdable interest					
Withholding at 20% will result in overwithholding on any income under.	19,000	15,400	12,367	10,771	8,857
3. Mixed income—part subject to 20% withholding and part not subject (no recognition of dividend exclusion or credit)					
a. Taxable income of $1,000					
Gross income	3,778	2,444	2,444	2,444	1,778
There will be overwithholding if—					
Amount of income subject to withholding is more than—.......	1,000	1,000	1,000	1,000	1,000
And the amount of income not subject to withholding is less than	2,778	1,444	1,444	1,444	778
b. Taxable income of $2,000					
Gross income	4,889	3,556	3,556	3,556	2,889
There will be overwithholding if—					
Amount of income subject to withholding is more than—.......	2,000	2,000	2,000	2,000	2,000
And the amount of income not subject to withholding is less than	2,889	1,556	1,556	1,556	889
c. Taxable income of $3,000					
Gross income	6,000	4,667	4,667	4,667	4,000
There will be overwithholding if—					
Amount of income subject to withholding is more than—.......	3,000	3,000	3,050	3,100	3,100
And the amount of income not subject to withholding is less than	3,000	1,667	1,617	1,567	900
d. Taxable income of $4,000					
Gross income	7,111	5,778	5,778	5,778	5,111
There will be overwithholding if—					

	Married Couple; Over 65; No Dependents	Married Couple; Under 65; No Dependents	Head of Household; Under 65; 1 Dependent	Single; Over 65; No Dependents	Single; Under 65; No Dependents
Amount of income subject to withholding is more than—	$4,000	$4,000	$4,100	$4,200	$4,200
And the amount of income not subject to withholding is less than	3,111	1,778	1,678	1,578	911
e. Taxable income of $5,000					
Gross income	8,222	6,889	6,889	6,889	6,222
There will be overwithholding if—					
Amount of income subject to withholding is more than—	5,100	5,100	5,300	5,500	5,500
And the amount of income not subject to withholding is less than	3,122	1,789	1,589	1,389	722
f. Taxable income of $6,000					
Gross income	9,333	8,000	8,000	8,000	7,333
There will be overwithholding if—					
Amount of income subject to withholding is more than—	6,200	6,200	6,500	6,800	6,800
And the amount of income not subject to withholding is less than	3,133	1,800	1,500	1,200	533
g. Taxable income of $7,000					
Gross income	10,400	9,111	9,111	9,111	8,444
There will be overwithholding if—					
Amount of income subject to withholding is more than—	7,300	7,300	7,800	8,300	8,300
And the amount of income not subject to withholding is less than	3,100	1,811	1,311	811	144
h. Taxable income of $8,000					
Gross income	11,400	10,200	10,200	10,200	Not Applicable
There will be overwithholding if—					
Amount of income subject to withholding is more than—	8,400	8,400	9,100	9,800	
And the amount of income not subject to withholding is less than	3,000	1,800	1,100	400	
i. Taxable income of $9,000					
Gross income	12,400	11,200	11,200	Not Applicable	
There will be overwithholding if—					
Amount of income subject to withholding is more than—	9,700	9,700	10,600		
And the amount of income not subject to withholding is less than	2,700	1,500	600		

EXHIBIT 1—*Continued*

	Married Couple; Over 65; No Dependents	Married Couple; Under 65; No Dependents	Head of Household; Under 65; 1 Dependent	Single; Over 65; No Dependents	Single; Under 65; No Dependents
j. Taxable income of $10,000					
Gross income	$13,400	$12,200	$12,200	Not Applicable	
There will be overwithholding if—					
Amount of income subject to withholding is more than—.......	11,000	11,000	12,100		
And the amount of income not subject to withholding is less than	2,400	1,200	100		
k. Taxable income of $11,000					
Gross income	14,400	13,200	Not Applicable		
There will be overwithholding if—					
Amount of income subject to withholding is more than—.......	12,300	12,300			
And the amount of income not subject to withholding is less than	2,100	900			
l. Taxable income of $12,000					
Gross income	15,400	14,200			
There will be overwithholding if—					
Amount of income subject to withholding is more than—.......	13,600	13,600			
And the amount of income not subject to withholding is less than	1,800	600			
m. Taxable income of $13,000					
Gross income	16,400	15,200			
There will be overwithholding if—					
Amount of income subject to withholding is more than—.......	15,100	15,100			
And the amount of income not subject to withholding is less than	1,300	100			
n. Taxable income of $14,000					
Gross income	17,400	Not Applicable			
There will be overwithholding if—					
Amount of income subject to withholding is more than—.......	16,600				
And the amount of income not subject to withholding is less than	800				

	Married Couple; Over 65; No Dependents	Married Couple; Under 65; No Dependents	Head of Household; Under 65; 1 Dependent	Single; Over 65; No Dependents	Single; Under 65; No Dependents
o. Taxable income of $15,000					
Gross income	$18,400				
There will be overwithholding if—					
Amount of income subject to withholding is more than—.......	18,100				
And the amount of income not subject to withholding is less than	300				

EXHIBIT 2

WITHHOLDING OF TAX AT 20% ON DIVIDENDS AND INTEREST

Analysis of Points at Which There Will Be an Overwithholding of Tax Under Various Stated Assumptions

(All Computations Assume Total Deductions as Indicated and Do Not Include the Retirement Income Credit)

	Married Couple; Over 65; No Dependents	Married Couple; Under 65; No Dependents	Head of Household; Under 65; 1 Dependent	Single; Over 65; No Dependents	Single; Under 65; No Dependents
1. Income solely from dividends; present law as to exclusion and credit for dividends (Footnote 1) Withholding at 20% will result in overwithholding on any income under	$32,103	$28,633	$20,153	$16,116	$14,384
2. Income solely from withholdable interest (Footnote 1) Withholding at 20% will result in overwithholding on any income under	24,384	20,125	14,847	12,192	10,063
3. Mixed income—part subject to 20% withholding and part not subject (no recognition of dividend exclusion or credit) (Footnote 2)					
a. Taxable income of $1,000 Gross income	4,250	2,750	2,750	2,750	2,000
There will be overwithholding if— Amount of income subject to withholding is more than—	1,000	1,000	1,000	1,000	1,000
And the amount of income not subject to withholding is less than	3,250	1,750	1,750	1,750	1,000
b. Taxable income of $2,000 Gross income	5,500	4,000	4,000	4,000	3,250

[1] These computations assume total deductions equal 13% of adjusted gross income. The ratio of deductions to adjusted gross income reflected in taxable returns for 1958 of individuals claiming itemized deductions and with adjusted gross income between $25,000 and $50,000 was 13.43%. This ratio was computed from data in Statistics of Income—1958, Individual Income Tax Returns, Table 10, page 57, Columns (2), (3) and (4).

[2] The following computations assume total deductions equal 20% of adjusted gross income. The ratio of deductions to adjusted gross income reflected in taxable returns for 1958 of individuals claiming itemized deductions and with adjusted gross income of less than $10,000 was 19.53%. This ratio was computed from data in Statistics of Income—1958, Individual Income Tax Returns, Table 10, page 57, Columns (2), (3) and (4) for the total of adjusted income brackets on lines 1 through 14, inclusive. For computation purposes, the 20% ratio was used even though the assumed adjusted gross income exceeded $10,000. For informational purposes, the actual ratios of deductions to adjusted gross income in the brackets of adjusted gross income in excess of $10,000 were as follows:

Adjusted Gross Income	Ratio of Total Deductions to Adjusted Gross Income
$10,000 under $15,000	16.91%
$15,000 under $20,000	15.55%
$20,000 under $25,000	14.56%
$25,000 under $50,000	13.43%

	Married Couple; Over 65; No Dependents	Married Couple; Under 65; No Dependents	Head of Household; Under 65; 1 Dependent	Single; Over 65; No Dependents	Single; Under 65; No Dependents
There will be overwithholding if—					
Amount of income subject to withholding is more than—	$2,000	$2,000	$2,000	$2,000	$2,000
And the amount of income not subject to withholding is less than	3,500	2,000	2,000	2,000	1,250
c. Taxable income of $3,000					
Gross income	6,750	5,250	5,250	5,250	4,500
There will be overwithholding if—					
Amount of income subject to withholding is more than—	3,000	3,000	3,050	3,100	3,100
And the amount of income not subject to withholding is less than	3,750	2,250	2,200	2,150	1,450
d. Taxable income of $4,000					
Gross income	8,000	6,500	6,500	6,500	5,750
There will be overwithholding if—					
Amount of income subject to withholding is more than—	4,000	4,000	4,100	4,200	4,200
And the amount of income not subject to withholding is less than	4,000	2,500	2,400	2,300	1,550
e. Taxable income of $5,000					
Gross income	9,250	7,750	7,750	7,750	7,000
There will be overwithholding if—					
Amount of income subject to withholding is more than—	5,100	5,100	5,300	5,500	5,500
And the amount of income not subject to withholding is less than	4,150	2,650	2,450	2,250	1,500
f. Taxable income of $6,000					
Gross income	10,500	9,000	9,000	9,000	8,250
There will be overwithholding if—					
Amount of income subject to withholding is more than—	6,200	6,200	6,500	6,800	6,800
And the amount of income not subject to withholding is less than	4,300	2,800	2,500	2,200	1,450
g. Taxable income of $7,000					
Gross income	11,750	10,250	10,250	10,250	9,500
There will be overwithholding if—					
Amount of income subject to withholding is more than—	7,300	7,300	7,800	8,300	8,300
And the amount of income not subject to					

EXHIBIT 2—*Continued*

	Married Couple; Over 65; No Dependents	Married Couple; Under 65; No Dependents	Head of Household; Under 65; 1 Dependent	Single; Over 65; No Dependents	Single; Under 65; No Dependents
withholding is less than	$4,450	$2,950	$2,450	$1,950	$1,200
h. Taxable income of $8,000					
Gross income	13,000	11,500	11,500	11,500	10,750
There will be overwithholding if—					
Amount of income subject to withholding is more than—.......	8,400	8,400	9,100	9,800	9,800
And the amount of income not subject to withholding is less than	4,600	3,100	2,400	1,700	950
i. Taxable income of $9,000					
Gross income	14,250	12,750	12,750	12,750	12,000
There will be overwithholding if—					
Amount of income subject to withholding is more than—.......	9,700	9,700	10,600	11,500	11,500
And the amount of income not subject to withholding is less than	4,550	3,050	2,150	1,250	500
j. Taxable income of $10,000					
Gross income	15,500	14,000	14,000	14,000	13,250
There will be overwithholding if—					
Amount of income subject to withholding is more than—.......	11,000	11,000	12,100	13,200	13,200
And the amount of income not subject to withholding is less than	4,500	3,000	1,900	800	50
k. Taxable income of $11,000					
Gross income	16,750	15,250	15,250	15,250	Not Applicable
There will be overwithholding if—					
Amount of income subject to withholding is more than—.......	12,300	12,300	13,700	15,100	
And the amount of income not subject to withholding is less than	4,450	2,950	1,550	150	
l. Taxable income of $12,000					
Gross income	18,000	16,500	16,500	Not Applicable	
There will be overwithholding if—					
Amount of income subject to withholding is more than—.......	13,600	13,600	15,300		
And the amount of income not subject to withholding is less than	4,400	2,900	1,200		

	Married Couple; Over 65; No Dependents	Married Couple; Under 65; No Dependents	Head of Household; Under 65; 1 Dependent	Single; Over 65; No Dependents	Single; Under 65; No Dependents
m. Taxable income of $13,000					
Gross income	$19,250	$17,750	$17,750	Not Applicable	
There will be overwithholding if—					
Amount of income subject to withholding is more than—.......	15,100	15,100	17,100		
And the amount of income not subject to withholding is less than	4,150	2,650	650		
n. Taxable income of $14,000					
Gross income	20,500	19,000	19,000	Not Applicable	
There will be overwithholding if—					
Amount of income subject to withholding is more than—.......	16,600	16,600	18,900		
And the amount of income not subject to withholding is less than	3,900	2,400	100		
o. Taxable income of $15,000					
Gross income	21,750	20,250	Not Applicable		
There will be overwithholding if—					
Amount of income subject to withholding is more than—.......	18,100	18,100			
And the amount of income not subject to withholding is less than	3,650	2,150			
p. Taxable income of $20,000					
Gross income	28,000	26,500	Not Applicable		
There will be overwithholding if—					
Amount of income subject to withholding is more than—.......	26,400	26,400			
And the amount of income not subject to withholding is less than	1,600	100			
q. Taxable income of $22,000					
Gross income	30,500	Not Applicable			
There will be overwithholding if—					
Amount of income subject to withholding is more than—.......	30,200				
And the amount of income not subject to withholding is less than	300				

ESTIMATED DIVIDEND GAP 1955 TO 1959

(In millions of dollars)

	1955	1956	1957	1958	1959
Cash distributions to stockholders by domestic corporations, Statistics of Income	13,592	14,498	14,914	14,952	16,159[1]
Domestic dividends received by domestic corporations, Statistics of Income, less dividends received from Federal Reserve Banks	−2,563	−2,677	−2,669	−2,816	−2,990[1]
Net dividends paid by domestic corporations	11,029	11,821	12,245	12,136	13,169[1]
Domestic dividends paid abroad	− 302	− 284	− 321	− 408	− 442
Foreign dividends received by individuals	+ 171	+ 119	+ 114	+ 114	+ 115
Distributions paid to individuals, fiduciaries and tax-exempt organizations	10,898	11,656	12,038	11,842	12,842[1]
Distributions of small business corporations taxed as partnerships	...	...	...	− 67	− 103
Distributions exempt from tax	− 125	− 150	− 175	− 200	− 200
Distributions taxable as capital gains	− 278	− 368	− 349	− 329	− 506
Dividends received by corporate pension funds[2]	− 174	− 229	− 271	− 318	− 365
Dividends received by other tax-exempt organizations[2]	− 454	− 479	− 491	− 481	− 501
Dividends received by persons not required to file or who use 1040A	− 94	− 101	− 104	− 107	− 117
Dividends retained by estates and trusts	− 340	− 346	− 365	− 365	− 396
Total deductions	−1,465	−1,673	−1,755	−1,867	−2,188
Dividends includable on individual tax returns	9,433	9,983	10,283	9,975	10,654
Dividends reported on individual tax returns	8,100	8,892	9,432	9,058	9,714
Dividend reporting gap	1,333	1,091	851	917	940
Attributable to nontaxable filers	153	125	98	104	106
Attributable to taxable filers	1,180	966	753	813	834

Office of the Secretary of the Treasury
Office of Tax Analysis

May 3, 1961

[1] Estimated by relationship to Commerce Department estimates.

[2] Estimate limited to corporate pension funds as defined by SEC. Joint, union controlled and non-profit institution funds are included with other tax-exempt organizations.

EXHIBIT 4

[illegible] INTEREST INCOME OF INDIVIDUALS NOT ACCOUNTED FOR ON TAX RETURNS FOR 1956, 1957, 1958 AND 1959

An Analysis of Payments to Individuals of Interest Includable in Taxable Income, by Source of Payment, and the Amounts Reported and Not Reported on Federal Tax Returns

	1956	1957	1958	1959
	(In millions of dollars)			
Interest payments to individuals:				
Cash interest paid on Government securities[1]	1,200	1,400	1,200	1,600
Interest paid on corporation bonds and notes[1]	746	837	883	945
Interest on time and savings deposits[1]	1,564	1,976	2,231	2,522
Interest on savings shares[1]	1,120	1,384	1,627	1,939
Interest paid on holdings of foreign bonds	50	58	62	70
Interest on farm mortgages paid to non-farm individuals	181	198	214	240
Interest paid on non-farm mortgages	1,000	1,100	1,220	1,400
Interest paid to unincorporated brokers and dealers	71	69	86	109
Interest paid to unincorporated consumer credit companies	144	155	155	161
Interest paid on life insurance dividends left to accumulate	74	80	87	94
Interest paid to retail auto dealers	50	48	51	59
Total payments	6,200	7,305	7,816	9,139
Deduct:				
Interest reported as business income by sole proprietors	331	383	407	462
Interest received by low income individuals not required to file	133	154	166	188
Interest receipts of non-profit organizations	211	244	260	295
Total deductions	675	781	833	945
Interest includable in individual tax returns	5,525	6,524	6,983	8,194
Interest reported as such on tax returns:				
Individuals—Form 1040	2,872	3,319	3,659	4,542
Individuals—Form 1040-A	3	3	8	8
Partnerships	232	268	285	334
Fiduciaries	346	400	426	483
Total	3,453	3,990	4,378	5,357
Estimated amount of interest payments not accounted for	2,072	2,534	2,605	2,837
Attributable to nontaxable filers	622	760	782	842
Attributable to taxable filers	1,450	1,774	1,823	1,995

Office of the Secretary of the Treasury
Office of Tax Analysis

May 3, 1961

[1] These items include payments to nonprofit organizations.

LEGISLATIVE RECOMMENDATION FOR A SYSTEM OF TAXPAYER ACCOUNT NUMBERS

SUPPLYING OF IDENTIFYING NUMBERS

Resolved, That the American Bar Association recommends to the Congress that it enact legislation to improve the Internal Revenue tax administration by providing for the use of numbers to identify taxpayers on returns filed by taxpayers and on information returns showing payments of income to taxpayers; and

Be It Further Resolved, That the Association proposes that this result be effected by amending the Internal Revenue Code of 1954 by adding thereto a new section; and

Be It Further Resolved, That the Section of Taxation is directed to urge the following amendment, or its equivalent in purpose and effect, upon the proper committees of Congress:

Sec. 1. Part I of Subchapter A of Chapter 61 of the Internal Revenue Code of 1954 (relating to records, statements, and special returns) is amended by adding at the end thereof the following new section (insert new matter in italics):

SEC. 6002. SUPPLYING OF IDENTIFYING NUMBERS.

In addition to the requirements set forth in Parts II and III of this subchapter, when required by regulations prescribed by the Secretary or his delegate—

(1) Any person required by this title or by regulations made under authority thereof to make a return, statement, or other document shall include in such return, statement, or other document such identifying number as may be prescribed for securing proper identification of such person.

(2) Any person with respect to whom a return or statement of information is required by this title or by regulations made under authority thereof to be made by another person shall furnish to such other person such identifying number as may be prescribed for securing his proper identification.

(3) Any person required by this title or by regulations made under authority thereof to make a return or statement of information with respect to another person shall include therein such identifying number, received from such other person, as may be prescribed for securing proper identification of such other person, unless reasonable cause is shown for failure to so include such identifying number.

Sec. 2. The title of Part I of Subchapter A of Chapter 61 of the Internal Revenue Code of 1954 is amended to read as follows (eliminate matter struck through and insert new matter in italics):

PART I—RECORDS, STATEMENTS, ~~AND~~ SPECIAL RETURNS, *AND IDENTIFYING NUMBERS*

Sec. 3. The table of sections for Part I of Subchapter A of Chapter 61 of the Internal Revenue Code of 1954 is amended by adding at the end thereof the following:

Sec. 6002. Supplying of identifying numbers.

EXPLANATION

Summary

In order to enforce the income tax laws more effectively, the Internal Revenue Service should be able to establish for each taxpayer a master file from which it can readily obtain pertinent information shown on the taxpayer's own return and on information returns showing payments of income to him. This type of file, as well as automatic matching of such information, is possible with modern electronic computing equipment if there is adequate identification of the taxpayer.

The Service has initiated a program which contemplates a complete change-over in due course to the use of such electronic computing equipment for record purposes. The name and address of the taxpayer is all that is now required on information returns (other than information returns with respect to wages), and this is not adequate identification for an automatic data processing system with modern electronic equipment. It is necessary for adequate identification that each taxpayer be assigned an account number which will be used on the taxpayer's own return as well as on information returns reporting payments of income to the taxpayer.

It is contemplated that the proposed legislation would require every taxpayer to obtain and use a number similar to the Social Security number used by recipients of wages at the present time. It is understood that the Social Security number would be used by those taxpayers who now have such numbers; other taxpayers would in effect be required to obtain Social Security numbers.

The enactment of this legislation is recommended because it is needed by the Internal Revenue Service in order to adopt and put into full operation the master file concept of tax administration. Such legislation is an important step in making it possible for the Service, when dealing with a taxpayer, to do so with full knowledge of all pertinent information in the files of the Service. With this system, it will be possible for the Service to process automatically a great deal of information made available to it each year. Such master files will also provide the Service with a valuable and ready source of statistical information needed for other purposes.

Discussion

Careful and exhaustive statistical studies which have been made during recent years by the Committees of Congress and by the Treasury Department indicate the existence of so-called "gaps" of unreported income received by individuals. It is practically impossible to determine the exact amount of each gap but estimates by reliable sources range, in the case of dividends from the neighborhood of one hundred million up to one billion dollars, in the case of interest in the neighborhood of three billion dollars, and possibly as high as ten billion dollars in the case of entrepreneurial income.

The Internal Revenue Service cannot audit every individual income tax return (around sixty million for each of the last three years) for the purpose of ascertaining and recovering this lost revenue. The manpower is not available, but even if it were, the cost, relative to the gain, would be prohibitive.

In order to facilitate the audit work of the Service, Congress has for many years provided for information returns by various types of payors of income. By matching the information in such returns with the tax returns of the recipients of the income, the Service can readily spot any omission by them of income reported on the information returns. This, however, involves the association of the information returns with the tax returns of the recipients. For the reasons stated below, the Service has found it impracticable to accomplish any general association and, as a consequence, has not been able to use the information returns as effectively as would be desirable.

Identification of the income recipient shown in the information returns, which show only his name and address, has been one of the major problems encountered in trying to associate taxpayers' returns with information returns on any full scale

basis. The identification factors of name and address are subject to an almost endless variety of errors and mutations, any one of which makes it impossible (without further investigation) to match the information document with the tax return. For example, the name of a given individual might appear on the stock ownership register of different corporations as John T. Miller, John Tracy Miller, J. T. Miller, John T. Miller, Jr., etc. Similarly, the addresses of the taxpayer used by various payors may be different and may be different from the address used on the taxpayer's return. In many instances, identification is further complicated by the fact that many married persons own stock independently but file tax returns jointly. Conversely, stocks are sometimes owned jointly by persons who file returns separately.

Thus, it seems clear that a simple and reliable identification medium should be adopted if the full enforcement potential of information returns is to be realized.

It is believed that the adoption of a system which would require each taxpayer to obtain and use a number would solve most, if not all, of the identification problems and thus greatly facilitate the association of taxpayers' returns with information returns.

The great volume of returns involved has also been a serious problem in connection with the association of returns. More than sixty million income tax returns were filed by individuals for the year 1960. Nearly 325 million information returns were received by the Service for 1960. Of these returns, more than 208 million were Forms W-2 (wages paid to and tax withheld on employees), approximately 110 million were Forms 1099 (information returns on payments of dividends, interest, etc.) and approximately 6 million were Forms 1087 (ownership certificate—dividends on stock). It appears obvious that, because of the great volume of returns involved, manual association, even with account numbers, would still be very costly, if not prohibitive.

In order to improve administration, including meeting the problem of volume, the Treasury Department now is developing plans for a change-over to a comprehensive system of automatic data processing of tax returns and related documents. A pilot plant, in the Atlanta region, is expected to begin returns processing in January, 1962. The general use of electronic equipment is contemplated as soon as projected acquisition and operational programs can be completed. An essential element of the use of such a mechanized system, however, is the use of account numbers in addition to names and addresses to identify taxpayers throughout the processing and record-keeping operations.

We are informed that reasonably complete and satisfactory association of information returns with taxpayer returns can be accomplished through the use of automatic data processing equipment if taxpayer account numbers are available for use in processing the documents through such equipment. Such association of returns should enable the Service to establish and maintain a master file for every taxpayer which would contain (in addition to taxpayer's number, name and address) such information as:

1. Detail of income and deductions as reported on his returns and as changed on account of audit adjustments.
2. Information reported on Forms W-2 (Withholding Tax Statement on Wages), 1099 (Information Return of Income Paid), 1087 (Ownership Certificate—Dividends on Stock) and other information returns by payors.
3. Estimated and withheld taxes paid by the taxpayer; bills sent to him; payments received from him; refunds made to him; balances due from him.

The recording of these categories of information in the master file would enable the Service to achieve specific objectives which are now either impractical or only partly practical. Thus, the following objectives could be accomplished:

1. Systematic check on failure of individuals and business entities to file returns.

2. Verification of mathematical accuracy of returns filed and computation of tax or refunds due.
3. Determination of taxpayer indebtedness for prior year taxes of all types prior to issuance of a current refund, and identification of duplicate refunds.
4. Provision for a consolidated tax account for each taxpayer that will reflect current tax status at any given point in time.
5. Matching of data reported on information documents with corresponding data on taxpayer returns.
6. Classification of returns for audit purposes.
7. Preparation of management, operating, and statistical reports.

It is believed that such master files would greatly facilitate the work of the Service in reducing the income gaps referred to above. They would also be of great help to the Service in detecting and correcting improper deductions.

Legislation is deemed to be needed before a general taxpayer account number system can be used by the Service. The proposed legislation would give the Service the needed authority to use such a system.

It is contemplated that if this legislation is adopted the Treasury Department would probably require those taxpayers who already have Social Security numbers to use these numbers and would probably require other taxpayers who make returns to obtain similar numbers which would be their permanent numbers similar to Social Security numbers. Since 85% to 90% of all individual income tax returns filed at the present time show a Social Security account number, this would appear to be a practical way of requiring every taxpayer to obtain a number for Federal income tax purposes.

Mention should be made of the problems of payors if a general taxpayer account number system is adopted. Payors will be required to obtain the account numbers from payees and show the account numbers thus obtained on their information returns. Admittedly this would involve additional time and expense on the part of payors, especially in the initial stages of the system. The seriousness of this factor would vary with different payors. It would also be aggravated in cases where payees were uncooperative. It might also, in some case, be more or less disturbing to payor and payee client relationships. It is believed, however, that the additional cost and inconvenience to payors would not be sufficiently great to offset the revenue benefit which would be expected to flow from a general association of returns, the establishment of taxpayer master files, and automatic data processing. This revenue benefit would redound to the benefit of taxpayers generally.

The question of sanctions should also be mentioned. It must be recognized that this legislation imposes many additional duties on payors of income. This new system may present a number of practical problems for payors, particularly during the transitional period when it is first being placed in operation. It is the opinion of the committee that, because of the nature and newness of the system, no severe sanctions should be imposed. The problem of uncooperative payees who fail or refuse to give their account numbers to payors of income should be handled by the Service; a report to the Service by the payor should discharge his duty in the matter. A penalty for noncompliance similar to that provided by section 6652, which is assessed in the same manner as taxes, would appear to be desirable. Both payors and payees should be given a reasonable amount of time for preparation for compliance before any other penalties are imposed. There should be no sanctions with respect to payors who comply with the requirements of putting on information returns the numbers received.

No specific recommendation is made with respect to the effective date of the legislation. It is believed that this determination should be made after consideration by Congress of the time needed by taxpayers for compliance with the new procedures. It may be noted in this connection that the time within which taxpayers are required to obtain and use account numbers for themselves could very well precede the time when such account numbers must be furnished to payors and used by the payors in connection with information returns. It is

further believed that in view of the additional cost and inconvenience to payors in adapting their procedures to this legislation, their problems should be given sympathetic attention, and Congress should adopt a liberal attitude with respect to the time to be granted them for compliance.

The present information return system recognizes that taxpayers may make their investments in the name of an agent or nominee rather than in their own name. Form 1087 is filed by the agent or nominee in order to disclose the true owner to the Service; this information need not be given to the payor of the income. It is expected that the Service will make appropriate provision for a similar system of anonymity for the true owner in the event the taxpayer account number system is adopted.

A mass income tax system was adopted in 1942 as a result of the demands of World War II. Prior to that date, there was a relatively thorough investigation of income tax liability. This thorough investigation has heretofore been impossible for the mass income tax system because of the vast number of returns involved. Sampling and similar techniques have been adopted to make efficient use of available personnel and equipment. The use of such techniques has failed to prevent the development of large gaps in the reporting of taxable income. Modern electronic equipment should facilitate a more thorough use of the information available to the Service (automatic data processing), and a taxpayer account number system is essential to the efficient operation of such equipment. In addition, automatic data processing is not limited to any one function, such as the matching of taxpayers' returns with information returns. It is likely that experience by the Service with modern electronic computers may enable it to develop other functions for this equipment which will permit an even more thorough investigation of income tax liability than that now contemplated.

It is believed that the adoption of the proposed legislation would, for the reasons set forth above, greatly facilitate the administration of the income tax laws, to the end of recovering large amounts of revenue otherwise lost. The enactment of such legislation is therefore recommended.

H.R. 10650: COMMENTS ON SECTION 19—WITHHOLDING OF INCOME TAX AT SOURCE ON INTEREST, DIVIDENDS, AND PATRONAGE DIVIDENDS

SECTION 3484—REFUND OF TAX TO INDIVIDUALS

The refund allowance under section 3484(b) is geared in such a manner that it cannot possibly take into account deductions in excess of standard deductions. Recipients of dividends or interest, particularly if they are aged, may have deductions for medical expenses, etc., well in excess of the standard deduction. In the case of these individuals, the refund allowance would not be sufficient to cover the excess withholding.

Also, the refund allowance in section 3484(b) does not take into account that the overwithholding may vary with the amount of dividends or interest received by a taxpayer. Thus, in the case of a married couple, both under 65, with no income other than from dividends and interest, the refund allowance under section 3484(b) would be $264 (22 percent of $1,200). If their income from interest were $2,000 and they had no other income, using the standard deduction, there would be a net tax payable of $120. There would have been withheld $400, so that the overwithholding would be $280. The refund allowance would be $264, which is only $16 less than the withholding in excess of tax liability. If this same married couple has $5,000 of income from interest and no other income, their tax liability would be $660 and the withholding of $1,000 would be excessive to the extent of $340. However, their refund allowance would be $264, just as in the case of the couple with $2,000 of interest income. Thus, there would be $76 of excessive withholding that could not be recovered until the filing of the tax return after the end of the year. Because of the progressive tax rates, the differential between the refund allowance and the withholding in excess of actual tax liability does not increase radically over the $5,000 of interest income level. Thus, in the case of $10,000 of interest income and no other income, the hypothetical couple would owe a tax of $1,636, which is $364 less than the $2,000 that would be withheld. This, of course, is exactly $100 more than the refund allowance.

Section 3484 also does not take into account in the refund allowance under subsection (b) the differential between the taxation of income from dividends and income from interest. For example, if the hypothetical couple both under age 65 received $5,000 in dividends and had no other income, their income tax liability would be $452. This is $548 less than the $1,000 that would be withheld on their dividend income. The refund allowance would still be $264, so they would have $284 of excess withholding that could not be recouped until the filing of their tax return the following year.

Another criticism with respect to section 3484 is that the refund would not be made ratably but would fall preponderantly in the early quarters. Going back to our hypothetical married couple, both under age 65, with $5,000 of income from interest and no other income, the refund allowance would be $264. Under section 3484(a), for the first quarter they would be entitled to a refund of $250, which is the amount of the tax deducted and withheld during that quarter and which is not in excess of the $264 refund allowance. They would receive a refund of $14 for the second quarter, and no refund for the third quarter. This may not be a defect since there may be merit in having the fast refund, but at least it is a peculiarity of the operation of section 3484 which warrants further consideration.

SECTION 3452—INTEREST DEFINED

In defining interest the bill introduces a new definition of indebtedness. If existing or prior definitions as to which case authority has been developed are found to meet the legislative intention there would be an advantage in avoiding the further confusion of multiple definitions.

For documentary stamp tax purposes the term employed is "certificates of indebtedness," which is defined in section 4381(a) to mean "bonds, debentures, or certificates of indebtedness; and includes all instruments, however termed, issued by a corporation with interest coupons or in registered form, known generally as corporate securities."

There is a considerable body of case law interpreting the stamp tax definition.

Under section 439(b)(1) of the 1939 code "outstanding indebtedness" was defined for borrowed capital purposes as "the outstanding indebtedness (not including interest) of the taxpayer, incurred in good faith for the purposes of

the business, which is evidenced by a bond, note, bill of exchange, debenture certificate of indebtedness, mortgage, deed of trust, bank loan, agreement, o conditional sales contract." Here again there is a substantial body of cas law interpreting the term.

The multiplicity of definitions may lead to confusion in an area in which without the use of receipts, it will be impossible to determine whether the with holding agent is adopting the same interpretation as to a given instrument a the payee claiming tax credit.

The report of the Ways and Means Committee, at page A140, states that "If an instrument can be transferred by endorsement it is not in registered forn even though a list is maintained by the corporation of the negotiable instruments issued by it. Therefore an evidence of indebtedness issued by a corporation falls into category (*a*) if it either is nonnegotiable, or if negotiable, was issued with interest coupons." The final statement seems too broad. An instrument may be nonnegotiable by reason of a legend inscribed on it destroying negotiability without being "in registered form," at least insofar as that term has been construed by the courts under provisions such as section 165(g)(2)(C) and section 1232(a)(1).

SECTION 3452(a)(7)(A)—INTEREST DEFINED

The Internal Revenue Service is understood to have had under consideration for some time the issue of whether withholding under section 1441 is applicable to discount. There is an early ruling, O.124, 2 C.B. 189 (1920), ruling that discount was not subject to withholding. The Service followed this ruling in I.T. 1398, I-2 C.B. 149 (1922), holding that gain arising from the buying and selling of discount bank acceptances was not subject to withholding. It is understood that the Service has drafted regulations reaching a contrary result, but that they have been under reconsideration. With the express reference to discount in section 3452(a)(7)(A), the Service may be foreclosed on the issue of withholding on discount under section 1441(b). The fact that the section 3452 definition is "for purposes of this chapter" may not prevent prejudice to other areas of the code.

SECTION 3462(b)(3)—DIVIDEND DEFINED

There is no indication whether the portion of the gain under section 333(e)(1), which is treated as dividend income to an individual, constitutes income subject to withholding. It is assumed that the omission indicates that no withholding is intended.

SECTION 3481(b)—LIABILITY FOR RETURN AND PAYMENT OF WITHHELD TAX PAID BY RECIPIENT

Under section 1463, if the recipient has paid the tax no penalties are imposed on the withholding agent in the absence of fraud. It is not clear why differing treatment is imposed under section 3481(b).

SECTION 3488—OBLIGATION SOLD BETWEEN INTEREST-PAYMENT DATES

The section expressly covers sales and exchanges, but it does not refer to redemptions. The treatment of a redemption as an exchange under section 1232(a)(1) is "for purposes of this subtitle." For purposes of section 1441 it is understood that the Service does not require withholding on interest paid upon redemption of bonds between interest dates. (See special ruling dated February 7, 1949, 5 CCH (1949) Standard Federal Tax Reporter par. 6094). In view of the administrative interpretation it may be desirable to include redemptions in section 3488 if withholding is desired.

SECTION 39(a)—TAX WITHHELD ON INTEREST, DIVIDENDS, AND PATRONAGE DIVIDENDS

This section provides a credit against the tax for the taxable year in which the amount subject to withholding "is received." In the case of accrual-basis taxpayers the credit will thus frequently fall in the year following the year of accrual. Such taxpayers who claim credit for such withholding in estimating their tax will have underpaid their tax. The year of actual receipt may very well be postponed for many years, as in the case of interest paid at maturity.

Some consideration must be given to the meaning of the term "receipt." If interest is credited to the account of a taxpayer under circumstances which would result in "constructive receipt," may the taxpayer claim credit for the tax withheld? It should be noted that section 3451(a) uses the term "pays," and there appears to be no doctrine of "constructive payment" corresponding to that of "constructive receipt."

Report of the Special Committee on Travel and Entertainment Expense

This special committee was constituted by the Council of the Tax Section to consider the problems of traveling and entertainment expenses in light of the Treasury recommendations in this area and of the "Discussion Draft" released by the Ways and Means Committee on August 24, 1961.

Two committee meetings were held in Washington, attended by nearly all members of the committee, and meetings have been held with representatives of the Internal Revenue Service and of the Treasury Department, and with the staff of the Joint Committee on Internal Revenue Taxation. The committee recognizes that there are serious administrative problems in this area, and appreciates the concern of the Treasury lest taxpayer's morale be adversely affected by traveling and entertainment abuses.

The committee's starting premise has been continuation of the basic rule that a taxpayer should be entitled to deduct his ordinary and necessary business expenses. We believe that the existing administrative problems can be mitigated without requiring any change in the aforesaid basic concept, which has been embedded in the income tax law virtually since its inception. The changes which the committee recommends are mainly in the interests of statutory clarification and of better enforcement. These changes will still leave borderline areas for the exercise of reasonable judgment by taxpayers, administrators, and courts, and will not keep dishonest taxpayers from filing fraudulent returns. By this time, however, we have all learned that no statute can foreclose attempts at tax evasion, nor can any statute eliminate controversy and litigation. If the objective is to retain the basic framework of existing law, and to administer it effectively, we are hopeful that this can be substantially achieved without arbitrary rules which would create inequities and distort the basic framework. Our committee suggests that sufficient time be allowed to assess the results of the Service's tightened enforcement policy, especially if that policy is strengthened by administrative and interpretative amendments such as those herein recommended.

COMMITTEE RECOMMENDATIONS

1. Elimination of the Cohan rule

The committee agrees that serious administrative difficulties have been experienced in policing excessive deductions because of the application of the so-called *Cohan* rule, and the committee favors elimination of the *Cohan* rule in order to conform the burden of substantiating deducted items to the same standards commonly applied outside the travel and entertainment area.

The "Discussion Draft" dated August 24, 1961, released by the Ways and Means Committee, contains a proposed new section 274(c) designed to accomplish that objective. It is as follows:

"(c) Disallowance of Expenditures Not Substantiated. No deduction shall be allowed—

"(1) under section 162 or 212 for any traveling expense (including meals and lodging while away from home), or

"(2) for any item with respect to an activity which is of a type generally considered to constitute entertainment, amusement, or recreation, or with respect to a facility used in connection with such an activity,

unless the taxpayer substantiates by adequate records or other sufficient evidence the amount of such expense or other item, the time and place of the travel, entertainment, amusement, recreation, or use of the facility, the business purpose of the expense or other item, and the business relationship to the taxpayer of persons entertained or using the facility."

The committee feels that provision to be a suitable method of achieving elimination of the *Cohan* rule. However, the committee understands that such a provision would not impose upon taxpayers the maintenance of formal books of account and would permit utilization of customary kinds of evidence with respect

to specific items deducted, of the same nature as are available as proof in other areas. To preclude possible misinterpretation of any proposed amendment the committee urges the inclusion of a statement to the following effect in the legislative reports:

"The amendment is designed to require reasonable evidence of the nature and amount of an expenditure so that the deductibility may be determined on examination of the taxpayer's return. The amendment would require more than an unsubstantiated estimate after the close of the taxable year. It is contemplated that such evidence may consist of receipts, bills, stubs, and similar documents. It may consist also of expense slips, account books, diary entries, and similar contemporaneous records. Moreover, since the purpose of the amendment is to require reasonable evidence of specific items of expense, and not to impose any formal or artificial rules of recordkeeping, any proper evidence is admissible, including the taxpayer's own testimony, if it tends to prove that amounts were spent on specific occasions, and if it tends to prove the amount of the expenditure with reasonable specificity. On the other hand, it is assumed that the taxpayer will have the specific burden of explaining the absence of any statements or other records which he could be expected to receive and retain in the ordinary course of his business."

2. "*Business gifts*"

The committee also shares the concern of the Treasury Department over the difficult enforcement problems in the areas of "business gifts" and favors legislative aid to better enforcement. The committee believes that the rules now being developed in the courts would properly classify most of the substantial items of this type as a deductible business expense of the payor, and as taxable compensation to the payee. It is considered undesirable to reverse this logical result merely because it is hard to collect the tax from the payee. Nor does there seem to be enough justification in any thoery of "public policy" to require an arbitrary disallowance of such an item which constitutes an ordinary and necessary business expense. On the other hand, a part of the questionable practices in this area appear to derive from the belief that payees, other than employees, receive a form of exempt income, although an examining agent, if alerted to the transaction, might determine that compensation had been received. A healthy deterrent to such practices would be the knowledge of a mandatory reporting requirement on the part of the payor, at least to the extent of disallowing a deduction to the nonreporting payor in those cases where it is ultimately determined that the amount is nontaxable to the payee. It may be assumed that few payors would take the risk of not disclosing a borderline payment, even if the payor correctly believes that the item should be reported as income by the payee.

Accordingly the committee suggests the enactment of a provision to the following or similar effect:

"CONDITIONS TO DEDUCTION OF BUSINESS GIFTS. In the case of any gift made directly or indirectly to any individual other than an employee or the taxpayer, no deduction shall be allowed under section 162 or section 212 to the extent that the amount of such gift, when added to the amount of prior gifts made to such individual during the same taxable year, exceeds $———, unless the taxpayer shall file with his return for the taxable year such information as to the identity of the recipient and the nature of the transaction as the Secretary shall prescribe by regulation."

Although the committee is aware of the undesirable aspects of additional cluttering of tax returns, and is reluctant to impose this nuisance upon taxpayers generally, it is believed appropriate to condition the allowance of the deduction upon some form of informative reporting. The recommendation has left open the minimum amount which Congress may consider to be appropriate, and it specifies Treasury regulations for the purpose of permitting flexible rules to meet the developing experience in this area. It is suggested that the congressional committee reports on this amendment state that it is not intended to interfere with the substantive tests on the compensation issue as they are now being developed by the courts.

3. *Expenditure disallowance except where directly related to business*

The committee further believes that the present law with respect to the deduction of ordinary and necessary business expenses should be clarified by strengthening the distinction between business and personal expenses. This objective might be sought by a specific statutory provision. The committee has considered

and finds acceptable, two alternative approaches which can be embodied in statutory provisions similar to the following:

"[First alternative:] EXPENDITURE DISALLOWED EXCEPT WHERE DIRECTLY RELATED TO BUSINESS. No deduction otherwise allowable under this chapter shall be allowed for any expense, or any portion thereof, with respect to an activity which is of a type generally considered to constitute entertainment, amusement, or recreation, or with respect to a facility used in connection with such activity, except to the extent that the taxpayer establishes that the expense, or a portion thereof, was incurred primarily for the furtherance of the taxpayer's business.

"[Second alternative:] EXPENDITURE DISALLOWED EXCEPT WHERE DIRECTLY RELATED TO BUSINESS. No deduction otherwise allowable under this chapter shall be allowed for any expense with respect to an activity which is of a type generally considered to constitute entertainment, amusement, or recreation, or with respect to a facility used in connection with such activity, unless the taxpayer establishes that the expense was incurred primarily for the furtherance of the taxpayer's business; and such deduction shall in no event exceed the portion of such expense incurred for the furtherance of the taxpayer's business."

Both alternatives are designed mainly to clarify existing law, by imposing the test that expenses which are generally considered to be for "entertainment, amusement, or recreation" are deductible only if they are incurred "primarily for the furtherance of the taxpayer's business." This is intended to combat an apparently widespread understanding that any faint relationship of an expense to the taxpayer's business is sufficient to justify a deduction. But see *Challenge Manufacturing Co.*, 37 T.C., No. 65 (January 10, 1962). It is especially intended to preclude deductions in an area which may be characterized as "social good will" unless the taxpayer can show that an expenditure which creates such good will was incurred by him primarily in furtherance of his business.

It is to be noted that both alternatives of this recommendation preclude deduction for the portion of any expense which is attributable to personal rather than to business purposes. For example, if the taxpayer's use of a social club is 80 percent for business entertainment and 20 percent for personal and family recreation, he may deduct only 80 percent of his dues, plus the specific charges applicable to his business entertainment. This is the correct result under existing law. Where the recommended alternatives differ is in the treatment of expenses which are predominantly for personal use. For example, suppose in the above case that only 20 percent of the taxpayer's club dues are attributable to business entertainment. The first alternative would allow him 20 percent of his dues, plus the specific charges for business entertainment. The second alternative would allow him only his specific business charges, with no deduction for any part of the dues.

This second alternative would be a substantial limitation of existing law. It is based upon the assumption that a taxpayer should not obtain a tax benefit for an expense which he incurred primarily for personal reasons, even though some portion of the expense concededly contributes to his business income. Moreover, it has the administrative advantage of eliminating the apportionment problem where an obviously minor portion of an expense is business connected. On the other hand, there appears to be a degree of inequity in refusing any deduction for these "mixed motive" expenses. And the elimination of any compromise "notch" below 50 percent would place an inordinate premium in the borderline case on establishing a 51-percent business motive. A further disadvantage in many types of expense would be the question of whether the expense is truly unitary or whether it is an aggregate of separate items; e.g., a single restaurant check for a number of people, home entertainment, etc. The committee has recognized the near balance of pros and cons on this problem, and is agreed that either approach would be acceptable.

CONCLUSION

The committee has desired to be of the utmost assistance to the Treasury Department in providing more adequate enforcement tools, but has not been convinced that enforcement needs require at this time abandonment of basic tax principles and adoption of arbitrary disallowance of designated items. Therefore, the committee, in accordance with the preceding discussion, suggests the following:

(1) Elimination of the Cohan rule;

(2) Imposition of a reporting requirement as a condition to a deduction for business gifts; and

(3) Strengthening the standards applicable to the deduction of ordinary and necessary business expenses by suggesting alternative provisions which the committee believes will tend to discourage allowance of personal expenditures.

Respectfully submitted.

MARK H. JOHNSON, *Chairman.*

Dated January 24, 1962.

H.R. 10650: COMMENTS ON SECTION 4—DISALLOWANCE OF CERTAIN ENTERTAINMENT, ETC., EXPENSES

Each of the following numbered comments on section 4 were received from a separate person:

1. The discussion draft of August 24, 1961, would have disallowed entertainment expenditures unless the "item was directly related to the production of income *and was not merely for goodwill.*" [Emphasis supplied.] The special committee on travel and entertainment expense objected, as did many others, to the disallowance of an entertainment expenditure because it was incurred solely for good will purposes. H.R. 10650 eliminated the words "and was not merely for good will," but the Ways and Means Committee report quite clearly says that an expenditure is not directly related to the active conduct of the taxpayer's business if it is incurred only for the purpose of creating good will for that business.

2. Section 4 is far closer to the recommendation of our special committee than it is to the Treasury's recommendation, and it is a considerable improvement over the discussion draft. And it is considerably better than the House committee's original decision to introduce a 50-percent deduction rule. Nevertheless, a few misgivings about the bill are in order:

(*a*) *The Cohan rule.*—The special committee recommended the discussion draft provision on this, but with the proviso that a committee report "preclude possible misinterpretation" of the statute as imposing "formal or artificial rules of recordkeeping." To the contrary, the text of the bill, as well as the House committee report, are more dangerous than the tentative draft and report. The discussion draft disallowed the deduction "unless the taxpayer substantiates by adequate records or other sufficient evidence" the amount, identification, and purpose of the expense. The bill now disallows the deduction "unless the taxpayer substantiates by adequate records or by sufficient evidence corroborating his own statement" the amount, identification, and purpose of the expense.

The House committee report states: "The requirement that the taxpayer's statements be corroborated will insure that no deduction is allowed solely on the basis of his own unsupported, self-serving testimony. However, the degree of corroboration required to support a claimed deduction will vary as respects the business relationship and purpose, the time and place, and the amount of the expense. Thus, oral testimony of the taxpayer, together with circumstantial evidence available, may be considered sufficient evidence for the purpose of establishing the business purpose required under the new provision. However, oral testimony of the taxpayer plus more specific evidence would be required to be sufficient evidence as to the amount of an expense."

Does not this get us back to the risk of a revenue agent demanding affidavits from taxi drivers and hat-check girls, unless the taxpayer keeps his little black book clutched in his hand and carefully notes the items for the delectation of his guests?

The special committee's report makes it clear that the taxpayer's own testimony should be sufficient if it is enough to identify specific occasions and reasonably specific amounts, subject only to normal inferences as to lack of credibility in the absence of records which he could be expected to receive and retain. The statute could well be interpreted as implacably denying the sufficiency of such evidence.

(*b*) *Relationship of expense to business.*—The discussion draft made no distinction between an "activity" and a "facility" for entertainment, nor did our special committee's report. The special committee therefore introduced the concept of "primarily for the furtherance of the taxpayer's trade or business" as applicable to both. The bill now separates "activity" and "facility" expenses, makes the "furtherance" test applicable only to the "facility," and applies a new test to both, viz, "that the item was directly related to the active conduct of the

taxpayer's trade or business." This pattern seems to be reasonable enough, if it is reasonably interpreted; but I do worry about the House committee report which explains it. I am especially concerned with the following excerpt, which seems to confuse this issue with the "quiet business discussion" test which the Treasury has been advocating and which raises the question of whether all goodwill expenses will be disallowed:

"If the expenditure is for entertainment which occurs under circumstances where there is little or no possibility of conducting business affairs or carrying on negotiations or discussions relating thereto, the expenditure will generally be considered not to have been directly related to the active conduct of business. Thus, the absence of the taxpayer or his representative from the entertainment activity ordinarily indicates that the entertainment was not directly related to the conduct of the taxpayer's trade or business. Similarly, if the group of persons entertained is large or the distractions substantial, the cost of the entertainment will not be deductible, in the absence of a clear showing of a direct relationship to the active conduct of the trade or business."

Incidentally, the more I think of the special committee's 50-percent rule which the House has adopted, the more misgivings I have about its correctness. My only consolation is that this did seem to be the alternative which induced the House to abandon its own 50-percent rule.

(c) *Business gifts.*—The bill adopts the discussion draft provision for disallowance of any deduction for gifts which are excludable from the gross income of the recipient. The special committee recommendation was to disallow such deduction unless the taxpayer files information on his return as to the identity of the recipient and the nature of the transaction. I still believe that the special committee recommendation is fairer, and more likely to prevent tax evasion by the recipient. After all, most of these so-called gifts *are* taxable income to the recipient under the prevailing rulings and decisions, so that the basic problem is one of disclosure as to the recipient, not of disallowance to the payor. Our thesis has been that the average payor would not take the chance of a disallowance if there was any possibility that the payee would be held nontaxable, and would therefore protect himself by reporting any borderline payment on his own return. Under the bill, there is no incentive for such reporting, and therefore less likelihood of tracking down recipients who should be reporting the items.

(d) *"Reasonable" meals and lodging in travel.*—The bill adopts the discussion draft provision for limiting the travel expense deduction to "a *reasonable* allowance for amounts expended for meals and lodging." Although the special committee report did not specifically disapprove this provision, it did advise against any changes in existing law beyond those which were recommended. I am not sure that this is worth fussing about at this stage, but I certainly deplore the prospect of convincing a revenue agent that in my old age I am entitled to eat and sleep while I endure the rigors of travel so that I can pay more income tax.

3. My reaction to section 4 of the tax bill is that the language is sufficiently vague that it could mean either (1) that the Ways and Means Committee adopted the special committee's approach to entertainment expense or (2) that it adopted the Treasury's proposal to disallow goodwill expenditures.

From the House committee report, particularly the bottom of page 20 and the top of page 21, I would judge that the Treasury interpretation has prevailed. In my judgment the paragraph in the report which indicates that an expenditure will "generally be considered not to have been directly related to the active conduct of business" where there is "little or no possibility of conducting business affairs or carrying on negotiations" will be used by the Internal Revenue Service in drafting regulations which will for all practical purposes bar the deduction of expenditures at nightclubs, theaters, football games, prizefights, and the like. This may not be a bad thing, but it seems to me that it goes far beyond the views expressed in the report of our special committee.

4. In general, the language of section 4 is satisfactory. It carries out the fundamental principles the Special Committee on Travel and Entertainment Expenses approved, and does so even with a few improvements. It has been suggested that the House committee report indicates that expenditures solely to create good will will not be "directly related to the active conduct of the taxpayer's trade or business." That is perhaps based on language in the last full paragraph on page 20 of the House committee report. While there is basis for concern in that language, there is doubt that the proposition will be seriously

pressed, particularly in view of the change in statutory language from the discussion draft. It seems that the result will be simply to require "a greater degree of appropriate relation between the expenditure and his trade or business than is required under present law."

Problems are raised regarding the special committee's position of "business gifts."

5. Section 4 is satisfactory. It appears that the efforts of the special committee "paid off." While one could "flyspeck," it doesn't appear that such efforts would be rewarded. The statutory proposals carry out to a very large degree the thoughts of the special committee.

6. Paragraph (7) of the proposed section 274(d) provides an exception for entertainment expenses in connection with meetings or conventions of business leagues, chambers of commerce, etc., which are "exempt from taxation under section 501(a)." The expenses of attending a convention should be deductible without regard to whether the business league or chamber of commerce is or is not exempt from taxation.

7. The proposed amendment of section 162(a)(2) is a mistake. Present law allows the deduction of "the entire amount expended for meals and lodging" while away from home on business. By providing that only a "reasonable amount" is deductible, we can be sure that agents will be constantly insisting that the taxpayer lived too well while away from home—he should have been satisfied with an $8 room instead of a $12 room, etc.

H.R. 10650: Comments on Sections 5, 6, 7, 9, 11, 12, 13, 15, 16, 20, and 21

INTRODUCTORY

The Committee on Taxation of Foreign Income of the Section of Taxation of the American Bar Association has reviewed the sections of H.R. 10650 which deal with the taxation of foreign income. These sections are:

Section 5. Amount of distribution where certain foreign corporations distribute property in kind.

Section 6. Amendment of section 482.

Section 7. Distributions of foreign personal holding company income.

Section 9. Distributions by foreign trusts.

Section 11. Domestic corporations receiving dividends from foreign corporations.

Section 12. Earned income from sources without the United States.

Section 13. Controlled foreign corporations.

Section 15. Foreign investment companies.

Section 16. Gain from certain sales or exchanges of stock in certain foreign corporations.

Section 20. Information with respect to certain foreign entities.

Section 21. Treaties.

This memorandum summarizes comments which have been submitted by individual members and by special subcommittees of the Committee on Taxation of Foreign Income. Because of limitations of time, this memorandum has not been submitted for formal adoption by the Committee on Taxation of Foreign Income.

Section 5

This section of the bill would add a new subparagraph (C) to section 301(b)(1) of the code to provide that dividends in property other than money from a foreign corporation to a corporate shareholder are to be taxed at fair market value instead of at the lower of fair market value or the adjusted basis to the distributing corporation under the present rule. An exception is made and the present rule is retained to the extent that the dividend qualifies for the dividends received credit under section 245.

It is stated in the committee report that section 5 is a companion provision to section 16 of the bill dealing with liquidations and sales of stock of controlled foreign corporations (committee report, p. 27).

The purpose of section 16 appears to be the taxation of income realized by a foreign corporation (the foreign corporation's earnings and profits) to U.S. shareholders as ordinary income at the time of liquidation of the foreign corporation or sale of its stock. If section 5 and section 16 are to be com-

panion sections, it would appear essential to provide for nonduplication of the ordinary income tax to U.S. shareholders with respect to the earnings and profits of the foreign corporation.

Section 5 contains appropriate adjustments for basis, but there are, however, no provisions for adjustment of earnings and profits of the distributing foreign corporation in cases where appreciated property is distributed. Under section 312 of the present code, which is not amended by the bill, earnings and profits would be reduced only by the basis of the distributed property. If the distribution of appreciated property is to be treated as a distribution of cash in an amount equal to the value of the property, section 312 should be amended to provide that any distribution of appreciated property would result in a reduction of earnings and profits of the foreign corporation in an amount equal to the amount of the distribution in the hands of the distributee. In this way there would be coordination between the provisions of section 5 and section 16. If earnings and profits of the foreign corporation are to be reduced only to the extent of adjusted basis, the total amount taxable as ordinary income because of distributions from a controlled foreign corporation would exceed the accumulated earnings and profits of such subsidiary by the amount of the unrealized appreciation on the distributed property. If the suggested amendment to section 312 is made, the present section 312(b) will still operate to insure that any unrealized appreciation on inventory items is ultimately taxed at ordinary income rates.

Section 5(d) of the bill provides that for purposes of section 902(a), relating to credit for foreign taxes, the amount of any distribution shall be the amount determined by applying section 301(b)(1)(B) rather than the amount of the distribution set forth under proposed section 301(b)(1)(C) dealing with distributions by foreign corporations. The effect of this provision is that the amount of any distribution for computing the amount of any foreign tax credit under section 902(a) will be the lesser of fair market value or adjusted basis. Section 5(d) of the bill is wholly inconsistent with the approach of section 5 which treats the amount of a distribution as its fair market value. If the amount of a distribution is to be its fair market value and deemed a withdrawal of earnings and profits from the subsidiary in such amount, then it would seem only logical in computing the amount of foreign tax credit that such distribution should be a distribution in the amount of its fair market value. Section 5(d) in its present form is unconscionable.

Section 6

This section would add a new subsection (b) to section 482 of the code, listing at great length factors to be considered in determining the allocation of income arising from sales of commission transactions between domestic and foreign organizations owned or controlled directly or indirectly by the same interests.

The proposed amendment does not purport to state a precise formula under which a proper intercompany price or intercompany commission can be determined and it is obvious that such a formula could not be developed which would fit all situations. To the extent that the factors set forth in the amendment are considered to represent a rigid formula, the provision would have unfair results. To the extent that the proposed provision is interpreted merely to suggest factors to be considered, it adds nothing to the present provisions of section 482 in authorizing the Secretary and his delegate to distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among entities, if necessary, to prevent evasion of taxes or clearly reflect income.

In order to make certain that the factors set forth in proposed section 482 (b)(2)(A) are not the only factors which the Secretary or his delegate must consider if others are appropriate, it is suggested that the last sentence of subparagraph (A) be restated to provide that the method of allocation "shall" also give consideration to other factors instead of "may" as contained in the present bill. Similarly, section 482(b) (2)(B) should give the taxpayer the right to establish an alternative formula "by the preponderance of the evidence" instead of requiring establishment "to the satisfaction of the Secretary or his delegate."

The provision in proposed section 482(b)(3)(A) requiring the use of basis or book value rather than market value in considering the assets factor would seem to be contrary to economic reality. The relative market values of the

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assets would seem to be of greater economic significance and should be usable if available. Basis or book value should be considered if market value is not available.

The provisions of section 482(b)(3)(B) eliminating inventory from the assets to be considered would also seem to be at variance with economic reality since the investment which a foreign subsidiary must maintain in inventory is of significance in determining the portion of the profit which should fairly be allocated to it.

Section 482(b)(3)(B) is also unclear in stating that the assets to be considered "include real property and tangible personal property (whether owned or leased by a member of the group)." If this is intended to exclude intangible assets from consideration, this should be made clear by rephrasing the provision to provide that the assets referred to "include only real property and tangible personal property." Moreover, it would seem improper to exclude intangible personal property such as patents, copyrights, and trademarks from a consideration of the proper allocation of income and if the intent is not to exclude them, the provision should be rephrased to make this clear.

Section 482(b)(6), providing for the allocation of no amount of income to a foreign organization whose assets, personnel, office, and other facilities which are not attributable to the United States are grossly inadequate for its activities outside the United States, would seem to be an improper provision. If an allocation is properly made on the basis of the factors previously enumerated in the section and results in the allocation of some amount of the foreign organization, the Secretary or his delegate should not be authorized then arbitrarily to ignore such an allocation by second-guessing business management as to the adequacy of assets, personnel, office, and other facilities.

It should be noted that the allocation factors set forth in the proposed amendment are quite different from those presently set forth in the regulations under section 863, where a foreign corporation is manufacturing abroad and selling in the United States, or manufacturing in the United States and selling abroad.

Regulation, section 1.863-3 provides for the allocation of taxable income within and without the United States, where an independent factory or production price has not been established, by apportioning one-half in accordance with the value, within and without the United States, of the taxpayer's property used in the production of the goods sold and by apportioning one-half on the basis of the taxpayer's sales of the product within and without the United States. This formula could differ materially in result from the result which would be achieved by applying the factors in the proposed amendment to section 482. Hence, a different allocation of income within and without the United States would result if a foreign manufacturing corporation manufactured its product abroad and sold it in the United States through a branch, making the regulations under section 863 applicable, or sold the product through a U.S. subsidiary, making the allocation under the proposed amendment to section 482 applicable.

If the proposed amendment is adopted, it is suggested that an amendment be added prohibiting any adjustment under section 482 unless the intercompany price is grossly unreasonable in order to prevent unnecessary harassment of taxpayers with trivial adjustments by the Internal Revenue Service.

It is doubtful that the proposed amendment to section 482 is needed if sections 13 and 16 of the bill are adopted. Under those sections some foreign income earned by controlled foreign corporations will be taxed to the U.S. parent corporations currently and all of it will be taxed eventually as ordinary income. Hence, there would seem to be little need to readjust prices in order to prevent the diversion of income from U.S. corporations to foreign affiliates. If sections 15 and 16 are not adopted, the adjustment of intercompany prices under section 482 becomes more important. It is doubtful, however, that the detailed provisions of the proposed amendment are necessary for an effective administration of section 482 and in any event the above-mentioned defects should be eliminated in order to prevent the amendment from being made the basis of arbitrary adjustments heavily weighted toward attributing income to the United States.

If the proposed amendment to section 482 is adopted, it would seem necessary for paragraph (8) to go further than it does to compensate for the fact that foreign taxes may have been paid on the income which is reallocated to the domestic organization. The present amendment treats the tax paid by the foreign organization as if it were paid instead by the domestic organization. The intent, of course, is to give the domestic organization a tax credit for the foreign taxes actually paid on the income reallocated to the domestic organi-

zation. However, this will be of little use unless it is also provided that the reallocated income is to be treated as income from the foreign country to which the tax was paid. For example, if a U.S. parent corporation manufactures goods here and sells them to its foreign subsidiary which takes title here and resells abroad, any readjustment of the intercompany sales price increasing the profit of the domestic corporation would not constitute income from sources outside of the United States under existing law. Hence, the attribution of the foreign tax to the U.S. parent would serve no useful purpose since, without foreign income, no foreign tax credit would be available to the domestic parent under the limitations of section 904. Paragraph (8) should therefore be amended to provide that the increase in the taxable income of a domestic organization through application of the section will be regarded as income from the foreign country to which the tax was paid for the purposes of section 904.

It is also suggested that a provision be added to the proposed amendment to section 482 which would permit adjustment of payments between the affiliated organizations corresponding to the reapportionment made by the Service without incurring any additional tax beyond that attributable to the reapportionment. For example, if it is determined that the price at which a domestic parent sells to its foreign subsidiary is too low and the parent is taxed on the profit that would have resulted if the intercompany price had been higher, the subsidiary should be permitted to pay the addition to the price to the parent corporation without such payment being taxed as a dividend.

Section 7

This section amends part III of subchapter G of chapter I of the Internal Revenue Code dealing with foreign personal holding companies.

The amendments change the definition of a foreign personal holding company with respect to its income requirements to provide that a foreign corporation shall be deemed a foreign personal holding company if at least 20 percent of its gross income is foreign personal holding company income. Under the present law, a corporation is a foreign personal holding company only if at least 60 percent of its gross income is foreign personal holding company income as defined.

Under present law, if a corporation is a foreign personal holding company, its entire undistributed foreign personal holding company income is taxed to the U.S. shareholders, whether or not distributed. Section 7 amends this law to provide as follows:

(*a*) If the foreign personal holding company income of the foreign corporation exceeds 80 percent of its gross income, then the U.S. shareholders must pay an income tax on their pro rata share of the company's entire undistributed foreign personal holding company income.

(*b*) If the foreign personal holding company income does not exceed 80 percent of the company's gross income, then the U.S. shareholders must pay a tax only on that part of their pro rata share of the company's undistributed income determined by multiplying such pro rata share by a fraction, the numerator of which is the foreign personal holding company income of the company and the denominator of which is the gross income of the company.

The purpose of the amendment, as set forth in the report of the Ways and Means Committee, is to conform the percentage of income requirements for foreign personal holding companies with the requirements of section 13 of H.R. 10650, which section deals with "controlled foreign corporations."

Technically, the section appears to be well drafted except for the fact that under proposed section 556(a)(2) dividend distributions are applied proportionately against personal holding company and other income. Hence, if a corporation derives its income principally from business operations and receives as little as 20 percent of its gross income in the form of personal holding company income, it must distribute all of its taxable income in order to avoid taxation to its shareholders of more than is actually distributed. There may be some justification for requiring the distribution of the personal holding company income even where it is such a small part of the total gross income, but since there may be legitimate reasons for accumulating the operating income, the statute should not be worded in such a way as to reflect a retention of the operating income as if it were a partial retention of the personal holding company income. If the proposed amendment to the personal holding company provisions is adopted, it should provide for the application of dividend distributions first against the personal holding company income.

Consideration, moreover, should be given to the necessity for continuing part III of subchapter G of chapter I of the Internal Revenue Code in the law if section 13 of the present bill is enacted. These foreign personal holding company provisions, section 551 through section 558, are enormously complex. The entire subject matter of this subchapter is now covered by section 13 with extremely limited exceptions. It appears that in practically every case in which a corporation would be subject to treatment as a foreign personal holding company under part III of subchapter G, it would also be subject to treatment as a controlled foreign corporation under section 13. The only exception would seem to be in a rare case in which a corporation failed to meet the stock ownership requirements under the attribution rules of section 13 but met the stock ownership requirement with respect to foreign personal holding companies because of the slightly wider family attribution rules of sections 554 and 544. Similarly, and with one limited exception, the U.S. shareholders of a corporation subject to treatment as a foreign personal holding company, would be taxed on their share of the undistributed foreign personal holding company income under section 13 of H.R. 10650. The single exception is in the case of a shareholder owning less than 10 percent of the stock of the foreign corporation, directly or indirectly, and after applying rules of attribution. Under the foreign personal holding company provisions, such a shareholder would be subject to tax on his pro rata share of the undistributed foreign personal holding company income. Under section 13, such a shareholder would not be subject to tax.

It would appear disirable to conform the policy with respect to the treatment of persons owning less than 10 percent of the shares with the policy under section 13 and if section 13 is enacted, the foreign personal holding company provisions should be deleted or the exemption of persons owning less than 10 percent of the stock should be extended to foreign personal holding companies.

It is therefore respectfully recommended that, if the provisions of section 13 of the bill are enacted, the foreign personal holding company provisions should be eliminated. If they are not eliminated, some provision should be made to indicate which provisions take priority if a foreign corporation meets the tests of both the foreign personal holding provisions and the provisions of section 13 of the bill. At present there seems to be no such provision.

Section 9

The net effect of section 9 is that, if a foreign trust is established by a U.S. grantor and makes distribution of prior accumulated income to any U.S. beneficiary, such beneficiary will be required to treat the income as gross income upon distribution for purposes of U.S. income taxation. Alternative formulas for allocating the income to prior years are provided to prevent the imposition of excessive surtax rates in the year of receipt by the beneficiary.

Section 9(a) of the bill would amend section 643(a)(6) of the code to redefine the distributable net income of foreign trusts and section 9(b) provides a new definition for accumulation distributions of foreign trusts created by U.S. persons. The restriction of the throwback rule to the five preceding taxable years of a trust is removed by section 9(c)(2) for foreign trusts created by a U.S. person. Section 9(e) creates a new section 669 of the code which provides that a beneficiary who is a U.S. person and who satisfies certain additional requirements may elect between two methods of computing the limitation on tax attributable to an accumulation distribution received from a foreign trust created by a U.S. person. The two methods provided are in addition to the methods available to the beneficiary of computing his tax in the ordinary way by including in income the entire amount of an accumulation distribution when it is paid, granted, or required to be distributed. Additional sections are proposed by section 9 requiring a return to be filed in the event of a creation of a foreign trust or the transfer of money or property to such trust, and a penalty is provided for failure to file such returns.

While the bill recognizes the validity and extraterritorial nature of foreign trusts, the proposed section fails to eliminate what has probably been the most important question in the area of foreign trusts in recent years, namely, What is a "foreign trust"? Section 9(h) would amend section 7701(a)(31) of the code to read "the term 'foreign estate' and 'foreign trust' mean an estate or trust, as the case may be, the income of which from sources without the United States is not includible in gross income under subtitle A." Section 9(h) is not a definition. In essence section 9(h) states a foreign trust is a foreign trust, since all previously attempted definitions have settled on the fact that a trust must

qualify as a nonresident alien to escape tax under subtitle A. No attempt is made in the committee reports to expand on the definition of a foreign trust. As a consequence, the law surrounding the taxation of foreign trusts remains unsettled. While the observation can be made that the confusion as to what constitutes a foreign trust may deter creation of such trusts for purposes of tax future deferral, it is doubtful whether confusion in the law should be relied upon to accomplish the intent of the legislators.

It is accordingly suggested that a foreign trust be defined as a trust "created or organized under law other than that of the United States or of any State or territory and principally administered outside the United States."

The proposed sections will impose the expense of additional administration on the part of the taxpayer and the Internal Revenue Service. If such expense is significantly exceeded by the collection of tax otherwise avoided, then the sections may be justified. Assuredly, some consideration should be given to an appraisal of the expenses and collections.

Section 11

This section provides for the grossup of the tax deemed paid by foreign subsidiaries (that is, adding to the amount of dividend declared by the foreign corporation, the amount of foreign tax deemed paid under section 902(a) of the 1954 code by the domestic corporate recipient).

It would seem that the amendment should be clarified to provide that the increase in gross income for the purpose of the tax credit computation is not to be included in income for the purpose of computing earnings and profits of the recipient domestic corporation. Otherwise there would be an overstatement of earnings and profits affecting the tax status of distributions by the domestic corporation under sections 301 and 316 of the code, since there is nothing which provides for the deduction of the subsidiary tax deemed paid by the domestic parent from earnings and profits if the increase in gross income has the effect of increasing earnings and profits. It is suggested that the parenthetical expression "(other than section 245)" in proposed section 78 of the code be expanded to read "(other than for the purposes of section 245 and the computation of earnings and profits)".

There is nothing in subsections (a)-(d), inclusive, or in the committee report to indicate that there is any intention to eliminate the rule now contained in section 902(c)(1) that dividends paid during the first 60 days of any year are attributable to profits accumulated during prior years. On the other hand, both paragraph (2) and the later "for the purposes of" sentence of subsection (f) might be read to exclude the traditional 60-day rule of section 902(c)(1). In order to eliminate any possible confusion, a sentence to the effect that the proposed amendments are not intended to affect the 60-day rule of section 902(c)(1) should be added to the committee report. It would also be helpful if Congress added a similar exception to subsection (f), perhaps at the end of subsection (f) somewhat as follows:

"For the purposes of the preceding sentence and of paragraph (2), dividends paid by a foreign corporation during the first 60 days of any year shall be treated as having been paid from the accumulated profits of the preceding year or years."

Section 12

This section amends section 911 of the Internal Revenue Code dealing with the exclusion of income earned by U.S. citizens working outside of the United States.

The provisions as drafted appear to carry out the policy set forth in the report of the Ways and Means Committee. Consideration, however, should be given to whether this policy will make it unduly difficult to get U.S. citizens to accept employment abroad.

Consideration should also be given to reexamination of the policy with respect to the treatment of compensation for services received in a year subsequent to the year in which the services were rendered, either by way of deferred compensation or by way of pension plan benefits. It is not apparent, and would seem undesirable, to tax such payments as ordinary income if they would not have been excludable from income if received in the year the services were rendered or in the immediately succeeding year, under the provisions of the section as drafted.

It is suggested that within the limitations of section 911(c)(1), the amounts abroad should be exempt, to the extent that the total amounts received do not

received at any time for services rendered during a period of qualified residence exceed (a) $20,000 in the case of an individual subject to the limitations of section 911(c)(1)(A), or (b) $35,000 in the case of an individual subject to the limitations of section 911(c)(1)(B).

Under the proposed statute, if a person who had been a bona fide resident of a foreign country for a minimum of 3 years had an employment arrangement providing for payment of $20,000 in the fourth year plus $5,000 additional for the fourth year's service to be paid during the sixth year, and a salary of $35,000 during the sixth year, such individual would owe an income tax on the $5,000 bonus payment paid in the sixth year, despite the fact that if it had been received in the fourth year, it would have been excluded from income. The reason for such a policy requirement is not apparent.

It is suggested that the exclusions from income be applicable to all amounts of earned income whenever received attributable to services rendered during the exempt period, subject only to the dollar limitations contained in the proposed section 911(c)(1).

Section 13

In general, the amendments proposed by this section constitute an inordinately complex set of provisions of dubious fairness in an effort to tax the income of foreign corporations which is generated abroad before it is distributed to U.S. stockholders. This attempt to tax anticipated income before its realization by the persons subject to U.S. tax presents serious constitutional problems, particularly to the extent that the provisions would tax undistributed income to persons who are not actually in a position to control the distribution. The committee report speaks of eliminating tax deferral which exists under the present law. Actually, the provisions are taxing anticipated income rather than realized income as under present law.

It is recognized that there have been abuses with respect to the use of foreign affiliates. The Treasury Department has a legitimate complaint to the extent that artificial transactions have been entered into in order to convert what is in substance income from U.S. sources of a domestic corporation to income from sources outside of the United States of a foreign corporation. However, adequate statutory authority for correcting such abuses already exists under section 482 of the code. Up to the present time, the Treasury may properly complain that it did not have enough information about these intercompany transactions to make effective use of section 482. However, the Internal Revenue Service has not yet received the full benefits of the amended sections 6038 and 6046. It will obtain the comprehensive information of form 2952 for the first time beginning in 1962. These should supply the Service with the information and source data it requires. A trial should be given to this approach before the blunderbuss approach of section 13 is adopted.

Section 482 affords a sufficient basis for eliminating any diversion of income to foreign affiliates. The only other reasonable complaint which the Treasury Department may have is the unreasonable accumulation of legitimately earned foreign profits in order to bring them back to the United States at capital gains rates on liquidation instead of at ordinary income rates by way of dividend. This motivation for accumulating earnings in foreign corporations could be eliminated by applying regular income tax rates when such unreasonable accumulations accumulated after enactment of the bill are ultimately distributed, whether by way of liquidation or dividend.

If, despite the foregoing objections to the whole approach of section 13, it is decided that the section should be enacted, substantial changes should be made in order to eliminate inequities, unfairness, and possible unconstitutionality.

Section 951 would tax so-called subpart F income and any other earnings invested in unqualified property to the U.S. shareholders even though not distributed. The section would apply to any person who, under rules of attribution, would be deemed to own 10 percent or more of the total combined voting power of all classes of stock or of the total value of shares of all classes of stock. This is a harsh and unconscionable provision since it would tax a person on income which he has not received and which is not actually within his control. Merely defining a 10 percent stockholder as a controlling stockholder does not make him one in fact. The section as drawn can mean that a stockholder who has not received the income and cannot compel its distribution will nevertheless be taxed upon it. The absurdity of the approach, in fact the absolute tyranny of the proposal, is made evident by the simple question: Where is such a stockholder to get the money with which to pay the tax? The Treasury apparently assumes

that every person who owns stock in a foreign corporation has ample income and funds from other sources with which to pay such a tax.

If this section is enacted at all, it should be drastically modified to tax only a person who actually or by reasonable rules of attribution has at least 50 percent control of the foreign corporation. Even then, such person should be relieved of the tax to the extent that he can show that there are legal restrictions which prevent the distribution of the income to him. The fact that the *Eder* case (138 F. 2d 27) is on the books demonstrates that the Treasury Department will not be inclined to meet the problem by a reasonable administrative approach if the matter of legal restrictions is not covered in the statute.

Section 952 defines subpart F income which is to be taxed to the U.S. shareholders under section 951. It is defined as the sum of (*a*) income derived from insurance of U.S. risks, (*b*) income from U.S. patents, copyrights, formulas, and processes, and (*c*) the net foreign base company income where the controlled foreign corporation is 50 percent owned by five or fewer U.S. persons. The terms used in (*a*), (*b*), and (*c*) are defined respectively in sections 952(b), 952(c), and 952 (d) and (e).

Section 952(c)(1) includes in income from U.S. patents, copyrights, and exclusive processes, not only income from the license, sublicense, or exchange of such intangible assets, but also from their use. Section 952(c)(3) defines income from use to be the amount which would be obtained as a gross rent, royalty, or other payment in an arm's-length transaction with an unrelated person for a similar use of the rights. Thus, a foreign subsidiary manufacturing under a patent obtained from its U.S. parent would be deemed to have subpart F income in the amount which it would have paid by way of royalty if it had obtained a license to use the patent from an unrelated person. Section 952(c)(2) specifically provides that the manufacturing expenses cannot be deducted in determining the subpart F income from these assets. Accordingly, it is possible that income would be imputed in these amounts to the subsidiary and taxed to the U.S. parent even though the subsidiary were actually operating at a loss with respect to the patented process, so long as it had earnings and profits from all of its operations. It is bad enough to tax a U.S. shareholder on income earned by a controlled foreign corporation before it is distributed. This section goes further and taxes the U.S. shareholder on income which may not even have been earned by the foreign corporation.

Section 952(c)(1) defines income from U.S. patents, copyrights, and exclusive formulas and processes to mean income from such assets which are either substantially developed, created, or produced in the United States or are acquired from a U.S person. This provision will have the direct effect of discouraging research in the United States and discriminating against the American inventor.

If the foreign subsidiary of an American corporation is seeking to acquire a patent or process from nonaffiliated interests for use in its foreign operations, section 952(c)(2) will be a direct inducement to buy the patent or process from a foreign inventor rather than from an American inventor. If it buys from the foreign inventor there will be no imputed income to the U.S. parent from the use of the patent or process. If it buys from an American inventor, there will be such imputed income to the U.S. parent even though the U.S. parent did not develop the patent or process and never had any property interest in it.

Similarly, section 952(c)(1) will be a strong inducement for U.S. corporations to transfer their research activities to foreign subsidiaries operating abroad. Any patents thus developed would escape the penalty of imputed income because they would neither have been developed in the United States nor acquired from any U.S. person.

Section 952(e)(2) defines foreign base company sales income as income in connection with the purchase of property from a related person and its sale to any person, or the purchase of property from any person and its sale to a related person where the property is manufactured *outside the country in which the controlled foreign corporation is incorporated* and sold for use or consumption outside such country.

This provision should be modified because the country of incorporation affords an insufficient basis for such a distinction. For example, a sale by a corporation incorporated in country A, for local use or consumption, of goods manufactured in the United States by a related parent does not fall within the definition; but, if the same goods were sold to the same customers by a company organized in country B (even if the sale is made locally in country A by corporation B), the resulting income falls within the section. This distinction appears purely tech-

nical—it is possible to fall outside the provision merely by incorporating in the country of the destination of the property.

Similarly, regardless of where the product is purchased, it falls within the definition if it is sold to a related person for use or consumption outside the country in which the controlled foreign corporation was incorporated. It would appear that the country of incorporation is of dubious relevance to the place or use of consumption of the products.

Section 952(e)(2) apparently is intended to include sales commissions in subpart F income where the foreign subsidiary sells as agent for the U.S. parent on a commission basis instead of purchasing and reselling. However, despite the reference to commissions parenthetically in section 952(e)(2), the typical commission transaction would not fall within the section because there would be no purchase of the property from a related person. There would simply be a manufacture and sale to the ultimate customer by the U.S. corporation with the foreign subsidiary acting merely as a commission agent.

Under section 952(e)(3) rents are to be included in foreign base company income and therefore in subpart F income without regard to whether or not such rents constitute more than 50 percent of gross income. This section could operate most unfairly where foreign corporations are used purely for local or nontax reasons. For example, if an individual operates an apartment house in Canada through a Canadian corporation, he would be taxed under proposed subpart F on the undistributed income of the Canadian corporation with no credit for Canadian taxes paid. On the other hand, were he able to operate through a domestic corporation, that corporation would pay little, if any, additional U.S. tax as a result of the foreign tax credit and the stockholder would pay no tax at individual rates until the corporation actually distributed the income. Thus, the bill would drastically penalize operation through a foreign corporation instead of achieving tax neutrality.

If rents are construed for this purpose, as they are under Regulation section 1.543-1(b)(10) with respect to personal holding company income, to include charter fees, section 952(e)(3) could operate most unfairly under the typical arrangements entered into for the financing of ships. In these cases U.S. shareholders have caused foreign corporations controlled by them to purchase ships with borrowed money and then chartered the ships to the users of the vessels. The financing arrangements require the charter fees to be applied to the payment of the debt and they could not be withdrawn as dividends. Nevertheless, the U.S. shareholders would be taxed on the amount of these charter fees without deduction for the amounts used to pay off the debt. They would thus be taxed on amounts which they not only had not received but would never receive. It seems certain that the payment of the debt on the vessels would not be regarded as an investment in qualified property in less developed countries since the activities of the vessels could not be carried on almost wholly within a less developed country or countries within the meaning of section 953(b)(3)(A)(ii).

Section 952(f) permits the computation of investment in qualified and nonqualified property for purposes of computing net foreign base company income to be made 75 days after the close of the taxable year. In effect, this gives the foreign corporation 75 days in which to complete the investment of its foreign base company income in qualified property in less developed countries. This is a wholly impractical time limit. It is suggested that a provision be added to permit as an alternative the establishment of reserves for such investment which would become subject to tax if not actually used for the designated purpose within a period of 2 or 3 years.

Section 953 is a catchall provision aimed at any undistributed income not taxed as subpart F income unless invested in qualified property.

Reinvestment in a business not within a less developed country or countries is permitted only if the business was in existence on December 31, 1962, or has been in existence during all of the 5-year period ending with the close of the preceding taxable year. This is a direct discrimination against any new business in countries other than the so-called less developed countries.

Under section 953(a)(2), the increase in earnings invested in unqualified property is determined as of the end of the year. There is not even the inadequate 75-day grace period provided in section 952(f) with respect to the reinvestment of foreign base company income. It is somewhat anomalous that a grace period is given for the reinvestment of a foreign base company income whereas the supposedly more favored income not falling within the definition of foreign base company income must be invested in qualified property before the end of the year in which it is earned in order to avoid taxation under section 951(a)(1)(B).

To avoid this problem, it is suggested that there be substituted for the narrow provisions of section 953 a provision along the lines of section 531 preventing unreasonable accumulations.

Section 953(b)(2)(A) requires that qualified property is located outside the United States. Section 953(a)(3)(A)(i) specifies that a qualified trade or business must be carried on outside the United States. Section 48(a)(2)(B), in defining domestic property eligible for the investment credit, recognizes that aircraft, rolling stock, vessels, motor vehicles, containers, and other property used in transportation present special problems of situs. It would appear that the temporary presence in the United States of such property should not disqualify it for investment, particularly if it is used predominantly outside the United States, a concept used in section 48(a)(2)(A).

Similarly, it would appear that a trade or business which is carried on predominantly outside the United States should not be disqualified under section 953(a)(3)(A)(i) because of incidental U.S. activities.

In the case of a controlled foreign corporation engaged in trade or business in the United States its gross income from sources within the United States is deducted in determining subpart F income under section 952(a)(2). There does not appear, however, to be a corresponding provision permitting the reinvestment of such earnings in property used in the trade or business within the United States. Thus, for example, two corporations, one a United States corporation and one a Canadian corporation having identical United States controlling stockholders, may engage solely in a trade or business conducted in the United States. The U.S. corporation may, within the limits of section 531, accumulate and reinvest its income in its business. The Canadian corporation apparently would be denied this privilege, although it would pay the same U.S. tax as its sister corporation.

Section 953(b)(3)(B) defines as a qualified trade or business, a trade or business which is a qualified trade or business for a corporation in which the controlled foreign corporation had an 80-percent stock interest since December 31, 1962, or during the 5-year period ending with the close of the preceding taxable year. The committee report (p. A98) indicates that the purpose of this provision is to permit investment by the controlled foreign corporation in the stock of a second foreign corporation which meets the tests of section 953(b)(3). However, literally, section 953(b)(3) states that the qualified trade or business of the 80-percent-owned subsidiary constitutes a qualified trade or business of the controlled foreign corporation parent. This would permit the controlled foreign corporation parent to invest in the same kind of business directly, but there is nothing which permits the controlled foreign corporation parent to qualify by investing in the stock of the subsidiary. To accomplish this, there should be inserted in section 953(b)(2) an additional subparagraph comparable to subparagraph (C), which permits investment in the stock of a 10-percent-owned subsidiary in a less developed country under certain circumstances. The new subparagraph would permit investment in the stock of a corporation described in section 953(b)(3)(B).

Section 953(b)(5) contains a most unsatisfactory definition of less developed countries. It sets forth no standards, except that certain named countries and the Sino-Soviet bloc will not be designated as less developed countries. There is no definition of the Sino-Soviet bloc. The result of this definition is that an investment made in good faith in a particular country can suddenly be subjected to all the burdensome penalties of section 951 at the mere sweep of the executive pen. With respect to the countries specifically listed, the designation of the Union of South Africa as a country which cannot be designated as less developed would seem questionable.

The definition of controlled foreign corporations to which the amendments of section 13 of the bill are applicable is contained in section 954. The basic definition in section 954(a) includes within the term "controlled foreign corporation" any foreign corporation of which 50 percent of the total combined voting power of all classes of stock entitled to vote is owned directly or indirectly by U.S. persons on any day during the taxable year of such foreign corporation. This test would seem much too broad since it would include publicly held foreign corporations where no U.S. shareholder really had any effective control over the corporation. It is submitted that the definition should limit the term to a foreign corporation more than 50 percent of the combined voting power of all classes of stock of which is owned by a single U.S. person or is attributed to a single U.S. person under reasonable rules of attribution. Under the present

definition, a U.S. investor in a foreign corporation may suddenly become subject to the provisions of proposed subpart F merely because a few additional U.S. persons buy a small interest in the foreign corporation during the course of a taxable year. It is also difficult to determine, in the case of a publicly held company, what portion of the total voting stock is owned directly or indirectly by U.S. persons.

Section 955 contains the rules of attribution applicable in applying the provisions of subpart F. Section 955(a) contains the rules for determining the stock which is to be attributed to a shareholder for the purpose of determining the percentage of the income or earnings on which he is to be subjected to tax. Section 955(b) contains broader rules of attribution for the purpose of determining whether the stockholder is a 10-percent stockholder so as to be subjected to tax under these provisions, for the purpose of determining whether the income of the foreign corporation constitutes foreign-base company income under section 952(a)(1)(C) and for the purpose of determining whether the foreign corporation is a controlled foreign corporation within the meaning of section 954(a).

Section 955(a)(2) attributes actual ownership to a U.S. taxpayer of his beneficial interest in stock of a foreign corporation owned by another foreign corporation, a foreign partnership, or a foreign trust or estate. The U.S. taxpayer thus becomes taxable on the undistributed earnings of a foreign corporation even though he directly owns no stock in such corporation and the stock is owned by a foreign entity which he does not control. For example, if the nonresident alien owner of all the stock of a family-owned manufacturing company transferred more than 50 percent of the stock to a foreign trust for the benefit of his children who are U.S. residents, such children would become taxable on the undistributed income of the foreign corporation even though they have no way of controlling the distribution of dividends by the foreign corporation and even though under the terms of the trust if dividends had been paid they would have been distributable to the beneficiaries only in the discretion of the trustee.

Similarly, a stockholder in a foreign corporation owning stock in another foreign corporation could be taxed under subpart F on income he did not receive and over which he had no control. For example, if 70 percent of a foreign corporation were held directly by U.S. shareholders and 30 percent were held in a Canadian corporation owned 60 percent by Canadian shareholders and 40 percent by a U.S. shareholder who was not in any way related to the U.S. holders of the 70 percent, the U.S. stockholder in the Canadian corporation would be taxed on the undistributed income of the operating foreign corporation even though he not only did not control the distribution of dividends by the operating foreign corporation, but could not control the distribution to himself of any dividends actually paid by such foreign operating corporation to the Canadian corporation.

It should also be noted that the statute is most unclear as to which beneficiaries of a trust are to be taxed on current income. If all of the beneficiaries are to divide the trust's share of the undistributed income of a foreign corporation whose stock is held by the trust in accordance with the actuarial value of their respective interests, it will mean that the remaindermen will be taxed on income which, if it had actually been distributed, would have gone to the income beneficiary. On the other hand, if the problem is resolved by taxing the income beneficiary, he will be taxed on income which, if not in fact distributed as a dividend, may ultimately go to the remaindermen.

Section 955(b) adopts the attribution rules of section 318(a) with certain modifications. It is difficult to understand the purpose or justification of the exception made in section 955(b)(2). This section provides that in attributing the stock held by a partnership, estate, trust, or corporation to the partners, beneficiaries, or stockholders if such partnership, estate, trust, or corporation owns directly or indirectly more than 50 percent of the stock of the foreign corporation whose earnings are to be taxed, it shall be considered as owning all the stock. On its face, this seems to be an attempt to legislate that black is white.

Section 957 entitles a domestic corporation to obtain a foreign tax credit for the taxes paid by the foreign corporation which are applicable to the foreign corporation's income taxed to the domestic corporation under subpart F. This is, of course, analagous to the credit which would be available to the domestic corporation if it received a dividend from the foreign corporation and accordingly it is conditioned upon a 10-percent interest in a directly owned foreign corporation and upon a 50-percent interest in a subsidiary foreign corporation being held by the directly held foreign corporation.

Since the subpart F approach really involves a complete disregard of the corporate entity, it would seem only fair that all taxpayers who are taxed on the undistributed income of a foreign corporation under subpart F should be entitled to a credit for the foreign taxes just as if the taxpayers themselves had operated directly the business conducted by the foreign corporation. This is particularly equitable in the case of individual shareholders because of the high individual rates at which undistributed corporate income will be taxed under these provisions.

Section 15

This section of the bill deals with the tax treatment of shareholders of foreign investment companies.

Under proposed section 1246(a) any gains realized by shareholders of such a company upon the sale of their stock would be treated as ordinary income to the extent of their ratable share of the earnings and profits accumulated after December 31, 1962, during the period while the stockholder held such stock. Earnings which would be taxable under the proposed new subpart F would be excluded from the operation of this section.

The statute proposes to impose on the taxpayer the burden of establishing the amount of his ratable share of earnings and profits accumulated during the period of his ownership. If he fails to meet this burden, all the gain would be considered ordinary income. Obviously no stockholder could ever be in a position himself to determine these figures; normally a corporation does not determine such figures more frequently than once a year although unaudited figures may be available quarter-annually. It is unlikely that a foreign investment company could reasonably be expected to assume the burden of a daily calculation of its earnings and profits. Accordingly, as a practical matter, it would be possible for the taxpayer only in that most exceptional situation where both purchase and sale took place on report dates to be able precisely to determine his ratable share in the earnings and profits for the holding period. Perhaps a provision should be inserted providing for a ratable allocation of earnings for the accounting period to any fraction of the period for which the stock has been held.

If a gain is to be taxable as ordinary income, it would seem equitable to give equivalent tax treatment to a loss on a sale if the taxpayer can establish that during the holding period the foreign investment company incurred a loss.

The definition in proposed section 1246(b) involves an obvious problem: If the foreign investment corporation is not registered under the Investment Company Act of 1940, how can it be compelled to disclose whether 50 percent of the total voting stock or 50 percent of the value of its stock was held by U.S. persons? It is submitted that any attempted presumptions in the absence of a disclosure would be unfair to the U.S. stockholders since the situation is not within his control.

Under proposed section 1274, a foreign investment company is granted an election to distribute income currently. The exercise of such election would exclude the shareholder from the application of subpart F and render proposed section 1246 inapplicable.

The election requires a distribution by the electing corporation of 90 percent or more of its taxable income calculated as if it were a domestic corporation. This formula may preclude the election by foreign investment companies where the applicable municipal law would make such a distribution unlawful, as where the law of the country of incorporation requires the establishment of reserves.

A serious defect in proposed section 1274 is the complete absence of a provision in respect to a shareholder who disposes of his stock within the year. What long-term capital gains would such stockholder of an electing corporation include in his return? Would each of two or more shareholders owning the same shares within a year be required to include in his income the entire applicable share of the capital gain for the entire year in order to be a qualified shareholder?

A U.S. shareholder would be required to include in his gross income his pro rata share of undistributed capital gains and pay the tax thereon. If he fails to do so he remains subject to proposed section 1246 and is not entitled to an adjustment of his basis. The principal objection to this provision is that it would require the stockholder to make a tax payment even though he has not received a dividend. Adaptation of the provisions of section 852(b)(3)(D) is not practicable in this situation in the absence of 100 percent U.S. stockholders.

Equity would require that the provisions of the code dealing with foreign tax credits should be integrated with proposed section 1247 to assure full availability of the credits to all shareholders.

It would appear desirable that the bill provides a reasonable opportunity—say until December 31, 1963—for foreign investment companies to reorganize tax free and become domestic corporations. It is likely that at least some would do so in the interests of their stockholders and thus avoid the discriminations and practical problems mentioned above. Such an opportunity would at least save from the penalty consequences of the bill the shareholders who relied on a legislative policy which encouraged them to invest in foreign investment companies.

Section 16

Section 16 of the bill changes materially the treatment of gains received by holders of 10 percent or more of the stock of a controlled foreign corporation upon the redemption, sale, or transfer of the stock held therein.

The committee on taxation of foreign income, in its comments on the draft bill released by the Committee on Ways and Means, advocated a study of "effective means to prevent the unreasonable accumulation of foreign income by a U.S. controlled foreign corporation which has no intention of reinvesting such earnings for expansion or growth in order to ultimately sell or liquidate on a capital gains basis."

The committee's report then proposed that such a study might consider "the possibility of applying regular income tax rates rather than capital gains rates on the ultimate liquidation of such companies to the extent the liquidating distributions represent unreasonable or excessive accumulations."

A similar suggestion is made in this statement in the general discussion with respect to section 13.

The proposed legislation incorporates only the method suggested by the committee's suggestion and not the gain to which the committee suggested the method be applied. The proposed legislation applies ordinary income rates to the taxpayer's gain to the extent of his proportionate share of (1) all earnings and profits of the controlled foreign corporation accumulated since 1913, where a redemption or liquidation takes place, and (2) all earnings and profits of the controlled foreign corporation accumulated during the period stock, sold or exchanged, was held.

The proposed legislation applies the regular income tax rate to accumulations of earnings and profits made prior to the date of enactment of this section. The retrospective effect of the proposed legislation should be carefully reviewed. If it is deemed desirable to close the present "capital gains loophole" available by the redemption or sale of a stock of a foreign controlled corporation, then the legislation should provide for the application of ordinary income tax rates to accumulations of profits and earnings made after the date of the enactment of such legislation. The present statutes give capital gains treatment to the receipt on liquidation of the accumulations of profits and earnings of foreign corporations or the realization of equivalent gains by way of sale. To retroactively increase the rate of tax on prior accumulations of those corporations is unjust and unfair. Secretary Dillon, in his testimony before the Committee on Finance, in describing this provision, has himself stated: "The committee may want to consider whether it wishes to retain the applicability of this provision to earnings heretofore accumulated."

Furthermore, there would seem to be no basis for the difference in result between a liquidation and a sale which would take place under proposed section 1246 (a) and (b). In the case of liquidations the gain is taxed to the full extent of the stockholder's share in the earnings and profits, whereas in the case of a sale the gain taxable at ordinary income rates is limited to the earnings and profits accumulated during the stockholder's holding period.

If adopted at all, proposed section 1248 should tax at ordinary income rates only profits accumulated during the period of the taxpayer's stock ownership after the effective date of the new provisions.

Consistent with the effective date provisions of the other sections of the bill dealing with foreign income, proposed section 1248 should be applied only to liquidations or sales taking place after December 31, 1962. It is unfair not to give taxpayers a chance to adapt their affairs to the new provisions when they have made investments in reliance on such vastly different rules of law of long standing.

Proposed section 1248 leaves open the question of whether the foreign tax credit will be available to a U.S. parent corporation with respect to the amounts taxed as ordinary income. This is, in essence, the same question dealt with in *Freeport Sulphur* and *Associated Telephone & Telegraph* and should be specifically treated here to remove any uncertainty.

Section 20

Section 20(a) proposes to amend section 6038(a) of the 1954 code. The latter section authorizes the Secretary or his delegate to require the furnishing of a variety of information with respect to foreign corporations controlled by "a domestic corporation." The proposed amendment would require such reports of "every U.S. person" who controls any foreign corporation. The phrase "U.S. person" means a citizen or resident of the United States, a domestic partnership or corporation, and a foreign estate or trust.

Section 6038(a) as amended would basically follow the substance of the section in its present form with appropriate changes to reflect the expanded reporting requirement. It should be noted, however, that the definition of control has been expanded to include the constructive ownership rules of section 318(a) with the familiar elimination of the 50-percent limitation of clause (i) of section 318(a)(2)(C).

Section 20(b) proposes to amend section 6046. The latter section now requires returns containing such information as the Secretary or his delegate may require where a foreign corporation has been organized or reorganized; such return to be filed by officers or directors or shareholders in prescribed circumstances. Under the proposed amendment the test of office holding or share holding would not be limited to the 60-day period after an organization or reorganization occurred but the new section would be invoked on or after January 1, 1963, whenever a U.S. citizen or resident became an officer of director of a foreign corporation or acquired the requisite 5-percent stock ownership.

Section 20(c) would add a civil penalty of $1,000 (in addition to any criminal penalty) where without reasonable cause there is a failure to file a return required by section 6046 or if filed, a failure to show the required information.

With respect to the loss of foreign tax credit provisions under section 6038(b), it would seem appropriate to provide that the penalty applies only for intentional failures to furnish the information. For example, where a dormant subsidiary, among many others, for one reason or another is inadvertently omitted, it seems a harsh result to deny a foreign tax credit with respect to the other subsidiaries.

In section 6046, it would seem appropriate to incorporate the heading into subsection (b) so that the information which can be required by the Secretary is limited to information with respect to organization, reorganization, or acquisitions of stock.

Section 21

This section of the bill would, in effect, amend present section 7852(d) of the code, which provides that code provisions shall not apply where their application would be contrary to any treaty obligation of the United States in effect on the date of enactment of the code, so that that section will not apply with respect to any amendment made by the bill, when enacted.

As a result of the amendment made by section 21 the gross-up amendments made by section 11 unilaterally affect a number of our tax treaties:

(*a*) Our treaties with Australia, New Zealand, and Honduras provide that the foreign tax credit provisions shall remain as they were when the treaty was signed.

(*b*) Our treaties with Austria, Belgium, Finland, Ireland, Norway, Pakistan, Switzerland, and the Union of South Africa provide that the foreign tax credit provisions shall remain as they were at the time of the treaty's "entry into force."

(*c*) The Japanese treaty provides that the foreign tax credit provisions shall remain as they were on January 1, 1954.

(*d*) As a result of the amendment of our treaty with the United Kingdom, the cutoff date is January 1, 1956.

Even though the so-called savings clause would appear to give the United States the right to determine (in the case of U.S. citizens, residents, and corporations) the taxable basis on which income tax is imposed, in the above cases we could be deemed to have waived our rights to use the savings clause. At the time the Canadian Treaty was last amended and the tax credit provision was

modified to eliminate the fixed-date provision which was previously like those in paragraph 3(b) above, it was stated that the change was being made because both governments considered it "undesirable to stabilize as of a particular date the laws relating to tax credits." Thus the change was deemed to require the consent of both governments.

As a matter of U.S. constitutional law, the later in time of conflicting treaty and Federal statute prevails. Therefore, there can be no constitutional objection to section 21. However, it does create the undesirable foreign policy result of breaching treaties and, as a matter of public international law, subjecting the U.S. Government to intergovernmental claims by the other nation-parties to our income tax treaties. It would appear that our action in amending our law, and therefore unilaterally modifying the treaties, is a shocking, unconscionable, and unnecessary violation of international agreements. Surely, at least a delay would be proper in order to permit renegotiation of these treaty provisions. To do otherwise is to invite retaliation because the law of most continental European countries is that the interpretation of the executive branch governs treaty commitments unless the treaty provision is clear and unambiguous. Even apart from any distatste which must arise because of the proposed unilateral action, it would appear unwise for the Congress consciously to jeopardize our treaty commitments.

H.R. 10650: Comments on Sections 2 and 14—Section 2—Credit for Investment in Certain Depreciable Property; Section 14—Gain From Disposition of Certain Depreciable Property

I. TECHNICAL COMMENTS ON SECTIONS 2 AND 14

Section 2

Section 2 of the bill incorporates a number of the technical suggestions which were made by the committee on depreciation and amortization in January. In its present form it is generally well drafted. There are, however, the following technical comments on the section:

1. *Failure to refer to part IV of subchapter C in proposed section 47(b).*—Proposed section 47(b) makes the recapture provisions inapplicable in the case of certain transactions. However, the exceptions do not refer to reorganization under part IV of subchapter C. If the intent was to except such reorganizations only if they qualify under section 381(a) and, therefore, under part III of subchapter C, it would be advisable for the statute or the committee report to so state.

2. *Leasing treated as a disposition for purposes of the recapture provision.*—While proposed section 47(a)(1) provides for recapture of the investment credit if property is prematurely disposed of, the committee report provides, on page A-12, that leasing out property will be considered a disposition if it is property which the taxpayer would ordinarily dispose of by sale "and it appears that a purpose of the lease is to avoid the application of section 47." This is not within the usual meaning of the word "disposition." If leases are to be considered dispositions in some cases, the statute should provide rules which are adequate to apprise taxpayers of the circumstances under which a lease will be considered a disposition. The rule now stated in the committee report, in its reference to "a purpose" of the lease, could be construed as applying to virtually any lease if the lessor was aware that an outright disposition would result in the recapture of the investment credit.

3. *Failure to recognize problems involving assets maintained in group or composite accounts.*—Both the credit recapture provisions in proposed section 47 and the committee report discussions of this provision are silent as to the effect of dispositions of assets from group or composite depreciation accounts. Presumably it is not the intention to treat normal retirements from such accounts as giving rise to recapture where the average life of assets in the account would not subject them to recapture.

4. *Definition of eligible section 38 property.*—The determination of what tangible property is used "as an integral part" of certain specified activities in proposed section 48(a)(1)(B)(i) will be difficult to administer. In the interests of clarification and administrative simplicity, it is suggested that proposed section 48(a)(1)(B) simply cover real property other than buildings and their structural components. If it is felt necessary to exclude other types of real property, they can be specifically enumerated.

Section 14

Section 14 of the bill has been changed very little from section 7 of the August 24, 1961, discussion draft. In its present form this section appears to have a number of relatively serious technical deficiencies:

1. *Relation of proposed section 1245 to other sections.*—Section 1245 overrides the provisions of many other, more narrow sections of the code. The person who devotes all his time to tax matters and who has an intimate familiarity with the code will doubtless bear section 1245 in mind in considering the provisions of sections which would be overridden by section 1245. However, a person not so familiar with the code as a whole is in danger of being misled by the language of these other sections, which gives no warning of the applicability of section 1245.

Sections which should be amended to give warning of the possible applicability of section 1245 include sections 336, 337, and 1231.

Other technical amenaments also appear necessary. For example, amendment of the type made to section 341(e) by section 14(e)(4) of the bill is called for in the case of section 1239.

Correlation should be provided between section 1231 and section 1245. Section 1231 now purports to deal with the treatment of gain on the sale or exchange of property of the type dealt with in section 1245.

2. *Treatment of property carried in multiple-asset accounts.*—The language of section 1245(a)(1) is such as to apply to the disposition of any single unit of property. A very large portion of section 1245 property is now carried in group or composite accounts. Under present treatment the normal retirement of an asset from such an account is not considered to be a sale or exchange under section 1231. Upon a normal retirement the income account is not affected; all entries are debits or credits to the depreciation reserve. Varying actual useful lives for the units of property in the account, including property of the same type and the same age put to the same use, and the fact that the disposition of one unit may result in positive salvage and the disposition of another unit in negative salvage, are all taken into account in fixing the average useful life and the depreciation rate approved by the Internal Revenue Service.

The term "disposition" in section 1245(a)(1) is broader than the term "sale or exchange" in section 1231(a). The committee report throws no light on whether the normal retirement of a unit of property carried in a multiple-asset account will be deemed not to constitute a "disposition" of the asset. Unless there is such an exception for items carried in multiple-asset accounts, section 1245 will result in very burdensome additional accounting costs in the maintenance of very detailed property records.

3. *Recapture of excess amortization.*—The recomputed basis should take into account amortization under section 162 in cases where the useful life of improvements to leased personal property is longer than the remaining term of the lease.

4. *Application to exchanges of mixed real and personal property.*—Under proposed section 1245(b) (4) and (5), on an exchange of a mixture of depreciable personal property and real property, it would be possible to realize ordinary income through the receipt of real property, even though the taxpayer also receives in the same transaction depreciable personal property the basis of which will reflect the depreciation previously taken on the property exchanged. The recognition of ordinary income would appear to be unnecessary in such a case.

5. *Treatment of installment sales.*—It is not clear whether the portion of the gain realized on a transaction for which installment sales treatment is elected which is treated as ordinary income under section 1245 would be a pro rata share of the gain attributable to each installment or would be all the gain on the early installments. The former would appear to be the preferable rule.

6. *Application to depreciation allowable but not allowed.*—The concept of the recapture of excess depreciation under proposed section 1245 would not appear to justify computation of the amount of ordinary income on any basis other than that of depreciation allowed. Consequently, it appears undesirable to impose any special burden of proof on the taxpayer as a prerequisite to calculation of the recapture provision on the basis of depreciation allowed, as the last sentence of proposed section 1245(a)(2) appears to do.

7. *Gross or net salvage.*—Neither proposed section 167(f) nor the committee report discussion makes clear whether the provision for electing to disregard salvage value of up to 10 percent of basis applies to gross salvage value or to

net salvage (gross salvage less the cost of demolition or removal). The preferable rule would appear to be to apply the 10 percent rule to net salvage since net salvage is the amount used in computing depreciation.

8. *Scope of election to disregard salvage.*—It is not clear whether taxpayers may elect to disregard salvage only on selected assets or on selected asset accounts, or whether any election to disregard salvage must be made across the board, so as to apply to all the taxpayer's depreciation accounts.

9. *Ten percent salvage computation in the case of a reduction in basis.*—Proposed section 167(f)(1) provides for the disregard of salvage which does not exceed 10 percent of basis "as of the time as of which such salvage value is required to be determined." Salvage value may be redetermined after the basis of an asset has been reduced by depreciation. (See Reg. Sec. 1.167(a)-1(c).) Consequently, a salvage value which is less than 10 percent of the basis of an asset when the asset is new may exceed 10 percent of the basis at the time of such redetermination—not because salvage value has been decreased, but because the basis of the asset has been reduced. It is suggested that, for purposes of proposed section 167(f), the salvage value should always be calculated as a percentage of the initial basis of the asset in the hands of the taxpayer.

II. ADDITIONAL TECHNICAL COMMENTS ON SECTION 14

As a general criticism, it is to be regretted that many of the issues have been resolved in the committee report rather than in the statutory text. For example, the committee report states that section 1245 gain is subject to deferral through use of the installment method.

The definition of section 1245 property has been expanded so as to minimze the problem of whether section 1245 gain is to be recognized in the case of a sale of fixtures which under State law are treated as realty. At the same time, the language chosen to effect this clarification creates its own problems. Section 1245, generally speaking, will cover real property other than a building or its structural components. There is no indication of the meaning of the phrase "structural components"; accordingly, doubt remains whether the owner of the building, who separately depreciates such items as heating system, cooling system, elevators, and the like is or is not subject to section 1245 on the rapid depreciation which may have thus been taken.

A further problem is created in connection with the limitation that the includible real property is subject to section 1245 only if now or previously used as an integral part of manufacturing, production or extraction, or the furnishing of transportation, communications, electrical energy, gas, water, or sewage-disposal services; or as a research or storage facility used in connection with any of the foregoing activities. What, for example, of an ordinary downtown office building which is occupied by tenants engaged in those activities? What of a public warehouse used to store manufactured products? Obviously, what is intended is that the real property so used must have been owned and used by a person engaged in one of the described activities, and the statute should say so. The statute should also deal with the problem of a long-term lease on all or a substantial part of the facilities of any such building.

Subsection (b)(2), which exempts section 1245 gain in the case of a transfer at death, remains vague on its face. The committee report, however, clarifies the text by making it explicit that death will result in a tax-free step-up of the basis of section 1245 property except to the extent that decedent had disposed of such property and died owning unrealized receivables with respect thereto.

The extension of section 1245 to cover certain real property brings into insistent focus the question of the taxation of nondepreciable boot which may be received in connection with a section 1031 exchange. Real property investment is the area par excellence in which section 1031 has been employed; and it is entirely possible that, as a result of the proposed text, a whole range of unintended section 1245 tax liabilities will result.

For example, taxpayer owns an intricate factory building located on inexpensive land at the outskirts of a city, the land, fixtures and building being worth $1 million and having a basis of $400,000. Taxpayer exchanges it for a much simpler office building located on high-priced land in the center of town. Obviously the taxpayer has exchanged land, buildings, and section 1245 property (i.e., fixtures) for land and buildings. None of the property received back is section 1245 property. Consequently, the entire section 1245 gain will be recognized even though the transaction is tax free under section 1031. Similarly, taxation under section 1245 may result, even where fixtures are both given up and received in a section 1031 exchange, if the value of fixtures received back

happens to be less than the value of fixtures given up. And again, even where the fixtures given up and those received back in exchange are of equal value, there is nothing in the legislation to prevent the Treasury from taking the position that the consideration received back should be prorated to all of the consideration given up, so that an exchange of factory buildings would be treated as the pro tanto receipt of fixtures, land, and building with respect to fixtures given up. This would result in a totally inexcusable section 1245 tax.

It is obvious that the policy expressed in proposed section 1245 runs counter to the policy embodied for over 40 years in section 1031 and its predecessors. It is strongly recommended that the present theory of proposed section 1245 (b)(4)(B) should be abandoned, and instead the problem be met by modifying the definition of "section 1245 property" so as to include all property of whatsoever character, to the extent that its adjusted basis is determined by reference to amortization or depreciation deductions theretofore taken with respect to section 1245 property.

It should be parenthetically noted that the committe report erroneously asserts that such an approach is in part at least already contained in the bill. The committee report states:

"* * * Even though the property is not used by the taxpayer as an integral part of an activity specified in clause (i), or does not constitute research of storage facilities within the meaning of clause (ii), such property in certain circumstances may, nevertheless, be section 1245 property under subparagraph (B). * * * Another illustration is when the adjusted basis of such property in the hands of the taxpayer reflects adjustments for depreciation with respect to other property (as, for example, in the case of a like kind exchange under section 1031) taken for taxable years beginning after December 31, 1961, at a time when such other property was used as an integral part of manufacturing by the taxpayer."

This is erroneous because it overlooks the fact that in order to qualify as section 1245 property at all both personal property (subpar. A) and "other property" (subpar. B) must meet the basic definitional terms of section 1245(a)(3). This means that no property can be section 1245 property unless it is or has been depreciable. Thus, nondepreciable real estate, received in exchange for fixtures, would not be section 1245 property. It neither has been nor is subject to depreciation.

The present concept of "section 1245 property," and the inclusion therein of fixtures, is subject to further criticism in that for a number of purposes, including the simple taxation of section 1245 gain, the determination of the amount of consideration given and received in tax-free exchanges, and the adjustment of the charitable contributions deduction, it would frequently be necessary to assign a value to fixtures. Yet no standard of valuation is given. Is the proper standard to be the replacement cost? Is the proper standard to be the market value of similar used fixtures? Is the market value to be the difference in value of the building as a unit with fixtures as against the same building as a unit without the fixtures?

The technical amendment contained in proposed section 1245(e)(4) is inadequate to its stated purpose. The committee report indicates that section 1245 property is not to be treated as collapsible property for the reason that, on liquidation of the corporation by any transferee of the stock, the underlying section 1245 gain will be recognized. However, the amendment covers only one part of the field; i.e., section 341(e). Consider the following possibilities for improper collapsible taxation: A collapsible corporation is liquidated by the original shareholders, as a result of which section 1245 gain is recognized to the corporation. Should not the statute expressly provide that such recognition constitutes the realization of income attributable to the collapsible propery for the purpose of applying section 341? And should not the shareholders be entitled to an adjustment to basis equal to the amount of section 1245 gain thus recognized (for the sole purpose of applying sec. 341)? Otherwise, the same collapsible gain may be taxed twice as ordinary income. While it is true that this can happen at present under section 341, the injustice ought not to be extended.

H.R. 10650: COMMENTS ON SECTION 3—APPEARANCES, ETC., WITH RESPECT TO LEGISLATION

1. I favor this provision since it liberalizes the treatment accorded such expenses under the Treasury regulations. I am concerned, however, because this

provision is more restrictive than the Boggs bill, H.R. 640. If the proposed section means that Treasury will henceforth require a proration and partial disallowance of dues paid to all organizations engaging in general legislative activity, I think this is unnecessary and unfortunate.

2. I do not know what proposed section 162(a)(1)(B) means when it speaks of "legislation or proposed legislation *of direct interest to the taxpayer* and to such organization." The committee report indicates that this is not to be interpreted so as to disallow a portion of the dues paid to an organization where the activity of the organization is only of general interest to all of its members. However, if a restrictive interpretation is placed on the words "of direct interest" as used above, as Treasury might see fit to do, all sorts of proration problems could arise. For example, if a trade association does legislative work relating to foreign trade as well as domestic trade, is a taxpayer paying dues to that association to be limited to a fractional deduction if his own business is concerned with foreign trade or domestic trade but not both? I am not satisfied in my own mind that the proposed statutory language is clear enough to support the statement in the committee report as to the effect of the new section.

3. I think the use of the word "direct" in "connection with appearances" is an *open* invitation to the Internal Revenue Service to continue the nonsensical battle of "hairsplitting" as to deductibility of legislative expenditures. Many trade associations engage in continual legislative research so that they will be able to testify intelligently when the need arises.

4. It might be helpful to indicate in the committee report that "appearances before, submission of statements to, or sending communications to, the committees, or individual Members of Congress," etc., includes the staffs of such Members and committees.

5. It is not clear from the bill what happens under proposed section 162(e)(1)(B) if the "organization" is not tax exempt. Are such communications as described between it and its members not deductible as to it but only as to its members? There is no logic in such a position.

6. The word "information" in subparagraph (B) is not very clear to me. A hostile Internal Revenue Service may dispute whether a communication is strictly an "informational report." I would strike the words "of information" as a needless restriction.

7. The flush material at the end of proposed section 162(e)(1) refers only to "dues" paid or incurred with respect to an "organization." Compare the language of regulations, section 1.162-15(c)(2) which refers to "dues and other payments." It is recommended that the broader phrase of the regulations be used, to make clear that contributions and special assessments are covered as well as regular "dues."

8. The House Ways and Means Committee report indicates that "nothing in this provision is intended to permit the deduction of entertainment expenses. Such amounts, if deductible at all, must meet the tests set forth in the section of the bill, explained below, without regard to this provision." I am not clear from the foregoing what is intended. Heretofore lobbying expenses have been nondeductible. Only the items specified in proposed section 162(e)(1) are to be made deductible. Specifically, what about the deductibility of *traveling* expenses to attend hearings before a legislative body to *hear* testimony on a subject of concern to the taxpayer's business? Are these deductible *traveling* expenses or nondeductible "legislative" expenses?

What about the deductibility of entertainment of legislators? If *legislation* is discussed, would this be considered a disallowable "lobbying" expenditure, or would it be a permissible "communication"? If legislation is not discussed, presumably, a deduction might be allowable under the "entertainment" provision.

9. I am not clear as to the intended meaning of the phrase in proposed paragraph (2)(B) of "segments thereof." I take it this is designed to prevent advertising in trade journals of particular interest to specialized groups of the economy. I think it would help to "committee report" this language.

10. This provision of the proposed section 162(e)(2)(B) disallowing the deduction of any amount paid "to influence the general public, or segments thereof," is too broad and vague. It might be construed as applicable to internal communications by a taxpayer to its stockholders or employees in legislative matters affecting the taxpayer's business, the cost of which should be deductible. Therefore, I recommend that either (1) the words "or segments thereof" should be deleted, or (2) immediately after those words there should be inserted "(not including stockholders or employees of the taxpayer)."

11. The failure to cover "advertising" will leave a large area of dispute between taxpayers and the Internal Revenue Service as to what constitutes permissible "institutional advertising" as distinguished from legislative "propaganda."

12. I note that the proposed relief for "lobbying" expenses is confined to section 162. What about the expenses of an individual under section 212 for the production, etc., of income? Why discriminate between *individuals* and *corporations* in this regard?

13. It seems to me that the proposals of section 3 are proper except for the provision allowing a deduction for the cost of communicating with individual members of a legislative body. Permitting such a deduction may too easily lend itself to abuse since visits or telephone calls are likely to be private. Communication with a committee is a public act open to the view of all. This difference is, I think, a proper basis for a difference in treatment.

14. I am somewhat concerned about proposed section 162(e)(2)(B), in view of its probable adverse effect upon institutional advertising. I would consider it most desirable for this provision to be expanded so as to give a taxpayer the right to deduct expenses incurred in resisting broad legislation which would strike at the heart of the taxpayer's business. I have in mind particularly the right of a distiller or brewer to oppose prohibition or the extension of local option rules or the right of a public utility to oppose the encroachment of public power. I realize that these matters are highly controversial as well as political.

15. I have again read the Ways and Means Committee bill, and though it does appear that it is possible for direct contact to be made with Members of Congress on an individual basis, I believe that the language which states, "with appearances before," would not mean the type of lobbying activity which is objectionable. I am convinced that we would not be faced with sub rosa appearances in private. There is certainly nothing wrong with individual conferences, and I can see no objection to that.

16. The new proposal certainly attempts to make clear that expenses in connection with preparing testimony or appearing before a legislative body are deductible. I much prefer the ABA proposal in its broad referral to section 212, for it appears to me that an attempt of this kind to "spell out" a type of deduction is what should be avoided in the Revenue Code.

H.R. 1065: Comments on Section 18—Inclusion of Foreign Real Property in Gross Estate

1. GENERAL

The proposed amendments would require that real property situated outside the United States would have to be included in the gross estate of decedents who were citizens or residents of the United States. This would be accomplished by amending sections 2031(a), 2033, 2034, 2035(a), 2036(a), 2037(a), 2038(a), 2040, and 2041(a) of the Internal Revenue Code of 1954.

The amendment would nullify an exemption that has existed since 1918 by virtue of a ruling by the Attorney General of the United States[1] and specifically provided for in all revenue acts beginning with the 1934 Revenue Act. The Attorney General's ruling was justified on the basis of legislative intention, principles of conflict of laws, and considerations of policy. The specific exemption in the 1934 Revenue Act according to the Senate Finance Committee report was justified by the "almost universally established principle of estate taxation that real estate should be subject to death duties only in the country where situated. To tax such real estate will make it difficult for many American citizens to live in foreign countries in the interest of American foreign trade, for they will be subject to a tax burden much grater than that imposed on foreigners in a similar situation."[2]

The foregoing arguments and reasoning are equally applicable today. In addition, it has been very appropriately stated that "the effect of the exclusion ultimately shall be to stimulate investment in foreign real estate. This development would seem logically consistent with the ultimate aim of the foreign aid program. Land investment is fundamental to both the industrial and agricul-

[1] 31 Op. Atty. Gen. 287.
[2] 48 Stat. 754, title II, sec. 404 (1934).

tural development which motivates foreign aid. Repeal of the exclusion cannot but hamper such investment. Without the incentive provided by the exclusion, the normal investor is understandably reluctant to undergo the risks and uncertainties inherent in investment in foreign real estate. It would be paradox indeed were this country to promote capital investment abroad through the costly medium of economic aid, while at the same time discouraging such investment in foreign realty by abolishing the exclusion."[3]

2. PROBLEMS IN COLLECTION OF TAX

Obviously section 18 raises serious legal questions in the fields of constitutional law and conflicts of law as well as practical problems for executors who cannot reach the real property for purposes of paying the estate tax.

Should not some provision be made for those cases where the executor cannot reach the real property for purposes of paying the estate tax? It is likely that many foreign governments would not permit the real property to be reached, particularly where it is not part of the probate estate. If the executor cannot reach the foreign real property, the inclusion of the foreign real property may cause all of the U.S. assets to be used for payment of the estate tax, leaving the American beneficiaries with nothing and the foreign beneficiaries with the real property. If this cannot be prevented by U.S. statute, then the foreign real property should be excluded from the gross estate where the executor cannot reach it.

If there is to be legislation with respect to foreign real estate it is suggested that the tax be made to obtain where there is effective U.S. jurisdiction over the transferees of the foreign real estate. This would mean a special tax with respect to foreign real estate that would recognize the special problems inherent in this subject matter.

Limiting taxability of foreign real estate to cases where a cause of action is given to the executor could result in discrimination between taxpayers depending on where the real estate is located and the accommodation given by particular foreign countries to U.S. executors.

If includibility of foreign real estate is made dependent on the law of a foreign jurisdiction in some cases that law may not be readily ascertainable. Moreover, in making the determination, do we rely on the law of the foreign jurisdiction as set forth in statutes and court decisions, or do we take into account the practical administrative position that foreign officials are likely to take, whether or not sanctioned by local law? Finally, and perhaps most important, in order to free local real estate from U.S. estate tax, foreign jurisdictions may adopt laws preventing foreign real estate from being reached.

3. RESIDENCES ABROAD

The long-established objective of fostering foreign trade should be preserved by continuing the exemption for homes which are the actual residences of U.S. citizens abroad who are bona fide residents of foreign countries.

4. SECTION 18(b) FAILS TO DEFINE "ACQUIRED" OR TO COVER ADDITIONS OR IMPROVEMENTS TO PROPERTY

Subsection (b) of section 18 refers in various subparagraphs to "real property * * * acquired by the decedent before February 1, 1962." Neither section 18 nor the House Ways and Means Committee report thereon defines the word "acquired." Such term is obviously ambiguous. Does it refer to the actual passage of title to the real estate or would an executory contract to purchase land entered into prior to February 1, 1962, qualify? Would the notice of the exercise of an option to purchase realty before February 1, 1962, qualify? Ambiguities as to the meaning of "acquired" should be resolved by the statutory language to the extent possible rather than relying on subsequent Treasury regulations and rulings which will undoubtedly have to be tested in the courts. Incidentally, the intent of Congress would seem clear to give relief to the American taxpayer who entered into a binding obligation to acquire foreign realty before the announcement of the decision of the House Ways and Means Committee.

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[3] Trusts and Estates magazine, February 1959, "Estate Tax Exemption of Foreign Real Estate," by Walter A. Slowinski and John F. Creed.

Furthermore, subsection (b) of section 18 should specifically deal with capital additions or improvements to real property by way of construction, reconstruction or erection on or after February 1, 1962, rather than leaving this subject solely to the committee report. In so dealing with this subject, subsection (b) of section 18 should resolve such questions as how such construction, reconstruction or erection is to be treated where it was commenced before February 1, 1962, and was completed thereafter, or where it was contracted for before February 1, 1962, and was commenced thereafter. Again, these matters can and should be settled by the statutory language and not left to the whim of regulations, rulings, and court decisions. Furthermore, the congressional intent would be clear that any construction, contracted before February 1, 1962, should be treated as constructed before February 1, 1962. Finally, any such statutory language on this point should eliminate the reference in the committee report to a material increase in the value of the real property arising from the capital additions, since this elusive test sows the seeds of needless litigation.

It should be apparent that the elimination of an exemption that has existed since 1918 for foreign real estate in the manner provided for in section creates a multitude of problems. These range from matters of national policy to legal and equitable considerations and include practical aspects that may be insurmountable. Expropriation or nationalization as well as currency restrictions could turn a bona fide investment in a foreign country into a liability. Section 18 if enacted should provide ideal material for those nations who are most anxious to direct criticism at this country.

(Whereupon, at 1:15 p.m., the committee recessed, to reconvene at 2:30 p.m. this same day.)

AFTERNOON SESSION

Senator KERR (presiding). Mr. Horne, Manufacturing Chemists' Association.

All right, Mr. Horne.

STATEMENT OF WILLIAM M. HORNE, JR., CHAIRMAN OF THE TAX POLICY COMMITTEE OF THE MANUFACTURING CHEMISTS' ASSOCIATION; ACCOMPANIED BY RAPHAEL SHERFY, COUNSEL TO TAX POLICY COMMITTEE

Mr. HORNE. Mr. Chairman, my name is William M. Horne, Jr., appearing as chairman of the Tax Policy Committee of the Manufacturing Chemists' Association.

Mr. Raphael Sherfy, on my right, is serving as counsel for MCA on this matter.

MCA—Manufacturing Chemists' Association—is a national trade association of more than 180 U.S. companies. The output of these companies represents over 90 percent of the total chemical production of the United States.

My testimony is principally directed to section 13 of the bill, the provisions dealing with controlled foreign corporations. But before I take up that section, let me turn to two other subjects which are dealt with by the bill.

We support section 17 of the bill relating to the tax treatment of cooperatives and patrons. We respectfully suggest, however, that the bill would be far more likely to accomplish its intended purpose if it required the annual written consent of the patron to take into income the amount of the cooperative's earnings allocated to him in the form of script, revolving fund certificate or similar patronage dividend.

If the committee is convinced that the administrative problems presented by the withholding provisions embodied in section 19 of the bill can be resolved, we would support these provisions.

Senator KERR. Are you familiar with the testimony before the committee of the represeentative of the Franklin National Bank, which is one of the 100 largest banks in the country, who told us that after the first year he figured that to withhold 20 percent from the interest payments on savings in his bank—and he was one of the 50 or 60 largest savings institutions in the country—would reduce their net earnings from someting like $10,025,000 to $10,010,000?

In other words, that after the first year he figured the cost to the bank would be about 15 cents per $100 of taxes withheld and transmitted to the Treasury and reported on to the depositors.

Mr. HORNE. We are not personally familiar with that testimony. However, as far as the chemical industry is concerned, we recognize that this will cost us something in the way of an additional expense, but our position is that, if the administrative problems which have been brought before the committee in the previous testimony can be resolved, we would support these provisions. This appears to be the appropriate way to make up the revenue losses that may be occurring now in the form of nontaxation of interest and dividends.

Senator KERR. Your companies make returns to the Treasury as to the amount of dividends paid, do they not?

Mr. HORNE. Information returns.

Senator KERR. Information returns.

Do you not think it would be a minor increase in expense to apply the withholding rate and send the check in and make a notation on the check to the stockholder?

Mr. HORNE. In those cases the expenses are incurred by the transfer agent, so we would have to depend upon them as to the actual amount of expenses.

Senator KERR. All right.

Mr. HORNE. We would urge, however, that further consideration be given to the effect of withholding on employees' pension trusts. Under the bill there is only a very limited exemption for these trusts from withholding on certain types of interest. Since these trusts ordinarily do not have employees subject to payroll taxes, the trusts will have to recover withheld taxes via the quarterly refund procedure. This will result in a loss of income to the trusts and in a consequent lessening of their ability to pay out pensions.

Besides this oral statement we have a more detailed statement for the record on sections 13, 17, and 19, which we are covering here, together with statements with respect to:

Section 5: Amount of Distribution Where Foreign Corporations Distribute Property in Kind.

Section 6: Allocation of Taxable Income Within a Related Group.

Section 11: Domestic Corporations Receiving Dividends from Foreign Corporations.

Section 12: Earned Income From Sources Without the United States.

Section 16: Liquidation of Foreign Corporations.

Section 20: Information Returns.

With permission, I would like to insert our detailed statement in the record later.

Senator KERR. This is the detailed statement of your association with reference to these particular provisions?

Mr. HORNE. That is right.

Senator KERR. It may be inserted in the record following your oral presentation.

The reporter will not duplicate language in this abbreviated statement with language in the more extensive statement.

Mr. HORNE. Turning now to section 13, we recognize that abuses have developed in the so-called tax haven area. The Treasury and the Congress are legitimately concerned with those abuses. The responsible business community is equally concerned. MCA supports legislation which would penalize sham "tax haven" corporations and the unreasonable diversion of income from U.S. income tax.

We do not support section 13. Instead, we urge that it be deleted from the bill.

Section 13 is not directed to prevention of tax abuses. Its avowed purpose is to restrict new foreign investment by U.S. companies, a purpose which is the opposite of that of the proposed reciprocal trade legislation which is pending before the House of Representatives. It is based on certain misconceptions and erroneous assumptions.

In our opinion, these assumptions are, as follows:

First, it is mistakenly assumed that tax considerations have been primarily responsible for the recent upsurge of investment in Western Europe, the United Kingdom, Canada, and Japan, the so-called developed countries. This cannot be the case since the so-called tax deferral privilege has been a fundamental principle of our tax laws for over 45 years. Actually, the upsurge in investment has resulted from the substantial growth in new markets in these countries. Rapidly rising standards of living have created a demand which warrants U.S. mass-production techniques.

Second, in our opinion, it is mistakenly assumed that if U.S. companies do not invest in plants abroad, they will invest the same funds in U.S. plants which can manufacture the goods for export. We believe that this is a misconception as to the realities of foreign trade. If the U.S. company fails to invest in a favorable foreign market, a foreign competitor generally will. The foreign market will then disappear so far as U.S. exports are concerned.

Third, in our opinion, it is mistakenly assumed that restriction of new foreign investment will solve the balance-of-payments problem. Secretary Dillon's statement to this committee on April 2 itself admits that the Treasury proposals will not fully solve the balance-of-payments problem in the short run and in the long run will have an adverse effect.

Fourth, it is mistakenly assumed that the restrictions on foreign investment will afford a so-called equality of investment opportunity. Equality can only exist for persons similarly situated. Foreign companies and domestic companies are not similarly situated. Even in the so-called developed countries, foreign corporations are subject to special risks to which domestic corporations are not subjected. These include currency restrictions, import controls and various types of political risks.

Fifth, it is mistakenly assumed that investment in foreign plant results in a decline in domestic employment. We have seen no statistics to support this argument and we are confident that none ca be produced. On the contrary, the implications from available statistics are that private foreign investment increases our foreign trad and thereby increases our domestic employment.

As an association we must, therefore, strongly object to section 1 in principle. We also wish to point out a few of the more obvious inequities which would result from its adoption in its present form.

(1) FIVE-YEAR RULE FREEZES OUT COMPETITION

The 5-year rule in section 13 is objectionable because it freezes out competition, vis-a-vis both U.S. competitors and foreign competitors.

For example, a U.S. company in 1963 may wish to establish a new subsidiary in Italy to produce plastic products. For the first 5 years, the undistributed earnings of this subsidiary will be subject to U.S. taxes. Compare this tax burden with its U.S. competitor which has a plastics subsidiary already established in Italy. The established subsidiary's earnings will be subject only to Italian taxes so long as the earnings are plowed back into the business or are invested in an underdeveloped or less developed country.

On the other hand, the U.S. company with a new subsidiary will be subject to tax on its undistributed profits.

Under these conditions, the proposed new operation will be frozen out. This inures to the benefit of foreign competitors, as well as to the established subsidiary of the U.S. company.

A similar problem is created by the bill's penalty tax on diversification. For some strange reason the bill seeks to impose a penalty on diversification, one that I do not believe our tax laws have ever sought to discourage before. Diversification may be necessary if the U.S.-owned subsidiary is to remain competitive in the local market. Take a U.S. company with a subsidiary in Ireland which has a plant that has been making ethical drugs for a number of years for consumption in Ireland.

Senator KERR. What is an "ethical drug"?

Mr. HORNE. An ethical drug is your normal prescription medicines as contrasted with what we call a proprietary drug or items such as toothpaste or sun lotion.

Suppose the subsidiary wishes to follow its local competitors and diversify by manufacturing a line of proprietary items, such as toothpaste. Is this a new trade or business? If so, the investment in the new business will subject the Irish company to U.S. taxes to the extent of its undistributed earnings. Suppose the Irish Government should pass a law prohibiting drug manufacturing in Ireland by foreign-controlled companies. And this is not too unusual. This has been done sometimes in lines of endeavor that a foreign government believes should be restricted to locally owned companies.

The Irish company would then be compelled to change to another line of business. Yet the penalty would still be invoked. Aside from the highly uncertain problems of what constitutes the "same trade or business," are these limitations in accord with our domestic policies as to competition and fair play?

The next inequity we would like to talk about is the matter of determining when a country is less developed.

(2) WHEN IS A COUNTRY "LESS DEVELOPED"?

A country generally qualifies as a "less developed" country, under the bill, when the President designates it as such in an Executive order. Except for enumerating 21 countries which would not so qualify, Congress retains no control, by review or otherwise, over the designation of "less developed" countries.

The use of an Executive order for this purpose poses serious problems. Suppose a U.S. company undertakes through its Venezuelan subsidiary a substantial expansion of its petrochemical plant serving the Venezuelan market. Midway through the expansion program, which may take several years to complete, the Executive order designating Venezuela as a "less developed" country is removed. The expansion program cannot be called off at this point. Financing, construction contracts, and other phases of the expansion program have been irrevocably committed. To treat the latter part of the expansion as "nonqualified property" because of revocation of the Executive order seems manifestly unfair.

(3) DEFINITION OF "CONTROLLED FOREIGN CORPORATION"

The definition of a "controlled foreign corporation," particularly the attribution of stock ownership rules, can lead to arbitrary and probably unintended results.

For example, a U.S. company may find its stock investment in a foreign corporation converted into a controlled foreign corporation through no action on its part. Conceivably, the action could be taken by a freign or a domestic competitor in order to place the U.S. company at a disadvantage taxwise.

Many specific cases could be cited in which U.S. companies have an interest of 50 percent or less in a foreign operation and, as a result, these companies do not have a controlling voice in the management. Superficially, such an interest in the foreign company would not appear to make it a "controlled foreign corporation." But the attribution of stock ownership rules of the bill may cause some unexpected consequences.

For example, a U.S. company may own 49 percent and a local foreign company may own the remaining 51 percent controlling interest. If the local foreign company itself has a few U.S. shareholders, their indirect ownership of the joint venture company may result in its being classified as a controlled foreign subsidiary.

In other words, the stock attribution rules regarding the ownership of the foreign partner by American citizens will result in having this joint venture foreign company treated as a controlled foreign corporation.

How, under these circumstances, is the U.S. company to know of the underlying stock ownership of its foreign "partner"? In many cases ownership of the foreign corporation will be in the form of bearer shares. Suppose the foreign partner deliberately sells its shares to U.S. persons to bring about this result?

And this, in effect, is what I meant earlier by saying that the foreign company could take action to place the U.S. company at a disadvantage competitively, taxwise.

To give another example, assume a Canadian petrochemical company is owned 40 percent by a U.S. chemical company, 40 percent by a Canadian oil company, and the remaining 20 percent of its shares are sold to the public on Canadian and U.S. stock exchanges. If the number of U.S. stockholders becomes more than 10 percent, the Canadian company automatically becomes a "controlled foreign corportation." The U.S. chemical company would then be taxed currently on its share of the Canadian petrochemical company's undistributed profits even though the petrochemical company's board of directors had determined these profits would be reinvested in its business. Also, the U.S. company might be unaware that changes in the public ownership had occurred.

(4) DOUBLE TAXATION OF "ROYALTY" INCOME

The bill can lead to double U.S. taxation of royalty income through its provisions for an imputed royalty. These provisions apply where a controlled foreign corporation has licensed, sold, or used patents, copyrights, or know-how either acquired from a related U.S. person or developed in the United States regardless of how acquired.

For example, a U.S. chemical company in 1956 may have sold to an unrelated German company the exclusive rights in Europe to its know-how for the manufacture of a type of synthetic fiber. The proceeds of this sale, whether received in a lump sum or as royalties, would be fully subject to U.S. income tax. In 1963, the German company sells the exclusive rights as to France only to a French company, 51 percent of whose stock is owned by a U.S. textile company. When the French company uses the process, the U.S. textile company will have to pay a U.S. tax on an imputed royalty. This results in two U.S. income taxes plus a German income tax on the royalty income.

(5) "REVERSAL" OF PRIOR RULINGS

The provisions for an imputed royalty can lead to current taxation of undistributed earnings even where the Internal Revenue itself has previously ruled that the transfer was not made for tax avoidance purposes.

These are the so-called section 367 rulings and section 351, under which the Internal Revenue Service may have ruled that the transfer of the patents in exchange for stock was not made for tax-avoidance purposes.

In effect, this constitutes a reversal of the prior tax ruling.

For example, assume a U.S. chemical company in 1951 had transferred patents and know-how to a newly organized Belgian chemical company in exchange for 51 percent of its stock. The remaining 49 percent of the stock was owned by another Belgian company which contributed plant, machinery, and equipment to the new business. The Internal Revenue Service ruled at that time that the transaction did not have a tax-avoidance purpose and no U.S. tax was required to be paid on the transfer. Beginning in 1963, the U.S. company would apparently be required to pay a tax on its share of the undistributed profits of the Belgian chemical company measured by an imputed royalty for the patents and know-how transferred in the tax-free exchange in 1951.

The final, and in many ways the most critical, example of the inequities of section 13 is:

(6) TAXATION OF PAPER PROFITS

The bill would tax paper profits of a foreign subsidiary when the U.S. parent may have no funds to pay the tax bill.

Suppose a wholly owned subsidiary in Austria has 1963 profits equivalent to $500,000, but its U.S. parent company has a net loss of $100,000 in its domestic business and a dangerously low cash position.

Assume, further, that the Austrian Government imposes stringent exchange controls, so that there is no opportunity for the Austrian subsidiary to remit any dividends to the U.S. parent company.

Under these controls, the Austrian subsidiary could reinvest its profits in Austria but it would not be able to convert its Austrian schillings into dollars to pay dividends to its U.S. parent. Yet under the bill, the U.S. parent company would be forced to pay U.S. income tax on these profits which it could not receive. This U.S. tax might force the U.S. company into bankruptcy.

Or suppose the U.S. company is not driven bankrupt but that it is able to borrow to pay its U.S. tax on liability on unremitted foreign earnings. Assume that in 1964 the Austrian company has losses of $600,000. The U.S. parent would then have been taxed in paper profits for 1963 which had totally disappeared in 1964. The U.S. parent would have to repay a loan incurred for U.S. taxes on income which it will never receive.

CONCLUSION

The provisions of section 13 do not apply uniformly to all U.S. business abroad. Also, section 13 would adversely affect U.S. legitimate business operating abroad vis-a-vis its foreign competitors and vis-a-vis certain established foreign operations of its U.S. competitors. We do not believe there has been adequate time to appraise the possible consequences of this type of legislation. Under these circumstances, we respectfully urge the committee to delete section 13.

That concludes our prepared statement.

Senator KERR. Thank you very much, Mr. Horne, for a very intelligent statement.

Any questions?

Senator CURTIS. Yes, I have a question or two.

Are any parts of the domestic business community supporting section 13 that you know of?

Mr. HORNE. None that we know, sir.

Senator CURTIS. Now, if an American company contemplated establishing a plant, a subsidiary plant, in a given foreign country, and its competition, we will say, for that same local market is in Germany, the country that succeeds in establishing that new business in the third country will have the inside track on exports there throughout the life of that company, will it not?

Mr. HORNE. That is right, sir.

I can give you an example that we have cited in our detailed statement on those lines.

One of our member companies actually had substantial export sales to a Latin American country. This company was urged to establish

a subsidiary there by the foreign government because they wanted a local supplier of this particular product.

The U.S. company did not see fit to make the investment at that time. This was back in the early 1950's. It did not make the investment, and, as a result, a European company did make the investment.

Today, in 1962, the U.S. company no longer has any export sales to that Latin American country, where before it had about $2 million export sales.

Senator CURTIS. What are the general types of export sales that are apt to flow from the establishment of a company, the establishment of a subsidiary?

Mr. HORNE. Well, in the beginning you will probably stimulate export sales to get your market established. In other words, you will have a period of time before you can get into production in the local market during which there will be a stimulation of additional sales from the United States.

Then, as you begin to manufacture locally, you will have a period in which you will bring in component parts and raw materials, perhaps, to be utilized in your manufacture.

At the same time, you will frequently stimulate what we call a supplementary line, so that you may be selling one particular product, but that will create a demand for other products that you manufactured in the United States and, therefore, stimulate those export sales.

Senator CURTIS. And an export sale sometimes of raw materials, parts, components, and repairs as well, does it tend to provide business when you have contacts and the experience of being a part of the business community in the foreign country?

Mr. HORNE. That is becoming more and more of an absolute essential.

In other words, in order to be able to market anything at all, you have to have a local organization, and the fact that you have an establishment there manufacturing tends to enlarge the area for your market.

Senator CURTIS. In other words, this might be oversimplifying it, but there is something to the contention that a foreign country says, in effect:

"If you will come here and start a business and employ our people, we will be buying from you and we will do business with you."

Mr. HORNE. That frequently is the case.

Senator CURTIS. And if the United States does not respond to that opportunity and some foreign company does, they are the ones to benefit by the exports in the later years?

Mr. HORNE. The foreign competition, as you know, Senator, is growing more intense all the time. Our foreign competition in the chemical industry is well financed. They are alert, aggressive businesses, well operated, and, more and more, we are feeling the competition in the foreign markets.

To the extent that we do not move in ourselves to satisfy these opportunities, the foreign businesses definitely will.

Senator CURTIS. Business does not operate in a vacuum. Where there is some business being transacted and acquaintances made and a chance to observe opportunities, there are going to be more business firms, is that correct?

Mr. HORNE. That is correct.

Senator CURTIS. Do you believe there would be administrative problems in connection with section 13 as it is written?

Mr. HORNE. I can speak personally on that, sir, as a corporate tax administrator, rather than officially for the MCA, but, as such, I feel that there are very definite administrative problems.

I have read this bill myself two or three times and have gone over the committee report, and I still feel that there are many areas of this bill that I have grave questions about. Frankly, some parts of it I do not think I understand.

I think that there are others like myself who are tax administrators, who have gone over the bill, and have grave questions as to their ability to comply with the bill.

I would hope that the Internal Revenue Service would be in a position to give this committee an evaluation of the problems of compliance that the Internal Revenue Service is going to have itself with this bill from the Government's standpoint.

Senator CURTIS. Now, if section 13 of the bill would aid the balance-of-payments problem in the short run, why is this not a good argument for its enactment?

Mr. HORNE. Well, on that one, sir, we are not convinced that this is going to aid the balance of payments in the short run.

I think the most recent statistics that Senator Kerr put in the record this morning from the Department of Commerce indicate that there is, as far as private foreign investment is concerned, a positive impact as far as the balance of payments is concerned.

In other words, the return back today to the United States in the form of dividends and other profit remittances, royalties, and so forth, from the foreign investment exceeds the new capital outflow.

I think the problem is not so much the new foreign investment abroad, private foreign investment, as it is the so-called portfolio investment.

Senator CURTIS. What do you mean by that?

Mr. HORNE. This is the temporary investment in securities, the shifting in bank balances, bank accounts, from one country to the other.

Senator KERR. Buying foreign bonds by U.S. people is what you are talking about, is it not?

Mr. HORNE. That is part of the problem, sir.

Senator CURTIS. In other words, you feel that we should not intermingle for the purpose of writing tax laws the matter of American businesses establishing legitimate operating businesses abroad with incorporated pocketbooks and operations that are truly a tax haven?

Mr. HORNE. Right, sir.

We think that there is authority under existing law to get these incorporated pocketbooks, but, to the extent the committee feels more legislation is needed, we feel section 6 of the bill, amendments to 482, and other amendments can be added to give the Internal Revenue Service more authority to attack the incorporated pocketbook.

Senator CURTIS. Now, if there is a problem with a few concerns in a few lines where American business might establish a business abroad in order to supply the domestic markets, there are other ways to deal with that problem besides the enactment of section 13, are there not?

Mr. HORNE. Yes, sir.

Senator CURTIS. In our general trade bills, quotas, and tariffs?

Mr. HORNE. I know that Secretary Dillon has made the statemen that the provisions of section 13 do not go as far as the British g in imposing direct controls on private foreign investment. It seems to us that the Secretary has substantially admitted that this is an indirect method of imposing those controls. This seems to be an unusual type of provision to put in the tax laws to try to contro indirectly private foreign investment as opposed to a strictly revenue measure or a measure designed to prevent tax avoidance.

Senator CURTIS. If I understand it correctly, Secretary Dillon has said that the Treasury is seeking to make foreign investments less attractive by special tax inducements. As I understand your testimony, you do not consider the present tax laws an inducement to oversea investment.

Would you care to explain your position a little more fully?

Mr. HORNE. Senator, we do not regard the present tax laws as constituting a tax inducement to foreign investment. I think this was brought out in Senator Douglas' questioning of the witness this morning. Senator Douglas indicated first that he felt that this so-called deferral had been put in the tax laws as a special inducement to encourage new investment in Europe.

Well, this has been a misconception that has crept into the newspapers somehow and has been repeated several times. But, as Senator Douglas himself subsequently pointed out this morning, this was not the case.

In fact, the method of taxing foreign subsidiaries has been on our tax laws since practically the tax laws were enacted, since 1918, at least.

And it is based on the jurisdiction to tax.

The witness this morning, I think, adequately pointed out that this is a matter of the jurisdiction to tax a foreign corporation. We do not, therefore, think that this is any special privilege or special consideration being given to foreign investment.

If it were, why would you not have had quite an influx of new investment in European countries, particularly back in the twenties or the thirties?

This same provision has been in the tax laws all this time.

I do not think the reason for the new investment abroad can be put on the basis of the tax laws. It is because of the new markets that are opening up and the new opportunities for new investment. These are the reasons that business is going abroad now, not tax considerations.

Senator CURTIS. According to Secretary Dillon, this section is intended to make foreign investment less attractive. Are you aware of any instances in which Departments other than the Treasury, Departments of our Government, have encouraged new foreign investments?

Mr. HORNE. I know there have been instances in which various agencies of the State Department have encouraged U.S. business to go into certain foreign countries in order that these countries will develop business, and will develop their operations along the free

enterprise system, rather than the Communist system. This has been a matter of concern to the State Department in a number of areas.

And, in fact, they have encouraged U.S. businesses in cases to invest in these countries.

Now, these generally, are the so-called less-developed countries, but I think there has been a case in which they have even encouraged U.S. business to go into West Germany and West Berlin.

Senator KERR. Would the Senator yield?

Senator CURTIS. Yes.

Senator KERR. The fact about the business is they have guaranteed these investments to the extent of hundreds of millions of dollars against loss by the American investors, have they not?

Mr. HORNE. They have in many cases, sir. Of course, even though you have the guarantees, you may still have a substantial portion of your investments not subject to the guarantees.

Senator KERR. I understand, but they have guaranteed?

Mr. HORNE. They have guaranteed.

Senator KERR. They have guaranteed hundreds of millions of dollars of these investments in foreign facilities by American investors.

Senator CURTIS. Take the Export-Import Bank, which I believe, in the main, has been a rather successful operation. It is based upon the premise of financing activities in foreign lands if they purchase their goods and acquire the know-how in this country. That is all, Mr. Chairman.

Senator KERR. Thank you very much, Mr. Horne.

Senator SMATHERS. Let me ask Mr. Horne one question before he goes.

Mr. Horne, I have heard it said that this bill does not apply to underdeveloped countries; that is, the foreign tax provisions. Is that your understanding?

Mr. HORNE. No, it is not, Senator Smathers. I think that the bill, while it does permit an investment in a less-developed country, the amount of investment that you are going to get in the so-called less-developed countries, particularly Latin America, is going to be substantially restricted by reason of the restrictions placed upon the investment in the so-called developed countries.

Business is going to go, obviously, where the profits are, and where the markets are.

And, in order to generate the profits overseas for investment, these profits are going to have to be realized, in most cases, in the developed countries before there will be funds for investment in the less-developed countries?

Senator SMATHERS. Do you understand, the way the bill is now drafted, does it, in fact, not apply to what the Treasury might interpret as less-developed countries?

Mr. HORNE. The question there, if I understand it, sir, is that you may go ahead with an investment in a less-developed country if you have the funds to do so.

But what I was trying to point out, sir, was that the funds that you use for this investment are generated from your other oversea operations.

Senator SMATHERS. I understand.

Mr. HORNE. The other point I wanted to make, sir, was that if this less-developed designation of a country should be removed, then there is under the bill as drafted a very substantial penalty that would follow. This penalty itself is so great that it would deter investment in the less-developed countries by a lot of corporations which otherwise would be considering investments there.

Senator SMATHERS. Do you know whether or not the countries of Latin America are considered by the Treasury or will be considered by the Treasury as underdeveloped countries?

Mr. HORNE. We have no way of knowing that, sir.

Senator SMATHERS. Have you seen any ruling or any statement by the Treasury Department to the effect that the Latin American countries are considered to be underdeveloped countries?

Mr. HORNE. Well, I personally have not seen any such statement. I know that some of the countries, Latin American countries, I think I have seen statements in the press about Panama, for example, has expressed concern as to the effect of the bill upon those countries.

Senator SMATHERS. You do not know whether the Treasury Department would consider the Republic of Panama as a less-developed country or not?

Mr. HORNE. No, I think the only thing that the bill states is that there are certain countries which automatically must be considered developed countries and not less-developed countries. Twenty-one, I believe, are enumerated in the bill, and the rest is left to the discretion of the administration to be promulgated in an Executive order.

Senator SMATHERS. You say there are 21 countries in the bill designated as less-developed countries, or are they designated as developed?

Mr. HORNE. As developed and not subject to being designated as less developed.

Senator SMATHERS. All right, sir.

Senator CURTIS. I did have one more question.

Do you have any views as to the constitutionality of section 13?

Mr. HORNE. We have not tried to go into that, sir, in this summary statement. In our detailed statement we have definitely taken a position. We feel that there is a grave constitutional question about the constitutionality of section 13.

I would take issue, I think, with the witness this morning, with all due respect for the American Bar Association and the eminent counsel here this morning. I would take issue as to the application of the bill to a wholly owned subsidiary.

I think that the constitutional question is there just as much for a wholly owned subsidiary as it is for a 51-percent-owned subsidiary.

Obviously, if you get below 51 percent, then you get beyond the question of control, and then you get an even stronger case. But I think the case is there for the wholly owned subsidiary as well.

The difference in the case cited by Senator Douglas this morning is that in that case the court was concerned with a matter of tax avoidance, and we do not think that section 13 is necessarily concerned with tax avoidance.

It will affect legitimate businesses operating abroad, and this question I do not think has been thoroughly explored, and if it is explored by the courts, could well result in section 13 being declared unconstitutional.

Senator CURTIS. That is all, Mr. Chairman.

(The supplemental statement of the Manufacturing Chemists' Association follows:)

SUPPLEMENTAL STATEMENT ON THE REVENUE ACT OF 1962 (H.R. 10650)

INTRODUCTION

The Manufacturing Chemists' Association is a national trade organization of more than 175 U.S. companies representing over 90 percent of this country's chemical production.

In the spring of 1961, representatives of this association presented to the Ways and Means Committee of the House of Representatives the association's views on President Kennedy's tax proposals. After extensive consideration of these proposals by the Ways and Means Committee, H.R. 10650 has been reported out and passed by the House of Representatives. Many important and far-reaching policy changes in the tax law are embodied in this bill. The MCA appreciates the opportunity of presenting this statement on H.R. 10650 to the Senate Finance Committee.

This statement is supplementary to the oral statement of the MCA presented to the Senate Finance Committee on April 24, 1962, and, in addition, sets forth MCA's comments on other provisions of H.R. 10650 which are of importance to it.

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I. AMOUNT OF DISTRIBUTION WHERE CERTAIN FOREIGN CORPORATIONS DISTRIBUTE PROPERTY IN KIND

Section 5 of H.R. 10650 provides that dividends in property (other than money) received by a domestic corporation from a foreign corporation will be taxed to the domestic corporation at the fair market value of the property. This method would apply even though similar property received as a dividend from a domestic corporation would be taxed at the distributing corporation's cost when such cost is lower than the fair market value. Committee recommendations accompanying H.R. 10650 justify this amendment in order to insure that the parent corporation is taxed upon the full value of the property received as a dividend in the same manner as if it had received cash as a dividend from its subsidiary.

MCA is opposed to this proposal, which has not been the subject of public hearings and has not received sufficient study. This proposal should be rejected for the following reasons:

A. Its discriminatory effect.
B. Its conflict with accounting concepts.
C. Its tendency to create an unfavorable impact on the balance of payments.
D. Its potential to restrict the development of the American economy.

1. Discriminatory effect

In justifying the continuation of the present provisions of section 301(b)(1)(B) with respect to dividends in kind from a domestic subsidiary cor-

poration to a domestic parent the House Ways and Means Committee report to accompany H.R. 10650 states as follows:

"Where both the distributing corporation and its corporate shareholder are domestic corporations, taking into account the adjusted basis when it is lower than the fair market value of the property may be justified on the grounds that the appreciated property *is still owned by a corporation and, in fact, very little has happened.*" [Italic added.]

It is submitted that when a foreign subsidiary corporation pays a dividend in kind to a domestic parent corporation the wording *underscored* above is equally applicable to the situation. The property is still owned by a corporation and, in fact, very little has happened. Departure from the present equal treatment constitutes gross discrimination against those organizations which have aided the American economy by extending their operations into the field of foreign trade.

2. Conflict with accounting concepts

Adoption of the proposed law would create a further conflict between tax accounting and regularly accepted accounting practices. This conflict would arise in the following ways:

(*a*) Current income would be charged with a tax liability based on the unrealized appreciation in the asset.

(*b*) In the case of depreciable property, the basis for tax depreciation would be different from the basis for book depreciation.

(*c*) In the event of ultimate disposition of the property a gain or loss for book purposes would differ from a gain or loss for tax purposes. The resultant tax effect would distort income in the year of disposition.

It is submitted that legislation which creates further conflicts between tax accounting and regularly accepted accounting practices should be rejected unless the necessity for such legislation is clearly demonstrated. The report of the Committee on Ways and Means does not provide justifiable proof of the need for this radical departure from acceptable accounting concepts.

3. Unfavorable impact on the balance of payments

Under present law a domestic corporation might be inclined to accept as a dividend a distribution of property from a foreign subsidiary even though the receipt of such property, although retained in the business, will cause a tax incidence to the extent of its cost to the distributing corporation less applicable foreign tax credits. If the proposal to tax the unrealized appreciation in value of such property is enacted, coupled with a desire to avoid the controversies which will subsequently arise in determining fair market value for tax purposes, many domestic corporations will purchase such property outright from their foreign subsidiaries. The result of such action will be a flow of funds from the United States, thereby causing an unfavorable impact on the balance of payments.

4. Potential to restrict development of American industry

One form of dividend in kind which has been flowing to domestic parent corporations has been a wealth of intangible dividends in the form of technical aid, secret processes, and similar improvements. This flow has been instrumental in permitting domestic corporations to improve their production methods, reduce operating costs, and create greater profits for the good of the American economy. In these instances the property in kind is rarely disposed of by the U.S. corporation. Taxation of such property, which generally has little or no cost basis, at its fair market value, would result in an undue burden on the domestic taxpayer. In addition, a controversial problem would arise in determining the proper valuation of such dividends for tax purposes. Lacking the resources to make outright purchases of such properties from the foreign subsidiary, or the inability, due to foreign restrictions, of obtaining licenses to use such property, it is probable that such improvements will no longer be available to domestic parent corporations. The effect will be a serious impairment of the capability of domestic corporations to improve their domestic position and to aid the American economy.

Due to the discriminatory nature of this proposed legislation, its conflict with accounting concepts, its tendency to create an unfavorable impact on the balance of payments, and its potential to restrict the development of the American economy, we strongly urge that section 5 of H.R. 10650 be rejected.

11. ALLOCATION OF TAXABLE INCOME WITHIN A RELATED GROUP

Section 6 of the proposed Revenue Act of 1962 would amend section 482 of the Internal Revenue Code by adding a new subsection which would provide a formula for allocating income from sales of tangible property within a group of organizations (one of which is a domestic organization and one is a foreign organization) if the taxpayer cannot establish that the sale was made at an arm's length price. MCA believes that no change is necessary in this area of the law since there is sufficient authority under present law for the Treasury to regulate.

Past experience shows that if this formula is put into the law, unless a sale between unrelated parties of identical materials under substantially identical conditions could be shown to have taken place at the same price, the Internal Revenue agents would tend automatically to throw the transaction under an allocation formula. With such a formula being suggested in the law, this tendency would be aggravated with the taxpayer as a practical matter not being able to establish a fairer method. The assumptions in any formula are not necessarily valid in all circumstances. Furthermore, any given formula would cause varying profit splits as between different classes of taxpayers. In the interests of fairness, the formula should be developed by the Commissioner in the regulations with the opportunities then present for individual taxpayers to present their views on a specific formula.

The solutions to these problems lie in other directions. Thus, the solution for resolving the difficulties experienced in obtaining factual and useful information and in overcoming the alleged uncooperative attitude in taxpayers lies in the increase of information which will be obtained under the reporting requirements of the recently enacted section 6038 and the proposed amendment thereto (sec. 20 of the bill) together with the stringent penalties attaching to these reporting requirements. The manpower problem and the problems inherent in dealing with unfamiliar foreign data under present section 482 lies in increasing the auditing staff of the IRS and in continuing the training of competent specialists to deal with the peculiar problems of international transactions.

Most businessmen really prefer to manufacture in the United States and export as long as they can do so competitively. Thus, even though foreign subsidiaries are frequently established abroad so as to make finished products on or near a foreign market, a tremendous amount of export takes place in the form of parts, components, and intermediate materials for fabrication, further processing, and final assembly by the foreign subsidiaries. If, as a result of overzealous application of the proposed amendment to section 482 and because the formula operates in a very one-sided fashion against manufacturer-exporters, the U.S. manufacturer of goods and materials finds that the bulk of the combined manufacturing and selling profit will be allocated back to the United States for full taxation here, its application will often be sufficient to tip the commercial equation in favor of exporting the manufacturing activity to a foreign subsidiary.

For example, a U.S. manufacturer exporting to Argentina sustains a 20-percent Argentine tariff which is not imposed on identical goods manufactured and exported to Argentina from Brazil. The proposed formula would impose a 52-percent tax on almost all of the profit from the entire transaction as opposed to the 23- and 33-percent corporate tax rates applying in Brazil and Argentina, respectively. This combination could require the export of the manufacturing activity to Brazil in order to remain competitive.

In the event that the committee believes that some statutory authority is necessary to help the Internal Revenue Service to police sham transactions, MCA submits that section 482 should be amended only to take care of the flagrant use of tax havens by limiting the use of the allocation formula to those cases where the foreign related person to whom a sale is made or from whom goods are purchased is obviously (because of grossly inadequate assets or costs or expenses) taking a grossly disproportionate share of the profits on the transaction. This would exclude from the allocation formula sales to foreign corporations who are engaged in further substantial fabricating, assembly, and processing goods purchased from U.S.-related persons. They would still be subject to the general requirements of reasonable prices under the existing provisions of section 482.

If something along the lines of the formula approach is to be adopted, then in lieu of the proposed untried and untested formula, MCA believes that the formula for allocating similar international income in the case of a single cor-

poration which is already provided in the Treasury regulations under 1954 code, section 863, should be adopted. This formula allocates income earned partly within and partly without the United States on the relationships of foreign property and sales to U.S. property and sales. This formula has withstood the test of usage for many years. It has apparently produced satisfactory results in allocating the income of a single taxpayer within and without the United States where fair market price cannot be determined. Since this formula is reasonably equitable in splitting the profit of a single entity, it likewise could be used to split the profit of a consolidated entity. It also recognizes the valid claim that part of the profit be assigned to the place of sale.

The following are further MCA suggestions for changes in the present proposal contained in section 6 should the committee adopt it.

(1) The proposed section 482(b)(2)(A) provides that the method of allocation set forth may also give consideration to other factors, including special risks (if any) of the market in which the property is sold. MCA recommends that the word "shall" be inserted in lieu of the word "may" in order to require consideration of other factors rather than having it permissive.

(2) The taxable income of the group of organizations to which the proposed new section 482(b) is applicable is allocated between the United States and abroad rather than between the domestic corporation and the foreign subsidiary corporation. MCA recommends that this rule of allocation be revised so as to be placed on an organization-by-organization basis which is the case in situations to which section 482 is presently applicable. The present proposal allocating taxable income between the United States and abroad cuts across rules relating to sources of income which is a separate and distinct subject.

(3) If the formula proposed in section 482(b)(2) is retained, MCA recommends that inventory, which is certainly income-producing property, be included therein.

(4) Proposed section 482(b)(8) allocates to the domestic corporation any foreign income taxes attributable to taxable income reallocated to the domestic corporation but it does not provide that the amount of taxable income so reallocated should be considered foreign source income. Hence the credit for the reallocated foreign taxes may not be allowable because of the fact that there is no foreign income. MCA recommends that to the extent that taxable income is reallocated to the domestic corporation it be considered from foreign sources, and, in addition, that a debtor-creditor relationship be established so that it can be repatriated without having double taxation.

(5) The broad sweep of the proposed section 482(b)(1) could result in the application of the allocation formula to items which are neither produced nor sold in the United States and which normally would have no relationship to U.S. taxes. MCA recommends that section 6 should be limited to sales of tangible property directly between the domestic corporation and a foreign affiliate.

III. DOMESTIC CORPORATIONS RECEIVING DIVIDENDS FROM FOREIGN CORPORATIONS

Section 11 of H.R. 10650 would require a domestic corporation, when reporting dividends from its foreign subsidiary, to include in its income that portion of a foreign subsidiary's income which could not be declared as a dividend due to its application to the payment of such subsidiary's foreign income tax liability. MCA recommends that this provision, commonly referred to as the "gross-up" proposal, be rejected for the following reasons:

(*a*) It is based on an erroneous assumption that its enactment will provide uniform treatment for the taxation of foreign income of branches and subsidiaries of domestic corporations.

(*b*) It tends to have an unfavorable impact on the budget.

(*c*) It destroys the incentive to invest in underdeveloped countries.

(*d*) It creates an unfavorable investment atmosphere which will hurt employment in the United States and cause further imbalance in the presently unfavorable balance of payments.

1. *Uniform tax treatment*

Proponents of the present bill have indicated that the adoption of "gross-up" is necessary to provide equality of taxation between the following organizations:

(*a*) Foreign branches of domestic corporations as opposed to foreign subsidiaries.

(*b*) Foreign subsidiaries operating in separate foreign countries where they are subject to varying income tax rates dependent upon the laws of the country in which the income is earned.

It is submitted, however, that uniform tax treatment cannot be achieved through adoption of "gross-up" for the following reasons:

(*a*) The majority of foreign branch operations conducted by domestic corporations are presently enjoying special tax preferences as opposed to operations conducted through foreign subsidiaries. These include the following:

(1) Percentage depletion allowances.
(2) Western Hemisphere trade corporation tax rate reduction.
(3) Deductibility by the domestic corporation of branch losses.

Gross-up merely increases the tax to some corporations without permitting these corporations to enjoy the tax benefits of branch operations.

(*b*) The arithmetic presentation which creates a parabolic effect wherein certain corporations appear to achieve an effective rate of foreign and U.S. income taxes of less than 52 percent is based on a complete disregard of the tax structures of foreign governments and the fact that many such governments place greater reliance for revenues on turnover, sales, capital stock and other taxes which are not allowable for credit purposes. "Gross-up", rather than achieving uniform tax treatment, will cause some corporations to bear heavier tax burdens and thereby destroy the rough equity achieved by the present foreign tax credit.

2. Unfavorable impact on the budget

The Treasury Department has estimated that enactment of "gross-up" will increase Federal revenues by $30 million annually. It is submitted that these figures do not take into consideration the inflationary effect which adoption of this proposal will have on foreign income taxes and the offsetting depressive effect on U.S. tax revenues. Factors causing a reduction in Federal revenues are the following:

(*a*) Foreign governments are aware that their failure to maintain their own income tax rates at 52 percent permits the adoption of "gross-up" to add more tax revenues to the United States. If "gross-up" is enacted, they are also aware that affected corporations would not be penalized further if the foreign income tax rates were increased to 52 percent. The only effect would be to shift current U.S. revenues, plus the additional revenues due to "gross-up", to the coffers of the foreign governments. There can be little doubt that many foreign governments will adopt such a course of action.

The following is an example of the loss of revenue that might be incurred:

	Present law	Proposed "gross-up"	Effect of foreign tax increase to 52 percent
Foreign income before foreign tax	$100.00	$100	$100
Foreign tax (presently 40 percent in this example)	40.00	40	52
Dividend to United States	60.00	60	48
U.S. tax on dividend	31.20	52	52
Foreign tax credit	24.00	40	52
Net U.S. tax revenue	7.20	12	------------

(*b*) American owned foreign subsidiary corporations currently endeavor to negotiate low tax rates in foreign countries, including tax forgiveness, and to take advantage of local tax privileges which reduce the effective tax rate when such reductions provide an overall tax benefit. Lacking any incentive, these endeavors will be unprofitable and useless. The result will be higher foreign taxes and lower revenues to the United States.

3. Destroys incentive to invest in underdeveloped countries

The principal impact of "gross-up" would be with respect to income earned in countries with a 15 percent to 40 percent income tax rate. In general, these countries in this category are those countries which would be classified as underdeveloped. These countries are also noted for the instability of their governments and economies thereby causing investors therein to incur greater risk of losses. "Equality of taxation" caused by enactment of "gross-up" would

tend to force investment funds to flow to the more stable, and higher tax rate, countries. The effect would be in direct conflict with the announced policies of the present administration.

4. Unfavorable investment atmosphere

The present foreign tax credit provisions were enacted in 1918. Since that time, private funds have been invested in foreign countries in reliance on the stability of our tax laws. Much of this investment has been the direct result of Government policy which encouraged private investment abroad.

It has been clearly demonstrated before the House Ways and Means Committee that this direct foreign investment yields a favorable return through dividends. It has also been shown that such investment creates exports and aids domestic employment. Considered apart from military spending and foreign aid, these factors have created a favorable balance of payments, have aided the domestic economy and have provided the Government with substantial revenues.

MCA submits that enactment of "gross-up," without consideration of the inequities created thereby, weakens the faith of businessmen in their Government. The result will be a reduction in such investment abroad with a corresponding curtailment of the net favorable flow of funds resulting from direct investment, a reduction in exports which would further affect the balance of payments, a loss of jobs in the United States, and a decline in the Federal revenues.

IV. EARNED INCOME FROM SOURCES WITHOUT THE UNITED STATES

Section 12 would introduce additional limitations on the amount and type of earned income received abroad by U.S. citizens which may be excluded from taxable income pursuant to provisions of section 911, Internal Revenue Code. The amendments would particularly affect citizens who are bona fide residents of a foreign country. Section 911(c)(1), as proposed, would limit the amount of earned income exclusion to a rate of $20,000 per year for the first 3 years a citizen of the United States is a bona fide resident abroad, and thereafter to a rate of $35,000 per year, both determined on a daily basis for the year, or part thereof, during which he was a resident. Although the MCA believes that the exclusion should be at least $35,000 for every year that a citizen is a bona fide resident of a foreign country or countries, if the $20,000 exclusion is retained by the Senate Finance Committee for the first 3 years, it is requested that the law be made clear that an uninterrupted period of 3 consecutive years will not be broken because of a transfer of an individual from one country to another. For example, assume the case of an individual who has served in Japan for a 3-year period and is now being transferred to England for an indefinite period. If this individual should visit the United States temporarily on his way to England, he should not be considered to have interrupted his 3-year period. Section 1.911-1(a)(2) presently provides in part the following:

"Though the period of bona fide residence must be continuous and uninterrupted, once bona fide residence in a foreign country or countries has been established, temporary visits to the United States or elsewhere on vacation or business trips will not necessarily deprive the citizen of his status as a bona fide resident of a foreign country."

The committee report would make it clear and certain that once an individual has become a bona fide resident of a foreign country or countries any transfer from one country to another will not break the uninterrupted period of such a bona fide resident status.

Section 12(b) of the bill would amend section 72(f) of the Internal Revenue Code by terminating, with respect to employer annuity contributions after December 31, 1962, the existing provision that in determining what the employee or annuitant paid for an annuity countract, there is to be included contributions of the employer, if, had these contributions been paid to the employee in the first instance they would not have been taxable to him. The existing provision was incorporated in the tax law on the philosophy that when an individual is entitled to a tax benefit, such individual should not be penalized or deprived of any benefit to which he might be entitled had the payments been available to him in the year in which contributed by the employer. In 1954, the present provision was carefully developed and recognized a principle of tax equality deemed desirable with respect to earnings of individual taxpayers.

The argument in favor of the proposal is based on the proposition that a U.S. citizen receiving annuities with respect to foreign service while living in the United States in retirement next to someone who has worked for the same employer and is fully taxable on contributions made by the same employer should have the same tax treatment. The American citizen who has been engaged in foreign service and retires to live in the United States has lived abroad under conditions and circumstances entirely different from the citizen resident in the United States.

MCA urges that section 72(f) of the Internal Revenue Code not be amended on the grounds that it would create, rather than correct, an inequity in the tax law.

V. FOREIGN-CONTROLLED CORPORATIONS

(a) General comments

The committee reports indicate that section 13 of the bill has a threefold purpose: (1) To prevent the use of a multiplicity of foreign tax jurisdictions to avoid taxation by the United States on what could ordinarily be expected to be U.S. source income; (2) the hoarding of income abroad for purposes other than for direct use in a trade or business; and (3) to prevent the repatriation of income to the United States in a manner which does not subject it to U.S. taxation.

As passed by the House of Representatives, section 13 seeks to accomplish these purposes through a most complex series of completely new rules which are inconsistent with long-established principles of taxation. The result is that in many ways it is at least as objectionable as the original Treasury proposal to tax American shareholders on their pro rata share of all undistributed income of their foreign corporations. It is submitted that the indicated purposes of this bill can be accomplished without adding these new and complicated rules and without violation of the key principle that shareholders are not to be taxed on the undistributed earnings of corporations which are pursuing the active conduct of a trade or business. Enactment of revisions of section 482 would prevent the diversion of U.S. source income to foreign sources and would also prevent the hoarding of income abroad, to the extent, at least, that such income had been realized from U.S. sources.

To attempt to tax current earnings of a foreign corporation which are legitimately attributable to its operations abroad would involve such a radical departure from longstanding tax principles that it is doubtful whether any correction should even be proposed. Despite MCA's belief that these basic proposals raise serious constitutional and jurisdictional questions, if these issues are going to be disregarded, any change in existing law in this area should be limited to the taxation of unreasonably accumulated earnings of a foreign corporation which is controlled by U.S. interests. In defining an improper accumulation of earnings, it should be made clear that earnings invested in the active conduct of a trade or business of the foreign corporation or in a related corporation should be exempt.

In summary, MCA recommends that section 13 be deleted, since all of the abuses listed by the House Ways and Means Committee as reasons for enactment of section 13 of the bill can adequately be corrected through amendment of other sections of the Internal Revenue Code, thus eliminating the need for these complicated computations and provisions.

However, if section 13 should be retained, the following comments are offered to point up specific defects which need to be clarified or corrected:

(1) *Pro rata share of undistributed income.*—Section 951(a)(2) of the proposed bill requires a shareholder who owns stock on the last day that a corporation is a controlled foreign corporation (hereinafter referred to herein as CFC) to include in income his pro rata share of certain income deemed to have been earned by the foreign corporation if on that day during the taxable year he owned at least 10 percent of the stock of the foreign corporation.

The effect of this is to require a shareholder who has sold all of his stock on the last day the corporation was a CFC and thus who at the end of the year will have no control over the activities of such foreign corporation to, nevertheless, report as taxable income his pro rata share of certain undistributed earnings of the foreign corporation simply because at some time during the taxable year he owned 10 percent of the stock of the foreign corporation, which at some time during the taxable year was a CFC. The undistributed earnings could have been realized after the shareholder had sold his stock.

Since a shareholder, who has sold his stock is no longer interested in the affairs of the CFC, MCA recommends that there should be no undistributed income attributed to him in respect of that year.

(2) *Royalties from patents, copyrights, etc.*—Section 952(a)(1)(b) requires the inclusion in subpart (F) income of a CFC, income from certain patents, copyrights, and exclusive formulas and processes. Section 952(c) defines such income to include not only gross rentals, royalties, or other income derived from licenses, sublicenses, sale, or exchange, but also imputed income attributable to the use or other exploitation in a manufacturing operation of patients, copyrights, and exclusive formulas and processes which are substantially developed, created, or produced in the United States or are acquired from related U.S. persons.

MCA strongly recommends that the imputed royalty provision be rejected. The provisions relating to imputed royalties mean that income from patents, copyrights, etc., will be attributed to U.S. shareholders not only where the CFC has received payment for use of the property, but also where the foreign corporation simply uses such property in the manufacture of goods and derives its income from the sale of its manufactured articles. This will result in an inordinate amount of administrative complications involved in attempting to estimate royalties where none have been paid and in segregating such income in order to prevent double taxation and for purposes of the foreign tax credit.

More importantly, the effect of these provisions is to completely read out of the law sections 351 and 367, which allow the tax-free transfer of property to controlled corporations under circumstances where the Commissioner of Internal Revenue is satisfied that one of the principal purposes of the transfer is not the avoidance of Federal income tax. The Commissioner of Internal Revenue has issued a number of rulings through the years to manufacturing subsidiaries of U.S. corporations, recognizing that an exchange of patents for stock in the foreign manufacturing corporation is tax free. If, in every case of a controlled foreign corporation's use of a patent, a tax on imputed income must be paid as if a royalty had been charged, it is difficult to imagine a circumstance under which a tax-free ruling would have any effect. The provision would apparently operate retroactively to effectively nullify all rulings issued by the Commissioner and accepted by taxpayers in good faith.

Since the Commissioner of Internal Revenue has the almost absolute authority under present law to prevent the avoidance of Federal income taxes through the tax-free transfer of patents, copyrights, etc., rights to controlled corporations, it is submitted that the proposed section is unnecessary. However, in view of the fact that it has been the long-standing practice of the Commissioner of Internal Revenue to refuse to issue rulings where the foreign corporation proposed to act simply as a licensing agent, there should be no objection to providing that income of a CFC which is attributable to the exploitation of patents, copyrights, etc., other than for use in its own or its subsidiary's manufacturing operations would be taxable. However, MCA sees no reason for royalties from patents, copyrights, etc., to be treated more harshly than other investment type income and recommends that relief from current taxation be accorded royalties comparable to that accorded subpart F income—a deduction, if invested in a less developed country.

In any event, the value of stock issued for patents, copyrights, etc., or of other property in kind exchanged, such as a cross license, should be treated as a part of the cost of the patent, or other similar property, which can be amortized as cost and expense allowance within the meaning of section 952(c)(2).

Any rule applicable to royalties should be with respect to future transfers of patents, copyrights, secret processes, and formulas.

(3) *Foreign base company sales income.*—The definition of "foreign base company sales income" contained in section 952(e)(2) would include income from the purchase or sale of personal property between related persons where the property was produced and sold outside the country in which the CFC was organized. This means that American exporters will be able to avoid immediate taxation under this section only if they establish foreign selling companies which sell at least 80 percent of the products they purchase within the country where they are organized.

With the advent of the Common Market and the Outer Seven in Western Europe, it has been common practice for U.S. firms to establish a single large size production unit for any given product line in one country to supply all other countries in one or both of these trade areas. The location of the production

facilities has been determined by factors such as availability of raw materials, power, labor, etc. Separate manufacturing subsidiaries have been established for each country in which production units are located. If each such manufacturing subsidiary has its own sales organization to cover Europe, none of the income attributable to the sales organization would be considered "foreign base company sales income" since the product sold would have been manufactured in the country of incorporation of the selling organization. If, on the other hand, a single European-wide sales organization is established to handle products from all the various manufacturing subsidiaries in order to (*a*) coordinate sales activities for more than one source of supply, (*b*) reduce selling expenses, and (*c*) increase selling efficiency against aggressive local competition—then the income attributable to the sales organization becomes "tainted" by falling within the definition of "foreign base company sales income." Arrangements of this latter type (i.e., manufacturing subsidiaries in various countries selling through a single separate sales subsidiary located in a low-tax country like Switzerland) are used extensively by European competing firms and are recognized and accepted by the European governments involved—even to the extent of their granting special tax concessions to facilitate such arrangements. It is difficult to understand why such operations, which are motivated by sound business considerations, and which result in minimizing only European taxes paid by U.S. subsidiaries, should be frowned on by the U.S. Government.

This would seem to work to the detriment of the U.S. revenue. For example, a Swiss selling company which is able to sell throughout Europe products manufactured in the United States and to pay only a 15 percent Swiss income tax will eventually pay dividends to its American shareholders which will be subjected to United States income tax at a net effective rate of 37 percent after foreign tax credit. On the other hand, if the U.S. parent elects to sell in Germany and Switzerland through separate selling companies in each country in order to avoid immediate U.S. taxation of profits of the Swiss company selling solely within Switzerland, the German company will pay in excess of 52 percent German tax on its income from sales in Germany so that on distribution of its earnings as dividends, the U.S. shareholder will owe no U.S. income tax.

(4) *Seventy-five-day rule.*—The provision in section 952(f)(2) to the effect that foreign base company income will be reduced by the amount of the annual increase of investment in qualified property in less developed countries to the extent it is reinvested within 75 days after the close of the taxable year is completely unrealistic. In the first place, it is doubtful that the tax law is the proper vehicle for encouraging investments in less developed countries. In the second place, it is questionable whether such a provision will act as an incentive. Furthermore, to expect that a U.S. shareholder could make an investment of earnings within 75 days after the close of the taxable year in which such amounts are earned, completely disregards the nature of corporate investments in permanent facilities abroad. Perhaps a company could commit such funds to be invested within some such period, but it would be physically impossible in most circumstances to expect that such an investment could actually be made within that period of time.

MCA is of the view that a period of at least 6 months should be provided, coupled with a rule that investments made at any time will qualify if resulting from commitments entered into within that 6-month period. The concept of what is a commitment should be liberally defined because so often contracts and arrangements have to be approved by many government authorities abroad which take a long time to obtain.

(5) *Qualified property.*—The provisions which are designed to encourage investments in qualified property in less developed countries are confusing in a number of respects. It would seem that such investments could consist only of (1) branch operations, or (2) owning stock in a second controlled foreign corporation which is incorporated and operating in a less developed country and which carries on the active conduct of a trade or business but only then if at least 10 percent of the stock is owned by the first controlled corporation, and more than 50 percent of the stock of the second controlled corporation is owned by five or less U.S. persons, or (3) in a trade or business carried on by a second controlled foreign corporation, 80 percent of whose stock is owned by the first controlled corporation. If it is true that loans from one controlled foreign corporation to another controlled foreign corporation operating within a less developed country do not constitute qualified property, then here again the bill seems to disregard the ultimate effect on the U.S. revenue. A loan is, of course,

repaid from earnings which have been subjected to tax but the lender and its parent are never entitled to any credit for foreign income taxes which might have been paid by the borrower.

Some doubt concerning whether loans in any case can be treated as qualified property arises from the interpretation of section 953(b)(3)(B) which would seem to allow a CFC to disregard the fact that it was operating through a subsidiary in a less developed country where it owned at least 80 percent of the stock of such subsidiary either on December 31, 1962, or during the 5-year period ending with the close of the preceding taxable year. If this is so, then it would seem that a loan by a CFC to its 80-percent-owned subsidiary would constitute property which could be ordinary and necessary for the active conduct of a trade or business within the meaning of section 953(b)(2)(A). However, there is nothing in the bill which would indicate how, or whether, interest on such loans would be taxed. Apparently such interest would be taxed as subpart (F) income even though under section 953 the corporate entities were disregarded.

MCA recommends that loans in this situation be treated as qualified property. A major reason for using debt investment in lieu of, or to complement, equity investments in corporations located in less developed countries is that during periods of exchange restrictions, repayment and servicing of debt often takes precedence in exchange priorities over return of capital and payment of dividends.

(6) *Pre-1963 property.*—In describing nonqualified property in section 953 (b)(1), it seems clear that the law intends to exempt earnings and profits of a CFC earned prior to January 1, 1963, from taxation prior to distribution. However, it is questionable whether such earnings would, in fact, be exempt if, after December 31, 1962, the form of their investment changed. For example, if on December 31, 1962, a CFC had $1,000 invested in a piece of property other than those described in section 953(b)(2), and thereafter exchanged such property for another property which would not constitute "qualified property," a question arises whether this would constitute property acquired after December 31, 1962, and, thereby, increase the investment in nonqualified property in the year of change or reinvestment. This could result in immediate taxation of earnings of the CFC prior to December 31, 1962.

MCA recommends that provision be made so that existing assets, qualified or nonqualified property may be shifted without there being an increase in nonqualified property.

(7) *Less developed country.*—There is absolutely nothing in the law which affords any guide with respect to what happens when a country is removed from the less developed country list. It would appear that when this happens the entire investment in a less developed country would constitute "nonqualified property" unless it consisted of stock in a company in which the CFC owned at least 80 percent of the stock on December 31, 1962, or for the 5-year period immediately preceding the end of the taxable year. If this is so, then there can be no incentive to investment in less developed countries since the deferment of tax accumulated to the year of redesignation would require the immediate payment of a huge tax bill out of amounts which had been invested, leaving little ready cash with which to pay tax. Since the redesignation would be completely outside of the power of the American shareholder to even anticipate, no firm plans could be made. Therefore, it is essential that investments already made, as well as those planned when the country involved was classified as a less developed country, be treated as qualified property.

Furthermore, it appears that an investment in nonqualified property in excess of earnings and profits will be carried over to succeeding years and result in immediate taxation even though in such succeeding years all earnings and profits are reinvested in qualified property. MCA believes this result inequitable. It stems from section 953(a)(1) which provides that only investment in nonqualified property to the extent of earnings and profits is to figure in the computation of the annual increase. Thus, any excess for a current year will serve as an increase in nonqualified property investment in subsequent years when there are additional earnings and profits.

(8) *Five-year trade or business rule.*—The proposal would prevent new manufacturing companies in developed countries—i.e., those organized after December 31, 1962—from reinvesting in the same business their earnings without payment of U.S. tax for a period of at least 5 years after organization. This will result from the definition contained in section 953(b)(3)(A) which defines a qualified trade or business as one carried on by a CFC since December 31, 1962, or during

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the 5-year period ending with the close of the preceding taxable year. It is difficult to see how a manufacturing corporation operating completely outside of the United States can in any way be said to be a tax-haven operation or to be avoiding U.S. taxes where it derives all of its income from manufacture and perhaps sells all of its product within the country where it is organized. To arbitrarily say that such a corporation must have been in existence and controlled by similar interests for a period of 5 years before its earnings are not taxable to its American shareholders is beyond comprehension. This may simply be an unintended oversight in the bill, but in any event, it should be corrected.

The MCA recommends that the 5-year rule should be abolished and that any proper investment in an operating business, whether or not new, should be treated as qualified property.

(9) *Controlled foreign corporation.*—The definition of a CFC contained in section 954(a) could cause considerable confusion and subject innocent U.S. taxpayers to unjustifiable penalties. A "controlled foreign corporation" is defined as one in which more than 50 percent of the stock is owned by U.S. persons. This makes sense only in a case where the U.S. persons could be expected to act in concert. However, it is not difficult to find cases where the interests of U.S. persons in a foreign corporation would be such that they would never act together to exercise control. For example, where two unrelated corporations each own 30 percent of the stock in a foreign corporation, neither can control without the other. Even though they may be opposing each other on every corporate matter, the foreign corporation would still be a CFC under section 954.

Furthermore, it is not unlikely that a U.S. shareholder could own stock in a CFC without ever realizing that it was controlled by U.S. persons. For example, a U.S. corporation owning 50 percent of the stock in a foreign company may discover that one or more shares of stock are being held in the United States by a shareholder who has acquired such stock or moved to the United States. In such a case penalties for prior years where this situation existed could be applied even though the 50-percent owner would not have been expected to know that other U.S. persons owned stock.

In order that these provisions apply only in situations where U.S. persons could be expected to act in concert, MCA recommends that the concept of a related person be adopted in section 954 so that a CFC will be limited to only those corporations which are controlled by related persons. In addition, in order to eliminate some of the situations which may be difficult, if not impossible, to ascertain whether a foreign corporation is a CFC, it is recommended that section 955(a)(2) be amended so that stock in one foreign corporation owned by a second foreign corporation will not be attributed to the U.S. stockholders of the second foreign corporation unless the second foreign corporation is itself a CFC.

(10) *Blocked income.*—It would be most inequitable and unfair to impose a current income tax on the undistributed profits of a CFC if it is impossible for such profits to be distributed because of foreign exchange controls or other restrictive laws of the foreign country involved. Under present law insofar as blocked foreign income is concerned, the Treasury has issued Mimeograph 6475, 1950-1 Cum. Bull. 50, which defers the reporting of block foreign income until the year in which it no longer qualifies as block income. The reason for the issuance of this mimeograph was because of the difficulty of ascertaining the value in terms of U.S. dollars of block income arising in countries which have monetary or exchange restrictions.

Because of these serious foreign currency problems which will be present to a greater extent if something along the lines of section 13 is enacted, MCA recommends that it be made clear that U.S. shareholders of a CFC will be permitted to apply and use the rules embodied in mimeograph 6475.

(11) *Same or substantially the same trade or business.*—For American business abroad, the most important determination contained in section 13 is whether or not property is qualified property which, in turn, is dependent upon an interpretation of what is and what is not the same or substantially the same trade or business. More specifically, qualified property is defined as "any money or other property which is located outside the United States and is ordinary and necessary for the active conduct of a qualified trade or business." A qualified trade or business is a trade or business carried on for 5 years or substantially the same trade or business.

With respect to the problem of determining whether or not it is the same or substantially the same trade or business the committee report at page A 98 states:

"* * * All the facts and circumstances of the particular case must be taken into consideration. The test is intended to prevent the use of earnings which have not been subjected to U.S. tax to diversify the business of the controlled foreign corporation, while permitting the controlled foreign corporation to compete in lines of activity it is presently engaged in. In this regard, circumstances which may be particularly important involve the nature of the product line of the controlled foreign corporation and the character of the principal foreign competitors of the controlled foreign corporation in that line."

Any test as vague as this one will be extremely burdensome upon American business operating abroad. It will introduce into business decisions an unanswerable question as to whether earnings invested in some related activity will be considered to have been invested in the same business or substantially the same business. It will be impossible to be certain that the representatives of the Internal Revenue Service will arrive at the same conclusion in subsequent audits. U.S. shareholders in many cases will not know whether or not additional income tax will be claimed with respect to foreign profits of CFC's until the statute of limitations has run with respect to the particular taxable years involved. Besides the basic restrictive policy of forbidding diversification except as the cost of current income taxation, lingering doubts as to whether foreign earnings were properly invested from a tax standpoint will handicap American business in its competition with foreign competitors.

The adoption of a test whether or not a trade or business is the same or substantially the same requires refined distinctions to be made. Whenever this test has been used in the law before it has been applied to more limited situations, such as loss carryovers and corporate spinoffs. Such problems arise as whether the discontinuance of a product line, or a change in geographical location of a major operation, or the opening of a new branch in another country producing the same product, is a change in the trade or business.

MCA considers that the results of predicating current income taxation on such a vague and indeterminate concept will cause chaos in the administration of the provision. MCA recommends that if section 13 is adopted at least the test should be whether earnings are invested in any trade or business carried on by the CFC.

The foregoing specific criticisms of provisions contained in section 13 do not purport to be exhaustive. It is submitted that they are results which should not be unexpected in the drafting of a bill which is as complicated and alien to the Internal Revenue Code as the present language is. Accordingly, it is recommended that section 13 of H.R. 10650 be excised from the bill.

(b) Basic jurisdictional-constitutional issue

The proposal to tax the foreign undistributed profits of a controlled foreign corporation raises serious constitutional and jurisdictional problems. Traditionally, ever since the landmark case of *Eisner* v. *MacComber*, 252 U.S. 189 the United States has never imposed a tax at the shareholder level on the undistributed operating profits of the corporate entity. True, in the case of tax avoidance a narrowly restricted provision has been upheld in *Eider* v. *Commissioner*, 138 Fed. (2d) 27, but this case can in no way be considered as a precedent for overriding basic constitutional principles. Can anyone contend that a shareholder owning 1 percent of the stock in a publicly held corporation with hundreds of shareholders can be validly subjected to an income tax under the Constitution on his prorata share of the undistributed profits of that corporation? Within the framework of our legal institutions a corporation is treated as a distinct entity and for more purposes than the imposition of income taxes is treated as separate and apart from its shareholders.

The Treasury creates a facade of legality by talking in terms of a controlled foreign corporation but at the same time proposes that a 10-percent shareholder should bear the burden in his own tax return of business profits over which he has no control. The first proposal of the Treasury Department which went so far as to tax a ratable proportion of the undistributed profits of a foreign corporation to a 10-percent shareholder in situations where there is no legal control even by a U.S. group owning more than 50 percent of the outstanding stock is patently inconsistent with the historic treatment of a corporation as a separate entity under our laws. The proposal contained in section 13 is similarly unconstitutional where the 10-percent shareholder is subject to tax on the undistributed profits over which he has no control even though by counting the shares of stock it can be proven that more than 50 percent of the out-

standing shares are owned by U.S. persons. It seems obvious that the courts may very well conclude that there is no justification in fairness or equity for imposing such a tax at the shareholder level where such 10-percent shareholder has no actual control over the corporation and has as a practical matter suffered an unrealized loss in value in his shares because of economic conditions such as a threat of nationalization or some other similar disaster to the business of the corporation. It is the position of this association that unless there are flagrant situations of tax avoidance, the courts of this country will respect the traditional separateness of a corporation from its shareholders.

(c) Violation of U.S. international commitments

Section 13 of H.R. 10650 (as well as the proposal of the Secretary that business income of foreign corporations be currently taxed) violates certain provisions of our income tax treaties.

All of the 21 income tax treaties which have been consummated by the United States have endeavored reciprocally to eliminate double taxation of, and to reduce and minimize the burdensome administrative requirements with respect to industrial and commercial profits of enterprises of each contracting state. In tackling this problem, the thrust of the various provisions appearing in the treaties has been for each contracting state to exempt from the United States income tax the industrial and commercial profits of an enterprise of the other contracting state except in respect of any industrial or commercial profits of a permanent establishment of that enterprise located in the United States. For example, under the United States-Finland Income Tax Convention, a corporation organized in Finland is not subject to U.S. income tax on its business profits unless it has a permanent establishment in the United States. A similar provision is in all of the income conventions to which the United States is a party. At the time the negotiations leading up to the adoption of this principle in a tax treaty were being conducted, it is understood that a complete explanation is always made by the U.S. delegation of the income tax laws of the United States to the representatives of the other government. In the past it certainly was known that the United States did not tax foreign business profits of foreign corporations. There is no doubt but that in adopting, reciprocally, the permanent establishment provisions the representatives of the other contracting governments well knew that the United States had traditionally and historically not taxed currently the foreign industrial and commercial profits of foreign corporations organized and created under the laws of foreign countries. Furthermore, it is clearly evident from the four corners of each and every income tax treaty which has been consummated that relationships between U.S. corporate entities and their subsidiary corporations organized under the laws of the other contracting party were being considered in connection with the negotiations and were being covered in some of the provisions.

There are numerous provisions in all of our treaties which establish beyond a shadow of a doubt that the rules set forth therein were designed to govern foreign subsidiary corporation of U.S. parent corporations as well as those which were not subsidiaries of U.S. corporations. One indication of this is the usual provision contained in the definition of the term "permanent establishment" which is in all of our treaties to the effect that the fact that a corporation of one of the contracting states (United States, for example) has a subsidiary corporation which is a corporation of the other state (Denmark, for example) or which is engaged in trade or business in the other state shall not of itself constitute that subsidiary corporation a permanent establishment of its parent corporation. For examples, see article II(1)(c) of the Danish Convention, article II(1)(c) of the Norwegian Convention, and article II(1) of the Irish Convention. Furthermore, authority under all of the treaties is provided in order to properly allocate profits between a U.S. parent corporation and its subsidiary foreign corporation where, by reason of its participation in the foreign corporation's management or financial structure, the U.S. parent makes with or imposes on the latter, in their commercial or financial relations, conditions different from those which would be made with an independent enterprise. For example, see article IV of the Canadian Convention. In many of our treaties, dividend distribution from controlled foreign subsidiary corporations to U.S. parent corporations are given a more favorable foreign withholding rate than is generally applicable to other dividend payments. See article VI of the Danish Convention and article VI of the Finnish Convention.

It cannot be said at all that the U.S. negotiators and the foreign negotiators did not have in mind that foreign subsidiary corporations of U.S. parent corpo-

rations were covered by the favorable benefits of our income tax conventions. In fact, it has been repeatedly pointed out as an important tax benefit of a treaty that foreign withholding rates on dividends are reduced so that the total foreign income tax burden will no longer exceed the U.S. tax, and thus there will be no foreign tax credit wastage.

The allegations of the Treasury Department that the income tax treaties of the United States are not being violated in any respect is clearly erroneous.

It is understood that when the Treasury was considering the effect of the proposed policy to tax undistributed foreign profits of foreign corporations, it considered basically two approaches to accomplishing this purpose, namely, (1) the taxation directly of foreign corporations managed and controlled in the United States on their foreign profits as if they were domestic corporations, and (2) the taxation of U.S. shareholders of foreign corporations on their undistributed foreign profits as provided in H.R. 10650. The latter approach was presumably adopted in order to create less of a conflict with income tax treaties provisions than would be the case if the former approach was followed. In support of this position, the Treasury has pointed out that in most of our treaties there is a provision which reserves the authority to the United States, regardless of any other provision of the treaty, to include in the basis upon which it imposes its taxes all items of income taxable under its laws in the case of citizens, residents, or corporations, and in this connection, it is concluded that technically there is no violation of these particular treaties. It is submitted that this is a highly technical and shallow argument and that within the purpose and spirit of each treaty and within the overall framework of the treaty program, the proposed legislation will violate the treaty agreement that industrial and commercial profits of corporations organized in the other country should not be subject to tax in the United States except to the extent of profits allocable to a permanent establishment in the United States. Merely because there is a general reservation provision is not a sufficient reason for violating the purpose of the treaties, namely, to establish rules as to when and the extent industrial and commercial profits of foreign corporations should be taxed.

But there are treaties which have been consummated which do not have any reservation clause upon which the Treasury can hang its hat. See the Australian, Irish, New Zealand, Pakistan, and the United Kingdom treaties. The convention between the United States and New Zealand is a case in point. This convention does not reserve the right of the United States to include in the income of its citizens, residents, or corporations any items of income it so desires, as if this convention had not been consummated. At article III(1) of the New Zealand treaty, the following categorical rule is established that "The industrial or commercial profits of a New Zealand enterprise shall not be subject to U.S. tax unless the enterprise is engaged in trade or business in the United States through a permanent establishment situated therein. If it is so engaged, U.S. tax may be imposed on the entire income of such enterprise from sources within the United States." This rule states that the industrial and commercial profits cannot be taxed by the United States. They cannot be taxed to anyone—corporation or shareholders. Can it be contradicted that, should the United States tax the shareholders on the industrial and commercial profits of a New Zealand corporation, that it is violating the specific language of this article? Can it possibly be claimed that the taxation of the U.S. shareholder on an amount measured by these industrial and commercial profits is not subjecting such profits to U.S. tax? In view of this convention and the foregoing language, how can the Secretary of the Treasury make the categorical statement that the adoption of his proposals to tax undistributed foreign business profits of foreign corporations does not violate any provision of any treaty? For similar language as above, see article III of the Austrian and German treaties.

It is very important also to observe that in the article relating to reciprocal exemption of profits derived from operating ships or aircraft the same prohibition exists in the New Zealand convention. Thus, article V provides: "Notwithstanding the provisions of articles III or IV of the present convention, profits which * * * a New Zealand corporation derives from operating ships or aircraft shall be exempt from U.S. tax." Does the Secretary of the Treasury actually believe that the taxation of the shipping and aircraft profits earned by a New Zealand corporation to U.S. shareholders is not a violation of this treaty? His proposal, of course, will result in the current taxation of shipping and aircraft profits derived by corporations covered in all of our treaties by specific reciprocal provisions.

It is well known that for the past 30 years the United States has entered into exchanges of notes under the authority of the internal revenue laws exempting shipping and aircraft profits of foreign corporations of another country if such other country reciprocally exempts the shipping and aircraft profits of our corporations. It is also well known that many foreign corporations flying a foreign flag are owned by U.S. shareholders. In an exchange of notes for the avoidance of double taxation the following language is typically contained in a letter from an official representative of the U.S. Government to the other country committing the United States to the exemption of shipping and aircraft profits of corporations created in the other country:

"The Government of the United States of America * * * shall, on the basis of reciprocity, exempt from tax on income and from any other tax on profits the earnings of corporations organized in * * * derived from the operation of ships or aircraft, documented or registered under the laws of * * *."

There are such reciprocal exchanges of shipping and aircraft notes between the United States and other foreign governments, based upon provisions of sections 872 and 883 of the code. For example, there have been notes exchanged with Argentina, Brazil, Greece, Belgium, Denmark, and Finland. Can it be that the Treasury is proposing that the United States nullify the commitments made all over the world with respect to the reciprocal exemption of shipping and aircraft? There clearly is no reservation in these notes permitting the U.S. Government to tax its citizens, residents, and corporations. Before this is done the United States should consider carefully the effect of the reversal of this long-standing policy and to evaluate the effect of this change on our shipping and aircraft companies throughout the world.

VI. LIQUIDATION OF FOREIGN CORPORATIONS

MCA opposes the adoption of section 16 of H.R. 10650, which would tax, as a dividend to a U.S. shareholder owning 10 percent or more of the voting stock of a foreign corporation in which U.S. persons own more than 50 percent of the voting stock, the gain on the redemption of stock in an exchange to which section 302(a) applies or the gain in complete or partial liquidation in an exchange to which section 331 applies. If such stock is sold or exchanged, the gain from the sale or exchange is treated as gain from the sale or exchange of property which is not a capital asset. The amount treated as a dividend in the case of a redemption or liquidation is the taxpayer's proportionate share of the earnings and profits of the foreign corporation accumulated after February 28, 1913. The amount treated as gain from the sale or exchange of property, which is not a capital asset, is the amount of the taxpayer's share of the earnings and profits of the foreign corporation accumulated during the period the stock was held by the taxpayer. Appropriate provision is made to exclude from the amount treated as a dividend or as gain from the sale or exchange of property which is not a capital asset, amounts already included in taxable income under section 13 of H.R. 10650.

Under present law, the gain or loss on the sale or exchange of stock in a domestic corporation, as well as a foreign corporation, is basically treated as a capital gain or loss. This treatment is accorded transactions to which section 302(a) applies and to partial and complete liquidations. Except in the unusual type of situation involving, for example, collapsible corporations and small business stock, the capital gain or loss treatment has been the traditional and basic legislative policy with respect to capital transactions such as sales, liquidations, and redemptions of capital stock, where the income received by the taxpayer generally represents the realization of income accumulated by the corporate entity over a period of years. Because of the similar treatment given gains and losses from sales of stock in domestic corporations and stock in foreign corporations, the Federal income tax law has been neutral in its influence as to whether to invest abroad or at home. However, section 16 will eliminate this tax neutrality between these two types of investment and will subject gains on transacitons involving foreign stocks to a higher and more burdensome tax.

The committee report indicates that the Ways and Means Committee has as "one of its objectives in the foreign income area, the imposition of the full U.S. tax when income earned abroad is repatriated." This legislation is also supported on the grounds that U.S. tax laws should be neutral and equitable as regards taxation of foreign and domestic source income and American capital

should not take into account somewhat lower income tax rates abroad in makin investment decisions.

Section 1248 would modify the tax treatment for gains incurred on such transactions, but losses would continue to be treated as capital in nature. In the case of corporations, such losses produce no tax benefit unless the corporate taxpayer has offsetting capital gains. Individuals are only permitted to deduct such losses to the extent of the gains from such sales or exchanges, plus the taxable income of the taxpayer or $1,000, whichever is smaller. It seems apparent that section 16 is neither equitable nor neutral with respect to taxpayers incurring losses abroad. The inequitable effect of this provision can best be illustrated by an example: Assume a taxpayer has not capital transactions during the taxable year other than the liquidation of two foreign controlled companies, A and B, in which he has a 10 percent interest. The taxpayer realizes a $25,000 gain on the liquidation of A and a $25,000 loss on the liquidation of B. There has not been any net economic gain to the taxpayer from the two transactions in the foreign area, but he will still have a substantial U.S. tax to pay on the liquidation of A and no corresponding tax deduction for the loss incurred on the liquidation of B. The fact that the taxpayer objected to the liquidation because he felt it was against his best interests and was outvoted by the majority of the shareholders of A and B, would have no effect upon his tax position. The picture is not quite as drastic, of course, if the taxpayer has offsetting capital gains, but the result is still inequitable since the gain on the liquidation of A is treated as ordinary income, whereas the loss on the liquidation of B can only be used to offset capital gains which are taxed at lower rates.

From a technical standpoint, this section is also deficient in that earnings and profits of the controlled foreign corporation are not adjusted for the gain which is treated as gain from the sale or exchange of a noncapital asset. Unless provision is made for a downward adjustment of earnings and profits for the amount treated as a gain from the sale or exchange of property which is not a capital asset, ordinary income tax rates will be applied twice to the same amount of earnings and profits accumulated by the controlled foreign corporation. This is illustrated by the following example: Assume A owns 100 percent of a foreign controlled corporation, B, from the time of its formation. As of January 1, 1963, the company has accumulated earnings and profits of $100,000. On that date, A sells his interest in the foreign corporation to C for $300,000. A has to treat $100,000 of the gain as gain from the sale or exchange of property which is not a capital asset. During the years 1963 and 1964, B has no earnings, but distributes $50,000 per annum to C as dividends. These amounts must be included by C in his taxable income as ordinary dividend income.

In summary, section 16 is inequitable in that the taxpayer is required to treat gains incurred on transactions covered by this section as ordinary income, while at the same time losses incurred on similar transactions must be treated as capital losses for tax purposes. It also can result in ordinary income taxes being paid twice on the same item of income. This association is opposed to section 16 because of the reasons cited above, and would recommend that it be deleted from H.R. 10650. However, if section 16 should remain a part of the bill, it is suggested that it be amended in the following manner:

(1) Losses incurred on the redemption or liquidation should be treated as an ordinary loss to the extent of the taxpayer's proportionate share of the accumulated deficit in earnings and profits of the foreign corporation accumulated after February 28, 1913, and losses incurred on the sale or exchange of such stock should be treated as loss from the sale or exchange of property which is not a capital asset to the extent of the taxpayer's proportionate share of the accumulated deficit in earnings and profits accumulated during the period the stock sold or exchanged was held by the taxpayer.

(2) Appropriate provision should also be made for reducing the accumulated profits of a foreign corporation for the amount treated as gain from the sale or exchange of property which is not a capital asset, and for eliminating a deficit in accumulated earnings and profits to the extent that a taxpayer has been allowed to deduct as an ordinary loss the taxpayer's proportionate share of the accumulated deficit in earnings and profits of a foreign corporation accumulated during the period the stock sold or exchanged was held by such taxpayer.

(3) Appropriate limitation should be adopted to the effect that only profits earned after the date of enactment of this bill should be treated as gain from the sale or exchange of property which is not a capital asset, and thus eliminate the retroactive feature of this section.

VII. TAXATION OF CO-OP INCOME AND WITHHOLDING ON PATRONAGE DIVIDEND

Inasmuch as many of the chemical companies, members of MCA, find themselves in increasing competition with cooperatives, it is gratifying to see that the Congress is giving active consideration to the correction of some of the serious inequities which exist in the present tax treatment of the income of cooperatives.

At the outset, however, it should be emphasized that MCA has no desire whatsoever to destroy cooperatives and certainly no desire to be free of competition. It is convinced that in order to perpetuate the free enterprise system, commercial endeavors which compete must be subject to the same governmental and tax burdens.

The failure of existing tax concepts to keep up with developments in industry and commerce as they bear on the activity of cooperatives and the resulting gaps in our income tax system is a matter of great concern. It results in an inequitable and unfair situation where certain cooperative corporations, whose earnings go largely untaxed, compete for sales and customers with increasing effectiveness and in an ever-increasing number of fields against other corporations which pay at 52-percent tax on their earnings.

First, a general statement about the provisions of H.R. 10650 which deal with co-op taxation. They seek to give effect to what Congress had always assumed to be the law: that co-op income be taxed either to the co-op or to its patrons. They would eliminate the loophole now existing in the tax statutes as a result of judicial interpretation of 1951 legislation on the subject.

H.R. 10650 enables cooperatives to utilize their traditional method of financing by retaining earnings and issuing paper or scrip to its patrons; at the same time, it assures that the cooperative's income will be taxed once. Application of the withholding tax to patronage dividends, embodied in H.R. 10650, accomplishes this without imposing a burden on the patrons to raise cash with which to pay the tax. Accordingly, the provisions of the bill in respect to taxation of the income of co-ops are basically sound so far as they go.

However, an important question under the present bill has to do with the method of handling the co-op patron's "consent" to be taxed with respect to co-op scrip received as a patronage dividend. There will probably be serious legal difficulties arising from the bill's provision for the taxation of such scrip patronage dividends to patrons if all that is required is that the co-op has in its charter or by-laws a provision that membership in it constitutes consent to include the scrip in the patron's taxable income.

To minimize the likelihood of the value of paper or scrip allocated as patronage dividends being challenged in the courts, it would appear desirable to require that the cooperative patron have the option of taking (i) cash or (ii) scrip which is redeemable at the patron's option within 90 days after receipt or (iii) of giving his annual written revocable consent to be taxed on the stated amount of co-op earnings allocated to him and for which scrip is given by the co-op. Language to accomplish this purpose, and which would in our opinion eliminate the legal questions inherent in the proposed bill, were embodied in the committee print of the House Ways and Means Committee dated August 24, 1962. The committee print dealt adequately with this subject and restoration of all of its provisions concerning patron "consent" should be made in H.R. 10650 as passed by the House.

MCA calls to the committee's attention a most serious omission in the provisions of H.R. 10650 dealing with co-op taxation. While it is believed that restoration into law of the intent of the 1951 amendment and a withholding tax on patronage dividends are definitely steps in the right direction, such proposals are but small steps toward the goal of adequately and fairly dealing with the difficult cooperative tax problem. The problem lies in the area which relates generally to the question: "What to do about earnings derived from co-op activities unrelated to traditional basic conception of marketing and purchasings?"

This problem arises from the changing pattern of co-op activities, particularly those commonly described as "purchasing cooperatives." Historically, these co-ops served the primary function of a retailer. Supplies were purchased in large quantities for resale to patrons. They also may have derived incidental income from rents, dividends, interest or sale of assets; and this income did not qualify for allocation as a patronage dividend. In recent years, however, such co-ops have been investing heavily, not in stocks, securities, or rental property, but in manufacturing facilities and sources of raw materials. They thus

have added to their traditional activities and have converted their primary pu pose from that of a wholesaler to that of an integrated manufacturer-who saler. A significant part of their earnings are now attributable to the manuf turing, processing, and mining functions.

The growth of co-op effort in these areas is nowhere more fully revealed th in the latest booklet on this subject entitled "Handbook on Major Regio Cooperatives," issued in January 1961 by the U.S. Department of Agricultu The report deals in some detail with the operations of 21 major regional coope tives handling farm supplies in the year 1958–59. Such regional cooperati are highly integrated corporations, many of them basic in raw materials. The business covers many major fields. It includes steel and other metal produc building materials, paints and roofing materials, containers and packaging mat rials, insecticides, sprays and farm chemicals, refrigeration equipment, hardwar petroleum products, fertilizer, tires, tubes, and automobile supplies, as well a feed, grain, flour, cereals, lawn and garden equipment, farm equipment and seed

In 1958–59, the net volume of all farm supply cooperatives is elsewhere note as $2.4 billion. The total farm supply volume of the 21 major regional coopera tives for the same year was $1.4 billion, or 58 percent (up from 45 percent in 1956) of the total business of the hundreds of farm supply cooperatives in exist ence. This does not take into account the farm supply business of 14 other majo regional cooperatives, each with minimum sales of $10 million annually, nor the farm supply business of regional marketing cooperatives. Co-op personnel assigned to such effort is also revealing. In 1958–59, 32 percent of the total personnel of the 21 major regional farm supply cooperatives was engaged in manufacturing, processing, and mining, including production of petroleum, up over 5 percent from the previous year.

Therefore, the point being made is more than of mere academic interest. The favorable tax treatment accorded to cooperatives, both by existing statutes and interpretations having the force of law and by H.R. 10650, can be justified where the co-op performs its historical function of purchasing and reselling to patrons. In most cases, patronizing co-ops is the only economical way for farmers to do business, and perhaps should be encouraged. However, where cooperatives move into an industrial or commercial area in direct competition with taxpaying entities, the tax-free status of the cooperative is an imposing and unfair advantage. This is particularly true because the 52-percent tax rate is such a substantial charge on doing business.

The objective of our tax laws should be to strive for neutrality and uniformity in their application. The fact that a co-op's structure differs from that of a business corporation does not mean that the cooperative should have an unfair advantage. It merely means that a different set of rules should be applied to achieve an equitable allocation of the tax burden.

It is, therefore, the recommendation of MCA that natural and logical extension of present Internal Revenue Code provisions, taxing investment income to co-ops, would be to include income from the use of capital in manufacturing, processing, or mining activities. Such earnings should be designated as from "unrelated business activity" and should be taxed to the co-op, just as unrelated income from rentals, interest, etc., are now taxable to it even though distributed to patrons.

Precedent for such an approach lies in the 1950 amendment to the Internal Revenue Code which taxes currently and at corporate rates the earnings of charitable or nonprofit organizations received from unrelated business activities. It is in just such "unrelated business" areas where the cooperatives' effort ceases to be joint purchasing and selling and becomes the accumulation of capital, its joint investment, and the receipt of profits resulting therefrom. It is also in the manufacturing, processing, and mining areas that the competitive advantages of tax-free operation at the cooperative level is most marked.

The enactment of this recommendation would be equitable to all concerned. Cooperatives could continue to enjoy their tax-free status to the extent they derive their income directly from transactions with their patrons or from activities immediately incidental thereto. On the other hand, if a cooperative were to engage in manufacturing, processing, or mining activities in direct competition with taxpaying organizations, the co-op also would be placed on a tax-paying basis. Thus, the cooperative would not enjoy an unfair advantage over its competitors and the tax burden would be more equitably borne.

Now a word with respect to withholding taxes on patronage dividends. The provisions of H.R. 10650 relating to the application of withholding on patronage dividends, as well as to other dividends and interest, are consistent with the

ag-established principle of withholding on salaries and wages. However, ere appears to be no sound reason why exemption should be made for persons er 18 years of age who expect to make no tax payments. There was no such emption for withholding on wages and salaries when the statute was adopted me 20 years ago even though the application to those items is of far wider ope than that under consideration today. If exemption from withholding on vidends and interest be made available, the decision should not be left to e discretion of the taxpayer as to whether he "reasonably believes that he ill not be liable for the payment of any tax." Exemption, if any, should be sed on expectation by the taxpayer of taxable income in an amount less than e minimum specified in the statute.

MCA supports the general objectives of H.R. 10650 with respect to taxation cooperatives but believes that (i) the provisions respecting patron "consent" be taxed on patron dividends in co-op paper should be strengthened by the imination of the charter or bylaw provision; and (ii) amendments should be cluded to deal with the more basic problem of treating co-op earnings from vestments in industrial and commercial activities as unrelated business income d therefore taxable as earnings of business corporations with which they mpete.

VIII. WITHHOLDING OF INCOME TAX ON INTEREST, DIVIDENDS, AND PATRONAGE DIVIDENDS

If the committee is convinced that the administrative problems presented by e withholding provisions of the bill can be resolved, MCA supports these provisions. It is urged, however, that further consideration be given to the effect of ithholding on employees' pension trusts. Under the bill there is only a very imited exemption for these trusts from withholding on certain types of interest. Since these trusts ordinarily do not have employees subject to payroll taxes, the rusts will have to recover withheld taxes via the quarterly refund procedure. This will result in a loss of income to the trusts and in a consequent lessening their ability to pay out pensions.

For example, assume that a pension trust regularly receives $100,000 in dividends a year, $25,000 being received each quarter of the year. Since 20 percent the dividends received during a quarter of the year will be withheld and coverable only through a quarterly refund procedure, $5,000 of these dividends will be held by the Government and will not be able to be invested. This figure , generally, be constant and will in most cases be equal to one-fifth of one uarter's dividend and interest received by pension trust.

IX. INFORMATION RETURNS

Section 20 of the bill amends section 6038 and 6046 of the Internal Revenue Code of 1954, so as to increase the information on foreign corporations which is required to be filed with the Treasury Department and provides civil penalties failure to comply. We are concerned with the amendments to section 6046 hich require information returns whenever a U.S. citizen becomes an officer or irector of a foreign corporation.

In order to protect the parent company's investment in foreign subsidiaries, irectors of foreign subsidiaries of domestic corporations are often selected because of their function with the parent corporation. Frequently, a change in a unction of an employee of the parent corporation also entails changes in officers and directors of foreign corporations. These changes take place as routine matters. There is no intent to evade U.S. taxes nor to hide information from the U.S. Treasury Department. It, however, can readily be foreseen that a normal change in the functional responsibility of an employee of the domestic parent, which as an incident thereto requires a change in the officers or directors of a foreign subsidiary, could be overlooked as far as having a U.S. tax consequence and thereby incur a civil penalty.

In the case of controlled foreign subsidiaries of domestic corporations this added requirement under section 6046 will not give the Treasury Department any additional data of consequence. It seems obvious that U.S. corporations which control foreign subsidiaries will be required to file needless information returns whose unintentional omission could result in civil penalties.

It is therefore proposed that controlled foreign corporations for which an information return must be filed under section 6038 be exempted from the provisions of section 6046 except in the case of a newly organized foreign subsidiary. uch an exemption would not reduce the information which the Treasury De-

partment is seeking, but it would cut down on unnecessary paperwork and reporting.

A technical objection might be made on the grounds that section 6038 does not specifically require data on officers and directors whereas section 6046 contains such a requirement. This defect could be easily remedied by providing in the proposed exemption under section 6046 that the exemption would be applicable only if data on officers and directors was filed with the return required under section 6038. In cases where returns are required under both sections, the proposal would also eliminate a filing and correlating problem for the Internal Revenue Service.

Experience with the present requirements of section 6038 has demonstrated the great difficulty of gathering the necessary information, because of the great differences in tax and accounting procedures in the various foreign countries. The foreign subsidiary would of course maintain its records in a form to meet its local tax and accounting requirements, which often differ substantially from U.S. practices, and it is then very difficult to reconstruct their financial statements in a manner to conform to U.S. tax laws and accounting practices. The desirability of confining requirements in this area to situations where a substantial U.S. tax interest is involved is obvious.

The revisions to section 6038 would raise almost insurmountable problems in the case of a U.S. company which is a member of an international group of affiliated companies. This would be particularly true where the U.S. company is a "down stream" one with no real control over any of its foreign affiliates. Technically, under the bill, the U.S. company would "control" every foreign company which is a member of the affiliated group (except where the total group interest in a particular foreign country is 50 percent or less) and would have to prepare information returns for each one. This would be true even though the U.S. company would not have one single transaction with any of the foreign companies and even though such information could serve no U.S. tax purpose whatsoever.

APPENDIX—WHY A U.S. FIRM HAS FOREIGN SUBSIDIARIES

U.S. firms generally establish manufacturing plants abroad for the sole purpose of competitively serving foreign markets. Long experience has demonstrated that as soon as the demand for an exported product reaches a size sufficient to support economically feasible plants, pressure is exerted by the foreign customer—and in many cases by foreign governments—for local or regional manufacturing. In one actual case, a U.S. firm was faced with the need to establish a plant in a European country because of notice from the principal customer in that country (accounting for over 50 percent of such sales) of its decision to switch to local sources of supply for all its purchases—a market developed over many years through U.S. exports would have been lost if the U.S. firm had not initiated local manufacture.

The pressure described is simply a natural preference for a dependable local source of supply over one which is located thousands of miles away. In addition, foreign quotas and tariffs have become a vital factor in any decision to manufacture abroad. If the U.S. firm does not establish its own production facilities, a local or foreign competitor will seize the opportunity to take over the business which has been tediously developed through U.S. exports at great expense over a long period of time.

U.S. firms no longer have a technological advantage to prevent this loss of markets. Foreign competitors can match most U.S. products either with the same product—or provide alternate materials so similar they can serve as substitutes for most end uses. Furthermore, since foreign labor gives evidence of becoming as productive as U.S. labor, but remains cheaper, if U.S. producers do not hold European markets (established through U.S. exports) by timely initiation of local manufacture, foreign producers are afforded the opportunity not only to establish large scale plants capable of capitalizing on these European markets but also to export to the U.S. and Latin America.

Thus, in most cases, at least, the establishment of production units abroad cannot be considered an "export of jobs." When the time is ripe, and the only question is whether a U.S. firm or a foreign competitor will do the manufacturing in a particular country, the export market will be completely lost to the U.S. company which does not move rapidly to serve customers in the manner desired.

If the U.S. firm undertakes to manufacture abroad, the income resulting therefrom will eventually flow back to that U.S. firm, and produce tax revenue to

the U.S. Government, all of which will be lost if the foreign competitor does the job. Moreover, with the U.S. firm as the foreign manufacturer, the continuation of some exports from U.S. plants to round out product lines of the foreign subsidiary and to supplement foreign production when demand exceeds the subsidiary's capacity, as well as the export of raw materials, parts or intermediates from U.S. plants for use by the subsidiary, will preserve markets for U.S. goods. It is obvious that these compensating exports would not materialize if the foreign market is taken over by a foreign competitor.

Two specific examples from the records of a large U.S. firm active in foreign operations emphasize this point:

(*a*) Following World War II, the U.S. firm developed a substantial market for one of its products in a Latin American country. In the early 1950's, export sales of that product to the Latin American country amounted to about $2 million, and pressure mounted for local manufacture of this product. In this case, a European company, rather than the U.S. firm, undertook local production and, thereafter, export sales of that product to the specific country declined rapidly and by 1961 had disappeared altogether.

(*b*) The results were strikingly different in the case of another product in Europe. The same U.S. firm's export sales of the second product to Europe grew rapidly in the postwar period, and by 1957, reached a total of $20 million. With the Latin American lesson in mind, and to forestall loss of the European market to a German competitor, the U.S. firm decided to build a large plant in a European country. With assurance of this nearby source of supply, the European business was retained and increased. By 1961, when the European plant was in production, European sales absorbed all of the local production and still required more than $20 million of exports from the United States. It is forecast that the exports of this second product to the Europen country will continue near this 1961 level for the foreseeable future to supplement European production, particularly in specialty grades. Obviously, these exports would have ceased if the U.S. firm had failed, as in the Latin American situation, to meet the demand for a closer source of supply, and its customers had switched to its German competitor.

Separate corporate subsidiaries are generally established in each country where a U.S. firm has foreign operations, rather than branches of the parent company or a single multicountry foreign subsidiary with local branches. The separate corporations permit a clearcut segregation of income subject to local tax, place a definite limitation on the amount of assets exposed to risk of loss (such as government seizure) in any one country, and make it possible to engage in joint ventures with local partners. In most cases, foreign governments prefer that business be carried on in their countries by locally incorporated organizations, rather than by branches of a foreign corporation. In some countries, such as Mexico, this is emphasized by active discrimination against branches in licenses, permits, concessions, etc.

Sales subsidiaries are established because these have been found to be more effective in marketing exported products than independent local distributors.

With the advent of the Common Market, and to compete for export business with entrenched local competition from such European companies as Bayer and Krupp of Germany, Imperial Chemicals Industries of England, Renault and Michelin of France, and Montecatini and Pirelli of Italy, many U.S. firms have established multicountry European sales organizations with headquarters in Switzerland.

The purpose of these subsidiaries is to increase selling efficiency by having an organization large enough to support the many marketing specialists, sales laboratories and other facilities required to match the service offered customers by competitors. The reasons for choosing Switzerland as the location rather than another European country include:

(1) The friendly attitude of the government toward private enterprise;

(2) The extensive trade and tax treaties with most other commercially important countries;

(3) Switzerland's strong currency and excellent banking facilities, together with a history of absence of foreign exchange restrictions;

(4) Availability of multilingual nationals who could fit into a selling operation;

(5) Central location and good transportation and communcations ties with other European countries;

(6) Favorable tax treatment of income from sales made to customers located outside Switzerland.

Senator KERR. Mr. Morton Levine.

STATEMENT OF MR. MORTON LEVINE, PARTNER, OF THE LAW FIRM OF SINGER, LEVINE, & PETTA, NEW YORK CITY

Mr. LEVINE. Mr. Chairman, my name is Morton Levine and I am a partner of the law firm of Singer, Levine & Petta, located in New York City.

I wish to comment on H.R. 10650, and more particularly on proposed section 1248(b) to the Internal Revenue Code which deals with the treatment of gain from sales or exchanges of stock in certain foreign corporations.

Under our present tax law the sale or exchange of stock (subject to certain exceptions) would be subject to a capital gain tax. There is presently no distinction in treatment between sales of stock of controlled U.S. corporations and controlled foreign corporations. The effect of the proposed section would be to treat any gain realized on the sale or exchange of stock in a foreign corporation completely different from gain on the sale of stock of a domestic corporation. While the gain on the sale of stock of a controlled U.S. corporation would continue to be taxed at capital gain rates this section proposes to treat the proceeds of a sale or exchange of stock of a foreign corporation as ordinary income to the extent of accumulated earnings and profits.

The break with precedent is obvious; one question remains, "Why?" There certainly must be a valid reason for the drastic conceptual change that is proposed. Section 12 of the House committee's report indicates the philosophy of the committee in this regard. It refers to the President's tax message of last year and its emphasis on removing tax benefits from so-called tax havens. The committee further states that:

> * * * The testimony before your committee did convince it that many have taken advantage of the multiplicity of foreign tax systems to avoid taxation by the United States on what could ordinarily be expected to be U.S. source income.

There is no question that tax havens have developed under our present structure of taxation. Many plans and gimmicks have been devised to avoid U.S. income taxes by resorting to foreign shelters. Though I can agree that the Internal Revenue Code should be supplemented to remove areas of tax avoidance, I strongly feel that all new provisions must be carefully drafted so that individuals who fall outside of the basic legislative philosophy are not unjustly penalized. There are many individuals who would be seriously injured by applying the section as presently drafted. They would fall within the words of the section but not its spirit. I would like to mention the situation of a number of our clients. I am sure you will agree that while they come within the letter of the section their control of a foreign corporation was in no way motivated by tax avoidance.

Our office represents a number of clients who were born in Europe in the early 1900's. Their families owned a corporation in Austria as far back as 1920 which never did and never has done business in the United States or indeed made any sales to persons in the United States. Because of the Nazi terror they were forced to flee their homes and businesses. The businesses they left behind were stolen by the Nazis. One of our clients was imprisoned and only released on condition that his business be turned over to the Germans as ransom.

They sought asylum in the United States and at the first opportunity became citizens of this country. They are individuals that the United States can be proud to have as citizens. These businesses were started and developed by people who at that time were not U.S. citizens. They were developed with foreign capital and foreign machinery and equipment and have never made any sales in the United States. None of these elements which went into beginning and developing these family businesses came from U.S. sources. They never have and do not now gain income from U.S. sources. After the termination of hostilities some of the fortunate individuals were able to regain their businesses. Our clients were among the fortunate. Many others found that what has been confiscated by the Germans was now confiscated by the Communists. The individuals who, as our clients, were successful in having their businesses restored, now find and will find that any success will be short lived. The result of their struggles will be a confiscatory tax on the part of the U.S. Government. Any gain from the sale or exchange of these businesses will, under this provision, be treated as ordinary income due to the accumulation of earnings and profits over a 40-year period from non-U.S. sources. A proposed provision of the law which would have the effect of lumping people, as those mentioned, in the same class as tax avoiders would be unconscionable.

In many cases the value of these businesses constitute the great bulk of the individual's net worth; a net worth which was painstakingly accumulated without American dollars and prior to the individual's becoming a U.S. citizen. It should not be our tax policy to confiscate by taxing at the 91-percent bracket the greater part of an individual's net worth as the price for becoming a citizen of this country. The theory of the proposed section is to prevent people from using American dollars in a way as to escape American taxation. It is aimed at preventing American citizens from escaping American taxation by going through mechanical acts now sanctioned under the present Internal Revenue Code. The philosophy of the section is certainly commendable. I do not feel, however, that it was the intention of this committee to injure the innocent in order to collect a proper tax from those who have taken unfair advantage of our tax statutes. We should not subject the property of U.S. citizens who owned said property for years prior to becoming U.S. citizens and which property has never earned income from U.S. sources to a discriminatory tax. As applied to these individuals the net effect of this section would be confiscation.

Equity and justice cry for relief so as to avoid a deplorable situation. In my opinion, this section should be amended so as to exclude those U.S. citizens who can trace their ownership of foreign corporations to a period prior to their becoming U.S. citizens. In the alternative, I feel the very, very least that should be done is to apply the ordinary income concept of this section only to earnings and profits accumulated after the enactment of the section. By taxing these people at ordinary income rates on earnings and profits accumulated over a period of many years, we will be discriminating against them, and I feel that remedial amendments are required to correct this unfair situation.

Senator KERR. Thank you, Mr. Levine.

Mr. Harold S. Geneen, International Telephone & Telegraph Corp.

STATEMENT OF HAROLD S. GENEEN, PRESIDENT, INTERNATIONAL TELEPHONE & TELEGRAPH CORP.

Mr. GENEEN. Mr. Chairman and gentlemen of the committee, my name is Harold S. Geneen. I am president of International Telephone & Telegraph Corp.

I appreciate this opportunity to express our views on the Treasury Department proposals to tax unrepatriated earnings of U.S.-owned foreign corporations. I have read the previous testimony carefully, and, knowing the burdens of this committee, I shall endeavor to avoid repetition of past material and deal chiefly with fresh aspects of our problems based on ITT's actual experience overseas.

Parenthetically, I would like to add that I have some realization from my own background as to the difficulties of this area of the bill and the difficulties which confront both this committee and the Treasury Department, and our comments are intended to be constructive.

ITT is one of the oldest and largest American-owned international companies in the world in the fields of telecommunications and electronics.

1. Briefly, we have over 80,000 direct U.S. shareholders and bondholders and many times more that number indirect shareholders through investment trusts, pension plans, insurance companies, etc.

2. We have, in total, 150,000 employees—130,000 of them overseas—practically all nationals of the host countries.

3. We operate 33 manufacturing and operating companies in 19 foreign countries.

4. We operate in all 50 States of the United States and have plants in 11 States which employ more than 20,000 people. These companies which have paid out over $1 billion in wages since inception were started almost entirely from our foreign capital and earnings which were U.S.-taxed on repatriation.

5. We have provided some 15,000 jobs chiefly in the underdeveloped areas of Latin America without subsidy or help.

6. ITT's foreign subsidiaries have always remitted at least 50 percent of their earnings except when blocked by currency restrictions.

7. In the past 10 years, they have remitted a total of $190 million net to the U.S. economy—$143 million from Western Europe alone.

8. In addition, we have imported very little into the United States from overseas and maintain an export surplus from the United States. This export surplus, in the 10 years to 1960, was over $175 million net.

9. In its history, ITT has not operated or used foreign subsidiaries for tax-haven purposes.

10. This record stands in spite of the fact that during World War II, most of our European companies were captured by the enemy and some of these were never recovered. Again, more recently, in 1960, we lost a $100 million telephone company in Cuba. Only 2 months ago, our telephone company in Brazil was seized.

We have experienced, in this time, blocked currencies, devaluations, and the usual risks of a foreign company operating abroad, which are not consistent with the risks of domestic companies.

Yet, despite these setbacks and experiences, we have, I believe, continued to do a good job for our shareholders and our Nation.

We have contributed significantly, as I have said, to the balance of payments.

In short, if you were to write a textbook, you could not provide a better example of an American company operating abroad in our national interests.

What, then, is the purpose of a tax bill that would weaken and destroy the competitive ability of a company like this, that has contributed on not one, or two—but on every count to the U.S. economy?

Let me say that we are being quite open and objective about expressing this view.

I appeared before the House Ways and Means Committee to testify on the trade bill. I did so because of the direct relationship between this tax bill now before you and the trade bill. American trade in the form of U.S. exports is entirely different from filling foreign markets that can only be met from manufacture abroad. These are the two areas of strength of American foreign trade. They are not exclusive of each other. Both activities can and should be carried forward in the national interest. Testimony brought out in the discussion between the chairman of this committee and the Secretary of the Treasury freely conceded that there were ample funds, ample management, and ample initiative already existing in the United States to do both of these jobs. This should be the basic approach of this Nation to enlarging its share of foreign trade.

Nor will passage of this section of the bill result, therefore, in more export growth in the United States to meet these markets. Nor will the limiting of one of these approaches, to create a surfeit of capital and management in the other, in any way add to the strength of the United States.

The purposes of the investment credit features of this tax bill seem intended to make U.S.-based companies more competitive by equalizing U.S. depreciation with oversea competitors.

From the standpoint of total tax burden that must be borne, competitively, tax neutrality between these two groups already exists without this bill. In fact, Secretary Dillon has already told this committee, and I quote—

* * * the fact of the matter is that our overall tax burden, Federal, State, and local in the United States is less than it is in some six of seven of the European countries * * *.

I am submitting a schedule (app. II) which bears out, based on ITT's experience, the correctness of this point.

Further, we do not believe the provisions of this bill will provide any substantial revenues. The countries where the income is earned have the first claim on additional revenues and undoubtedly would exercise their claim. We are all familiar with the special estate taxes imposed in many States to soak up the credit authorized by the Congress in 1926 against the Federal estate tax. In this case, the Congress intended the States to enact such soak-up taxes.

I am sure that the foreign countries are even now readying legislation for this purpose, and much of it will be "soaked up" anyway under existing withholding taxes on dividends, which, by way of example, even under present laws, would add 21 percentage points to our tax on unrepatriated earnings in Belgium, for example, to bring but 7 percent to the U.S. Treasury. The supplementing or creating of

such a tax would be a very simple matter, and to the extent that foreign countries adopt such soak-up taxes, there will be no increase in the revenues of the U.S. Treasury, while at the same time making our companies noncompetitive.

The fact that total U.S. domestic and total foreign tax burdens on U.S.-owned companies are thus already neutralized in world trade does not do away with the competitive injury we would suffer by this bill.

First, only a small percentage of these European taxes are creditable. In 1960, for example, the total French tax burden on the three French subsidiaries of ITT before deductions for taxes was 78 percent, 82 percent, and 78 percent, respectively, whereas the U.S. foreign tax credit recognized only percentages of 20 percent, 19 percent, and 16 percent, respectively.

Let me give you a few concrete examples of the effect this would have on three of our subsidiaries if these proposals were applied to 1960:

(1) In Belgium, where we conduct one of our major operations, we have to meet well-financed, well-qualified European competition, such as Philips Lamp of Holland, and Siemens and Halske of Germany. In 1960, under these proposed new taxes, we would have had a 117-percent increase in taxes on our retained earnings, to which our competition would not have been subjected.

(2) In Great Britain, our company makes electronic and telecommunications equipment. Its competition there comes from Pye, Plessy, and Marconi, and others. Our added burden in income taxes on retained earnings would have been a 41-percent increase.

(3) In Australia, we manufacture telecommunications equipment for that market. Our principal competitor there is a Swedish firm, L. M. Ericsson. Based on 1960, if the Congress should enact this tax bill, we would pay 79 percent more in income taxes on retained earnings than our chief competitor in Australia.

As nearly as we can determine, no other industrial country imposes or plans to impose taxes on its companies on the basis of the undistributed income of their foreign subsidiaries.

The schedule which we submit herewith (appendix III) will show the large extent of these increases in taxes that would result, again based on ITT's actual experience.

Furthermore, there will be a precedent established for special discriminatory taxes by foreign countries against U.S.-owned businesses. I cannot believe that this is in our national interest. But that is precisely what this proposed legislation would bring about.

Why, then, with contributions to balance of trade and payments, to employment and to national welfare, and for no important additional revenues do we want to make our oversea companies noncompetitive? It has been said that only a loss of growth results, with perhaps smaller dividends to shareholders and the damage is not serious. This is not true, as anyone running a company will assure you.

As an operating businessman, I know that you have to maintain and perhaps improve your market share to stay alive. Costs and profits depend directly on volume production corresponding to market share.

You are familiar with the term "growth company" as used by investors. A growth company is one that increases rapidly and holds

or increases its share of the market. Certainly one that was held to a negative growth would be increasingly noncompetitive in relative costs and would be immediately discounted as to its future. Its credit would also be immediately impaired. A company with dwindling dividends would be similarly considered.

These heavy extra burdens must, moreover, be considered in the countries where they would be presumed to apply—there is no "averaging" of tax rates or no "averaging" of competition—and wherever these discriminatory penalties would apply (as per app. III) we would become that much more noncompetitive.

I think I have shown by facts based on experience that these provisions of the bill are against the interests of our country from a competitive, trade, and contributions point of view. What, then, remains to justify these proposals?

Tax havens and balance of payments have also been mentioned as the reasons for these provisions. Let us examine them.

As noted, ITT does not use and has not used foreign subsidiaries for tax haven purposes.

Moreover, may I submit the simple, sound point to this committee that a publicly held company, such as ITT, fully and openly reporting all of its earnings and remitting 50 percent or more of these earnings to the United States, cannot ever be classified as a "tax haven" company. On the contrary, public companies, acting in this manner, should be encouraged to use every legal, competitively available method open abroad in order to increase the amount of their earnings and the amounts they can repatriate to the U.S. balance of payments.

ITT is not seeking to use tax havens and will endorse any reasonable action taken by this committee to reach those tax evaders and avoiders who unreasonably hoard money overseas. The 50-percent dividend payment and remittance test we have applied to ourselves follows closely the experience of U.S. domestic companies, and is, therefore, the natural expression of good management practice of partial reinvestment of earnings to stay competitive. It is not arrived at from tax considerations.

H.R. 10650, however, goes far beyond these requirements. In essence, section 13, through its so-called nonqualified investment provisions, penalizes Americans for making new investments in controlled subsidiaries in developed areas or from expanding existing operations there, because the earnings from these activities would have to bear a U.S. tax not borne by the foreign competition. While this section purports to allow expansion in the same narrow trade or business to be undertaken, free of this added tax penalty, this escape hatch is more apparent than real.

As one example of thinking, one could not know whether he could expand from refrigerators into air conditioners, although evolutions of this kind are normal, everyday competitive necessities. Multiply this example by thousands of operating decisions to be made from day to day in many areas under these kinds of rules and we would have a "stifling" weight of confusion and resulting indecision on U.S. companies' operations not borne by their competitors. The cost of administration by the Government would not be inconsequential either.

In addition to this crippling "nonqualified investment" feature, section 13 contains numerous other provisions calculated to subject for-

eign operating earnings to the burden of taxes not borne by our competition. To name only four:

(1) If an existing foreign manufacturing subsidiary decides to rent its products to consumers instead of selling them—an increasing trend in many industries, such as office equipment and switchboards—the rental income, for no sound reason, since this is a marketing and operating competitive problem, would be considered tax haven income and taxable to the U.S. parent corporation.

(2) If a foreign manufacturing subsidiary producing consumer goods desired to create a subsidiary in order to better finance the consumers' purchases of those goods as is done purely for financing reasons all over the world, all of the income of the financing subsidiary would be considered, without even review, tax haven income.

(3) If an American firm decided to form a sales company to sell for reasons of operating efficiency only through one common sales organization operating throughout the Common Market, the products of its foreign subsidiaries made in several countries, the income of that sales company, although in all respects operating income, would be classed as "tax haven" income. The administrative burden of these proposals would be enormous.

And, moreover, they are proposed to be applied even if, as we have pointed out, we report our income from all sources and remit 50 percent or more each year.

This present bill, therefore, places U.S. manufacturing subsidiaries overseas in an investment straitjacket as far as diversification and growth are concerned. For a technical company like ITT, with large competitive expenditures in research and development for continually changing products and the necessity of continually diversifying further to meet competition, this is an impossible burden.

In explaining the competitive injury of section 13, I have touched only lightly on the tremendous administrative burden that would be imposed, through uncertainty, litigation, and accounting costs—but again I would call these unnecessary inefficiencies to your attention, as the costs of these must also be recovered in the competitive price.

I should like to comment about section 16 which would tax as ordinary income on sale, exchange, or merger of the stock of the controlled foreign subsidiary, all of the gain representing foreign tax-paid accumulated earnings, without receiving any credit for the foreign taxes paid on such earnings. While this provision may be aimed at collapsible corporations, it has the effect in the case of operating companies to discriminate against American oversea companies in their ability to make ordinary competitive acquisitions through exchange or merger. This proposal would also discourage new investment in Latin America since gains on such sales would be subject to ordinary income tax treatment while losses through confiscation or other causes would generally be treated as capital losses only.

Attached to this testimony is appendix I which shows also the heavy impact of the gross-up provision on less developed countries and makes certain recommendations which parallel the period of development of our announced Alliance for Progress and other aid programs.

Finally, there is the balance-of-payment reason given for these provisions. I am going to use Western Europe as a basis for my comments because this is the greatest developed market outside of

our own. The Treasury Department tables based upon the idea that our American subsidiary investments in Western Europe increase at an incremental rate of 110 percent each year are not supported by the record of the past 10 years. Particularly important is the sharp reversal of recent years' trends shown by the 1961 Department of Commerce statistics which would indicate that the whole tide has turned. These 1961 data were not presented by the Treasury Department to this committee in its testimony. The official 10-year Commerce Department figures through 1961 give a clearer picture of what has actually been happening.

In the first 7 of these 10 years, new direct U.S. investment in Western Europe, with the exception of 1956, remained relatively nominal and repatriations to the United States in the form of dividends, interest, royalties, and fees substantially exceeded new outflow in every year. Then in 1959, 1960, and 1961 we did see a substantial increase in that outflow. This was due mainly to two special factors. One was that European currencies were then rapidly being made fully convertible. The other was the rapid emergence of the Common Market with rapidly rising standards of living and consumer purchasing power. U.S. industry in these 3 years telescoped their investments which would ordinarily have been spread over a longer period of years.

However, significantly, in 1961, despite the heavy outflow of the previous 2 years, earnings brought home to the United States from Europe exceeded once again the new investment outflow. Moreover, new outflow to Europe declined 32 percent, while money brought home—income from Europe—increased 25 percent over 1960. Our business investments in Europe appear to have reached a balance-of-payments maturity.

Taking the entire 10-year period, American firms in Western Europe repatriated $444 million more than they sent abroad in new direct investments. In only 2 of these 10 years, 1956 and 1960, did new direct investment exceed repatriated earnings and this was chiefly due in 1960 to one $370 million purchase which the Commerce Department compilations have described as special and nonrecurring.

These Government figures show also that the responsible U.S. firms who make up the majority of our foreign commerce bring home, on the average, nearly 50 percent of their earnings each year and in 1960, they brought home 55 percent.

In 1961 U.S. private merchandise exports to Western Europe alone exceeded our imports from that area by a staggering $2.7 billion. No one can say how much of this would have been lost but for the existence of our foreign subsidiaries in those foreign markets.

These are good illustrations of American foreign subsidiaries working in a developed market. In Western Europe, the great bulk of U.S. direct investments are conducted through subsidiaries rather than branches. Contrary to the Treasury data, this is true of the operations which U.S. petroleum companies conduct there. Hence, Western Europe is a fair test of the operations of our controlled foreign corporations.

We have assembled for your use these Commerce Department balance-of-payment figures in convenient form and they are shown on the next two pages, both in graphic form and tabulation.

(The charts referred to are, as follows:)

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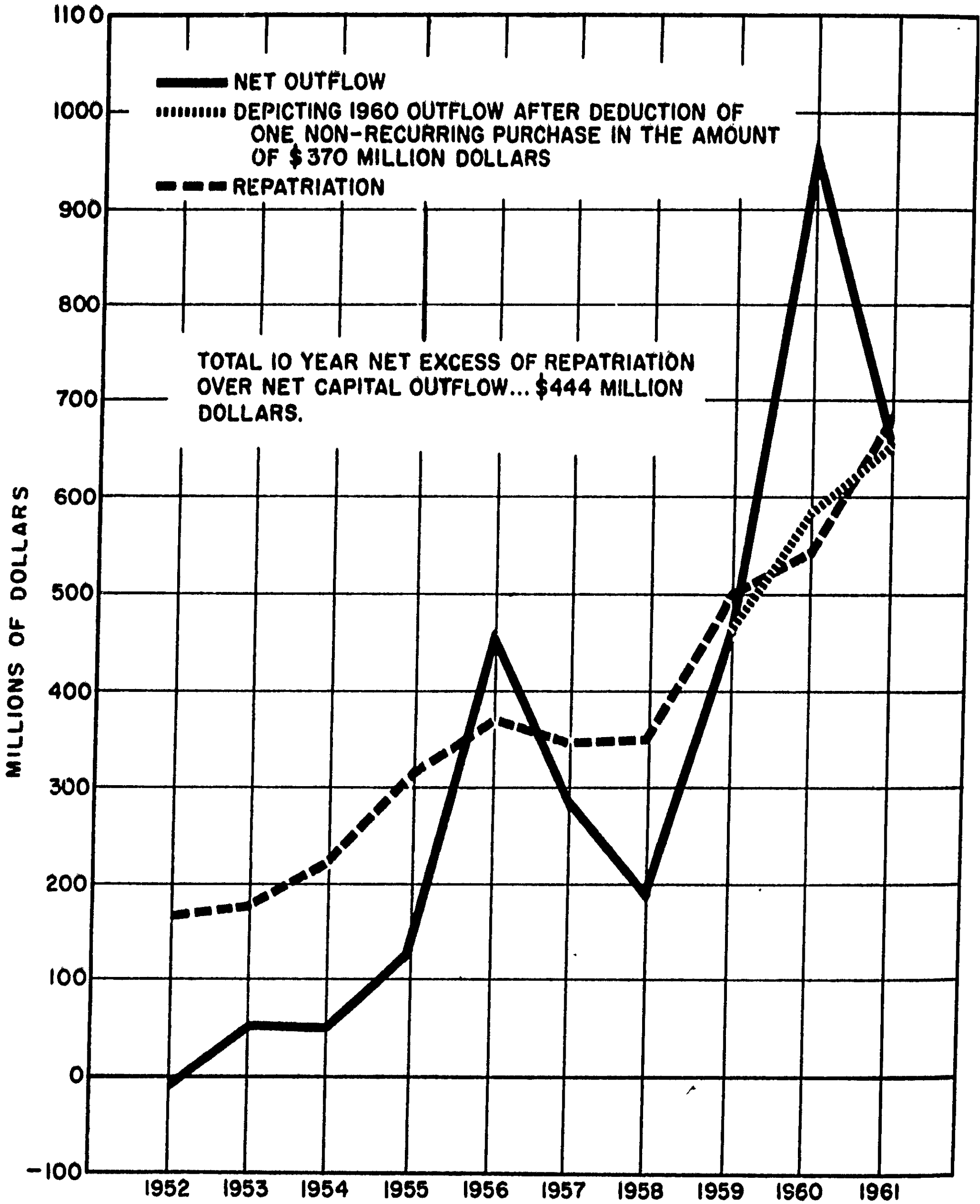
WESTERN EUROPE 1952-1961 ALL COMPANIES
ANNUAL NEW U.S. NET DIRECT INVESTMENT AND ANNUAL REPATRIATION
(SOURCE: U.S. DEPARTMENT OF COMMERCE)
NET OUTFLOW
DEPICTING 1960 OUTFLOW AFTER DEDUCTION OF ONE NON-RECURRING PURCHASE IN THE AMOUNT OF $370 MILLION DOLLARS
REPATRIATION
TOTAL 10 YEAR NET EXCESS OF REPATRIATION OVER NET CAPITAL OUTFLOW... $444 MILLION DOLLARS.
MILLIONS OF DOLLARS
1100
1000
900
800
700
600
500
400
300
200
100
0
-100
1952
1953
1954
1955
1956
1957
1958
1959
1960
1961

Western Europe, 1952–61, all companies—Annual new U.S. net direct investment and annual repatriation

[Millions of dollars]

	Net outflow (inflow= minus)	Repatriation		
		Total	Dividends, interest, and branch profits [1]	Royalties and fees
1952	–8	166	140	26
1953	51	177	152	25
1954	50	229	197	32
1955	139	318	274	44
1956	456	373	314	59
1957	287	345	281	64
1958	190	371	299	72
1959	466	500	393	107
1960	[2] 962	547	427	120
1961	604	685	551	134
Total	3,257	3,701		
Less		3,257		
Total, 10 years net excess of repatriation over net capital outflow		444		

[1] Only an insignificant percentage of total investment in Western Europe is through branches rather than subsidiaries and earnings therefrom are not separately published by the Government.
[2] Includes 1 nonrecurring purchase in the amount of $370,000,000.

Source: U.S. Department of Commerce.

Mr. GENEEN. I would particularly like to call your attention to some facts that are quite clear from the first chart here [indicating]. If you will take the year 1958, the black line representing the outflow, you will notice that the amount is approximately $200 million in 1958.

Again, in 1959, the outflow is $500 million.

Again, in 1960, it is $950 million, including the $370 million Ford transaction.

The total of these is approximately $1.7 billion.

Now, the Treasury has made the statement that this money will only come back to us over a period of 25 years, or a rate of 4 percent a year. At that rate we would expect the return, the heavy dotted line which shows the year 1958, $350 million, to increase by the amount of $60 million, or, roughly, to $400 million by 1961.

Instead, we find from the Commerce Department's statistics that this amount has increased to $650 million, or at a rate five times as fast as the Treasury Department's statement.

Coming to the ITT "balance of payments" for the same 10 years, we have brought both capital and earnings home to the United States. Rather than a new capital outflow, we have had a capital return of $25 million and, in addition, we have repatriated, net, $118 million in dividends, interest, and fees from Western Europe alone is the 10 years, 1952–61.

The fact remains the amount we have brought back from Europe is something like one-third the net contribution of balance of payments in the 10-year period ending 1961.

Let me say that there are many other American firms in the same position as ITT, having this same kind of maturity, assisting American industry as a whole to maintain a balanced international investment account with Western Europe.

I cannot agree with the idea advanced by the Treasury Department that earnings brought home from abroad in one year have no relation to new outflows of the same year. This is like saying that I will make investments in a plant abroad without even looking at the earnings account. This is a ridiculous statement. You cannot disentangle in an operating entity the past from the present. At all times one is replacing obsolete equipment and old products lines to stay competitive—or integrating for manufacturing cost savings or broadening product lines for marketing efficiency. The profit and loss flow is directly geared to the replacement-expansion cycle. In other words, decisions on investment and repatriation are inextricably linked and both are a part of the same operating plant requirements that create the revenues and are, therefore, not separable decisions.

The official statistics of the Department of Commerce cannot be interpreted in the manner of the Treasury Department.

To proceed with these proposals, therefore, will be an open disclosure to the world that we cannot carry on a strong foreign trade position of exporting from the United States and also of operating abroad. Maintenance of this position is essential to confidence in our dollar. Failing as a nation to make the best uses of these trade advantages would be like the businessman who openly did not exercise his cash discounts and thus immediately gave notice of his distress and impaired his credit.

The necessity of the balance of payments is, in the final analysis, "to maintain confidence in the dollar." Failure to maintain our twin foreign market position will tend to destroy this confidence.

Investors and bankers recognize thoroughly the difference between a dollar of U.S. investment in a strong income-producing trade position in Europe as against a dollar of aid spent—although the statistics presented make no such distinctoin in quality between the figures.

Not only European investors and bankers, but U.S. investors also will be quick to recognize the advantages to foreign-owned companies that these proposals would create, since they do not apply to the foreign company.

To show what is already happening I place before you a copy of a series of clippings describing large, new portfolio offerings of foreign securities in the U.S. capital markets including Philips, one of our largest foreign competitors, scheduled for the very near future in the amount of $400 million in one transaction alone. The new tax bill will greatly accelerate this trend by providing an even greater advantage to foreign-owned companies in our own capital markets here, and without further control, which I gather the Treasury referred to, it cannot be stopped.

Moreover, these foreign firms do not now pay any U.S. corporate taxes on the earnings paid to their U.S. shareholders. In the case of Philips, there is not even a foreign withholding on dividends paid to U.S. residents. Referring to this morning's testimony, they do not even file an information return. Therefore, U.S. oversea companies are at a direct disadvantage with their foreign competitors in our own capital markets. This bill will further extend this disadvantage.

Moreover, these foreign companies are not concerned with U.S. balance-of-payments contributions or the creation of U.S. exports.

Although the intended purpose of the bill is to help our balance of payments, it is basically proposed to do this by indirectly rationing capital through tax penalties, which, as these examples show, tend to just the reverse: to force American investment into foreign portfolio holdings, which will lead inevitably to licensing of new issue capital flow with attendant adverse effects on the balance of payments.

In closing, let me say I have not attempted to deal with all aspects of the bill, including such matters as constitutionality, the effect on our treaties, the inevitable injury to our prestige, and others. I do believe that our experience shows that this bill, though well intentioned, would not produce substantial tax revenues, would do irreparable harm to our competitive position, and in the end injure our balance of payments.

I thank you for your patience in hearing me. I have full confidence that this committee will evaluate the bill on the basis of the facts and make an equitable decision in conformity with our national interest. I will be glad to answer any questions. Thank you.

(The attachments referred to are, as follows:)

APPENDIX I

SUPPLEMENTARY STATEMENT OF HAROLD S. GENEEN WITH RESPECT TO PROPOSED "GROSS-UP" OF FOREIGN DIVIDENDS

Congress, in originally enacting the foreign tax credit provision of the law, decided that a credit should be given to a domestic taxpayer for a share of those foreign income taxes deemed applicable to the income from which the dividends stem, regardless of the concept of income in the country involved, and regardless of the rate of tax in the country involved. In doing so, it attempted to give some credit against domestic income for foreign taxes paid without going into all of the details of the system of taxation in effect in each foreign country, and without analyzing the concept of income which exists in each foreign country. This system of rough justice has been in effect some 40 years without appreciable change, and essentially without criticism. It should not now be changed on the basis of an essentially irrelevant arithmetic concept.

In support of this position, we have developed certain new data which can only support our view that the gross-up will have two very undesirable results in particular: (1) It will substantially increase the ineffectiveness of the foreign tax credit in terms of recognizing the real foreign tax burden for which credit should be allowed; and (2) it will be most arbitrary in effect, striking both developed and underdeveloped countries, but bearing on the underdeveloped countries much more heavily.

These additional data demonstrating the ineffectiveness of the foreign tax credit in meeting the true foreign tax burden are attached hereto. In schedule I we have shown the sources of tax revenue of the national governments of certain foreign countries expressed in terms of the percentage that various taxes bear to the total tax revenue of the national government. We have also set forth the same percentage with respect to the United States. A comparison of these figures is startling and dismaying. The United States, for example, obtains 84 percent of its revenues from personal and corporate income taxes. Of the 31 foreign countries analyzed, the greatest reliance on personal and corporate income taxes as a source of revenue is Japan, where 59 percent of the total government revenue comes from personal and corporate income taxes. The startling thing about the whole analysis is that the arithmetic average for all personal and corporate income taxes of the 31 foreign countries is only about 37 percent of total government revenue. The average reliance on corporate in-

come taxes alone for the 17 countries from which such data was available to us is approximately 17 percent versus 29 percent for the United States. This makes it apparent that other countries do not use personal and corporate income taxes as revenue-producing measures to nearly the same extent as does the United States. This being so, these countries must rely on other sources for their revenue. Schedule I shows that the United States relies to the extent of 13.76 percent on turnover, sales, production, and excise taxes, and customs duties for revenue, whereas the reliance for turnover, sales, and production taxes in the 31 countries analyzed, on the average, is 14.68 percent, and their reliance for excise taxes and customs duties is 38.37 percent. If the reliance of these 31 countries on corporate and personal income taxes, turnover, sales, production, and excise taxes and customs duties are all added together, they come to 89.93 percent, which is very close to the U.S. reliance on income taxes alone.

The obvious conclusion to be gathered from the figures shown on schedule I is that, in computing income taxes in foreign countries, the income basis upon which the tax is computed is much smaller than that for the United States, since turnover, sales, production, and excise taxes, and customs duties have been deducted from income before the computation of the income tax. (In addition to the fact that large tax burdens have been taken out of income before the computation of the income tax, there is, of course, the fact that the concept of taxable income varies from country to country. For example, foreign tax jurisdictions may recognize revaluing of inventories to compensate for the changing purchasing power of their currency and may grant special deductions from income as an incentive to keep the investment in capital goods current, which deductions are not allowed for U.S. tax purposes.)

The above analysis is substantiated by material submitted to the Ways and Means Committee showing the disparity between the total effective foreign tax burden on subsidiaries of ITT abroad, and the foreign tax of such subsidiaries which the U.S. foreign tax credit now recognizes (see schedule II, reproduced on p. 3023). This schedule conclusively demonstrated that the actual tax burden of these subsidiaries is much greater than that recognized by the U.S. foreign tax credit. For example, in 1960 the total French tax on the income of the three French subsidiaries of ITT before deduction of such taxes was 78, 82, and 78 percent respectively; the U.S. foreign tax credit recognized percentages of only 20, 19, and 16 percent respectively. For ITT's German subsidiary, the percentage of tax burden was 65 percent and the percentage recognized for credit purposes was 55 percent; for Italy, the percentages were 59 and 36 percent respectively.

It is possible that the analysis of sources of national government revenue contained in schedule I might be criticized on the grounds that it omits state, provincial, and local taxes in existence in each of the foreign countries analyzed. However, the existence of such taxes does not materially affect either the validity of the schedule or the conclusions we have drawn from it.

While we do not have the statistics for the United States for the year 1960, the statistical abstract of the United States for 1960 shows that individual and corporate income taxes for the year 1958 constituted 80.57 percent of total Federal Government tax revenues. In the same year, out of total tax revenues of $30,380 million of State and local tax revenues, personal income taxes constituted $1,759 million and corporate income taxes constituted $1,018 million. Thus, if the State and local tax revenues are added to Federal tax revenues, and State and local personal and corporate income taxes are added to the Federal personal and corporate income taxes, the percentage which personal and corporate income taxes is of total Federal, State, and local tax revenues, becomes 58.52 percent. Of the 31 countries analyzed on schedule I, only 8—Italy, Norway, Spain, Sweden, Denmark, Finland, Japan, and Switzerland—have state or local income taxes eligible for treatment as foreign tax credits. It is apparent that, if all of the state and local taxes in the 23 countries which do not have state or local income taxes, and the state and local taxes in the 8 countries which do have such income taxes are added to each of the various categories of taxes, the average percentage which income taxes are of total revenues must, of necessity, decline from the average of 37 percent shown on schedule I. Therefore, our basic conclusion—namely, that other countries rely to a much smaller extent on income taxes than does the United States—still remains. The percentages might shift somewhat, but this would not affect the basic comparison.

The second answer is that, insofar as a comparison between foreign branches and foreign subsidiaries is concerned, a full deduction for all state and local taxes paid to any foreign government against the operations of the foreign branch is allowed against the income of the domestic company and is also allowed in the computation of any income tax paid to a foreign government against the operation of the branch. Although a foreign subsidiary may be allowed a deduction for state and local taxes it has paid in computing the net income subject to income tax in the foreign country, no deduction is allowed as such against U.S. income; and only if the state or local tax is an income tax may it be used in computing a foreign tax credit of the domestic parent. A perfect example of this situation is Portugal. If a foreign branch is used in Portugal, all taxes paid in Portugal, whether federal, state, or local, may be deducted in computing the net income subject to tax in the United States of the domestic company. If a foreign subsidiary is used, the domestic parent gets no deduction from net income for U.S. tax purposes, nor is it allowed any foreign tax credit for dividends received from the Portuguese company, since Portugal does not have an income tax within our concept of the term.

In schedule II, where an analysis of the effect of the "gross-up" proposal is given, full weight has been allowed for any state or local income taxes in the computation of the foreign tax credit. Therefore, it may be stated that, in determining the relative reliance placed upon income taxes in the United States and in foreign countries, it is obvious that reliance is placed to a much greater extent on income taxes in the United States than in foreign countries, and the ultimate fact that the foreign tax credit, as it is presently computed, does not give full consideration to the full tax burden borne by foreign subsidiaries.

Schedule II attached hereto is an analysis showing the foreign tax credit allowable for each of the foreign countries analyzed on schedule I, plus others for which we have data, on both the present basis of computing the foreign tax credit and on the "gross-up" basis (assuming $100 of net income before income tax). Analyses of this schedule show that the "gross-up" proposal is no respecter of countries. It has no uniformity of effect. It hurts the developed country and the underdeveloped country alike, although the averages show it has a far greater impact on the underdeveloped countries than on the developed countries as a whole. Its effect cannot be determined solely by reference to the rate of income tax in a foreign country, since this effect is complicated by the system, or lack thereof, of a withholding tax on the remittances of dividends. Obviously, since a withholding tax does not vary in dollar terms per dollar of dividend remitted, the impact of the "gross-up" expressed as a percentage increase in tax on foreign income must vary arbitrarily depending on the withholding rate.

Schedule II shows conclusively that the "gross-up," on a country-by-country basis, will have no uniformity in effect or result. Certainly the foreign tax treatment of branch income is not uniform from country to country. Therefore, an arithmetic formula which produces such spectacular varying results between countries cannot be regarded as a rational attempt to equate the tax treatment of foreign subsidiary income with branch income. The one effect that can be predicted with certainty, however, is that the impact of the "gross-up" will bear most heavily on underdeveloped countries, leaving such advanced countries as Canada, France, Germany, and the United Kingdom relatively untouched.

We firmly believe that before the Congress is requested to change a method of taxing income from foreign sources which has been in existence for over 40 years, the Treasury Department should be requested to submit data to the Congress showing the true burden of taxes borne in each of the various foreign countries and the effect on that total burden of an arbitrary adjustment of the burden such as "gross-up."

Schedule II, attached hereto, shows conclusively that the impact of the "gross-up" proposal bears most heavily on income from the less-developed countries—a result which seems to be directly counter to the statement made in the aid bill enacted only last year that the Government wishes to foster the flow of private capital into the less-developed countries. Accordingly, we urge that the enactment of the "gross-up" proposal be deferred until a proper study of its total impact can be made, or in the alternative, that a grace period for the application of the "gross-up" principle be added to the bill to cover the duration of the aid program to less-developed countries, as exemplified by the Alliance for Progress, during which time our tax treatment of dividends would be consistent with the purposes of the aid bill and the Alliance for Progress.

SCHEDULE I

Sources of tax revenues of the United States and certain foreign countries expressed in the terms of the percentage of such tax revenue bears to the total tax revenues of the country

Country and period	Corporate income taxes	Personal income taxes	Total income taxes	Turnover, sales, and production taxes	Excise and customs duties	Estate, gift, capital, and stamp taxes	Miscellaneous taxes	Total taxes	Percent corporate income tax rate
United States (year ended June 30, 1960)	28.89	54.73	83.62	----------	13.76	2.16	0.46	100.00	52
Western Europe:									
Austria (year 1960)	10.38	8.21	18.59	32.84	20.19	7.66	20.72	100.00	52.00
Belgium (year 1960)	(1)	(1)	35.54	16.64	9.98	37.45	.39	100.00	[2] 40.00
Netherlands (year 1960)	12.15	41.75	53.90	19.44	20.84	5.82	----------	100.00	47.00
Denmark (year ended Mar. 31, 1960)	6.21	31.23	37.44	----------	56.27	3.50	2.79	100.00	44.00
Finland (year 1960)	7.81	10.92	18.73	27.81	31.99	8.67	12.80	100.00	50.50
France (year 1960)	10.30	18.03	28.33	37.88	19.23	6.13	8.43	100.00	50.00
Germany (year 1960)	23.32	26.09	49.41	23.52	20.75	4.85	1.47	100.00	[3] 58.00
Great Britain (year ended Mar. 31, 1961)	(1)	(1)	50.46	9.23	34.29	6.02	----------	100.00	53.75
Ireland (year ended Mar. 31, 1960)	20.07	10.62	30.69	----------	54.67	6.88	7.76	100.00	40.00
Italy (year ended June 30, 1960)	(1)	(1)	35.12	41.09	15.15	7.37	1.27	100.00	[4] 37.00
Norway (year ended June 30, 1960)	5.93	17.96	23.89	35.86	36.27	3.35	.63	100.00	59.50
Spain (year 1960)	15.25	7.55	22.80	38.26	15.00	23.94	----------	100.00	37.50
Sweden (year ended June 30, 1960)	8.83	31.59	40.42	6.93	40.41	4.17	8.07	100.00	48.00
Switzerland (year 1960)	(1)	(1)	30.92	25.47	34.50	----------	9.11	100.00	[5] 33.00
Average for those countries for which detail is available	12.03	20.40	34.02	22.50	29.25	8.99	5.24	100.00	46.45
Latin America:									
Argentina (year 1959)	(1)	(1)	35.84	19.65	31.83	12.68	----------	100.00	[6] 42.00
Colombia (year 1960)	(1)	(1)	60.43	----------	24.74	13.92	.91	100.00	[7] 45.00
Costa Rica (year 1960)	(1)	(1)	12.96	5.10	75.02	6.67	.25	100.00	30.00
Guatemala (year ended June 30, 1960)	8.04	----------	8.04	----------	80.91	10.17	.88	100.00	30.00
Mexico (year 1960)	(1)	(1)	34.39	10.44	51.81	2.30	1.06	100.00	[8] 52.00
Panama (year 1960)	(1)	(1)	23.76	7.15	48.75	20.34	----------	100.00	34.00
Peru (year 1958)	35.43	16.00	51.43	----------	45.72	2.85	----------	100.00	35.00
Venezuela (year 1959)	(1)	(1)	55.06	----------	44.94	----------	----------	100.00	45.00
Average for those countries for which detail is available	21.74	8.00	35.24	5.29	50.47	8.61	.39	100.00	39.13

Far East:									
Australia (year ended June 30, 1960)	18.16	34.98	53.14	13.02	26.71	1.28	5.85	100.00	40.00
Philippines (year ended June 30, 1960)	28.65	17.23	45.88	14.61	38.20	.94	.37	100.00	30.00
New Zealand (year ended March 31, 1960)	(1)	(1)	58.85	8.16	25.47	4.15	3.37	100.00	50.00
India (year ended March 31, 1961)	20.24	5.96	26.20	----	72.35	1.45	----	100.00	45.00
Japan (year ended March 31, 1960)	36.31	23.16	59.47	----	35.86	.72	3.95	100.00	50.00
Thailand (year 1960)	4.96	6.02	10.98	33.24	50.18	5.60	----	100.00	25.00
Malaya (year 1960)	(1)	(1)	23.06	----	70.39	6.55	----	100.00	40.00
Average for those countries for which detail is availalbe	21.66	17.47	39.65	9.86	45.59	2.95	1.95	100.00	40.00
Canada (year ended March 31, 1960)	24.05	34.51	58.56	15.45	24.14	1.85	----	100.00	50.00
Union of South Africa (year ended March 31, 1961)	33.92	15.02	48.94	13.18	32.97	4.91	----	100.00	35.00
Average for those foreign countries for which detail is available	17.37	18.78	36.88	14.68	38.37	7.17	2.90	100.00	42.85

[1] Detail not available.

[2] Corporate income tax rate assuming no distribution of profits. With 50 percent distribution rate would approximate 34 percent, with 100 percent distribution rate would approximate 28.5 percent.

[3] Corporate income tax rate assuming no distribution of profits. With 50 percent distribution rate would approximate 50 percent, with 100 percent distribution rate would approximate 38 percent.

[4] Includes approximately 8 percent for excess profits tax levied at 15 percent on profits in excess of 6 percent of capital and certain reserves.

[5] Federal income tax of 8 percent plus 25 percent income tax (approximately) for cantons.

[6] Includes approximately 9 percent for excess profits tax levied at rates of 10-30 percent on profits in excess of 12 percent of capital and certain reserves.

[7] Includes approximately 9 percent for excess profits tax levied at rate of 20-56 percent on profits in excess of 12 percent of capital and certain reserves.

[8] Approximate combined income, excess profits and distributable profits taxes.

Schedule II

Schedule showing actual additional U.S. income tax impact of "gross-up" on full dividend distributions by showing percentage point increase in U.S. income tax country by country

Country	Grossed-up dividend (income before foreign tax)	Foreign income taxes (including State and local)	Income available for dividend	Foreign withholding tax on dividend		U.S. tax on dividend before gross up			U.S. tax on dividend after gross up			Percentage point increase in U.S. tax
				Rate	Amount	Taxable at 52 percent	Less foreign tax credit	Net U.S. tax	Taxable at 52 percent	Less foreign tax credit	Net U.S. tax	
				Percent								
Western Europe:												
Austria	100	52.0	48	5	2.4	25.0	27.4	----------	52	54.4	----------	----------
Belgium	100	28.5	71.5	31.50	22.5	37.2	42.9	----------	52	51.0	1.0	1.0
Netherlands	100	47.0	53.0	----------	----------	27.6	24.9	2.7	52	47.0	5.0	2.3
Denmark	100	44.0	56.0	----------	----------	29.1	24.6	4.5	52	44.0	8.0	3.5
Finland	100	50.5	49.5	5	2.5	25.7	27.5	----------	52	53.0	----------	----------
France	100	50.0	50.0	15	7.5	26.0	32.5	----------	52	57.5	----------	----------
Germany	100	38.0	62.0	15	9.3	32.2	32.9	----------	52	47.3	----------	(2)
Great Britain	100	53.75	46.25	----------	----------	24.05	24.86	----------	52	53.75	----------	----------
Ireland	100	40.0	60.0	----------	----------	31.2	24.0	7.2	52	40.0	12.0	4.8
Italy	100	37.0	63.0	----------	----------	32.8	23.3	9.5	52	37.0	15.0	5.5
Norway	100	59.5	40.5	5	2.0	21.1	26.1	----------	52	61.5	----------	----------
Spain	100	37.5	62.5	15	9.4	32.5	32.8	----------	52	46.9	5.1	5.1
Sweden	100	48.0	52.0	10	5.2	27.0	30.2	----------	52	53.2	----------	----------
Switzerland	100	33.0	67.0	5	3.3	34.8	25.4	9.4	52	36.3	15.7	6.3
Average of Western Europe countries (14 countries)	100	44.2	55.8	8.06	4.5	29.0	28.5	2.4	52	48.8	4.4	[3] 2.0
Latin America:												
Argentina	100	42.0	58.0	8	4.6	30.2	29.0	1.2	52	46.6	5.4	4.2
Brazil [1]	100	30.0	70.0	25	17.5	36.4	38.5	----------	52	47.5	4.5	4.5
Chile	100	25.0	75.0	25	18.75	39.0	37.5	1.5	52	43.75	8.25	6.75
Colombia	100	45.0	55.0	12	6.6	28.6	31.3	----------	52	51.6	.4	.4
Costa Rica	100	30.0	70.0	20	14.0	36.4	35.0	1.4	52	44.0	8.0	6.6
Guatemala	100	30.0	70.0	----------	----------	36.4	21.0	15.4	52	30.0	22.0	6.6
Mexico	100	52.0	48.0	----------	----------	25.0	25.0	----------	52	52.0	----------	----------
Panama	100	34.0	66.0	----------	----------	34.3	22.4	11.9	52	34.0	18.0	6.1
Peru	100	35.0	65.0	20	13.0	33.8	35.8	----------	52	48.0	4.0	4.0
Venezuela	100	40.0	60.0	----------	----------	31.2	24.0	7.2	52	40.0	12.0	4.8

Average of Latin America countries (10 countries)	100	36.3	63.7	11.77	7.5	33.1	30.0	3.9	52	43.8	8.3	4.4
Far East:												
Australia[a]	100	40.0	60.0	15	9.0	31.2	33.0	----	52	49.0	3.0	3.0
Philippines	100	30.0	70.0	30	21.0	36.4	42.0	----	52	51.0	1.0	1.0
New Zealand[a]	100	50.0	50.0	----	----	26.0	25.0	1.0	52	50.0	2.0	1.0
India	100	45.0	55.0	20	11.0	28.6	35.8	----	52	56.0	----	----
Japan[a]	100	50.0	50.0	----	----	26.0	25.0	1.0	52	50.0	2.0	1.0
Thailand	100	25.0	75.0	----	----	39.0	18.75	20.25	52	25.0	27.0	6.75
Malaya	100	40.0	60.0	----	----	31.2	24.0	7.2	52	40.0	12.0	4.8
Average Far East (7 countries)	100	40.0	60.0	10	6.0	31.2	29.1	4.2	52	46.0	6.7	2.5
[a]Developed countries (3 countries)	100	46.7	53.3	5.63	3.0	27.7	27.7	.7	52	49.7	2.4	1.7
Underdeveloped countries	100	35.0	65.0	12.30	8.0	33.8	30.1	6.9	52	43.0	10.0	3.1
Canada	100	50.0	50.0	15	7.5	26.0	32.5	----	52	57.5	----	----
Union of South Africa	100	35.0	65.0	7.5	4.9	33.8	27.6	6.2	52	39.9	12.1	5.9

[1] Foreign tax rate of 30 percent includes 23 percent income tax and 7 percent for excess profits tax levied at 20–50 percent on profits in excess of base amounts.

[2] In the case of Germany a dividend distribution in excess of approximately 75 percent is necessary in order for any additional U.S. tax to result from the "gross-up" principle; therefore, no increase in U.S. tax is shown for Germany.

[3] As adjusted for 75-percent distribution in Germany.

APPENDIX II

INTERNATIONAL TELEPHONE & TELEGRAPH CORP.

Foreign system operations, year 1960—combined foreign income taxes and other taxes on ITT foreign subsidaries showing total foreign tax rate burden placed on unrepatriated income before any tax levies on income

[In percent]

Company and country	Taxable income before deduction for foreign income taxes and before deduction for other taxes not recognized as U.S. tax credits	Foreign income taxes [1]		Levies on income of types not recognized as U.S. tax credits expressed as a percent of column 1					Total foreign tax burden placed on income per column 1 (3+8)
		(A) Statutory rates on income after deduction of levies on income of types not recognized for U.S. tax credit	(B) Effective rate on taxable income before any tax deduction (other than payroll and property taxes)	Turnover production and sales taxes	Taxes on capital	Stamp taxes	Miscellaneous	Total (4, 5, 6, 7)	
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Europe:									
London: England	100	51	37						37
Creed: England	100	51	51						51
Antwerp: Belgium	100	30	20	6	1		2	9	29
Hague: Netherlands	100	47	36	22				22	58
CGCT: France	100	50	20	56			2	58	78
LMT: France	100	50	19	61	1		1	63	82
LCT: France	100	50	16	62				62	78
Stuttgart: Germany	100	66	55	3	4	1	2	10	65
Lisbon: Portugal	100	42	42			1		1	43
Madrid: Spain	100	37	28	18	6	1	2	27	55
Crame: Spain	100	37	33		6			6	39
Milan: Italy	100	43	36	20	3			23	59
Zurich: Switzerland	100	36	32						32
STK-Oslo: Norway	100	60	59		2			2	61
Stockholm: Sweden	100	48	40	10				10	50
Helsinki: Finland	100	52	52	7				7	59
Copenhagen: Denmark	100	44	35			2		2	37

Latin America:									
Buenos Aires: Argentina	100	[2] 33	28	21	3	3	4	31	59
CIDRA: Argentina	100	[2] 33	18	------	3	1	15	19	37
Radio: Brazil	100	[2] 23	20	25	------	------	3	28	48
Standard: Chile	100	25	35	3	------	7	------	10	45
Radio: Chile	100	25	24	------	------	1	------	1	25
Chiltelco: Chile	100	28	26	------	------	2	1	3	29
Standard: Mexico	100	46	42	------	------	------	20	20	62
Perutelco: Peru	100	37	33	7	------	------	3	10	43
Ricotelco: Puerto Rico	100	37	31	7	------	------	------	7	38
Radio: Puerto Rico	100	37	36	------	------	------	------	------	36
Far East: Sydney—Australia	100	35–40	29	------	------	2	------	2	31
Canada: ITTESCO	100	21–50	21	------	3	------	------	3	24

[1] The taxes shown in col. A and in col. B are the same taxes, the 2 different rates reflecting the respective premises described at the head of each of these columns.

[2] Excluding excess-profits taxes at sliding scales.

APPENDIX III

INTERNATIONAL TELEPHONE & TELEGRAPH CORP.

Foreign system operations, year 1960—Effect of proposed legislation on unrepatriated foreign subsidiary earnings showing comparison to foreign competitor rates on same and total resulting burden of income taxation

[In percent]

Company and country	Foreign income taxes on unrepatriated earnings; percentages based on income after all other taxes levied on income; percentage points of tax (1)	Competitive disadvantage with local companies; percentages of additional tax on unrepatriated earnings caused by proposed legislation on U.S. owned foreign subsidiaries; percentage points of tax (2)	Percentage penalty over local competitor taxation rates imposed on U.S. foreign subsidiaries (2÷1) (3)
Europe:			
London, England	37	15	41
Creed, England	51	1	2
Antwerp, Belgium	24	28	117
Hague, Netherlands	46	6	13
CGCT, France	49	3	6
LMT, France	50	2	4
LCT, France	42	10	24
Stuttgart, Germany	63	(11)	(17)
Lisbon, Portugal	42	10	24
Madrid, Spain	39	13	33
CRAME, Spain	35	17	49
Milan, Italy	47	5	11
Zurich, Switzerland	32	20	63
STK-Oslo, Norway	60	(8)	(13)
Stockholm, Sweden	45	7	16
Helsinki, Finland	56	(4)	(7)
Copenhagen, Denmark	35	17	49
Latin America:			
Buenos Aires, Argentina	42	(1)	(1)
CIDRA, Argentina	22	(1)	(1)
Radio, Brazil	27	(1)	(1)
Standard, Chile	39	(1)	(1)
Radio, Chile	24	(1)	(1)
Chiltelco, Chile	27	(1)	(1)
Standard, Mexico	52	(1)	(1)
Perutelco, Peru	37	(1)	(1)
Ricotelco, Puerto Rico	33	(1)	(1)
Radio, Puerto Rico	36	(1)	(1)
Far East: Sydney, Australia	29	23	79
Canada: ITTESCO	21	31	148

[1] Not applicable.

[From the New York Herald Tribune, Apr. 13, 1962]

NEW U.S. WORRY—LOW INTEREST

(By Ben Weberman)

The Nation's money managers at the Treasury and the Federal Reserve System have shifted their interest in balance-of-payments developments to international flows of capital and credit and away from the structural problems of trade and investment. The view is held that solid progress has been made toward improvement of the balance of trade and that even the Government-aid expenditures have been contained in reasonable limits.

There is fear, however, that low interest rates here, which are designed to encourage domestic business activity, may also attract numerous foreign governments and corporations to the New York market.

The sagging Wall Street stock market may also encourage investors who are fearful of further declines to place their funds in foreign securities through purchases on foreign markets or by acquisition of American depository receipts.

Net purchases of foreign securities by American residents, including bond issues floated here, new stock issues sold here and direct buying abroad, aggregated almost $200 million in the first 2 months of this year and the pace has not slowed in the following month and a half, it was learned.

New Zealand filed a registration statement yesterday with the Securities and Exchange Commission covering proposed sale here of $25 million, 25-year bonds to be marketed May 9 through a group headed by Kidder, Peabody & Co.

The Japan Fund, Inc., registration statement became effective yesterday and 1,250,000 shares of common were offered to the public here at $12.50 a share through Bache & Co., Paine, Webber, Jackson & Curtis and Nikko Securities Co., Ltd. The $15.6 million offering is a bit smaller than was originally planned, with the registration statement having offered 2.2 million shares.

A rather large amount of funds may flow out of this country when Philips Lamp makes its stockholder offering soon.

The fight on this outflow can not be waged on an interest-rate basis because of domestic problems, but must be made through international central-bank cooperation.

Germans are being encouraged to invest abroad and yesterday Italy abolished the limit on the maximum amount of foreign bonds and stocks that Italian companies may hold. It had been 20 percent of capital and reserves.

The move by the Inter-American Development Bank to raise money in Italy ($24 million, which will be spent in Latin America) and in other European financial centers also will contribute in some measure to correction of the adverse balance of capital flows.

The bond market was quite strong yesterday—particularly after stock prices started to sag. Most corporate issues gained ⅛ to ¼ point.

A new offering of $6 million Mississippi Power Co. first mortgage bonds is being made through Merrill Lynch, Pierce, Fenner & Smith, Inc., at 101.656 with a 4½ percent coupon to yield 4.4 percent. The 30-year, first-mortgage bonds were won on a bid of 100.8079. Initial reception is expected to move almost 70 percent of the total.

U.S. Treasury issues were unchanged to 2/32 higher. Bills were particularly strong. The new 3¾s of 1968 closed at 100 1/32 bid and were active.

Dealers will be watching investor action today because purchases today will be settled on Monday when cash is received by institutions which turned in maturing 1-year bills.

Another one to watch is the $180 million Federal Land Banks offering of 4 percent bonds to be dated May 1 and to mature May 22, 1967. Pricing will be set Wednesday for offering Thursday, John T. Knox, fiscal agent, and a nationwide group of dealers will make the offering.

Producers Cotton Oil Co. placed on the market 200,000 shares of common at $14 a share through Kidder, Peabody & Co., Inc., and Dean Witter & Co. The company will use proceeds to acquire additional cotton-producing lands. Profit was $1,393,000, or $1.68 a share, in the 8 months to February 28.

[From the New York Times, Apr. 4, 1962]

FINANCING SLATED BY PHILIPS LAMP—MOST OF MULTIMILLION-DOLLAR OFFERING OF COMMON TO BE EXECUTED IN UNITED STATES—6,153,140 SHARES DUE

MARKET VALUE OF THE STOCK ABOUT $400 MILLION, BUT A DISCOUNT IS EXPECTED

Philips Lamp of the Netherlands made known yesterday plans for a multimillion-dollar equity financing. Most of the offering will be executed in the U.S. market.

The Dutch company is widely held by U.S. investors.

The offering will take the form of an offering to shareholders of 6,153,140 common shares of Philips, N.V., a financial management concern that owns 99.96 percent of Philips Industries.

Philips Industries produces television and radio sets, electronic tubes, electric lamps, pharmaceuticals and other products. It has factories in the Netherlands and 29 other countries. World sales last year exceeded $1,300 million.

The dollar aggregate of the financing was not formally designated in a registration statement that was filed yesterday with the Securities and Exchange Commission.

It was said in Wall Street that the offering would be the biggest here by a European enterprise since Royal Dutch Petroleum Co. shares priced at $228,068,550 were marketed in 1958.

Discount is expected

If priced at current market value, the Philips N.V. share offering would total about $400 million. However, the Philips shares are expected to be offered for shareholder subscription at a sizable discount from market value, in keeping with the practice in Europe.

Philips is selling at about 800 percent of par value, and there is much resistance abroad to offering new shares at a price far above the par value. Adjusted for a pending stock split, the Philips, N.V. shares have had a price range in the over-the-counter market this year of 69⅝ to 62⅞.

The offering is not being underwritten. It will be managed in the United States by Smith, Barney & Co., which will form a group of investment dealers to solicit subscriptions.

Company shareholders will get rights to subscribe to the new stock on the basis of one new share for each five shares held.

European manager

The Rotteramsche Bank, N.V. of the Netherlands will be manager of the overall offering and of the European subscription agents, but will not participate in the solicitation or offering in the United States. Burnham & Co., a participating dealer here, will act as agent abroad for the U.S. soliciting group.

Philips has called a special stockholders' meeting for April 19 to approve a 2-for-1 split of its common shares to a par value of 25 guilders. (A guilder equals about 26 cents.)

Philips, N.V., is known in the Netherlands as N.V. Gemeenschappelijk Bezit van Aandeelen Philips' Gloeilampenfabrieken. It has no business other than administering the shares of the wholly owned subsidary, Philips Industries (N.V. Philips Gloeilampenfabrieken).

The management company owns 99.96 percent of the common shares and 99.76 percent of the preferred shares of Philips Industries. The articles of corporate association require that Philips Industries must issue and sell shares only to Philips N.V., and that neither Philips' N.V., nor Philips Industries may issue additional shares unless both issue the same number and class of shares simultaneously. Philips Industries will receive the net proceeds from the sale of its parent's shares and will use the money for working capital and expansion.

[From the New York Times, Apr. 20, 1962]

INVESTMENT COMPANY LOOKS TO JAPANESE STOCKS

Financing for the Japan Fund, Inc., was completed yesterday when the managing underwriters handed over a check for $14,250,000 to managers of the new closed-end investment company. The check represented net proceeds from the sale of 1,250,000 shares of common stock. The offering was made on April 12 by a group headed by Bache & Co., Paine, Webber, Jackson & Curtis, and the Nikko Securities Co., Ltd. Closing ceremonies were held at First National City Bank, which acts as transfer agent.

Japan Fund is described as the first closed-end investment company in this country that will invest primarily in common shares of Japanese companies. Plans are to invest at least 80 percent of assets in Japanese securities. The rest will be in additional securities or cash. Nikko will act as investment advisers. The new company was incorporated in Maryland.

Senator SMATHERS. Senator Curtis, do you have any questions?

Senator CURTIS. A few questions.

The Financial Journal has said that about 37 percent of the shareholders in the Philips Co. are citizens of this country, residents of the United States.

Mr. GENEEN. That is correct. That is the figure I have seen, Senator.

Senator CURTIS. Now, section 13, if it is enacted into law, will those holders of shares in Philips have a more favorable tax position than shareholders in your company, if you operate a competitive company with Philips?

Mr. GENEEN. The answer is "Yes." They already hold a more favorable position. There is no tax or withholding on any direct foreign dividends, for example, of Philips coming into the United States. The money which we bring into the United States to pay our dividends is already taxed under our rules on repatriated earnings.

It will be increasingly taxed under the gross-up formula, and, as I have said before, just coming to the withholding provisions which were discussed this morning, there are no foreign withholding taxes on dividends Philips pay to U.S. shareholders, as there are on our own, as well as no U.S. information returns.

Senator CURTIS. Would section 13 make the situation——

Mr. GENEEN. I want to move on further. That is with relation to the shareholder himself.

With relation to the equity value of his shares, obviously, these foreign people will be operating, as I have said before, with complete competitive freedom from these provisions.

Now, as a matter of fact, Philips, which is based in Holland, is probably the largest company in Europe of its type, much larger than we are, pays no tax under the Dutch laws on even repatriated earnings, let alone unrepatriated earnings, and, in addition to that, I would say it has many other particular advantages; particularly if we were to enact this legislation, it would be entirely free of these many things which I have pointed to, which would be a handicap to an operating company and which are contained in sections 13 and 16.

Senator CURTIS. The enactment, then, of sections 13 and 16 might tend to speed up investment by U.S. investors in foreign companies and slow it down in our own companies?

Mr. GENEEN. It would certainly add an additional incentive, and since the basis of this bill seems to be a type of capital licensing, it is obvious we have not attempted to put any type of restraint on our foreign portfolio investments.

Now, actually, to do anything of that sort would lead you to the comments made by the Secretary that you would be into a licensing situation. If this incentive becomes large enough, and the disparity between the treatment of U.S.-owned foreign operations abroad competitively becomes more difficult as a result of enactment of law, this trend will be accelerated, and may well force us to such a licensing.

Senator CURTIS. If ITT reincorporated in the Netherlands, it would avoid section 13, would it not?

Mr. GENEEN. Well, I will be a little facetious. I presented this one day to one of the members of the Treasury Department and after going over this problem and looking at what we had done, the best answer I got back is that we should have been a foreign company.

But I do not agree with that.

We kicked in here, as I have shown, something like almost $400 million worth of net contributions to the balance of payments of this country in the last 10 years, and I think we are entitled to fair handling.

Senator CURTIS. How many employees do you have in this country?

Mr. GENEEN. 20,000, sir, and those are companies which—there is a reason for us being an offshore company to the degree we are. Back in the 1920's the offshore properties of Western Electric for various reasons at that time were divested, and this became the nucleus of our operations. So we have been developing our U.S. operations out of foreign tax-paid earnings. We have done the same in Latin America and the same in the rest of the world.

As I said in my comments here, we have created 15,000 jobs in Latin America without subsidy or aid.

Senator CURTIS. Would you have these same jobs here if it were not for the foreign operations?

Mr. GENEEN. Certainly not. I can say that our capital is brought back here for us to do this with, and we have pressed as hard as we can to expand here.

There are certain natural advantages which we have in operating abroad which are not open to competition from here. I might say that it is quite clear that in many of these countries you must have local manufacture. A great share of our markets are to the governments of those countries themselves which could not be filled from here.

There are other bases of competition which represent products which can only be manufactured and sold from there.

Now, the extent that they can be made and sold from here, we would be trying to do that in the areas that we are experienced in and could do so.

Obviously, there are much more well-financed and sound companies in the United States if you were going to initiate entirely new lines with which we are not familiar.

Senator CURTIS. To put it another way, do the foreign operations cut down the number of employees you have in this country?

Mr. GENEEN. No, absolutely not.

I gave a figure of $175 million of exports that we had created in the last 10 years out of our companies here—I mean from the United States to abroad. Well, over three-quarters, or 80 percent of that we can trace directly to our own company as being the source of the orders.

I would say that in that same period—I have not got an exact figure—I would doubt if our imports during that period would have added up to $25 million, and considering that we have done abroad in that period somewhere in the order of $3 to $4 billion worth of business, you can see that we are not taking any jobs by this process. We are contributing.

Senator CURTIS. To the extent your exports exceed your imports, you are providing jobs?

Mr. GENEEN. Oh, yes: providing jobs.

I thought you meant the other way, through income repatriation to the United States.

Senator CURTIS. Now, in what States does ITT have plants, sir?

Mr. GENEEN. Well, I will have them checked out; those in my mind are Illinois, Mississippi, Tennessee, New Jersey, California, North Carolina, Massachusetts, New York. Perhaps I have skipped some.

Senator CURTIS. Indiana?

Mr. GENEEN. We have two large ones there.

(The following was later supplied for the record:)

ITT has plants, laboratories, operations, and offices in all 50 States; and major plants in addition to those named in Virginia, Missouri, and Rhode Island and another under construction in Nebraska.

Senator CURTIS. Have you computed how much this proposed tax bill would cost ITT?

Mr. GENEEN. We have not because it is very difficult to determine what the cost of it will be. If I look at section 13, there is not only the question—let me move down to some of these areas—there is not only the question of the sharp increase in taxes that I have referred to here. There are all of the questions of the interplay of section 13.

Many of the areas that we get into there where we have used normal methods of renting equipment, using finance approaches for consumer uses, all of these are not limited to any one country, because this becomes a bill now against certain methods of operating.

My point, which I raised before, is, we are not a tax-haven company. We are a large international company operating almost in the public benefit, and to begin to apply all of these kinds of regulations in here, plus the cost of administration, I could not tell you what this will cost us.

Now, I will move over into another direction which gets into the competitive area.

Apart from the fact it will cost us this money competitively, I have no understanding whatsoever at this moment as to what our relations will be with the governments that we serve in each of these countries, remembering that we are a foreign company operating in each of these countries, selling over half our output to the governments of those countries.

And now we are to become a company which has been singled out for perhaps discriminatory tax treatment by those governments, and, as a result, we will probably have to—because we will have withholding tax liens on most of our earnings—pay out a very substantial part of our dividends, even if we have to repatriate them back there again.

What this will do with our relations with those governments, I could not compute.

What the effect of this discriminatory retaliation will have with our governments in Europe, I cannot tell you. Certainly it does not add to our competitive strength.

Senator CURTIS. Since the proposed tax is to be placed on the U.S. shareholders and not on the controlled foreign corporation itself, how can you say that the foreign subsidiary will be hurt competitively?

Mr. GENEEN. This is a very fine euphemism that does not really apply. I have to draw these funds from somewhere to pay the tax and to pay the dividend.

Now, if I have a tax which is applied, in effect, measured by my earnings if you will, in any one of these countries, as I see it, that money is the difference between the foreign tax rate and 52 percent is what is proposed to be taxed by this law.

Now, wherever, for example, I have a foreign withholding tax, I have a secondary lien on those earnings, and the only way I can discharge that lien is to take those earnings out of that country over to the United States. Then what I have left is subject to U.S. tax.

So I am not going to be able to sit back here and just apply this on the overall company.

Senator CURTIS. It is not as simple as just increasing the rate——

Mr. GENEEN. I think it is more subtle than that. You have got a whole organization consisting of people and management, and it is not possible to conceal from them or their governments and the customers or competitors the fact that you are, basically speaking, stripping your earnings out of these countries on the basis of some type of repatriation entirely beyond the normal requirements of a good operating requirement in that country. I think you would get all kinds of pressures.

Senator CURTIS. Representatives of the Treasury Department told us that they do not regard U.S. direct ownership of European corporations as necessary in the public interest. Can you give us specific reasons why the United States should continue to own direct subsidiaries in Europe?

Mr. GENEEN. Well, I think I have given some in my testimony, Senator Curtis.

I have pointed out that we have contributed $190 million in net payments to the U.S. balance of payments; that we have contributed $175 million in exports net; that we have created 20,000 jobs and paid $1 billion in wages. I think these are pretty good reasons. But I would go beyond that.

There is a great deal in the way of exports, prestige, power, strength, that come out of our ownership and control of these companies.

As a minor example, we buy some $30 million of copper and lead a year. This is an international commodity. We can buy it from companies or countries which are somewhat within the sphere of those things that we are interested in.

Certainly you could hardly say that the ownership or control of these companies does not bring with it strength that can be applied entirely beyond even these which I have mentioned, which are quite considerable.

Senator CURTIS. Now, if this bill is enacted, what effect will it have on our existing ownership of subsidiary corporations?

Mr. GENEEN. This is a very hard question to answer. Obviously, to the extent it makes us noncompetitive, we begin to be worth more dead than alive, or, to put it differently, we are worth more to a foreign owner than we are to an American owner. It is pretty hard to say what the effect will be.

I have one specific case in my mind as I speak. It is a rather odd one.

We own 51 percent of our subsidiary in Italy. Now, you tell me how much local pressure I am going to receive from, you might say, the minority group in that company as to relinquishing control for no other reason than a discriminatory sort of tax which would be applied to them, as well as us, for the median of 2 percent of the stock.

Senator CURTIS. That is all, Mr. Chairman.

Senator SMATHERS. Senator Douglas, do you have any questions?

Senator DOUGLAS. No.

Senator SMATHERS. Mr. Geneen, you have said that section 13 of this proposed bill, if enacted, will create a straitjacket as far as your company and other foreign subsidiary companies are concerned.

Would you elaborate on that?

Mr. GENEEN. Yes, I would, because, while it is intended apparently to get at tax haven-type companies, certainly not companies of the size and nature of operations of our own, it does create some tremendous problems for an operating company. Let me just pick out a few.

I have named a couple in the testimony. Let me add one I have not named.

For example, it says that all of our profits for the year must be committed in the form of new investments, which, generally speaking, very often means plant, fixtures, and equipment, by December 31 of that year. Otherwise, it will be thrown into the category as tax-haven income.

This is a completely unworkable concept, however it got into the bill.

Again, the question of what is a new product, and how can we move from one area to another, and who do we get permission from and how do we operate under these circumstances—these are operating questions which give great problems.

The question of how we can manage our business, particularly with the growing Common Market, where you would, normally speaking, make new products or components in one area and ship to another.

This is the way we do in the United States in a large market and which we shall be free to do so under this.

Under the rules, as we have them now, new products or components moving from one country to another which happen to move into an assembly that goes out into export or something, then you have the problem of trying to devise some kind of method of measurement of some infinitesimal amount of "nonqualified" movements and how many of them are items which become under this section 13 "tax-haven" areas.

I mean it is obviously not intended this way, but that is the way it is written.

Just some very simple areas of rentals for equipment, which is quite normal as a marketing problem, nothing to do with tax havens, all of this, as I have mentioned, is automatically thrown into a tax-haven area and becomes again a problem of how to operate. The same is true of finance companies which are legitimate marketing procedures.

I have mentioned in section 16, these mergers. For example, in consolidation of the TV industry, which has taken place in many appliance fields, it has been necessary for many companies to merge companies and pull them together to create a continuing marketing share against the increasing competition.

Under section 16 of this bill, which is also part of the same problem, all of this would immediately be taxable as ordinary income, not even capital gains.

It seems to include mergers and transfers as well as sales. A very recent case we had where we needed, for example, a machine shop in one of our countries in Europe in order to develop some automation equipment and stay competitive with our major competition.

We acquired this company through an acquisition in the manner of exchange of stock. All of these things seem to be areas where normal operating companies must have freedom to work, if they are going to operate in this manner.

Now, you might say that beyond that we are going to get other kinds of problems which are more difficult to define but which, as a manager, you will recognize immediately.

If the United States is going to pull out from support of these companies and is going to actually discriminatorily tax them in relation to their own competition, it becomes increasingly clear to the people whom you are competing with that you are working against some kind of an uphill situation.

As a result, for engineers, management people, all kinds of things become more difficult for an operating company, and, remember, we are already a foreign company operating in a foreign land. This is not an easy problem, to start with.

Senator SMATHERS. You referred in your statement to the fact that the tax bill is a form of capital rationing through taxation.

Do you think it would be better or worse to deal with this situation through direct licensing rather than through taxation?

Mr. GENEEN. Well, if you go down the chain of reasons for these provisions, I have already addressed myself to the tax-haven area and made it quite clear the type of company we are and the size and manner we have operated.

We have never used them, and I do not think any large or public companies are doing this. We are not talking about tax havens.

If there is some problem of, as somebody also would put it, "catching the rats without burning the barn down," that is the kind of a problem for which a solution is needed.

On the other hand, when you get over to the question of the indirect type of licensing control which seems to be the only basis for this bill at the moment, since there is very little revenue—I predict dwindling revenues involved—it seems to hit at the companies who are already overseas, who are already supporting and sending back substantial contributions to the balance of payments, as our own statements will show, and the man who is going over there currently and probably will have no revenues to even talk about for a year or two until he gets set, he is not bothered at all by it until he begins earning.

So here is a type of indirect licensing that does just the contrary of what I would think would be required in the sense of preventing capital from going abroad and, at the same time, making noncompetitive that capital which is contributing from abroad.

Now, I think the consequences of this kind of a bill could well force, as I have pointed out, a major switch of investors. You should not legislate an investor into direct foreign ownership. If this happens, you will be forced into some kind of licensing to prevent the kind of portfolio investment which is increasing. I think, by the same token, that the advent of such licensing would be a very major catastrophe from the standpoint of the confidence in our dollar.

So I am not recommending it.

I think there are a great many other things we should be doing, and I would coin a very simple comment. I have this headline here "$400 Million for Philips". I would assume that somewhere somebody is busy finding out what these foreign countries are going to do in supporting some of these things which are creating this balance of payments problem rather than killing off these good commercial beachheads that we have.

I would say, without recommending that, that we would be better handled under such a licensing agreement because there you can sift out those things which are important to the national interest against those which are not.

But I recognize the difficulties that this would lead us to, Senator.

Senator SMATHERS. You have many simple recommendations, Mr. Geneen.

Recognizing that there are such things as tax havens, and your company is not one that takes advantage of them and is not the basis of our complaint, how do we get at these people who do use the present tax laws with respect to oversea operations as tax havens and not hurt or injure legitimate companies, like yours, for example, that returns a net balance of payments to the United States?

Mr. GENEEN. Well, I think if our purpose were only to get at tax havens, this might not be so difficult. It has been said by a number of people who are more informed than I that there already exists ample provisions in the law, the revenue code, to handle that situation.

I must say that in support of this I know of no situation in Europe or any other developed country which has found it necessary to tax repatriated earnings as the only solution to the tax haven problem.

But what I am afraid we will keep running into is a combination of tax haven interest tied up with this balance of payments licensing problem, and then, when you try to put these two things together, you begin to get the balance of payments problem I was speaking of.

As I pointed out in the case of my company—and I think this would go for all of our large international companies—you can hardly have a tax haven company that reports its earnings and remits regularly a substantial part of its money.

As I said, we should be almost encouraged to do anything to avoid foreign taxes, increase our income that we send back here. But then, when you get to these areas which are troublesome, which are unpleasant, and, when they are uncovered, and which give rise to a great deal of concern, I think that you are dealing with an entirely different kind of a problem.

And I think you will find that all of the large industries are entirely behind any necessary legislation that would be put forward for that purpose.

But I do not think that this legislation, as we have it proposed here, like section 13, is actually aimed at tax havens. It seems to be aimed at something much broader than that, approaching the taxation of unrepatriated earnings.

Senator SMATHERS. You operate in several of what probably would be described as the less developed countries. Is it true under the bill that income from U.S. developed patents, even when derived from less developed countries, is taxed to the U.S. shareholders?

Mr. GENEEN. If I understand your question correctly, Senator, you are saying is income from underdeveloped countries taxed when it is repatriated to the United States?

Senator SMATHERS. No.

Where the income in the less developed countries is derived from a patent, so to speak?

Mr. GENEEN. Oh, the patent?

Senator SMATHERS. Yes, are you familiar with the patents?

Mr. GENEEN. I am not clear on that one, frankly. That is a question of whether—I am sure of one thing. All income that is derived abroad and brought in the United States under present rules is taxed.

Senator SMATHERS. Let me put it this way.

It is my understanding that, while we have a provision in the bill which says that the foreign tax provisions would not apply in certain respects to less developed countries, nevertheless, in a less developed country where a business is operating, if the income which it derives is derived by virtue of some patent that had been granted in the United States originally, then the exemption to the less developed countries is no longer allowed.

Mr. GENEEN. I am not completely clear on that, but I think that all of section 13, which would include that, does not apply in the underdeveloped countries.

That is my understanding.

Senator SMATHERS. That is right.

It does not apply unless you get the principle of patents involved.

Mr. GENEEN. Yes. It is correct that income from patents and processes in the less developed countries would be subject to section 13.

Senator SMATHERS. Anyway, I will not pursue that at this time.

If there are no other questions of Mr. Geneen—Senator Douglas?

Senator DOUGLAS. May I ask, sir, if any of your foreign subsidiaries are incorporated in Switzerland?

Mr. GENEEN. Yes. We have a company in Switzerland, Senator. It has been there for about 40 years. We make about 35 percent of the telephone equipment that is used in Switzerland. It is a hardworking manufacturing company complete with machinery, salesmen, manufacturing, and engineers.

It is not a tax haven.

Senator DOUGLAS. In which cantons are they incorporated?

Mr. GENEEN. This happens to be in Zurich because that is where the plant is.

Senator DOUGLAS. Both in the canton?

Mr. GENEEN. I think it is in the canton in Zurich. I could not be sure on that.

Senator DOUGLAS. Do you have any in Italy?

Mr. GENEEN. No.

Senator DOUGLAS. Or in the Bahamas?

Mr. GENEEN. We have one company in the Bahamas. I will say simply it has a loss in it. It was formed simply for the purpose of the work we are doing in Puerto Rico. It seemed more preferable to have an offshore company do the job.

Senator DOUGLAS. Do you have any companies incorporated in the Virgin Islands?

Mr. GENEEN. No. We run the telephone company there. I should say yes to that. We do. We run the Virgin Islands Telephone Co. down there, a complete operating entity.

Senator DOUGLAS. Would you tell me about the Bahamas? Do they have a corporate tax in the Bahamas?

Mr. GENEEN. The corporate tax is low there, but that was not our particular reason.

Senator DOUGLAS. I understand.

Mr. GENEEN. The administration costs—I believe they do—the administration costs for our particular purpose were very low, no filing fees, very low and so on.

Senator DOUGLAS. Virtually no corporation taxes?

Mr. GENEEN. That is correct.

Senator DOUGLAS. Is there a personal income tax there?

Mr. GENEEN. I do not know. I do not think we have anybody drawing their salaries as a resident of the Bahamas.

Senator SMATHERS. All right, sir, thank you very much, Mr. Geneen.

Mr. GENEEN. Thank you, sir.

Senator SMATHERS. The next scheduled witness is Mr. G. R. Collins, National Constructors Association.

STATEMENT OF G. R. COLLINS, VICE PRESIDENT OF THE LUMMUS CO., AND PRESIDENT OF THE NATIONAL CONSTRUCTORS ASSOCIATION; ACCOMPANIED BY JOSEPH J. GIBBONS, ASSISTANT TREASURER, BLAW-KNOX CO.

Mr. COLLINS. Mr. Chairman and members of the committee, my name is G. R. Collins. I am president of the National Constructors Association, of which 29 large nationally and internationally known firms of engineering and construction contractors serving the oil, chemical, power and steel industries are members. I am also vice president of the Lummus Co., one of the members of the National Constructors Association. My statement today is on behalf of the member companies of the association.

I wish to digress for a moment to introduce my associate. He is Joseph J. Gibbons of the Blaw-Knox Co. He is assistant treasurer of that company and he assisted in the preparation of our statement. The Chemical Plants Division of Blaw-Knox is a member of the National Constructors Association.

The member companies do an annual volume of engineering and construction of approximately $5 billion per year. This includes large and complex industrial facilities in the United States and in practically every country of the world, except those behind the Iron Curtain. This volume consists, for the most part, of contracts undertaken for both American and foreign clients, including private businesses and governments, the performance time for which ranges from 1 to 5 years.

A relatively high percentage of these contracts are on a fixed-price or lump-sum basis, thus involving not only the usual risks inherent to the construction industry, but, because of their long-term nature, also involve exposure in domestic operations to the hazards of inflation, wage increases and legislative changes, both State and Federal.

In the case of foreign engineering and construction there are the additional hazards and contingencies of strange construction sites, availability and cost of personnel, housing for that personnel, applicable local legislation, and, in particular, customs, duties, and taxes, not only on income but on capital, turnover, wages, property, et cetera, and the perils of exchange rate fluctuations and currency convertibility.

In most cases the period allowed for the preparation of bids is only a few weeks. No extensive period for the thorough and exhaustive investigation of local conditions, particularly on foreign projects, is normally available. It is, therefore, necessary to rely on a quick team survey of the site and local conditions, plus published information readily obtainable and hope that no sizable cost factor has been inadvertently overlooked in the preparation of the estimate.

Competition in the industry is unusually keen. If the average engineer constructor realizes a net profit of 1 to 2 percent on sales volume and 5 to 10 percent on net equity, he considers himself fortunate. The profit factor fluctuates widely and no company in the industry is wholly free from the possibility of severe losses. This competition is not only between domestic concerns but on foreign work is with similar firms throughout the world, with the most severe competition coming from European engineering constructors. These firms are given especial encouragement by their governments in the form of tax concessions, protection against currency, credit and political risks, and even inflation guarantees.

This protection is given in the realization that engineer constructors bring a very substantial volume of heavy machinery and equipment orders to local factories, thus stimulating the economy and, in addition, adding considerably to the prestige of the country involved, thus broadening its market opportunities. In addition, there is appreciation by these countries of the fact that successful initial installations invariably lead to repeat orders not only for replacement machinery and equipment, parts, and so forth, but also for future expansions and even new plants.

We, therefore, respectfully submit that any measures, the effect of which is either to deter U.S. engineer constructors from entering or staying in foreign markets or of placing them in a position where they cannot compete on a relatively equal basis, represents a severe curtailment of U.S. economic opportunities, prestige, and the loss of trade balances and tax revenue, far surpassing the not inconsiderable contribution of the engineering construction industry itself. We firmly believe the industry needs and must have additional encouragement in the realm of package financing, workable and practical credit, political and inflation guarantees, and at least equal tax position vis-a-vis foreign competitors; not a tax bill constituting, in effect, broad additional areas of uncertainty, hazard, and exposure to additional and unexpected taxation occurring several years after the long-term commitments inherent in the industry and necessary to successful competition have occurred.

We wish to point out again, as we did in our statement to the House Ways and Means Committee last year, that the establishment of foreign subsidiaries in the construction industry is done to meet legal requirements, to satisfy feelings of national pride in some countries, to enable local participation in some cases, to permit the use of financing not presently available to our domestic companies, and other similar reasons, all dictated by business considerations. The use of such subsidiaries is not designed to take advantage of lower wage rates, lower raw material prices, or as a clever device to avoid taxes.

We further submit that the measure presently proposed as applied to the engineering construction industry may ultimately result in an

overall loss of tax revenue to the United States. The additional tax revenue from the engineering construction industry itself is apt to be outweighed by the ultimate decrease in tax revenue from U.S. manufacturers, suppliers, and contractors arising from—

(a) The decline in orders for machinery and equipment going into plants constructed abroad resulting from the inability of U.S. engineer constructors to maintain their competitive position.

(b) The loss of part of the market for replacement of machinery, equipment, and parts used initially in these plants.

(c) The loss of plant expansion contracts.

(d) The possibility that the investment tax credit will not, in fact, result in additional industrial plant expansion in the United States of America.

It is in this general framework that we submit separately our comments on the President's tax message and the proposed revision of the Internal Revenue Code, known as House bill No. 10650.

The National Constructors Association appreciates the opportunity of being heard by this committee.

A further word, Mr. Chairman, if I may.

In saying that we are submitting our comments separately, I am referring to our supplementary statement, copies of which have been supplied to all members of the committee. This supplementary statement contains specific comments and recommendations concerning eight sections of the proposed Revenue Act of 1962.

(The supplementary statement referred to is as follows:)

SUPPLEMENTARY STATEMENT OF G. R. COLLINS, VICE PRESIDENT OF THE LUMMUS CO. AND PRESIDENT OF THE NATIONAL CONSTRUCTORS ASSOCIATION, RELATIVE TO THE REVENUE ACT OF 1962 (H.R. 10650)

(NOTE.—This statement supplements a general statement presented orally to the committee and contains detailed comments on sections 2, 4, 6, 11, 12, 13, 16, and 21 of the bill.)

SECTION 2. CREDIT FOR INVESTMENT IN CERTAIN DEPRECIABLE PROPERTY

We are dubious that the investment credit will actually accomplish the purpose for which it is intended, that is, to stimulate the investment of additional capital in new machinery and equipment.

This provision also discriminates against taxpayers, similar to engineering and construction contractors, who derive income primarily from unique and basic services rather than from a heavy investment in machinery and equipment. These services, in themselves, however, may develop into, and in the case of engineering and construction contractors do so, heavy outlays of capital for machinery and equipment on the part of those using contractors' services.

It is noted, also, that this provision of the proposed bill will exclude from the definition of property under section 38 that property used predominantly outside the United States. No distinction is made as between a branch or foreign subsidiary. A distinct advantage is given to those who invest in the United States. Thus, the foreign branch of a domestic company, not to mention a foreign subsidiary of a domestic company, is placed in a position of tax inequality.

The consequences of such legislation can be easily foreseen. American business abroad will be further handicapped in meeting foreign competition with a consequent withdrawal of American business from foreign countries with a concomitant deleterious effect on all American engineering and construction companies now doing business abroad, together with secondary adverse effects on the sale and export of American equipment and machinery.

If this section of the bill is enacted in its present form, it is suggested, at the least, that there be included in the definition of property under section 38, machinery and equipment purchased by U.S. companies, either through foreign

branches or their foreign subsidiaries. However, our recommendation would be that serious consideration be given to a provision for accelerating depreciation in order to place American engineering construction contractors in a more competitive position with foreign competitors.

SECTION 4. DISALLOWANCE OF CERTAIN TRAVEL AND ENTERTAINMENT EXPENSES

In the construction industry travel and entertainment expenses are unavoidable. First, with respect to travel, the projects are located at unusually large distances from the contractor's home office, and clients are scattered far and wide around the world. Construction sales and administrative personnel have to be on the road much of the time, both domestically and internationally.

It is necessary to entertain in order to establish relations with potential clients and to maintain established relations with existing clients, and particularly in the case of foreign clients, to meet the level of entertainment customary in their respective countries and afforded to them by our foreign competitors.

We have no disagreement with the broad purpose of this section. However, we should like to point out that the competition and level of profits in our industry are such that travel and entertainment expenses necessarily are closely scrutinized and carefully controlled. The present law and active enforcement by the Commissioner are adequate to correct any abuses. There is no need to add further administrative problems by the enactment of this section.

SECTION 6. ALLOCATION OF INCOME BETWEEN RELATED FOREIGN AND DOMESTIC ORGANIZATIONS

With respect to section 6 of the proposed legislation, the industry believes that the provisions of this section serve to increase the uncertainties and risks in transacting business abroad.

Long-term construction contracts requiring a relatively quick estimation of proper selling price and years in physical completion generally deny the industry the ability to promptly adjust to changes in policies of taxation by both the U.S. Government and the governments of other nations. Although this section provides for the establishment of some method of allocation other than those specified if it clearly reflects the income of each member of a group, the burden of the proof that such a method is proper is on the taxpayer. The association is concerned that the establishment of uniform benchmarks in this unique industry would be difficult or impossible to develop. The complexities of the business and the wide variety of constantly changing conditions dictated by competition, customers, the nature of the particular projects, and the governments of the various foreign countries tend to make each project unique in itself.

We believe that a hindsight application of an arbitrary formula for allocating profits in a long-term construction project could result in double taxation as between the United States and a foreign country and at least temporary confiscation of money necessary to the continued operation of the business.

While foreign tax credit is to be allowed against the allocated income, the House Ways and Means Committee, in its report on this bill, has stated that such income will not be considered "foreign source" income for purposes of the overall or per country limitation on foreign tax credits. Conceivably then, no tax credit would actually be allowed, at least until a dividend was declared by the foreign subsidiary, if the taxpayer had no other foreign source income. This is true because the limitation formula is foreign source income over total taxable income times the U.S. income tax. Therefore, the taxpayer could in certain circumstances be required to pay out over 100 percent of its combined income and would not obtain relief until such time as its subsidiary was in a position to declare a dividend.

Again, the uncertainties created by this bill and the inherent administrative problems because of these uncertainties render it necessary that the industry seek assurances that the committee will take appropriate action to prevent the destruction of the industry's ability to compete in the world market.

SECTION 11. DOMESTIC CORPORATIONS RECEIVING DIVIDENDS FROM FOREIGN CORPORATIONS

Section 11 of the proposed bill would require a domestic corporation, whenever it derives dividend income from its foreign subsidiaries or affiliates, to in-

clude—gross-up if you will—that portion of the foreign subsidiary's income which was used by the subsidiary to pay its tax liability to the foreign country in which it is located. It is alleged that the foregoing will provide uniform treatment for the taxation of foreign income of branches and subsidiaries of domestic corporations.

Such an argument disregards completely the unequal and entirely different aspects and situations of both branch and subsidiary types of operations.

The principal argument against such action is that it is a deliberate encouragement to all other countries to raise their tax rate to the same point as it is in the United States, that is, 52 percent, particularly in the underdeveloped countries. This does not present much of a problem, at the present time, in the highly developed countries inasmuch as the income tax rate in these countries already is pretty much equivalent, if not more, than that of the United States.

It would place American enterprises at an even greater disadvantage with its competitors in many foreign countries which in their tax laws exempt income earned abroad and in those countries which through their bilateral tax treaties recognize the right of each of the contracting states to tax exclusively the income of permanent establishments in each one's territory.

Furthermore, we believe the philosophy behind this move to be incorrect. It would tax as income that portion of earnings of a foreign corporation used to pay income tax to the country in which it is organized and which earnings the American parent never received or from which it never derived any benefit.

The present foreign tax credit has been in force for many years. American construction companies have gone abroad and made their long-term commitments based on existing statutes.

SECTION 12. EARNED INCOME FROM SOURCES WITHOUT THE UNITED STATES

Sixteen of the National Constructors Association's member companies are working at this time on 178 projects in 39 foreign countries. They are engineering and constructing complex units, such as oil refineries, chemical and petrochemical plants, steel mills, power generating facilities and similar industrial installations, contributing to the improvement of the U.S. balance of trade, both directly and indirectly, and to the prestige of U.S. technical ability and equipment.

The Americans assigned to these projects have been delegated the administrative and technical responsibilities of supervising actual construction, interpreting engineering design and training foreign nationals during the construction period in the construction and operational skills of modern industrialized society.

These NCA member companies have over 500 Americans supervising construction on foreign projects. It is significant to note that this number has been decreasing each year for the following reasons:

(1) The American contractor is simply unable, at this time, to afford any additional incentives to the American being assigned to a foreign construction project. Any additional incentives would increase the American contractor's costs and impair the American contractor's competitive position with foreign engineering and construction companies. Therefore, it is of prime importance that the present incentives, at least, be retained and any inequities developing from them be corrected. Accordingly, the retention of the 17-month exemption rule is of utmost importance, but an inequity has developed from the $20,000 limitation on the 17-month exemption rule and the $20,000 limitation being placed on the bona fide resident. First, the $20,000 limitation on the 17-month exemption rule was established approximately 10 years ago and is no longer realistic due to the trend of the economic situation. Second, the yearly salary of the American who is in charge of foreign projects ranges from $16,800 to $25,000. Many of the Americans under the American project manager are able to avail themselves of full U.S. tax exemption as their salaries fall below the $20,000 limitation. As a result of the proposed legislation, those in charge of the projects would be taxed on any income exceeding $20,000 and the required differential between the American project manager and his American technicians would be lost. A majority of those who run the projects have made foreign construction their careers and established bona fide residence. They are highly skilled administrators possessing the ultimate proficiency in foreign construction. They are thoroughly familiar with living abroad, working with foreign nationals and the techniques of foreign construction under all conditions. We

should like to suggest that a $25,000 limitation be placed on bona fide resident for the first 2 years, with $35,000 thereafter.

(2) To be able to compete with foreign engineering and construction com panies, it has become necessary to utilize the services of some foreign nationals supervisory capacities—nationals whose salaries are significantly less than thos of Americans. This employment trend will increase if the American contractor' costs rise further through higher compensatory salaries to offset taxes and if th American contractor is unable to maintain the present incentives available t American construction workers.

SECTION 13. CONTROLLED FOREIGN CORPORATIONS

The basic intent of this section of the bill is to continue tax deferral in the case of operating businesses owned by Americans and located in the economicall developed countries, while at the same time taxing special kinds of income including investment-type income. This is a considerable improvement over the President's recommendations that all earnings be taxed regardless of source or classification.

We call to the committee's attention, however, that there are two current developments in the construction industry which will make these provisions unworkable. They will place a great hardship upon our industry.

The first situation of increasing importance in our international business is that our customers are looking to the contractor for part of the project financing. Even through special financial institutions exist to furnish the major part of the financing, the customer looks to the contractor for his residual requirements. This trend requires the holding of liquid funds in foreign construction subsidiaries for the financing of projects. During and between projects this ebb and flow of funds between those used directly in the business and those held in investment status for later use will create a conflict of interpretation. It will be next to impossible to determine when such funds were necessary in the business and when they were being held as "nonqualified" property or as passive investments.

This problem is further complicated by exchange restrictions and fluctuations in exchange rates. The contractor making long-term commitments to his customers requires unusual liquidity as protection against the risks accepted in these long-term contracts.

The second set of conditions we call to the committee's attention are caused by local laws and regulations of certain countries. There is a tendency for some foreign countries to encourage and sometimes to insist that the local construction firm have substantial ownership by citizens of the foreign country. In this instance the American firm enters into joint ventures with local firms and may have to take a noncontrolling position. Under the definitions of a "controlled" firm as used in this section, the firm may be "controlled" for tax purposes but actually noncontrolled when important business decisions are made. This is due to the definition that the firm is "controlled" for tax purposes if on any one day during the year more than 50 percent of the voting stock was held by U.S. persons. Thus, the American construction firm participating in the joint venture may find a tax imposed upon him due to business decisions beyond his control. Furthermore, it is quite unlikely that funds would be available from the joint venture to pay the tax assessment.

It is our firm belief that construction contractors in Western Europe will have a profound competitive advantage over American international contractors because of the former's ability to more flexibly utilize liquid funds. If the American contractors try to retain their current flexibility, this section of the bill will cause a hopeless morass of administrative and enforcement difficulties.

SECTION 16. GAIN FROM CERTAIN SALES OR EXCHANGES OF STOCK IN CERTAIN FOREIGN CORPORATIONS

Section 16 of the bill would tax the profit realized by a U.S. shareholder on the liquidation of a foreign corporation, the redemption of his stock or the sale or exchange of the stock at ordinary income tax rates. While in no way do we condone the conduct of those U.S. companies that accumulate unused, untaxed, liquid surplus funds in a foreign subsidiary and then liquidate the subsidiary—or sell the stock thereof—in order to avail themselves of the generally favorable capital gains tax rates, we do believe a distinction should be made between the liquidation of a foreign subsidiary as described above and a foreign subsidiary which required the surplus funds to conduct its operations

but which no longer has a business reason for its continuation. Because of business and legal considerations in many foreign countries, construction and engineering contractors will form a foreign subsidiary and make binding commitments of 3 or 4 years' duration, basing their obligations on the existing statutes. Due to the necessity of having working capital for the duration of these commitments, profits, if any, will not be remitted. Only when the business reasons for the continuation of the subsidiary ceases is the money, if possible, remitted to the parent.

Under these circumstances we believe that the least that could be done to mitigate the hardships of section 16 would be to make the action of this section prospective rather than retrospective. In addition, if the profits on the liquidation, sale, or exchange is going to be taxed at ordinary rates, then any loss arising out of such liquidation, sale, or exchange should be fully deductible. Otherwise, business with long-term commitments would be placed at a disadvantage.

When a corporation is formed for the purpose of avoiding or evading taxation without any genuine business purpose, it is within the purview of the authorities to prevent such a company from enjoying an advantage not available to those other taxpayers who conduct their business in a normal, straightforward manner. This section would make no distinction between these two types and, in effect, would be penalizing the legitimate operator as against the devious.

Once again, this proposal places the American contractor operating abroad at a tax disadvantage with foreign contractors. As we stated before, other countries impose other forms of taxation which we do not use, instead of our high rates of corporate income tax. If in addition to all the foreign taxes they are already subjected to, foreign subsidiaries of American corporations are also subject to full U.S. taxes, then American enterprise abroad will receive a harsh blow.

SECTION 21. TREATIES

The association is additionally concerned with the possibilities in an adverse worldwide reaction to section 21 of the proposed legislation.

The deliberate, unilateral abrogation of the many tax treaties by operation of this section of the bill would encourage similar action by the other contracting nations, thereby rendering useless all such treaties in the sense that reliance on a particular treaty or section thereof would become perilous.

In their foreign operations, the member companies of the association must have the ability to rely to a great extent on the continuation of the benefits of a given tax treaty for a period of from 2 to 5 years in the determination of a competitive but profitable selling price for a long-term construction project. If we must now face the possibility that sudden and unilateral abrogation of tax treaties is now being encouraged, we must add to all the other risks inherent in oversea operations, the risk that the anticipated profits from a long-term project may be suddenly eliminated by the actions of a foreign government in this area. In fact, not only could profits be eliminated by such action, but in view of the relatively narrow margin of profit in the industry, the loss of treaty benefits could conceivably generate substantial losses.

The industry respectfully requests that this section be struck from the bill and that the United States continue to honor its tax treaties with the foreign nations, negotiating equitable adjustments, as in the past, under the provisions of the respective treaties.

Respectfully submitted.

NATIONAL CONSTRUCTORS ASSOCIATION,
G. R. COLLINS, *President*.

Senator SMATHERS. All right, sir.

I have no questions.

Thank you very much, sir.

Our next witness is Mr. Riley Williams of the Worthington Corp.

STATEMENT OF RILEY WILLIAMS, VICE PRESIDENT, WORTHINGTON CORP.

Mr. WILLIAMS. Mr. Chairman, I am going to make my presentation brief, as I find a great deal of it to be a repetition of what has already been said.

My name is Riley Williams. I am vice president of Worthington Corp. I am a member of the Foreign Policy Committee of the Chamber of Commerce of the United States. I have a background of 40 years' experience in international business with Worthington Corp., a pioneer in U.S. international trade.

Worthington's first export of capital goods was made over 110 years ago and its first European manufacturing facility was established at the end of the 19th century. The company now operates 15 manufacturing facilities in major world markets.

During this period we have developed a vigorous, sound and diversified international business, composed of U.S. exports together with sales of products manufactured by our foreign associated companies. We believe our operations represent a typical pattern of U.S. industry.

I am appearing here today on behalf of myself and my company to oppose those portions of H.R. 10650 which would adversely affect U.S. international operations, and to express our opposition to the bases of the Treasury Department's recommendations for additional taxation on our foreign operations.

Senator SMATHERS. Did you appear and testify before the House Ways and Means Committee?

Mr. WILLIAMS. No, sir.

The base of our opposition are the following:

1. EFFECT ON RAISING FOREIGN CAPITAL

Levying a tax on foreign-based operations would (*a*) create political and/or fiscal problems of a serious nature when such corporations had foreign stockholders and (*b*) make difficult the raising of local capital.

2. INHIBITION OF U.S. INTERNATIONAL TRADE

It would place U.S. foreign based operations in a definitely noncompetitive position with their foreign competitors insofar as the use of income earned abroad for further expansion is concerned. U.S. foreign-based corporations would be paying taxes not imposed on its foreign competitors.

I would like to emphasize this point because I think American industry has done a wonderful job attaining the volume of exports from this country that it has. But I hope the committee realizes that this has been done in the face of vigorous and well-grounded competition of foreign countries. We must be competitive because we are already at a disadvantage with higher rates, we have less great facilities, and we are getting high taxes.

3. STIFLING OF U.S. EXPORTS

In our international operations the initial basic objective is U.S. exports. As export markets are developed, local manufacture frequently follows as a matter of necessity. However, local manufacture does not replace exports, a frequently mistaken conception, but generally expands them. Our exports show an average yearly increase of 12 percent over the last 15 years, during which period our foreign manufacture expanded rapidly. The manufacture of our products by foreign associates is only undertaken when U.S. ex-

ports are no longer possible. Our customers and/or competitors generally decide this. Foreign manufacturing facilities help maintain our market position and support strong local sales and service organizations thus increasing our ability to sell those items which can be imported from U.S. plants. Our experience over many years clearly demonstrates that local manufacture makes possible a greater volume of U.S. exports than if no local manufacture existed.

4. BALANCE OF PAYMENTS

During the 10-year period 1951–61 our total contributions to balance of trade is as follows:

Exports	$179,043,000
Receipts, dividends, royalties, fees, etc	10,528,000
Total receipts	189,571,000
Total U.S. dollar capital investment	3,145,000
Net dollar inflow to United States	186,426,000

I submit these figures refute the arguments of the Treasury Department concerning the unfavorable effect on dollar inflow from investment abroad. Certainly this return of dollars to the United States did not all result from investments made many years ago. It must be remembered that U.S. investors have traditionally planned to recapture their foreign investments within a relatively few years because of the risks involved in such investments when permitted to remain abroad for long periods of time.

I understand the Treasury Department's concern with the outflow of U.S. dollars in recent years, but I would point out that this unusual rate of foreign investment in Europe and the Common Market area will surely not continue. This high rate of foreign investment has been for the purpose of U.S. firms establishing a position in that market and we can now anticipate a decline in this particular type of foreign investment.

This decline in investment together with the simultaneous return of dollars in the form of additional dividends and other income resulting from the recent investments in developed countries, should contribute to maintain a substantial rise in dollar inflow to the United States, notwithstanding the Treasury Department's arguments to the contrary, and for elimination of tax deferral.

5. UNFAIRNESS OF ADDITIONAL TAX ON U.S. COMPANIES

Most of our foreign associated companies are subject to high taxes. For example, in France there is a 50-percent income tax and a production tax of about 20 percent on most purchased materials. On the other hand, tax concessions are frequently granted on exports. These companies remit a substantial percentage of their income each year to the parent corporation. That generally runs around 50 to 55 percent. Any additional tax, such as on retained earnings, would make these operations less competitive and ultimately have an adverse effect on U.S. exports. It could start a trend to licensing rather than of manufacturing abroad. I wish particularly to emphasize this point. Licensees are generally interested in selling only what they make and

have a poor record of selling imported equipment. This would have an adverse effect on U.S. exports.

6. TOTALITY OF FOREIGN TAX BURDEN

The tax bill completely overlooks the "total tax burden" on companies operating in foreign countries. Most developed countries, in addition to income taxes, impose turnover, sales and/or production taxes which, when added to the income tax, exceed the taxes paid in the United States by a comparable corporation. However, when funds are repatriated to the United States no foreign tax credit is allowed for any of these taxes other than the income tax. To further tax these undistributed earnings puts us at a serious disadvantage with foreign competition.

I might mention here that in Germany we have a German company. We have had one for 60 years. We receive a reduction in our income tax as a bonus on exports. Any exports, even at a loss or with no profit, provide a reduction in income tax on the balance of the income which the company might earn. This is typical of what our competition has, because they are German companies or British companies or others in Europe that we have to compete with.

7. ENCOURAGEMENT OF INCREASES IN FOREIGN TAX RATES

Income tax rates abroad are rapidly approaching our domestic rate and when they equal ours as some do now, there will be no additional revenue accruing to the Treasury under the proposed bill.

8. COMMERCIAL VALIDITY OF FOREIGN TRADING COMPANIES

We have foreign trading companies. These are sometimes erroneously called "tax haven" companies. They are definitely not set up for this purpose and provisions of the present law should be fully adequate to cover any abuses by those companies that are really established for tax evasion. I am not opposing changes in the present law which punish the evasion of U.S. taxes through the improper use of foreign subsidiaries or by any other means. However, it must be recognized that our competitors in foreign fields which are foreign-owned companies have trading companies, and they are not taxed.

Mr. Geneen brought that out, as did several other witnesses previously.

Our competitors establish trading companies to improve their position in the export market and, in fact, are encouraged along these lines by their own governments, but H.R. 10650 would penalize similar U.S.-owned companies.

The President on December 6, 1961, stated:

> If American industry cannot increase its outlets in the Common Market our own expansion will be stifled.

Both the Treasury Department's tax recommendations and H.R. 10650 as related to foreign investments, if enacted, would deal a severe and crippling blow to improving our favorable balance of trade sought by the President. If we are to increase our outlets in the Common Market, we must not be unduly burdened by taxes which defeat

that very purpose. The major objective of our foreign companies is to promote the business of the parent U.S. company in world markets by exports from the United States. Investment in foreign facilities is made only when necessary to support this objective.

Senator SMATHERS. Thank you, Mr. Williams.

Our next witness is Mr. Walter E. Schirmer, of the Clark Equipment Co., executive vice president.

STATEMENT OF WALTER E. SCHIRMER, EXECUTIVE VICE PRESIDENT, CLARK EQUIPMENT CO.

Mr. SCHIRMER. I am Walter E. Schirmer, executive vice president of Clark Equipment Co. and president of Clark Equipment International, a wholly owned subsidiary which carries on all oversea sales, licensing, servicing and promotion of Clark products.

Clark is a manufacturer of industrial materials handling equipment, such as forklift trucks and tractors, construction and earthmoving equipment, highway commercial trailers, and heavy-duty transmissions, axles and torque converters. It has five plants in medium-size communities in Michigan, and additional plants for building trailers in Indiana, Pennsylvania, and Washington.

As a capital goods manufacturer in the United States, an exporter of these goods to some 70 other countries in the free world, and with manufacturing affiliates overseas, my company is indeed deeply concerned and affected by the proposed foreign income tax legislation now under consideration by your committee. We have examined House bill 10650 and do not believe it will produce the results claimed by its supporters, but will have adverse results for the United States and for U.S. manufacturers.

Clark's export activities were practically negligible until after World War II. From then until 1955, exports of Clark products even though well distributed by our Armed Forces during the war and thereafter as surplus property, were only slightly increased despite our establishment of an export division and an intensified campaign of oversea selling. Basically, this was caused by our own high prices of manufacture, and the development, particularly in Europe, of competitors using the basic concepts imported by the equipment which our Armed Forces had left in Europe, and which could be manufactured relatively cheaply there due to new plant and equipment, provided by Marshall plan dollars, coupled with much lower wage rates.

In analyzing this competitive situation, it was immediately apparent that we could effect no substantial reduction in manufacturing costs, with annual wage and cost-of-living increases leading to increasing prices of labor and material here, plus transportation, insurance and tariff costs in order to enter these local European markets, nor could we compete in so-called third-country markets which could be served by either the United States or European sources.

To cite some examples of this situation, our Belgian affiliated manufacturing source, which purchases from us the transmissions, axles, and hydraulic components from our U.S. factories, can deliver to the port of Santos, Brazil, a 2-ton capacity forklift truck, freight prepaid, for $4,763, compared to the same truck produced at our Battle

Creek plant, and delivered at Santos at a price of $6,605. Similarly a 3-ton capacity truck from Belgium has a delivered price of $6,62[illegible] compared to the same truck from Battle Creek at $9,340. Profit margins are substantially identical, and the U.S. content by value in the Belgian-made truck exceed 40 percent. On this basis, competitio from the United States appears impossible.

Because of this type of situation, in 1955 Clark initiated a program to develop manufacturing operations overseas through a combination of licensing coupled with equity ownership of at least a substantia minority position ranging from 25 to 45 percent ownership. This was for the purpose of maintaining a U.S. income after any licensing provisions had expired. To carry out this program, Clark organized a foreign corporate entity designed primarily to serve as a foreign sales and service organization, with engineering, accounting, and management staffs. Through this corporation, a distribution chain of 180 dealers and service stations in 80 free world countries was established for the promotion, sales, and servicing of Clark products. The engineering, accounting, and management staffs, operating out of Brussels, with sales engineers, field service engineers and technicians in 7 foreign branch offices complete a staff of 80 highly trained management people serving Clark licensees, distributors and customers overseas.

This personnel has used its skills to contract selected foreign manufacturers under terms requiring such manufacturers to manufacture certain Clark products to specified standards of performance and quality for sales in oversea market areas. For the many services and technical skills imported by the Clark International staff to these manufacturers a fee is paid based on production. In addition, the highly technical components, such as torque converters, automatic power-shifted transmissions, and planetary axles are purchased by these manufacturers from Clark's U.S. plants. In addition, low-volume models, specially engineered devices, and service parts are purchased from these same plants. The Clark International staff has organized, trained, and directed the distributor organization for efficient marketing of Clark products in all oversea markets from U.S. production as well as from the oversea manufacturing affiliates.

This development of foreign markets and foreign manufacturing affiliates has effectively served its function. The fees and other earnings received by International have been used to make equity investments in these same foreign manufacturing affiliates.

Exports from Clark's U.S. plants in 1955 totaled $5,500,000, consisting solely of machines and parts to distributors. By 1961 such sales had increased to $12,500,000, and in addition component sales to manufacturing affiliates rose to $10,500,000, for a total of $23 million total exports from U.S. plants, excluding exports to Canada amounting to an additional $3 million.

While total sales of Clark products overseas in 1955, therefore, was only $5,500,000, in 1961 this figure had risen to $88 million, including $65 million sales of the Clark manufacturing affiliates. Also, in 1961, 1 out of 9 Clark employees in the United States was employed in our export and oversea business, a total of 900 out of 8,000. In 1955 this figure was 1 out of 21 U.S. employees.

Clark's program of investment overseas, far from being detrimental to our U.S. investment program, has produced profits for the parent company both in the sale of components, never sold overseas prior to this program, plus finished machines and service parts. This has provided increased funds in the parent company available for investment in facilities and working capital. During the years 1955-61 the parent company has invested in U.S. facilities and working capital $40 million, and in that same period has invested in Clark International $1 million. All further investment on behalf of Clark International has been out of earnings and debt not guaranteed by the parent.

Thus, it is obvious that the Clark foreign investment program has not in any way interfered with our domestic program, nor has it to any material extent affected our balance of payments, since the earnings of the parent company on its oversea exports has exceeded by far the original investment in International.

Mr. Stanley Surrey, Assistant Secretary of the Treasury, has said with regard to H.R. 10650:

> * * * the entire thrust of the foreign income provisions is to remove tax inducements to investment abroad as against investment at home.

We are unable to export many of our U.S.-manufactured models today because they cost too much compared to foreign competitive models. Without our foreign manufacturing program, set up by limited capital investment and developed and expanded by earnings not produced in the United States, we have developed an appreciably increased market for our components manufactured here, providing jobs, wages, and taxable profits here that would not otherwise be available. Is this type of operation per se bad for the U.S. economy? We think not. We cannot agree that Clark's foreign program has provided tax benefits at the expense of accelerated growth here at home.

Following the overall profitability of Clark's program in industrialized countries such as France, West Germany, Great Britain, and Belgium, it was possible to provide, out of these earnings, for a substantial investment in Brazil, a less-developed country. This investment now amounts to almost $10 million, no portion of which has come from the parent U.S. company. It is by far our largest single investment, and almost one-half of it was the purchase of machinery, tools, and supplies here in the United States. Such an investment in a country such as Brazil requires greater capital, and a much greater risk because of dependence upon untrained labor, insufficient supplies either in quantity or quality of materials, lack of local capital, governmental instability, and other deficiencies. This plant was started early in 1957 and did not make any profits whatsoever until June 1961. It will be at least several more years before our earlier losses can be wiped out and the entire operation considered satisfactory.

As an officer and director of our parent company, I can assure you that no such investment of aftertax parent company earnings would ever have been risked in this project.

If H.R. 10650 becomes law, I am not qualified at this time to say what its exact overall effect will be on our company, but certainly it is going to reduce materially our earnings from our oversea operations. This will, of course, cause a substantial reduction in our over-

all foreign investment program, with the major reduction taking place in the less developed countries, where we will undoubtedly curtail any further expansion because of the risks involved. Our future investments in Western European manufacturing facilities will obviously have to be spread over a longer period of time, placing us at a great competitive disadvantage. However, to maintain our position such investments will have to be continued, or the business and our markets will be lost to our local European competitors.

Section 13 of H.R. 10650, in my opinion, will not and cannot stimulate increases in investment in our U.S. facilities. In fact, because of loss of profits in our oversea operations by reason of this section, it may means a call on our U.S. resources to maintain the growth of our oversea facilities.

In reading over some of the observations of proponents of this specific legislation, they seem to advocate neutrality of tax laws. We agree that that is proper if governmental services secured by such means are equivalent. But between whom do they wish to assert this neutrality? If our foreign competitors pay lower taxes, the imposition of higher U.S. taxes on the earnings of our own foreign companies will not impose such neutrality between these Clark foreign companies and their local foreign competitors. A controlled foreign corporation of Clark domiciled completely overseas and carrying on no business in the United States receives no services from the United States so any tax charged on its income not transferred to the United States is certainly not tax neutrality.

Looking at the other side of this question, it is my considered opinion that many foreign governments, seeing the United States applying a full 52-percent tax on foreign earnings of a U.S.-controlled foreign corporation owning assets in their country, may decide to apply the same type of tax on earnings taken out of their country, thereby offsetting any U.S. revenue and defeating the competitive position of the U.S. affiliate in their country.

Income taxes are a part of the cost of any manufacturer making a profit. To return a given percentage to the shareholder and to provide an amount to be reinvested in the business takes considerably less profit at a 10-percent rate than at a 52-percent rate. Reductions in the tax cost allow reductions in price for the same return. Consequently, the foreign-owned company, not related to any U.S. company, can have an appreciable competitive advantage over his U.S. controlled counterpart, thus penalizing severely the U.S.-controlled corporation.

The President of the United States has specifically stated that he does not want to penalize legitimate private investment abroad, which will strengthen U.S. trade and currency in the years to come, yet that is exactly what this legislation will do to our company. To take a broad international view on freer trade and reduction in tariffs on the one hand, and to propose a highly restrictive isolationist-type tax structure on such trade, seems highly inconsistent.

Many of the provisions of this legislation have questionable legality, and may be considered by some countries a violation of existing tax treaties. In reading it, one is impressed with the highly complicated and uncertain language employed, which will take years to

clarify, and has the feeling that it was concocted in great haste and without due consideration of all of the phases of U.S. foreign operations.

We certainly agree with the proponents of the bill that tax deferral should not be obtained by so-called paper companies in sham operations. However, the U.S. Treasury now has the necessary preventive controls available to control such situations, if properly exercised. While presumably this legislation seeks to improve these controls, it goes far beyond that legitimate goal. It will destroy the incentive for U.S. business to operate effectively and competitively overseas, and in my opinion penalizes much too severely the conduct by U.S. manufacturers of business activities overseas on a legitimate and ethical basis.

I respectfully request that this committee reject the foreign income tax proposals of this bill and that the entire matter be referred to the Joint Committee on Internal Revenue Taxation to develop proper and effective legislation that is not contrary to all of our present concepts of taxation, and which will serve a useful purpose for further strengthening U.S. trade and currency.

Senator SMATHERS. All right, Mr. Schirmer.

Did you testify before the House Ways and Means Committee?

Mr. SCHIRMER. No, I did not.

Senator SMATHERS. Thank you very much, sir.

Our next witness is Mr. George E. Brown of the Samuel M. Langston Co.

STATEMENT OF GEORGE E. BROWN, SECRETARY-TREASURER OF THE SAMUEL M. LANGSTON CO., CAMDEN, N.J.

Mr. BROWN. Mr. Chairman, I am George E. Brown, secretary-treasurer of Samuel M. Langston Co., Camden, N.J., a manufacturer of machinery for the paper converting industry.

The company, its officers, employees, and stockholders first wish to express their thanks for this opportunity to be heard on a matter which directly affects the livelihood of all of us. The opportunity assures us that the principles of democracy on which our country was founded are still very much alive.

The tax revision measures embodied in section 13 of H.R. 10650 are, for the most part in our opinion, ill conceived, for they infer a cynical disregard for principles long established by your predecessor Congresses for the orderly flow of commerce between U.S. private business and other areas of the world, which principles have long been the basis for substantial investment by private business and the basis for acceptance of these efforts by private business abroad and their governments.

Our company has been in business for 60 years making paper converting equipment and has been a principal supplier of machinery for the production of corrugated paperboard from the infancy of that industry. Our primary market, of course, has been in the United States and Canada where this product has become a principal container material and its development has reached a highly sophisticated stage. Other areas of the world have been slow to accept this product for diverse reasons, but we did enjoy, prior to World War II, a modest

oversea business based on letter of credit sales out of the U.S. ports. Our name, therefore, is known throughout the world and our equipment is in operation in 26 countries and on all continents.

World War II, of course, destroyed much of the productive capacity overseas and subsequent thereto we experienced a heavy demand for a replacement of this capacity. To cope with this demand, we appointed a British firm as manufacturer's agent for the United Kingdom and Western Europe, continuing to service other oversea areas on a direct communication basis.

Within a few years it became apparent that the scarcity of U.S. dollars abroad had become a major impediment to sales negotiations, and we found it necessary to cancel our manufacturer's agent agreement and to license a British manufacturer to make our product in order to continue to service our customers in the sterling bloc area. This arrangement was quite successful, becoming a major portion of the business of the British manufacturer and producing substantial royalties to our company.

It should be pointed out that the license to manufacture overseas in no way reduced the possible workload of our U.S. plant, since currency restrictions made the sale of domestic products impossible. Indeed, our failure to license would have invited a loss of a market already conditioned to acceptance of our products. A further advantage to our licensing agreement was the income enjoyed by our company from a steady stream of critical parts supplied to our licensee in support of his manufacturing effort.

As Western Europe recovered industrially and economically from its postwar nadir and as the first steps in the formation of a European Common Market were taken, several changes to our company trade position took shape. On the one hand, the European Common Market concept promised a much higher standard of living to its inhibitants which, in turn, promised a severalfold expansion in the market for our machinery over the next decade. On the other hand, the lower labor rates in the European Common Market and the rising tariff barriers are generating a manufacturing and marketing cost differential which may well place our British licensee in a noncompetitive position in contrast to new manufacturers inside the Common Market area. It became quite obvious to us that we must take a manufacturing position inside the Common Market either by license or by direct investment in order to remain competitive. Licensing held little promise because of the full employment of suitable licensees in other lines of manufacture and because of the need to establish our position as rapidly as possible in the face of the new threat of competition. It was decided, therefore, to make direct investment, and this has been accomplished.

The existence of the provisions in the U.S. tax law for deferral of tax on nonrepatriated earnings of foreign subsidiaries was helpful to us in this process of building up our oversea competitive position since, under proper arrangement, it provided the means of minimizing the direct outflow of U.S. dollars for investment and allowed a rapid buildup of funds from early oversea earnings to be reinvested in the balance of plant and working capital needed to secure our competitive position. This made sense from all standpoints, since our company benefits from its ownership of the foreign subsidiary, our em-

ployees benefit from the work required to manufacture the U.S. components for the oversea subsidiary, and the U.S. Government benefits from the tax dollars on ultimately repatriated dividends, none of which would be possible if our competitive position was lost.

Based on estimated sales for the first 5 years of production from our oversea activity, we believe that our target of plant investment and working capital accumulation can be gained in 3 to 5 years in line with the attached schedule A. The figures as set forth in the schedule speak for themselves and for the soundness of our reasoning.

We wish to emphasize again the minimum outflow of U.S. dollars required for direct investment and also wish to point out that the U.S. Government has nothing to lose taxwise if our venture fails, but has much to gain through taxation of our profits if the venture is successful—and no one will deny, we think, that a 52-percent interest in our profits qualifies as a major gain potential. We also point out that the pattern described above supports previous testimony concerning the favorable balance of international payments created by direct investment.

The proponents of this tax measure refer frequently to the use by U.S. taxpayers of foreign "tax haven" subsidiary corporations, implying that such corporations are formed primarily for the purpose of evasion or avoidance of U.S. tax. We deeply resent this allegation. It should be obvious from this testimony that the motives of this company for acting as it did (and of hundreds of other companies also) were in no way concerned with avoiding tax, but rather concerned with valid business reasons based on the aggressive promotion of U.S. products and technology throughout the world. While we admit that some cases of maneuvering for the purpose of tax avoidance have occurred, we believe these represent a very small minority of transactions. It occurs to us that it is not practical allegorically to treat an infected finger by cutting off the arm.

If this tax reform legislation, particularly with respect to taxation to the parent company of undistributed income of foreign subsidiaries, is enacted, it will certainly direct our company and many others to reassess our oversea business arrangements. Logically, we would find that our planned rapid buildup of capital to fortify our oversea plant and working capital is severely restricted by the payout of U.S. tax on undistributed earnings. Our first alternative is to export more U.S. dollars to counter this loss. In consequence, no favorable balance of payments to the United States will accrue. Our second alternative is to admit European capital, either private or government, into partnership, but this could possibly dilute our equity to the point of loss of control of the enterprise and, at the least, create an implied obligation to rearrange our enterprise in a manner which would direct a major portion of income tax of our profits to the Government of the domicile of our oversea subsidiary. This second alternative is the most logical from a business standpoint, since we are losing U.S. Government support and gaining foreign government support. However, the total ultimate tax loss to the U.S. Government under this arrangement would most likely be on the order of 80 percent.

It is the earnest hope of my company that your committee will give due consideration to the facts and reasoning contained in this testi-

mony and eliminate section 13 of the proposed tax legislation, or recommit it for further study. We are sure that Congress has no intention of performing its duties as elected representatives in a manner which will largely destroy the confidence and faith in its integrity held by the U.S. business community and its friendly foreign counterparts.

We again express our sincere appreciation for this opportunity to be heard.

(The schedule referred to is as follows:)

SCHEDULE A

Samuel M. Langston Co., forecast oversea operation

[In thousands of dollars]

Year	U.S. dollar direct investment	Sales	Pretax earnings	Posttax earnings	Capital increase	Dividends	U.S. tax
1	250	750	150	135	135		
2		1,250	250	225	225		
3		2,000	400	360	360		
4		3,000	600	540	30	510	204
5		4,000	800	720		720	238
Total	250	11,000	2,200	1,980	750	1,230	492
6 to 10		25,000	5,000	4,500	1,000	3,500	1,400

Senator SMATHERS. Did you testify before the House Ways and Means Committee?

Mr. BROWN. No, sir.

Senator SMATHERS. Did somebody testify for your company before the House Ways and Means Committee?

Mr. BROWN. No, sir.

Senator SMATHERS. All right, thank you very much.

The committee will stand in recess until tomorrow morning at 10 o'clock.

(By direction of the chairman, the following is made a part of the record:)

SUMMARY OF RECOMMENDATIONS OF THE COMMITTEE ON FEDERAL FINANCES OF THE INDIANA STATE CHAMBER OF COMMERCE ON THE PROVISIONS OF H.R. 10650—THE REVENUE ACT OF 1962[1]

Submitted by John V. Barnett, Director of Research

I. BUSINESS EXPENSES

The committee approves the general idea of supporting business expenses by adequate records and believes that legitimate businesses welcome this type of recordkeeping. The committee assumes that in the administration of these provisions the Internal Revenue Service will continue to exercise the same good judgment that has characterized its activity in previous years.

II. INVESTMENT CREDIT

It was the recommendation of a majority of the committee that this proposal not be approved by the Congress for the reason that it had many of the characteristics of an outright subsidy and discriminated against those businesses

[1] Developed at the meeting of the committee in Indianapolis on Mar. 23, 1962. These recommendations do not become official State chamber policy until they have been submitted to and approved by the board of directors of the State chamber.

that had gone ahead with expansion and modernization plans in previous years. The committee majority was of the opinion that a general revision in depreciation schedules and overall tax reform would serve as a greater and more lasting stimulus than the investment credit.

A minority of the committee recommended that the investment credit be adopted since it would constitute an incentive for investment in development of new products which is needed and would be particularly helpful to growth companies. The minority statement viewed as very remote the chances of overall tax reform or revision of depreciation schedules at this time.

III. APPEARANCES, ETC., WITH RESPECT TO LEGISLATION

The committee believes the proposed sections pertaining to this issue constitute an improvement over the present highly inequitable situation wherein the businessman is not encouraged to take an appropriate interest in governmental affairs. However, the committee still advocates the adoption of the more comprehensive language included in the Boggs bill (H.R. 640) and the Hartke bill (S. 467).

IV. TAXATION OF COOPERATIVES

The Indiana State Chamber of Commerce has had a longstanding policy of tax equality—that all businesses should compete on the same basis taxwise. It is the opinion of the committee that the proposals in H.R. 10650 are still inadequate but that they are a step in the direction of tax equality and should be supported.

V. WITHHOLDING OF TAX ON DIVIDENDS AND INTEREST

The committee recommended that this proposal not be adopted for the following reasons:

(*a*) There is evidence that the gap in tax payments on interest and dividends is substantially overstated because of the large amount of income of this type which goes to tax-exempt foundations, etc., and to individuals who do not owe Federal tax;

(*b*) The withholding procedures would place a heavy administrative burden on the thrift institutions that would be affected;

(*c*) Automatic data processing should improve the situation in the next year or so;

(*d*) Certain interrogatories could be added to the individual return which would improve greatly taxpayer comprehension of tax liability on this type of income.

VI. DOMESTIC CORPORATIONS RECEIVING DIVIDENDS FROM FOREIGN CORPORATIONS

The committee recommended opposition to the "gross-up" provisions.

VII. EARNED INCOME FROM SOURCES ABROAD

The committee recommends that this proposal not be adopted. Some committee members are associated with companies having operations abroad and it has been their experience that some additional incentives are required to encourage individuals to go into foreign service, and that those in this service forego many governmental services that are available to residents of this country.

VIII. CONTROLLED FOREIGN CORPORATIONS

The committee believes that this proposal should not be adopted on the basis that it constitutes a confiscatory tax and would tend to worsen the balance of payments. The committee stated further, however, that the State chamber should support legislation that would make subject to taxation capital accumulated outside the country for the express purpose and no other purpose but to evade payment of Federal taxes.

IX. TAXATION OF MUTUAL SAVINGS BANKS AND SAVINGS AND LOAN ASSOCIATIONS

The committee recommended approval of the amendments which would put all types of lending institutions on the same Federal tax basis as a step in the general direction of tax equality to which the State chamber long has been committed.

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X. GAINS FROM SALES OF DEPRECIABLE PROPERTY

The committee believes that if good depreciation schedules at ordinary rates are adopted and followed this proposal has merit and would eliminate the source of many disagreements between the taxpayer and the IRS.

THE PHILIPPINE SOCIETY OF CALIFORNIA,
San Francisco, April 17, 1962.

Re section 16 of revenue bill of 1962 (proposed sec. 1248, Internal Revenue Code):

Hon. HARRY FLOOD BYRD,
Chairman, Senate Finance Committee,
Washington, D.C.

DEAR SENATOR BYRD: The Philippine Society of California wishes to submit the following statement in protest against section 16 of the revenue bill of 1962.

Section 16 proposes to tax at rates applicable to ordinary income all gains from the sale or other disposition of stock in foreign corporations which are at least 50 percent owned by American citizens provided the seller owns at least 10 percent of the stock. There is a limitation that the gain taxable at such rate will not exceed the amount corresponding to the undistributed profits earned by the corporation since 1913.

The Philippine Society of California consists of former residents of the Philippines who now live in northern California. Most of them are American citizens who went to the Philippines before World War II while the Philippines was still an American possession. The majority are retired but many still own stock in businesses which they developed in the Philippines during their residence there. These members would suffer serious adverse consequences if section 16 were adopted.

In the past the policy of the U.S. Government has been to encourage Americans to develop businesses in foreign countries. Among the reasons for this policy were: (1) that the development of U.S. business abroad increased American trade and the overall economic strength of this country; (2) that it helped underdeveloped countries and reduced the need for foreign aid; (3) that it helped combat communism. The Government recognized the greater risks of doing business abroad arising from nationalism, political unstability, exchange control and other problems, and to encourage Americans to go abroad reduced taxes so that Americans would not have to pay substantially higher taxes than their foreign competitors who were free from all but the local taxes.

Now there has been an about-face in this policy. The Treasury Department has indicated that the purpose of the existing legislation is to "equalize" tax burdens here and abroad so that American capital will not flee this country in search of "tax havens."

It is respectfully submitted that section 16 does not equalize tax conditions but makes the position of the American businessman abroad, particularly the small businessman, much worse than the businessman in the United States.

For example, an American in the Philippines who owned and operated a Philippine corporation which earned and plowed back into its business $25,000 a year for 10 years would under section 16, be taxed as follows if he sold his stock:

Taxable income for 10-year period	$250,000
Philippine corporate taxes at existing rate of 22 percent	55,000
Total	195,000
U.S. income tax at ordinary income tax rates	152,320
Net left to taxpayer	42,680

NOTE.—In addition any other income taxpayer had in the year of sale would be taxed at 90 percent.

On the other hand, had he operated in corporate form in the United States his taxes would have left him the following:

Taxable income	$250,000
U.S. corporate taxes (32 percent)	80,000
Total	170,000
U.S. capital gains tax	42,500
Net left to taxpayer	127,500

NOTE.—The tax on his other income would not be increased.

The penalty as against U.S. taxes which section 16 imposes grows faster with the success, development and age of the enterprise.

It is obvious that section 16 will very effectively deter small American businessmen from making any future investments in foreign countries where risks are severe enough without such a tax deterrent. While some of these penalties could theoretically be avoided in organizing new businesses through avoiding the use of a foreign corporation, it is often impractical and undesirable for reasons other than tax reasons for the small American businessman who resides in a foreign country to operate in any form other than as a corporation incorporated in that country. Moreover, because of the lower tax rate available to the foreign businessman the American businessman would be unable to compete if he operated in the form of a corporation incorporated in the United States.

If the Government's philosophy is now to put an end to new investments by small American businesses abroad we can only say that such a philosophy will seriously hamper the development of countries such as the Philippines which badly need American capital and know-how. It will also hamper this country's overall economic growth and foreign trade.

As to any American unlucky enough to be forced to liquidate an existing corporate business in a foreign country before he died, the application of these tax penalties would be the worst kind of retroactive confiscatory action. Even if he were able to avoid liquidation for the time being an American with an existing foreign corporation would in effect be denied the right to reinvest future profits within his corporate structure since if he did he would be building up a larger and larger potential tax penalty should he later be forced to liquidate.

Very truly yours,

PHILIPPINE SOCIETY OF CALIFORNIA,
By WILLIAM H. TAYLOR, *Secretary*.

BEVERLY HILLS, CALIF., *April 20, 1962*.

Re H.R. 10650.

Hon. HARRY F. BYRD,
Chairman, Senate Finance Committee,
Washington, D.C.

DEAR SIR: We have been following with great interest the proposed revision of our income tax laws by the Revenue Act of 1962, and in particular the portions thereof dealing with the taxation of income from foreign sources. As lawyers specializing in the field of taxation we feel an obligation to contribute to the enactment of sound and equitable revisions. We also feel that our responsibility to clients requires us to point out any inequities which may adversely affect them. Our purpose in writing you is to discharge both responsibilities.

This letter will discuss three subjects:

1. The retroactive effect of section 16 of the bill containing proposed I.R.C. section 1248.
2. The effect of section 13 of the bill on individual shareholders (as opposed to corporate shareholders).
3. The definition of rents as passive income.

1. Retroactive effect of proposed I.R.C. section 1248

Under our internal revenue laws, individual U.S. shareholders of a foreign corporation have for many years been taxed at capital gains rates upon the dissolution of a foreign corporation or the sale of stock therein, provided that section 341 of the I.R.C. relating to collapsible corporations was not applicable.

Proposed section 1248 provides, however, that upon the liquidation of any controlled foreign corporation (or upon the sale of its stock) gain realized by U.S. shareholders will constitute ordinary income to the extent of the corporation's earnings and profits accumulated since 1918. Thus, for example, a shareholder who formed a controlled foreign corporation in 1920 and who has suffered all the risks of operating abroad will be required to treat gain on sale of his stock as ordinary income, even if such gain is attributable to earnings of the corporation many years ago.

It is submitted that the retroactive effect of proposed section 1248 is entirely inconsistent with the fair administration of our tax law and our country's basic abhorrence of ex post facto laws. Our citizens are entitled to reasonable advance notice of the tax consequences of their acts and should be able to rely on the laws in force at the time action is taken. This is particularly true when the change encompasses not merely a technical correction of an inequity, but an entirely new approach to a broad subject, such as the taxation of foreign income.

So far as we can determine, the balance of the provisions in H.R. 10650 affecting foreign income have been carefully drafted so as to avoid a retroactive effect or to give taxpayers an opportunity to take remedial action before the effective date thereof. We can see no basis for treating the transactions covered by proposed section 1248 any differently.

Proposed section 1248 will tend to neutralize the Treasury Department's efforts to achieve a favorable balance of payments with foreign countries. Instead of encouraging our citizens to bring back to this country any funds they may have abroad, proposed section 1248 will impose a catastrophic tax on any individual who might wish to return his assets in a foreign corporation to this country. Thus, the retroactive effect of proposed section 1248 works at cross-purposes with one of our important overall fiscal objectives.

2. Amendment of section 13 of the bill to provide for election to be taxed as U.S. corporation

We believe section 13 of H.R. 10650 unfairly taxes individual U.S. shareholders of foreign corporations. It appears to us that the drafters of section 13 were primarily concerned with a controlled foreign subsidiary of a U.S. parent corporation. In this situation the prospective application of section 13 will not penalize the user of a foreign corporation, since the subpart F income of the foreign subsidiary will be currently taxed to the U.S. parent at the maximum corporate rate of 52 percent. In other words, the foreign income will be taxed at the same rate of tax as if the U.S. parent corporation had itself earned the income.

On the other hand, if the controlled foreign corporation is owned by individual U.S. residents or citizens, its subpart F income will be taxed currently to these individuals at progressive rates up to 91 percent. Had these individuals forms a U.S. corporation to operate abroad, the maximum tax payable currently by the U.S. corporation would have been 52 percent. Thus, individual shareholders of a foreign corporation are penalized, not merely equalized with, shareholders of a U.S. corporation. The House committee report indicates a desire merely to avoid a postponement of U.S. tax on certain types of foreign income, so that the possible increase in the rate of tax on individual shareholders of foreign corporations appears to have created an unintended hardship.

This point was recognized in the Treasury draft of the bill which contained an election permitting foreign corporations created before December 31, 1961, to be taxed as U.S. corporations (section 961 of the Treasury draft). A fair administration of the tax law would indicate that such an election should be restored to the bill.

If for any reason such an election is unacceptable to the Congress, it is submitted that a substitute provision should be added to the bill to avoid penalizing individual shareholders of foreign corporations. Under section 367 of existing law, it is impossible to reorganize a foreign corporation into a domestic corporation tax free without prior Treasury approval. According to the committee report at the time of its enactment, section 367 was adopted to prevent the avoidance of U.S. tax on the sale of appreciated property, by first transferring such property to a foreign corporation in a tax-free transaction. Thus, the section was intended to permit the Treasury to deny tax-free treatment only where the purpose of the transaction is to place assets beyond the taxing jurisdiction of the United States and not where the transaction's purpose is to bring the assets back to the U.S. taxing jurisdiction. More specifically, we suggest that a possible alternative to the election proposed by the Treasury is an amendment to section 367, to permit the tax-free reorganization of a foreign corporation as a domestic corporation without the requirement of prior Treasury approval.

3. Rents as passive income

Under section 952(e)(3) of the bill, all rents are included in foreign base company income without regard to whether or not such rents constitute more

than 50 percent of gross income. Page 62 of the report of the House Ways and Means Committee indicates that rents are so classified on the theory that active American business operations abroad should be encouraged on an equal competitive footing with locally owned businesses, while U.S. taxation of portfolio-type income and the passive collection of income of foreign corporations should not be postponed. To achieve this objective, however, we feel that a distinction should be made between the rental income of an active business and a more passive investment.

For example, a foreign corporation may purchase or manufacture automobiles or machinery and lease them in a foreign country. In this connection it may employ a large sales staff, a substantial maintenance crew, and other personnel to operate the rental business. It is difficult to distinguish between such a business and one which sells rather than rents similar property. Both types of enterprises should be taxed as active business. On the other hand, we recognize the logic of classifying as passive income the rent collected under a net lease by a landlord which purchased an existing building solely for income from such lease.

The problem of distinguishing between active and passive rental income becomes particularly acute in the motion picture and television industries where the generally accepted method of exploitation is by rental rather than by sale. We submit that where a corporation itself produces a motion picture and thereupon disposes of it in the method normal to the industry; i.e., by rental, such rental is not merely the passive collection of income but the fruits flowing from the active operation of a complicated enterprise.

We understand that consideration is being given to a proposal to remove from subpart F income rental income earned through the active efforts of a taxpayer (as opposed to the passive collection of rents). We submit that this distinction only meets the problem halfway, and that a taxpayer who either manufactures the product leased or who performs substantial services in the rental process should not be classified as a passive investor.

This distinction will, of course, have relevance in many other businesses as well, such as, for example, in the construction of apartment houses, convention halls, business machines, etc.

We are sending copies of this letter to each member of the Senate Finance Committee, to Commissioner Mortimer Caplin, to Representative Wilbur Mills, chairman of the House Ways and Means Committee, to Senator Thomas Kuchel, and to Senator Clair Engle. Should either of these committees feel that we might make a contribution to their deliberations on the proposed bill by testifying in person, we would be pleased to do so. Naturally, we would also be happy to amplify any portions of this letter which might not be wholly clear.

Your consideration of our views is greatly appreciated.

Very truly yours,

IRELL & MANELLA.

CREOLE PETROLEUM CORP.,
Caracas, Venezuela, April 16, 1962.

HON. HARRY FLOOD BYRD,
Chairman, Finance Committee,
U.S. Senate, Washington, D.C.

DEAR SIR: Your committee is currently holding hearings on H.R. 10650, revenue bill of 1962, passed by the House of Representatives on March 29, 1962. I wish to make the following statement on behalf of Creole Petroleum Corp. directed at section 12 of the bill and request that it be incorporated in the record of said hearings. I have limited my remarks to the individual tax problems created by the bill because so many others have testified with respect to treatment of corporate income earned abroad.

There are thousands of American citizens who have chosen careers with U.S. business outside the United States in all parts of the world. Over 700 of them are employed by Creole Petroleum Corp. in Venezuela. Section 911 of the present U.S. tax law excludes from gross income, income earned by a U.S. citizen who is a resident of a foreign country. We wish to urge that such exclusion be continued in its present form and that the changes proposed by the House of Representatives in section 12 of the revenue bill of 1962 (H.R. 10650) not be approved. That section would impose an annual ceiling of $20,000 on such exclusion for U.S. citizens who take up residence in a foreign country, which ceiling would increase to $35,000 after 3 years of continuous foreign residence.

It is important to keep in mind that the proposal of the House is not to create such $20,000 and $35,000 exclusions. It is rather to take away, at least in part, exclusions which have existed since 1926 and around which American businesses operating abroad and American citizens living and working abroad have built a good part of the financial aspects of their lives. Therefore, in order to justify this change, either the circumstances under which the exclusions were originally granted must have changed, or there must be a reason of great, overriding importance which exists today but did not exist then.

The reason given in 1926 for granting the exclusion was the encouragement of foreign trade. It is submitted that the foreign trade of the United States is more important to the country today than it was 36 years ago. Moreover, during the intervening years, the expansion of commercial and political intercourse between the nations of the world has proceeded at an almost unbelievable rate so that today U.S. business abroad plays an indispensable role in the relationships between the United States and other countries.

Among the reasons given for the tax proposals made by the President a year ago, those given to justify the modification of the earned income abroad exclusion seem to be two: first, that the exclusion had been abused by a few, and second, that it would supply additional revenue needed to make up that to be lost by the proposed investment credit. We do not believe the ends justify the means.

The exclusion of individual income earned abroad encourages foreign trade by putting U.S. business abroad on the same footing as its competitors. The major mercantile and manufacturing countries outside the United States do not tax the income that their nations earn abroad. A list of some of these countries is attached. The Congress in 1926 extended this principle to American businessmen operating abroad. Without this, it is more expensive for U.S. citizens who reside in a foreign country to live and work there than for the people with whom our citizens must compete. Or, if the employer must make up the difference in order to keep his American employees, it will cost him more to do business in that foreign country than it costs his competitors.

The foregoing assumes that in order to do business abroad, it is necessary for U.S. companies to have American employees in the countries in which they operate. This is true in many countries, because there are not enough trained people there to perform the needed operations. Furthermore, it will always be desirable to have a number of Americans in foreign operations of U.S. companies to look after the interests of U.S. stockholders.

The reasons which prompted the Congress to act in 1926 are still valid today. The President of the United States is endeavoring to expand the foreign trade of the country even further. Moreover, today, to a far greater extent than was true in 1926, the private enterprise system upon which the American type of democracy is founded is under attack by the totalitarian states. The attack on this and other U.S.-type institutions is so severe that it is said that we are in a kind of war. To win this cold war the United States spends billions of dollars each year in aid to foreign governments. And it spends millions of dollars each year for the Peace Corps to make friends for the United States by letting people in foreign countries see Americans and learn firsthand what they are like and by teaching people to read and write, farm, build roads, and otherwise better their living conditions.

But U.S. business has been doing this for years. The billions of dollars spent in developing private business abroad have contributed substantially to accomplishing what the U.S. Government now wants to do and have done so at much less cost to the U.S. taxpayer. Creole Petroleum Corp. employs 12,000 people in Venezuela. It provides basic, technical, and higher education for many of its employees and their families and provides housing and hospitals in many areas. It has built roads and other public works as community contributions and has subscribed to public works bonds. The story is similar in other countries. Frequently, the only Americans that people in other countries know are employees of American companies. Without this kind of assistance from American business abroad, the cost of fighting the cold war in many parts of the world would be astronomical. It seems clear, therefore, that what the Congress was endeavoring to encourage in 1926 should be encouraged to an even greater extent in 1962. Instead, the House bill proposes to discourage Americans from living abroad or to raise the costs to their employers of keeping them there or both. For what?

It is said that the present earned income abroad exclusion is abused by Americans who take up residence abroad solely to reduce their tax burdens. The ex-

ample most frequently used is that of movie stars. But the percentage of Americans residing abroad for the purpose of avoiding taxes must be very small when compared to the thousands who reside abroad because their jobs take them there. The average length of residence in Venezuela of the more than 700 Creole foreign service employees is 9 years. If the group is limited to 30 top executives, the average length of residence abroad is over 20 years. Surely, it is unfair and unwise to change a salutary tax provision of 36 years' standing for the sole purpose of preventing a few taxpayers from abusing it.

It is also said that additional revenue would be provided by the change in the amount of the exclusion and that the additional revenue is needed to help make up the revenue loss which would accompany the new investment incentives. The additional revenue was originally estimated to amount to about $10 million a year. Compared to the billions budgeted each year, this is an almost insignificant amount and it is not much different from the cost of the Peace Corps. It seems inconsistent to vote additional money so that the Government can do many of the things that private business can do and is doing abroad and at the same time make it more difficult for private business to operate abroad and thus contribute to these objectives at less cost. It should be remembered, moreover, that state ownership is favored over private enterprise in many areas of the world, even in countries friendly to the United States. If the Congress is concerned about this attitude, it should act to strengthen and not weaken the position of those who are trying to teach the advantages of private enterprise to other nations.

The proponents of the bill speak of curing abuses, but say nothing of the inequities which the specific changes in the proposed foreign-earned-income exclusion would create. It is said that $20,000 to $35,000 is a generous allowance. But this assumes that conditions are the same in all countries outside the United States. It may be generous in one country and thus not affect Americans living there. In another country, such as Venezuela, the effect may be considerable. Salaries depend in large part on cost of living. The attached chart shows the great disparity between costs in several countries with which the United States does business. Costs in Caracas, Venezuela, are almost 80 percent higher than those of Washington, D.C., and more than double those of some other countries. The present exclusion is fair because it puts all Americans working abroad in the same position from a tax standpoint as the other people working in the same country. Moreover, the proposed changes put the greatest penalty on the highest paid positions which are apt to be filled by people who have spent the greatest time abroad in the promotion of American foreign trade and by the people who are the most important to the continued existence of U.S. business abroad.

Proponents of the proposed changes in the exclusion deprecate the effect of their proposal on individual Americans living abroad with the assertion that their employers will compensate them for the increased taxes. This theory has several flaws. First of all, since competition in foreign areas comes from companies whose countries of origin do not tax the income their nationals earn abroad, American businesses would incur higher costs than their competitors by absorbing the increased taxes of their employees. This would make American business less competitive at a time when it is receiving increased competitive pressure from all quarters. Secondly, the application is unfair because, due to the varying levels of cost of living pointed out above, the effect on companies in country A might be negligible (with an accompanying negligible benefit to the U.S. Treasury) and the effect on companies in country B could be considerable. Only certain companies of all that are doing business abroad, therefore, would be required to meet the brunt of the increased revenue aspirations of the House.

An equally important consideration is the effect that increasing American employees' compensation would have on the economies of many countries. To do so without raising the pay of the other employees would surely be greeted with the charge that the imperialists have again taken care of their own people but not those of the host country—in spite of explanations as to the reasons for the increase. Creole takes great pains to insure the principle of equal pay for equal work. On the other hand, to grant all employees pay increases equal to those received by American employees for tax reasons would further increase costs of U.S. companies and further reduce their ability to compete. Moreover, this would tend to create wage spirals and inflation in the host countries. In short, American business would be subjected to severe criticism whichever option it chose—an unenviable position.

In summary, it is our conviction that the changes in the earned-income exclusion for individuals residing abroad as proposed by the House in section 12 of the revenue bill of 1962 will reduce the ability of American business to compete abroad; will make it more difficult to attract Americans for oversea employment; will be detrimental to efforts to expand American influence and ideals abroad; cannot be justified as a measure to correct abuses; will produce little additional revenue for the Government; and will operate in a discriminatory manner.

If the Congress is nevertheless persuaded that this bill must contain provisions to correct abuses permitted by section 911 of the present law, it might consider how this could be accomplished without causing the unfortunate effects on U.S. business abroad which are described above. For instance, both of these ends might be partially obtained by a limitation of $35,000 per year of excluded income for the first 3 years of foreign residence, increasing to $50,000 at the end of 3 years and $75,000 at the end of 6 years. This would certainly reduce the area of abuse and would mitigate the effects of the limitation on bona fide foreign service employees and their employers. Other solutions will undoubtedly occur to your committee.

In closing, I wish to thank you and your committee for your consideration of our views.

Very truly yours,

HARRY A. JARVIS.

Indexes of living costs, excluding quarters

[Washington, D.C. = 100]

Country	Index	Date of report
Caracas, Venezuela	177.4	June, 1961.
Bogotá, Colombia	83.3	October, 1960.
Dhahran, Saudi Arabia	103.5	April, 1960.
Mexico City, Mexico	86.3	May 1961.
Lima, Peru	91.5	December 1960.
Aruba, Netherlands Antilles	121.1	February 1960.
Buenos Aires, Argentina	81.7	May 1961.

Source: U.S. Department of State.

TAXATION PROVISIONS AFFECTING INDIVIDUALS IN MAJOR ECONOMICALLY ADVANCED COUNTRIES [1]

A review has been made of the tax laws of 20 economically advanced foreign countries to determine whether any of them would impose income tax on employment income earned abroad by citizens who are bona fide residents of another country.

The tax laws of the following countries were examined:

Australia	Netherlands
Belgium	Netherlands Antilles
Canada	New Zealand
Denmark	Norway
Finland	Portugal
France	South Africa
Germany	Spain
Hong Kong	Sweden
Italy	Switzerland
Japan	United Kingdom

Confirmation of the results of the study has been obtained from tax advisers in each country.

The general rule, in each of the countries listed above, is that they do not tax employment income of its citizens who are bona fide residents of, and working in, a foreign country. With only four exceptions, the countries, on the basis of residence, do not tax income earned abroad by citizens who are resident abroad; the only income of nonresidents that is taxed is domestic source income. Since Hong Kong, Portugal, South Africa, and Spain (the four exceptions) as a

[1] Source: Tax department, Creole Petroleum Corp.

general rule do not tax foreign source income, they have no specific earned income exclusion based on nonresidence.

AMERICAN CHAMBER OF COMMERCE IN BELGIUM A.S.B.L.,
Brussels, April 19, 1962.

Hon. HARRY BYRD,
Chairman, Finance Committee,
Senate Office Building, Washington, D.C.

MY DEAR SENATOR BYRD: The American Chamber of Commerce in Belgium wishes to follow up its telegram of March 21, 1962, signed by its President who is temporarily absent from Belgium, by submitting the attached memoranda concerning H.R. 10650 which is now up for consideration by the Senate. It is therefore respectfully requested that this letter, with memorandums attached, be made a matter of record and be included in the printed record of your committee's hearings.

Although it is strongly felt that the arguments propounded in the attached memorandums constitute in themselves enough valid reasons why the measure should not be enacted in its present form, what concerns this chamber most are certain intangible factors involved in the situation, which should be viewed in the wider framework of the relationship of the United States vis-a-vis her Western allies. Inconsiderate treatment by the United States of her political, as well as trading, partners through the passage of shockingly radical if not unconstitutional legislation, which would violate the long established principles of international fiscal laws as well as the spirit, purpose, and basic principles of existing tax treaties, would add one more adverse factor to an already serious and ever-growing sense of disillusionment among our friends abroad. To the European, the introduction of new and untried fiscal principles which would tax the income of his own corporations and in effect interfere with his own laws, this extraterritorial legislation is unjustified and indeed constitutes aggressive action on our part. This is the sort of stuff that the "image of America" is made of, whether for good or ill.

What cannot be explained away in Europe is the fact that the House Ways and Means Committee supported the measure knowing full well that certain provisions would run counter to our international obligations; and even went so far as to adopt a provision to the effect that, in the event of a conflict between a provision of the bill and a treaty, the treaty is overridden (section 21). Other friendly countries, being fully aware that treaties and acts of Congress both are fundamental laws of the land, are seriously concerned with this premeditation which constitutes unilateral abandonment, and wonder whether this sets the pattern to be followed in trade and other agreements to be made in the future.

This is particularly unfortunate following so closely the President's acceptance of the Tariff Commission's recommendation to increase the tariff rates on woven carpets and glass. The lamentable results of this move, which seemed ill advised and badly timed, have already included a united reaction by the Common Market to protect one of its members, specifically Belgium. The European Economic Community, acting as a unit for the first time, addressed a strongly worded memorandum (dated Apr. 3, 1962) to the U.S. Government and requested consultations under the GATT procedure to offset the U.S. tariff increases.

After the widely publicized drive by the United States to move toward a more liberal trade policy, and the announced intention of the administration to enter into further negotiations with the Common Market to reduce tariffs, such action on our part undermines confidence in the word of the U.S. Government. More and more are Europeans considering that Americans preach to them about principles on the one side, but act contrary to their preachments on the other side when their own interests are concerned.

Every ill-considered action on our part which leads to loss of confidence builds up the "image" abroad of American ambivalences. The effect is cumulative, and it is this factor we feel which may well redound to our national disadvantage in terms of diminution of prestige and leadership potential with our Western allies.

This aspect of H.R. 10650 in the long run will undoubtedly prove to be much more important even than the tax injustices and shortsighted economy inherent in certain provisions of the bill—or the added $85 million which the Treasury Department expects to pick up in taxes from oversea earnings. Furthermore, what abuses may exist of a tax haven nature, it is believed, can be nullified by

enforcing the present law or by other means less radical and less costly to the national interest than those provided for in the present measure.

At this juncture, it is the naive American at home, not the "ugly American" abroad, who is most likely to do our country the greatest injury.

A letter identical to this one is also being sent to the chairman of the Senate Foreign Relations Committee.

Respectfully yours,

ROBERT F. DESBERG, *Vice President.*

[Enclosure No. 1]

APRIL 10, 1962.

ADVERSE BELGIAN REACTION TO EXTRATERRITORIAL FEATURES OF NEW TAX PROPOSALS (H.R. 10650)

Undoubtedly the committee will have received submissions from numerous and varied sources expounding the reasons why the proposed bill, if enacted, would violate the spirit, purpose, and basic principles of the tax treaties in effect between the United States and some 44 friendly governments—if not strictly the letter of these treaties—through the levying by the United States of a tax based on the undistributed income from foreign sources of corporations established in the 44 countries concerned. Let us, therefore, try to avoid duplication and confine our attention to the results that we, as an American chamber of commerce abroad, have obtained from an investigation conducted in competent circles in Belgium. Whereas none of the conclusions drawn in this memorandum, or any of the answers reported to the questions asked, emanate from Belgian official sources, the questions posed were put to and answered by individuals fully conversant with Belgian fiscal policies and with the thinking of those responsible for such policies.

BELGIAN THINKING REVEALED BY QUESTIONS AND ANSWERS

By direct questioning of the selected sources noted above the following interesting answers were obtained.

1. Under a company and tax law in Belgium:

(*a*) Is a company a juridicial entity separate from its shareholders?

Answer: Yes.

(*b*) Can the shareholders be required to pay tax on income derived by and belonging to the company before it is distributed to them?

Answer: No.

2. Are the foregoing principles inherent in the income tax convention between Belgium and the United States?

Answer: Yes.

3. Under the said income tax convention:

(*a*) Should the United States tax a company resident in Belgium on business income not allocatable to a permanent establishment in the United States, or on dividends or other income not attributable to U.S. sources?

Answer: No.

(*b*) Does the so-called "saving clause" in said tax convention (which states that each government may tax its citizens, or residents, or corporations on the basis of all items of income taxable under its laws, subject to granting a credit, exemption, or other relief from double taxation), permit the United States now to include in the basis of its tax, on its citizens, residents, or corporations all or part of the income of a company resident in Belgium from sources therein or elsewhere outside the United States before it is distributed?

Answer: While no provision in the treaty specifically prevents this, it is certainly against the spirit and principles of said tax convention.

(*c*) Could the Belgian Government retaliate by including in the taxable income of shareholders resident in Belgium a proportionate part of the undistributed income of a corporation organized in the United States?

Answer: If the Belgian Government decided to retaliate it could do so in this manner. It seems that it would rather resort to raising its rate on income payable to U.S. shareholders. Two of their reasons for protesting and envisaging retaliation would be:

(1) It has been an old-established policy of the Belgian Government to tax undistributed profits at a level lower than that imposed on distributed profits, for the obvious purpose of encouraging corporations to expand their industrial

facilities. The effects of the proposed U.S. fiscal measures affecting so-called tax haven profits would tend to nullify this Belgian internal fiscal policy so far as Belgian entities fully or partially owned by U.S. interests are concerned.

(2) The Belgian Government has taken a number of measures—including temporary exemptions from, or reductions in, income tax—to foster industrial investments by its nationals as well as by enterprises of the United States and other foreign countries. The U.S. draft bill, if enacted, would bring long established subsidiaries in Belgium of U.S. corporations who have never committed any tax abuses, within the scope of the U.S. tax in respect to part of their undistributed income from foreign sources. There would be imposed a burden that would in effect be discriminatory as compared with that borne by competing companies owned by nationals of other countries who are not subject to a levy such as that proposed by the U.S. Treasury.

[N.B.: We should ever be mindful that, should a tax of extraterritorial character, such as is now proposed by the U.S. Treasury, be imposed by a foreign government on the basis of the undistributed income of U.S. corporations from U.S. sources, it would fall within the purview of section 891 I.R.C. which authorizes the President to double the U.S. rates of tax, subject to a maximum of 80 percent on income from U.S. sources derived by citizens or corporations of a foreign country which imposes on U.S. citizens or corporations discriminatory or extraterritorial taxes.]

(*d*) Would the Belgian Government object to the de facto invasion by the United States of its jurisdiction over the resident company through the United States demanding balance sheets, profits and loss statements, and other information concerning the transactions of the resident company with companies in third countries in order to determine the basis of the proposed tax?

Answer: Yes. Such a novelty would, at the least, entail a renegotiation of the tax convention. No European government requires its corporations to supply data about income of foreign subsidiaries attributable to sources outside its territory. Certain countries may tax a foreign corporation if it has its central management and control in their respective territory, but the tax is on the corporation and not on the shareholders.

(*e*) Would the Belgian Government permit U.S. revenue agents to examine in its territory the books of resident companies?

Answer: No.

(*f*) Presupposing that the United States has ample authority under its law and its tax convention with Belgium to allocate to the U.S. parent corporation profit diverted to the subsidiary in Belgium by transactions which enable the subsidiary to derive therefrom more income than an independent enterprise would receive, is the Belgian Government bound by said tax convention to assist the United States in reallocating to the U.S. parent corporation income diverted to the subsidiary?

Answer: Yes.

(*g*) If the subsidiary in Belgium derived income (1) from selling to customers in third countries goods purchased from the U.S. parent or an affiliated company in a third country; (2) from licensing patents or rendering technical services to affiliated companies in third countries; (3) from interest on loans to or (4) dividends on shares in such companies, does the United States have the right under the laws of Belgium or the tax convention with the United States to levy a tax based on such income before it is distributed to the U.S. parent?

Answer: No.

(*h*) Would the Belgian Government assist the United States in collecting such a tax?

Answer: No.

(*i*) If the Treasury bill were enacted and if the U.S. shareholders voted to distribute income of a company resident in Belgium in order to pay the tax, excluding income set aside in reserves required by law, but including profits needed for reinvestment in its business, and thus harmed the interests of minority stockholders resident in Belgium, would the Belgian Government object in their behalf?

Answer: Yes, insofar as relations with the Belgian company are concerned.

(*j*) Would the Belgian Government consider as extraterritorial the basing of a U.S. tax on a local company's income from sources in Belgium or third countries?

Answer: Yes.

(*k*) Would the Belgian Government consider as discriminatory the basing of a U.S. tax on a local company's profits from selling or licensing to persons in

third countries, and from other perfectly normal although arbitrarily termed "tax haven" transactions (in the present bill called subpart F income, including foreign base company income), but not on the income from manufacturing in Belgium?

Answer: Yes.

(*l*) Would the introduction of a U.S. tax on the basis of a part or all of a local company's undistributed income be considered as the creation of a new form of taxation contrary to the spirit of the tax convention between Belgium and the United States?

Answer: Yes.

(*m*) If the United States introduced such a tax, would the Belgian Government protest or even denounce the convention?

Answer: Yes; in any event, steps would doubtless be taken immediately to renegotiate the tax convention.

ANALYSIS OF INVESTIGATION

In brief, we feel that this investigation in Belgium has fully borne out a statement which we made in our "memorandum concerning certain proposals in the President's tax message of April 20, 1961" (page 3) submitted to the House Ways and Means Committee under cover of a letter to the committee chairman dated June 1, 1961, albeit that that memorandum concerned itself solely with two subjects included in the administration's proposals, namely those relating to "tax deferral" and those relating to the exclusion of income earned abroad by American citizens residing overseas. With equal validity the following statement holds true as regards subpart F income including foreign base company income:

"The unprecedented influence by the Government of the United States on the affairs of foreign legal entities would without any doubt be highly resented and would give rise to unnecessary tensions between friendly governments, since foreign governments might vary understandably consider it an encroachment upon their sovereignty."

Furthermore, the principles laid out in the Fourth Report of the OEEC Fiscal Committee 1961, on the elimination of doubt taxation, in the commentary on article XX concerning the taxation of dividends inter alia, reflect general acceptance in Belgium, and we dare say represent a consensus of European opinion on the subject. We quote as follows:

"Under the laws of all European countries such joint stock companies are legal entities with a separate juridical personality distinct from all their shareholders or members.[1]

"The position is different for the shareholder (as distinguished from a partner); he is not a trader and the company's profits are not his; so they cannot be attributed to him. He is personally taxable only on those profits which are distributed by the company."[2] [N.B. There follows a parenthetical clause to the effect that, apart from the provisions in certain countries' laws relating to the taxation of undistributed profits in special cases—which clause refers to legislative provisions in Belgium, the United Kingdom, Ireland, Germany, Greece, and the Netherlands[3]—no provision is made for taxing the shareholder on the income of the company before it is distributed.]

"Where a company which is a resident of a contracting state receives profits or income from the other contracting state, such other state may not levy any tax on the dividends paid by the company to persons who are not residents of that other state, or subject the company's undistributed profits to a tax on undistributed profits even if the dividends paid or the undistributed profits consists wholly or partly of profits or income arising in such other state."[4]

The commentary on this paragraph states: "Paragraph 5 adopts a provision already contained in a number of conventions. It rules out extraterritorial taxation of dividends and further provides that nonresident companies are not to be subjected to special taxes on undistributed profits."[5]

In short, the proposal to tax the so-called tax haven profits of controlled foreign corporation and especially profits from sources in foreign countries is considered to be contrary to—

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[1] Fourth Report of the OEEC Fiscal Committee 1961, annex F, par. AI, p. 37.
[2] Id.—Annex F, par. 13, p. 37.
[3] Id.—Pars. 43 to 50, pp. 46–48.
[4] Id.—Annex A, art. XX(5), p. 25.
[5] Id.—Par. 42, p. 46.

(1) The fundamental principles in the laws of all European countries and of all other countries whose laws are modeled on European laws or embody said principles; said principles exist also in the law of the United States.[6]

(2) The provisions in article XX (5) has been agreed to by the 18 members of the OEEC. The United States participated in the work of its fiscal committee as an associate member. Presupposing that the OECD will have a fiscal committee to continue the work of the OEEC fiscal committee, the report states that the recommendations relating to avoidance of double taxation adopted by the OEEC Council will be maintained and that "they will apply thenceforward to the United States and Canada."[7]

(3) The principles in the national laws mentioned under (1) which are inherent in the tax treaties between 44 of said European and other countries and the United States.

CONCLUSIONS TO BE DRAWN

From the foregoing we conclude the following:

(1) The United States could not properly subject the controlled foreign corporation itself to tax on income not allocatable to the United States under the Internal Revenue Code and tax conventions, and should not include in the income of U.S. shareholders all, or part, of the income of a controlled foreign corporation especially if it is from sources outside the United States, even though defined as subpart F income, including foreign base company income.

(2) Taxation of U.S. shareholders on the basis of income belonging to a controlled foreign corporation was never contemplated as being within the purview of the "saving clause" in tax treaties under which each state reserved the right to include in the basis of its tax income taxable under its laws, regardless of any contrary provision in the tax treaty.

(3) The introduction now of such a tax would contravene the basic principles of the laws of foreign countries and the spirit of the tax conventions concluded by the United States with such countries.

(4) If such a tax were enacted, it can be fairly assumed that foreign governments would resent such an incursion in their fiscal jurisdiction, would not permit U.S. revenue agents to examine the corporations' account books and records in their territory, and would not cooperate in enforcing or collecting the tax on income from sources outside the United States.

(5) While foreign governments, under the provisions for mutual administrative assistance in tax conventions, would presumably help the United States in reallocating to the United States for tax purposes any profits diverted from a U.S. corporation to a corporation in their territory by transactions not on an arm's-length basis, they could not be expected to assist in the taxation of profits properly attributed under their laws to sources in their respective territories or the territories of third states.

(6) Under the above concepts the proposed tax would be extraterritorial.

(7) Moreover, it would discriminate against certain items of income and certain taxpayers.

(8) The proposal would introduce a new form of taxation which was not contemplated when the tax conventions were concluded and would be contrary to their spirit and basic principles.

[Enclosure No. 2]

APRIL 19, 1962.

MEMORANDUM ON LEGAL AND TECHNICAL PROBLEMS IN THE APPLICATION OF H.R. 10650

Aside from the generally distruptive effects on the life of a corporation caused by taxing shareholders on undistributed income of a corporation, the following specific problems would arise:

(1) The constitutionality of the measure would be questioned. Taxing shareholders on the income of a corporation could be held to violate the fifth amendment (*Hoeper* v. *Tax Commission*, 284 U.S. 206 (1931).

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[6] *Hoeper* v. *Tax Commission*, 287 U.S. 206; *Eisner* v. *Macomber*, 1920, 252 U.S. 189.
[7] Fourth Report of the OEEC Fiscal Committee, 1961, par. 34, p. 19.

(2) Due to loss carryovers, legal reserves and other requirements or provisions of local law, receipts which would not be subject to foreign tax or which can never be distributed would, under the proposed bill, be subject to U.S. tax.

(3) Despite the provision for tax credits, if income already taxed to the U.S. shareholder is distributed, it may be subjected to a higher foreign tax rate than the U.S. rates. (Foreign taxes on undistributed profits are often lower than on distributed profits.) In such case no U.S. tax would have been due on the income. However, because U.S. taxation under the bill occurs prior to distribution, U.S. tax would already have been paid.

Income, under these circumstances, may be subject to double taxation.

(4) The income of third tier, or more remote foreign controlled corporations would be subjected to U.S. tax; and no tax credit relief would be available.

(5) Incredibly burdensome double accounting would be required by the foreign corporation if it attempts to satisfy the need of its shareholders for information necessary for U.S. tax purposes as well as maintaining the required accounts for local law.

BRUXELLES, *March 21, 1962.*

Hon. HARRY BYRD,
Chairman, Finance Committee, Senate Office Building, Washington, D.C.:

The American Chamber of Commerce in Belgium, a private nonprofit organization contributing to advancement of mutual interests of United States and Belgium in trade and investment, with 600 membership comprising many American firms, wishes to draw committee's attention to and include in the printed record of the committee's hearings the following points on foreign source income.

New tax proposals will:

First, violate the long-established principles of international fiscal laws as well as the spirit, purpose, and basic principles of existing tax treaties as outlined in our representations to the House Ways and Means Committee dated June 1 and November 30.

Second, destroy the ability of American enterprise to compete in world market.

Third, surrender hard-won U.S. position, prestige, and technology to foreign interests.

Fourth, injure our foreign trade by sharply reducing export and shipping port activities and air traffic.

Fifth, wipe out jobs dependent upon trade and upon foreign earnings now reinvested here.

Sixth, dry up private investments in less developed countries, thereby requiring more taxpayers' dollars for foreign aid.

Seventh, injure our balance of payments by killing off favorable flow of dollars from American investments overseas.

Eighth, inevitably increase already heavy burden of American individual and business income taxes.

ROBERT H. JEROSCH, *President.*

BECKMAN INSTRUMENTS, INC.,
Fullerton, Calif., April 17, 1962.

Hon. HARRY F. BYRD,
Chairman of the Senate Finance Committee,
U.S. Senate, Washington, D.C.

DEAR MR. BYRD: The proposed Revenue Act of 1962 (H.R. 10650) contains in its section 13 legislation which will unreasonably tax legitimate foreign operations of domestic companies. We support and second the sound arguments of principle set forth against this legislation by such organizations as the American Institute of CPA's.

In addition, we feel you will be interested in the personal observations and experiences of a company which literally started in a garage in California some 27 years ago and now sells its California-manufactured products throughout the world.

Beckman Instruments, Inc., started in 1934 with a capitalization of a few thousand dollars. Its current annual sales rate is $80 million. We manufacture precise, quality scientific instruments. The development and manufacture of this type of instrument requires an excellence of engineering and assembly skills and, for that matter, the sales and service of such items demands the same standards.

Experience in the early 1950's taught us that to compete in the European market it was necessary to establish an operation locally. Consequently, a manufacturing subsidiary was established in Munich, Germany, in 1953. This manufacturing operation at that time (and currently) only makes a few of our instruments. It is difficult to export the skills required for the manufacture of our complex products. The tariff changes resulting from the formation of the Common Market increased the importance of our manufacturing operation within the territory. At the same time, the same reasons fostered our need for an operation in the sterling area, and a manufacturing subsidiary was established in Glenrothes, Scotland, in 1958. Each is an independent subsidiary of a Swiss holding company. Foreign sales are handled through a third subsidiary of the Swiss holding company. Foreign subsidiaries are used for the very practical reason that in at least two jurisdictions we would be subject to a higher tax rate and possibly some of our local profits would be taxed if we did not function through an independent subsidiary.

The following chart shows the increase in our sales, both foreign and domestic, throughout the years and the chart below it shows the increase in our employment figures, both foreign and domestic.

Fiscal year	Foreign sales				
	U.S. production		Foreign production		Total
	Amount	Percent of total	Amount	Percent of total	
1959	$4,266,854	75.0	$1,425,721	25.0	$5,692,575
1960	5,722,697	74.0	2,007,331	26.0	7,730,028
1961	7,757,991	75.0	2,579,668	25.0	10,337,659
1962 [1]	8,857,000	73.2	3,243,000	26.8	12,100,000

[1] Estimate.

	Domestic only	Foreign only	Total, domestic and foreign
July 1, 1958	2,628	307	2,935
July 1, 1959	3,121	299	3,420
July 1, 1960	3,735	525	4,260
July 1, 1961	4,044	499	4,543
Jan. 1, 1962	4,468	543	[1] 5,011

[1] Estimate based on October 1961 figure.

Regardless of the existence of manufacturing operations, we do not assemble a product in a foreign country unless the competitive factors, which are dominated by the tariff problem, prevent us from shipping instruments from California. There are many reasons for this, such as duplication of capital investment, complications in exporting the needed skills, and our feeling of a strong responsibility to produce as much as possible in this country in preference to other countries. It is no secret that the lower labor rates of other areas do not assure lower per-unit cost in such areas. We have found that it is impossible to transport the American efficiency resulting from the abilities of our labor and management.

I am sure you noted from the tables above that the percentage of our foreign sales resulting from the production within the United States has not decreased in the last 4 years even though we added a second foreign manufacturing facility. Rather than exporting jobs, we are exporting sales which have resulted in more jobs being created in the United States and principally in California. The rather sizable increase in our employment figures within the United States, as shown in the above table, substantiates this.

In 1959, when the company's total foreign sales were approximately $5.7 million, we transferred the manager of our foreign operations to Europe in order to facilitate his supervision of the sales activities in Europe and the production there. Certainly no one can argue that a business of this size needs on-the-spot management. This is particularly true in our case as our German operation had yet to see a profitable year; the Scottish operation had just been commenced; the complexity of our products requires highly skilled personnel and management to stimulate their sales and to supervise their servicing.

A close, highly technical liaison is required between ourselves and the customer in order for him to receive value from our complex instruments. Skilled personnel must demonstrate our instruments, instruct the customer in their application and maintenance, and service the instruments. There is a mushrooming reciprocity between our foreign and domestic sales: more parts are shipped from here abroad, and a customer using one of our instruments becomes acquainted with, and a potential customer for, more precise and elaborate instruments of the same type or a completely different instrument, neither of which is apt to be currently made in our foreign manufacturing operations.

In fiscal 1959 our foreign sales originating from the U.S. production was $4.2 million. As a direct result of our organization of foreign subsidiaries, this fiscal year our foreign sales resulting from U.S. production will total $8.8 million.

There were many disadvantages to establishing a headquarters and sales office at one of our existing production locations; consequently, we looked for another location which was geographically convenient and where living conditions would be acceptable to the personnel that had to be moved and which had a stable economy and monetary system. Switzerland was the obvious choice. Consequently, we now coordinate all of our production, sales and service activities from Switzerland.

The expansion of our foreign operation naturally required capital, and we made an equity investment in these foreign operations. Because of the startup working capital requirements, we made short-term loans to these companies. These loans will be repaid from profits.

The growth of our foreign operation parallels our domestic growth and more capital may be required. It is true that we have a potential source of capital within the United States which we could export to Europe. We believe, however, that by reinvesting the profits of our foreign operations in Europe we avoid increasing the gold outflow. As we repay the existing loans we will actually stem the gold outflow.

There will come a time when future capital requirements will not necessitate additional investment in Europe and as the profits, then greater because of the larger investment, are returned to the United States they will be fully taxed. Currently taxable income within the United States is produced from the products exported and from the interest payments made to the United States and from royalty payments made from both manufacturing subsidiaries to the United States. We do not accumulate royalty payments in our Swiss holding company. These payments are made directly to the United States.

Our foreign operation is a legitimate day-to-day business operation and not conceived or functioning as a tax haven. We are not exporting jobs. Our activities are in line with all of the normal objectives of this country. Our European activities are not in undeveloped areas; on the other hand, no foreign industry had previously existed in the Bavarian area of Germany prior to our commencement of operations there, and only very few foreign companies operated in Scotland when we commenced operations there. Certainly neither of these areas could guarantee the success of a foreign operation. We strongly resent the penalties which the proposed legislation would inflict upon us and indirectly upon our 5,000 employees and 6,000 stockholders. I am sure that in voting upon legislation a Member of Congress examines both the short range and long range consequences. No one should be so shortsighted as to believe that this legislation would not promptly cause reprisal legislation in a country such as Switzerland; all of our profits would be taxed there and we, our employees, and stockholders, and this country as a whole would never realize the benefits from our foreign profits and growth.

The Treasury Department, without this additional legislation, has the means to, and should attack paper tax haven operations and the unreasonable accumulation of profits in these tax havens. It apparently only lacks the courage to use the existing means. We simply wish to reemphasize that our operation functions as a genuine business activity, has caused increase in our U.S. sales and profits, and in no way functions as a paper transferring tax haven. We do not sanction those indefensible operations which are truly tax havens.

In summary, our growing foreign market provides more jobs within this country. The use of profits from our foreign operations stems the necessary gold outflow which would be required for us to remain competitive. For these reasons, we hope that you will seriously consider your vote upon the H.R. 10650 ad, if it contains section 13 in its preset form, vote against it.

Very truly yours,

L. N. DURYEA, *Counsel.*

MEMORANDUM BY ARTHUR ANDERSON & CO. TO THE MEMBERS OF THE SENATE FINANCE COMMITTEE ON THE FOREIGN INCOME PROVISIONS OF H.R. 10650

Arthur Anderson & Co. is an international firm of certified public accountants organized as a partnership under the laws of the State of Illinois with its headquarters in Chicago, Ill. We have 31 officies in the United States and 24 offices in 19 other countries. The clients of our oversea offices include not only subsidiaries of U.S. corporations but also corporations owned or controlled by shareholders who are nationals of countries other than the United States. We are particularly familiar with business conditions in Europe, Canada, Mexico, South America, and Australia.

We respectfully object to the foreign provisions of the pending bill and urge their defeat. Our position is based upon the following grounds:

1. The statistics compiled by the U.S. Department of Commerce purporting to show that the existence of American business overseas adversely affects the balance of payments are based upon incomplete questionnaires and do not support such conclusion.

2. A majority of the foreign subsidiaries of our U.S. corporate clients were set up to expand into markets not available through an export operation from the United States and with no U.S. tax avoidance in mind.

3. Enactment of these provisions will cause a decrease in U.S. exports because, (*a*) many of these oversea subsidiaries will be sold to foreign interests and (*b*) the pricing provisions of the bill will put a premium on the purchase of foreign goods rather than U.S. exports.

4. The tremendous risks of setting up an enterprise in an underdeveloped country with an unstable government and an unstable currency will now be increased by the tax uncertainties created by this bill; the reward for developing a country will be an increased tax burden.

Finally, and perhaps most importantly, the technical provisions of this bill are fantastically complex, in our judgment will prove almost impossible for the Internal Revenue Service to administer, and render it impossible for any U.S. corporation to know its U.S. tax liability until many years after its return is filed.

As an example of an ill-conceived provision, the terms "earnings" and "earnings and profits" are used in a number of places in the bill. Most of the world follows the civil law and in those countries they have a commercial code, a civil code, and usually a company act. None of them have any such accounting concept as earned surplus or accumulated earnings. In most of these countries the company is required by law to set up a "legal reserve" out of net income. Would a provision to such a reserve be deductible? In many of the countries revaluation of assets is either mandatory or permissible to recognize inflation. Does the credit arising from a revaluation of assets become a part of earnings? If it does, then how should depreciation on fixed assets be calculated when the laws of that country say that such depreciation should be based upon the revalued assets? There are a host of reserves other than the legal reserve that are either required or permitted by the laws of a particular country. In determining earnings of a foreign corporation under this bill, do we apply a theoretical U.S. law to a corporation that is not subject to it? In determining earnings and profits of a U.S. corporation for U.S. income tax purposes the rule is that commercial accounting concepts are to be followed except when a provision of the Internal Revenue Code requires otherwise. In determining the earnings and profits of a foreign corporation, do we apply the accounting concepts of the country in which it is organized and operates, or should we disregard the laws of that country and make theoretical computations having no relationship to the actual operations of that company abroad?

SPECIFIC SUBSTANTIVE COMMENTS

Section 6. Amendment of section 482 (allocation of income and deductions)

1. Present section 482 authorizes the Secretary to distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among related organizations in order to prevent evasion of taxes or clearly to reflect the income of such organizations, trades, or businesses. We believe the present section combined with the reporting requirements of section 6038 contains broad enough powers for the Treasury Department to correct any abuses in the allocation of income and deductions between domestic and foreign corporations. There is no need whatsoever for new allocation rules.

2. The proposed amendments to section 482 give too much discretion to the Commissioner to allocate income. The proposal establishes certain factors which the Secretary or his delegate must take into consideration. The bill seems to require consideration in a subjective manner. As a result it will be difficult for a taxpayer to overcome the agent's determination. In practice such a provision would often mean that a taxpayer would probably have to resort ultimately to court action in order to overcome the agent's allocation. The safeguards of "arm's length price" or "alternative methods" of allocation, as a practical matter, will provide little assistance to the taxpayer.

3. As this section is presently written any income allocated to a U.S. taxpayer will be considered to be nonforeign source income. Allocated with the income will be any foreign income taxes paid on such income. However, since the income will be nonforeign source, it will not be possible to apply the foreign income tax as a credit against the U.S. tax due on such income. Thus the income will be taxed both in the foreign country and in the United States with no foreign tax credit allowed—clearly a case of double taxation. This provision alone may cause many U.S. companies to become noncompetitive abroad.

4. In many cases, because of local competitive conditions a company may find it necessary to sell to its foreign selling subsidiaries at a price lower than that charged to other customers. It would be very difficult for such a company to meet the arm's-length definition set forth in the bill, thus subjecting it to allocation.

5. The additional administrative problems and costs involved in attempting to arrive at a satisfactory allocation factor with the Treasury Department under the proposed rules will be much more burdensome than the present test, which is fair market value of property sold between related companies. Any attempt to develop a statutory formula, at best, will be artificial and a generalization and, as a result, will create hardships and inequities since it cannot be all inclusive. It seems far better to apply a test of reasonableness of the pricing and allow each taxpayer to work out any differences with the revenue agent.

Section 7. Distribution of foreign personal holding company income

1. The proposed reduction of the foreign personal holding company gross income requirement to 20 percent could very easily operate as a tax trap for U.S. companies who have no intention of avoiding U.S. taxes through operating a foreign subsidiary. A U.S. parent with two foreign operating subsidiaries, one owning the stock of the other, could have that subsidiary become a foreign personal holding company merely by its receiving dividends in excess of 20 percent of its gross income. H.R. 10650 fails to recognize that the personal holding company provisions of the Code are intended for companies which own stock or securities for the receipt of passive income such as dividends and interest (an incorporated pocketbook). They were not intended to penalize an operating company carrying on a productive trade or business which becomes a foreign personal holding company merely by having another foreign operating subsidiary.

Ordinarily, the U.S. companies which will be sufficiently closely held to fall into this trap will also be companies which would be classified as small business. The major U.S. corporations, in almost all instances, have widely diversified stockownership. Thus, the companies which could be injured by this provision will be many of the same small businesses which are to be assisted in other programs and legislation being carried on and considered by the executive and legislative branches of the Federal Government.

Section 11. Domestic corporations receiving dividends from foreign corporations

1. The foreign tax credit has been in our tax laws almost from the inception of such laws. Since its introduction into the Code, there have been a number of cases establishing the rules on the operation of the credit. Many companies have set up their corporate organizations based on these established rules. As a result, a change at this time would work a hardship on such companies, particularly in view of the fact that any future rearrangement of corporate structures would be hard to accomplish under the present Code requirements.

2. Bill section 11(f) provides that if earnings are not paid out prior to January 1, 1965, then the new rules will apply. Thus in essence this provision can be applied retroactively. We believe it would be much more equitable to allow all prior years' earnings to be paid out as dividends under the old rules and limit the new rules to profits earned by the company subsequent to the date enacted into law.

3. This provision will produce sizable amounts of revenue only when the foreign income tax rate is significantly below our top corporate 52-percent rate. Since most economically developed countries have rates approximating our rate (United Kingdom, 53¾ percent; France, 50 percent; Japan, about 56 percent; Canada, about 50 percent), the only real impact will be on dividends from companies in underdeveloped countries. For example, the income tax rates in Nigeria and Argentina are 40 percent and 38¾ percent, respectively. Thus the provision will restrict investment only in such countries. This result is in direct conflict with an obvious purpose of section 13 of the bill.

Section 12. Earned income from sources without the United States

1. One of the major problems for U.S. business operating abroad is to obtain competent personnel who are willing to leave the United States and take up residence in a foreign country, particularly in underdeveloped countries. With the future potential of foreign operations and the complexity thereof, it is almost mandatory that top-level executives be the persons transferred. These factors mean the transferring of highly paid executives. The proposed provisions to provide only a $20,000 limitation for the first 3 years of bona fide residence and a $35,000 limitation thereafter appear to be too low to induce the necessary qualified executives to take up foreign residence.

2. It is probable that as a direct result of the changes in section 911 a number of U.S. citizens will give up their citizenship. We have heard of several contemplating this. If this is the result of such a change, the U.S. Treasury will lose not only the tax on the earned income of those individuals, but also any tax on other types of income such as interest, dividends, capital gains, and so forth. This could cause a greater loss in revenue than the loss caused by the present provisions of section 911.

Section 13. Controlled foreign corporations

1. The taxation systems of most industrialized countries throughout the world do not tax foreign income until it is returned to the home country. Even when taxed at the time when brought home, many countries provide beneficial tax treatment for foreign source income. The Netherlands, Belgium, and the United Kingdom all provide tax exemption or special tax privileges for foreign source income. This policy is followed by those countries which are inherently faced with balance-of-payment problems. Incentives are given to companies to earn foreign currency. In light of the policies of other countries, it would seem that H.R. 10650 would work in an exactly opposite manner to the practice other countries have found to be desirable in solving their balance-of-payment problems.

2. It is recognized that some companies have taken advantage of foreign operations and have handled them in a manner not consistent with the tax laws of the United States. It is our observation and sincere belief, however, that such abuses can be rectified through effective enforcement of the present tax laws of the United States, as agumented by regulations, case decisions, and international organization of the Revenue Service, etc., and that resort to a new set of complex tax laws in order to police the foreign area is unwarranted and will prove to be an unwise move.

3. The provisions for taxing all income from patents, processes, formulas, etc., developed in the United States ignores the business reasons for having these property rights owned by foregin companies. In many cases this is the only avenue for properly utilizing these patents, formulas, etc., in the foreign markets. To the extent that there are abuses in this area, section 482 of the present Revenue Code contains the machinery for halting those abuses. To, in effect, severely restrict the use of such property outside of the United States will result in a slowing down of the flow of technology to the underdeveloped nations. Since these nations have a dire need for such technology, proposed section 952(c) directly conflicts with sections 952(d) and 953 which represent an attempt to assist the underdeveloped nations.

4. The bill's proposal for taxing sales income ignores the business reasons for having separate sales organizations abroad. In many instances the use of separate sales organizations is the one factor responsible for an aggressive and successful sales effort. This principle has been followed by many domestic companies quite successfully, and certainly is not a practice known only to the foreign area. Again, to the extent there are abuses in allocating profit to foreign sales activities by U.S. companies, section 482 provides ample authority to curb such abuses. It would be far more reasonable to continue to approach the prob-

lem as a matter of intercompany pricing than to propose stiffer tax legislation. We have observed that most other industrialized nations, such as West Germany, the United Kingdom, and France, police intercompany pricing quite rigidly and are very successful in guarding against the artificial siphoning off of this type of profit. To the extent such foreign jurisdictions do allow a maximum sales profit to be taken by the selling company, it is done with full knowledge of the government and is intended as a tax incentive to induce the manufacturing industry to locate within that country.

5. Imputing income to the U.S. parent in the form of royalties for the use of patents, copyrights, processes, and formulas will undoubtedly result in double taxation. The imputed royalty will in all probability not be deuctible in the foreign jurisdiction. Therefore, the income producing the imputed royalty will be taxed in the foreign country and the royalty itself will be taxed in the United States. In addition, these provisions may also result in imputing income where an adequate purchase price for the property right being used already has been paid by the foreign company.

6. The proposed treatment of rental income as passive income does not recognize that there are many instances where a rental arrangement rather than direct ownership by a local company is necessary as the best isolation of an asset from political and economic risks in a particular country, or the best business arrangement where a joint venture company is involved.

In addition, the bill would apparently tax rentals from hotels and motels as passive income. Obviously this type of income is active income which should not be within the scope of the present bill.

7. The complexities involved in determining gross income and the application of percentage limitations or percentage tests are difficult when dealing with domestic corporations where one applies U.S. laws, well-defined accounting policies, and well-organized accounting records in making the determinations. The situation will be even worse when foreign corporations are involved—accounting policies and practices are different; local laws require specialized treatment; accounting records generally are not up to our standards.

8. The provisions dealing with the reinvestment of nonsubpart F income contain features which are illogical and almost impossible for business to operate under:

(*a*) The timing requirements for making qualified reinvestments are completely unworkable. Subpart F income must be reinvested within 2½ months after the end of the year. Other income is not even allowed the 2½-month grace period. It is obviously unsound to attempt to reinvest all current profits of a company as they are earned. Management does not know what profits are to be reinvested until several weeks after its yearend. Even the 2½ extra months allowed for subpart F income is insufficient. Domestic companies ordinarily plan and accumulate funds for future expansion over several years. Any requirement for immediate reinvestment would lead to forced disorganized reinvestment rather than an orderly and properly planned expansion of foreign activities.

(*b*) The 5-year "seasoning" required before a new company will be entitled to reinvest in qualified property is an unwarranted penalty for (and in many instances a prohibition against) new businesses. When a business commences operation the major part of its initial investment and reinvestment is carried on during the first 5 years of its operations. The House Ways and Means Committee's contention that the provision is necessary in order to keep companies from starting businesses before they are ready in order to have such businesses available for expansion coming at a later time is completely unrealistic. It presupposes that American companies initiate business operations abroad strictly for tax purposes. This is not true. To force a company to pay U.S. tax on income earned during its startup years will be placing a straitjacket on growth of American business abroad.

(*c*) The provisions of section 13 with respect to qualified property being money or property located outside the United States which is ordinary and necessary to the active conduct of a trade or business, if enacted, will cause an annual debate with tax examiners. What is "ordinary and necessary" and what is "the active conduct of a trade or business" have been difficult problems under existing U.S. tax law. They certainly will be even more difficult when involved with operations carried on outside our borders. In addition it will be necessary for each foreign subsidiary to keep records with respect to each asset as to whether or not it is qualified or nonqualified property and whether it was such

at December 31, 1962. This provision will cause a tremendous volume of added recordkeeping.

(*d*) The requirement that in order for stock investment to be considered a qualified trade or business the company must own 80 percent of the stock of the subsidiary is a poor provision since it would not allow the investment in capital stock in many underdeveloped countries to be considered as qualified merely because the particular country requires more than a 20-percent interest by nationals. Such a requirement is not uncommon in present-day laws and governmental practices. For example, governmental practice in Mexico recently has been to require majority ownership by Mexicans.

(*e*) The provision that for stock in another controlled foreign corporation to be considered as qualified property, the controlled foreign corporation and no fewer than four other U.S. persons own 50 percent or more of the stock would place a heavy burden on the controlled foreign corporation to determine who the shareholders in the corporation are and whether or not they are U.S. persons. In many cases this determination may be impossible. Further, the provision that the rule does not apply where, under the laws of a less-developed country in which such a percentage of ownership is not permitted, does not provide necessary relief in those instances where not the law but the practice of the country forbids such percentage of stock ownership. For example, in Japan, the government must approve foreign investments. The practice has been to allow the maximum foreign participation to be 50 percent. In many instances, foreign ownership of less than 50 percent has been required in order to obtain approval.

9. The writers of the bill do recognize to some extent the complications in the foreign tax credit area which will be caused by taxing income in one year and actually receiving that income in a later year. The relief provided, however, leaves the taxpayer in a disadvantageous position. At the time the income is actually returned to the United States the corporation will have to recompute its prior years' foreign tax credits. This may entail going back over an extended number of years, which in itself will create problems. In addition, if the credit cannot be used at the time of the distribution, or the total tax is not sufficient to recoup the amount of credit available, the company may have to file a claim for refund.

10. The provision of the bill, which increases the tax basis of stock in a foreign subsidiary for earnings taxed in the United States and reduces it for dividends actually paid from prior taxed earnings will create another complication. It will require a taxpayer to keep separate tax records as to his tax basis for such stock in addition to his regular accounting records, and thus add to the additional administrative and overhead costs of the company.

Section 15. Foreign investment companies

1. Foreign investment companies are nothing more than a means for U.S. investors to invest in the expanding economic activity outside of the United States. The effect of ordinary income treatment for a gain on sale or exchange of foreign investment stock certainly will result in a retrenchment of U.S. investment abroad. This again will leave it to other countries to make such investments, thus assuring further advantage over U.S. investors.

2. The concepts of accumulated earnings and profits, as described earlier, is a complex one when considered for U.S. tax purposes. The concept will be even more complex when earnings are computed under foreign laws and must be computed by a shareholder who has little or no information with which to work. Normally a foreign investment company shareholder will have nothing more than the company's financial statements to use. When one considers that these statements will be based on the laws and accounting practices of the country of incorporation, obviously it will be difficult for the shareholder to arrive at any reasonable computation. Failure of the investment companies to reflect depreciation or depletion in the financial statements cannot possibly be corrected by the shareholder. He will not be able to determine if any portion of the dividend was a return of capital. As a result, he may be paying tax on what should be nontaxable receipts.

3. The complex set of basis provisions provided by section 15 of the new bill alone are enough to cause administrative problems sufficient to warrant defeat of the bill. The adjustment of basis completely through a U.S. company to the individual shareholders plus the adjustment to basis of stock which passes through an estate for earnings and profits accumulated, and the allocation of

estate tax as a deduction against gross income are all contributing factors to the multitude of problems inherent in these provisions of the bill. Most shareholders will find the advice of experts in the area essential in order to properly determine their tax liability.

4. An essential element in taxation under this section is ownership of more than 50 percent of the voting stock of the foreign investment company by U.S. persons. With the diverse stock ownership possibilities today, it will be a virtual impossibility for a shareholder to determine whether this criteria is met.

5. Of particularly harsh treatment is the provision which would tax pre-1962 earnings and profits on a redemption or liquidation. This provision amounts to retroactive taxation. The same is true for the taxation of an increment in value which incurred before December 31, 1962, and which is realized on a sale after that date.

Section 16. Gain from certain sales or exchanges of stock in certain foreign corporations

1. This section requires the daily allocation of earnings and profits of a foreign subsidiary. As indicated earlier in this material, the concept of earnings and profits has not been defined for U.S. purposes with any great certainty, and certainly is far from clear where foreign earnings, foreign accounting and foreign laws are involved. To add to the confusion in this problem, the necessity of allocating those earnings or profits on a daily basis makes this section entirely unworkable.

2. This section apparently applies if a corporation was a controlled foreign corporation at any time during a 5-year period ending on the date of the sale or exchange. This is a tax trap into which many companies unknowingly could fall. In many cases it will be impossible to know the exact stock ownership of a foreign corporation for every day of the last preceding 5 years. This is an unwarranted burden to place on the shoulders of an organization.

3. The addition of the attribution rules to this section combines with earnings and profits to provide a multitude of complexities which will be almost impossible to comply with.

4. The provision that a sale or exchange can be ordinary income will be a potent weapon in the hands of the Internal Revenue Service in rendering rulings under section 367 of the Code. In many instances it is found to be a necessary business matter to transfer stock owned in a foreign corporation to another foreign corporation. In practice today it is extremely difficult to convince the Service of the business purpose in making such transfers, even where a gain on such transfers would be taxable at capital gains rates. This additional weapon given to the Service by making sales or exchanges ordinary income will make such rulings almost impossible to obtain.

Section 20. Information with respect to certain foreign entities

1. The additional reporting requirements would result in increased administrative work and requirements for nonproductive time on the part of the executives, stockholders, etc. The most troublesome, however, is the section which allows the Secretary or his delegate to require the furnishing of any other information which is "similar or related in nature" to that specified by the particular code or bill section involved. This broad language could lead to "fishing expeditions" by the Internal Revenue Service considerably beyond the scope of a normal examination.

Section 21. Treaties

Section 21 of the proposed bill will probably have a damaging effect on the image of the United States abroad. Many countries have cooperated in negotiating treaties with the United States with the full understanding those treaties would continue in existence subject to bilateral modificaion as necessary. We have continued to reprimand countries which have confiscated property of U.S. businesses or citizens in violation of established agreements. We contend that sanctity of ownership, sanctity of contract and rights of U.S. businesses or citizens should be recognized and not be violated. What a damaging effect a provision of our tax laws could have, which, if passed, would in spirit, abrogate almost every U.S. tax treaty negotiated with other countries. Certainly this bill, in particular this section, is an invitation for each country to disregard its treaties, trade pacts, etc. to the detriment of the United States.

COMMENTS OF A TECHNICAL NATURE

The following comments are to point out problems the drafters of the bill apparently did not consider or else did not completely cover in the bill.

Section 6. Amendments of section 482 (allocation of income and deductions)

1. The allocation factors provide by this section have several serious defects in them which we believe should be corrected.

(*a*) It seems highly improper to include in the allocation factors production assets when the foreign subsidiary carries on no production activity. This should be made clear in the bill, if such an allocation theory is to be followed.

(*b*) Normally in statutes allocating income between the States in the United States, an extremely important factor is sales in the State versus sales outside of the State. This factor has not been included for consideration by the Secretary. In apportioning profits the sales factors is essential.

(*c*) As in the case of (*a*) above, production employees should not be considered in any type of factor where a foreign sales company without production facilities is involved.

(*d*) It also appears that inventory should be a factor to be considered in any allocation formula. Section 6 as written excludes inventory as a consideration.

2. As this section presently is written, it could be applied against a foreign parent corporation and its U.S. subsidiary or against transactions between two U.S. companies if there is a foreign corporation somewhere in the picture. As we understand the purpose of the section, it is not intended to cover such situations. This should be made clear in the section itself.

Section 7. Distribution of foreign personal holding company income

1. Provision should be made in the bill for foreign tax credit treatment similar to that under section 13 of the bill when income is imputed to the U.S. parent company. Without such a charge, income previously taxed to the parent may be later distributed by the subsidiary and subjected to a withholding tax by the foreign country without the parent having any foreign source income against which to apply the wtihholding tax as a credit.

Section 11. Domestic corporations receiving dividends from foreign corporations

1. The increase in income caused by this revision, because it is dividend income, could cause certain companies to become personal holding companies or foreign personal holding companies and others to lose their status as Western Hemisphere trade corporations without those companies doing a thing. The section should include a provision that the foreign income tax is a part of the dividend solely for purposes of taxing the dividend and for no other purpose.

Section 12. Earned income from sources without the United States

This section grants the higher tax exemption of $35,000 to "a bona fide resident of a foreign country or countries for an uninterrupted period of 3 consecutive years." The word "year" carries with it several possible interpretations.

1. Twelve months.
2. Three hundred and sixty-five days.
3. Calendar year.

Each interpretation could give a different tax result. We suggest the exact meaning of this word be specifically stated in the section.

Section 13. Controlled foreign corporations

1. The requirements with respect to the time for investment or reinvestment into qualified property appear unnecessarily restrictive. In the case of subpart F income such income would have to be reinvested within 2½ months after the close of the taxable year. For nonsubpart F income the reinvestment must occur by the end of the year. As indicated previously, such provision would encourage disorderly reinvestments. It would seem that at a minimum, business should be allowed an accumulation of several years income before the application of U.S. tax in order to allow business to plan an orderly program of investment abroad.

2. We see no logical reason for excluding income from patents, processes, formulas, etc., from income eligible for reinvestment. A great deal of business activity goes into using the property involved and servicing it. This income

is no less genuine business income than are dividends or interest from an operating company. We believe this income should be considered as qualified income also.

3. If the proposition of taxing foreign income before it is actually distributed to the parent is adopted, then it seems only equitable that operating losses of foreign companies should be available against income of the U.S. parent. In the past this concept has been completely ignored by the Internal Revenue Service even though foreign companies were liquidated and the provisions of present code sections 381 and 382 should have applied. The bill, if passed, should contain some language making the position of operating losses clear. These provisions should consider the varied results which can arise from such situations as:

(*a*) All loss operations in the foreign subsidiaries.

(*b*) Profitable operations in some foreign subsidiaries and loss operations in others.

(*c*) Operating at a profit in a foreign subsidiary 1 year and at a loss the next year.

(*d*) The effects of changes in the value of the foreign currency with which each subsidiary carries on its business. A profit in foreign currency can actually be a loss in dollars. A profit made one year can be wiped out the next through a change in the currency valuation. Official devaluation of the currency after the profit is made but before it is distributed as a dividend in a later year should be considered.

4. Many nations, both developed and undeveloped, grant tax concessions in order to induce foreign capital to make investments in the country. For example, Italy grants sizable reductions in income and other taxes for investment and reinvestment in the "Mezzogiorno" (certain economically depressed or undeveloped areas in the south of Italy), Trieste, and northern Italy. There is no provision made in this section for recognition of these concessions. As a result, in many instances, the concession benefits will be negated by the assessments of U.S. taxes. This could cause a redirection of American capital away from the particular country which would be contrary to our desired governmental policy. The adverse effect could be corrected by insertion of provisions similar to the "tax sparing" provision contemplated in some of our tax treaties under consideration.

Section 15. Foreign investment companies

1. The gain being taxed as ordinary income under this section is not designated a dividend. As a result it would appear there would be no foreign tax credit available to corporate shareholders against this tax. It is submitted that this omission should be corrected.

2. Most companies do not know their profits until several weeks after the end of their year. As a result they may make errors in distributing 90 percent of income during the year. Provision should be made in the bill to allow distributions to be made within a specified time after the end of the year (for example, 90 percent of the income could be distributed during the year or within 90 days thereafter).

3. Laws of certain countries often forbid or limit dividend distributions because of foreign exchange problems; for example, Japan effectively forbids them; Italy restricts them. Provision should be made in the bill to allow deferral of the tax on distributions until it is legally possible to make them. If this is not done, it will be necessary to pay tax on income which cannot legally be distributed to the shareholders.

Section 16. Gain from certain sales or exchanges of stock in certain foreign corporations

1. The foreign tax credit will apparently be available for liquidation or redemption because the gain is to be treated as a dividend. The right to the foreign tax credit is not so clear, however, with respect to sales or exchanges. Subsection (b) provides that the gain is to be treated as gain from an asset which is not a capital asset. It would be better to indicate in the law itself that the foreign tax credit is available on such transactions.

2. This section seems to indicate that it might not be possible to liquidate a foreign corporation free of tax. The section should clearly state that the Commissioner of Internal Revenue shall be able to issue rulings making the liquidation free of tax under section 367 of the present code if the situation warrants it.

Section 20. Information with respect to certain foreign entities

1. The penalty provided by this section would be imposed without any willfulness by the taxpayer in failing to provide complete or accurate information. No allowance is made for error or inadvertence on the part of the taxpayer. Where there is no willfulness on the taxpayer's part, no penalty should attach.

REYNOLDS INTERNATIONAL, INC.,
OFFICE OF CHAIRMAN OF THE BOARD,
Hamilton, Bermuda, April 16, 1962.

Re: H.R. 10650, section 13, tax on American-controlled foreign corporations.

Senator HARRY F. BYRD,
Senate Office Building,
Washington, D.C.

DEAR SENATOR BYRD: Although our company appears to be particularly affected by the provisions of the section referred to above, we are at a loss to understand whether this section is intended to provide revenue for the U.S. Government or, on the other hand, is in the nature of a regulation whose purpose is to prevent the export of American capital.

If this bill is intended as a revenue measure, it would appear that the revenue department is overlooking the fact that the effect of this tax will be to drive American companies out of the foreign market. American companies would certainly have a difficult time surviving in competition abroad were they to bear a tax which their foreign competitors do not. Were our foreign enterprises to close down as a result of this tax bill, it is obvious that the revenue therefrom would diminish to the vanishing point.

If, on the other hand, the purpose of this bill is to prevent the export of American capital, then it would appear that the U.S. Government has adopted a policy completely at variance with its centuries-old tradition as well as with current attempts to devote billions abroad to foreign aid.

I know that you are anxious to hear how this proposed legislation would actually affect a corporation engaged in foreign business.

Our corporation is a Panama corporation, wholly owned by a Delaware corporation, Reynolds Metals Co. We have operations in many areas all over the world and are aggressively planning many more. In nearly all of these operations around the world we share the ownership with citizens of the countries in which we do business.

At the present time we have operations in Canada, Mexico, Colombia, Venezuela, Italy, Germany, Greece, Belgium, Denmark, Philippine Islands, and Japan. We are planning operations in a great many other areas and have recently received licenses to construct reduction plants in Argentina and India. We are planning an aluminum reduction plant in the Philippines and are negotiating the matter at the present time with the Philippine Government.

In all these operations we feel that the United States derives a great many tangible benefits. We have made a sizable market for U.S. exports, not only in the machinery which we have shipped abroad to these companies, but also in the aluminum which we have shipped to supply these fabricating companies. In the past 5 years we have shipped over $100 million worth of aluminum from our U.S. plants to the companies in which we have invested abroad. At the same time shipments back from these companies to the United States have been so infinitestimal as to be negligible. The United States, however, derives benefits from our foreign enterprises far and above the immense contribution that they make to a favorable balance of trade for the United States. As an example, the oldest of our foreign enterprises, our Mexican operation, is typical.

In Mexico we set up a corporation at the end of World War II to fabricate aluminum. Our Mexican partners held 49 percent and we took a 51-percent interest. The machinery for the plant that we established near Mexico City was purchased by the new corporation from the United States. The raw material used by the plant, aluminum, has all been shipped from the United States. Nothing from this plant has been shipped back to the United States. The profits have generally been accumulated except for reasonable dividends which have been paid.

As we understand this bill, it would purport to tax the undistributed profits of this Mexican company to our parent company, Reynolds Metals Co., in the

United States. Obviously this would be a tax on this Mexican operation which our competitors in Mexico, other than U.S.-owned corporations, would not bear. The tendency, therefore, would be to throw a burden upon our operation not borne by other competitors. In the difficult and highly competitive field of foreign business you can well imagine that the effect of this would tend to diminish the interest of Reynolds Metals Co. in its Mexican operation.

If we were to assume the worst, and to assume that this taxation would in fact terminate our interest in an operation in Mexico, we find then that the United States would lose these advantages:

1. The opportunity to export U.S. equipment through a friendly purchaser to a Mexican operation.
2. The opportunity to export a U.S. raw material to a friendly purchaser.
3. The loss of any possible profits to the United States from such an operation in the form of inflowing cash.
4. The possible loss of U.S. taxes because the business might be sold under desperate conditions at a loss, which would be reflected in the tax returns of Reynolds Metals Co.
5. The loss of the jobs for the Americans now employed there.
6. The loss of the influence for the American competitive system which these American employees now act as ambassadors for.
7. The loss of the contracts which these Americans provide for our CIA State Department, Department of Commerce, and military establishments.
8. The cultural exchange which is involved, at no expense to the U.S. Government, by having American employees in these countries.

In addition of course the Mexican Government would also lose for it would have to rely on other nations, perhaps the Iron Curtain countries, to provide the technical know-how which would no longer be available from the United States.

This description of events with references to Mexico applies equally to all the other countries with which we do business, and in all the other countries with which we expect to do business. Hence, the effect of this tax would be very widespread. I presume that all U.S. corporations doing manufacturing business abroad would be affected accordingly, so these effects on us would be multiplied many times by the effects on all companies.

It must be realized that the operations in which we and other similar American companies are engaged are at the moment not given any protection by the United States, and on the face of it a tax on such operations would appear to be morally unjustified. For instance, we, as a great many other American corporations, lost our total investment in Cuba. If we had been paying a tax on this corporation's profits we would certainly be justified in demanding police protection from the U.S. Government, although you and I probably agree that such police protection could not be provided. Since the protection cannot be provided, the tax itself would be unjustified.

One very vital point to remember is that the next 10 to 15 years would seem to be of crucial importance in the stabilizing of trade relationships. If, during this period, Americans are prohibited by their Government's tax policies from participating in the industrial activities of other countries, the place which Americans might have otherwise occupied will be filled by the nationals of other countries, and America will be foreclosed from then on from any participation. It is an alternative of now or never.

I am confident that when you and your colleagues in the Senate consider the many undesirable ramifications of this section 13 of the 1962 revenue bill you will agree with me that it should be stricken from the bill.

Cordially yours,

J. LOUIS REYNOLDS.

P. R. MALLORY & Co., INC.,
Indianapolis, Ind., April 13, 1962.

Subject: Revenue bill of 1962 (H.R. 10650).

Hon. HARRY F. BYRD,
Old Senate Office Building,
Washington, D.C.

DEAR SENATOR BYRD: We have reviewed the proposed revenue bill of 1962 (H.R. 10650) and wish to express to you our views on certain sections of the bill in the hope that they will be helpful to you in obtaining the enactment of a bill that will be in the best interests of our country and its economy.

Section 2. Credit for investment in depreciable property

As one of many manufacturing concerns which are aware of th inadequacy of the currnt allowable rates and practices for depreciation contained in bulletin F for sound business administration and growth, we feel some relief is necessary if industry is to prosper and provide the job opportunities that are so necessary for the well-being and safety of our Nation in the future. The approach contained in the proposed bill is not, in our opinion, the best possible, since it will be cumbersome in administration and discriminatory against the enterprises which have made investments in plant and equipment before the date provided for in the proposed bill. While we believe the more direct route of adjustments to the depreciation schedules is preferable for business and more viable for the Internal Revenue Service, we would support the limited relief provided in the bill if the preferred method is not possible.

Section 4. Entertainment and other business expenses

We support completely the proposals relating to the substantiation and allocability of entertainment expenses to business purposes, with the sole exception of the proposal that the deductability of traveling expenses be changed from "the entire amount expended" to "a reasonable allowance." Since sound business administration and control mandates the approval by responsible employers of only legitimate business expenses, this standard, together with the normal safeguards of Internal Revenue Service audits, is sufficient to establish reasonableness. There is no need for introducing a nebulous yardstick of a "reasonable allowance" which would be subject to interpretation by revenue agents with varying backgrounds of experience and opinions, and whose initial determination would shift the burden of proof to the taxpayer.

Section 13 (a). Taxation of foreign income

We are firmly opposed to the provision that certain defined earnings of a foreign controlled corporation are subject to U.S. tax unless reinvested in foreign controlled corporations in so-called less developed nations. The decision by business to invest capital in foreign countries would, to the extent influenced by taxation, be affected by decisions on which countries are "underdeveloped," and hence on varying political climates, rather than purely based on sound business judgment.

We also oppose the "gross up" provision relating to the calculation of the foreign tax credit. This would mean higher taxes to many companies operating abroad and tend to make foreign investment less attractive.

The remainder of the revisions proposed by this section of the bill we believe to be equitable.

Section 14. Gain from disposition of certain depreciable property

We believe that the present law should not be changed insofar as it relates to gain realized on the disposition of "section 1245 property" used in trade or business. The imposition of ordinary tax rates on gain through the disposition of such property could affect decisions on the most efficient employment of capital and could tend to work against disposals which should be made to help finance a replacement which is economically desirable as a result of accelerating technological advances.

Section 19. Withholding of income tax at source on interest and dividends

This company opposes this provision of withholding of income tax on interest and dividends. The company presently has 7,095 shareholders to whom dividends are being paid on a quarterly basis, hundreds of whom receive substantially less than $50 per year in dividends from us. The imposition of the responsibility for withholding income taxes on dividends paid by our company is, in our opinion, an unreasonable responsibility and would involve a substantial amount of expense to us. In addition, we believe that withholding would add a great deal of expense to the Government in recordkeeping and making quarterly refunds to many stockholders. Finally, it is likely to result in inequities for stockholders, despite exemptions for minors and persons over an age prescribed in the proposed legislation.

In other respects we support H.R. 10650.

Your consideration of the foregoing opinions, which we feel are in the best interests of the economic strength of the United States, will be sincerely appreciated.

Respectfully yours,

G. B. MALLORY.

STATEMENT ON INVESTMENT TAX CREDITS BY ROBERT EISNER, PROFESSOR OF ECONOMICS, NORTHWESTERN UNIVERSITY

I should begin by indicating some of the research as well as the premises and point of view which underly this statement.

A major part of my work for more than a decade has been devoted to the problem of determinants of business investment. Results have been embodied in a number of publications, listed below in a bibliographical appendix. My approach has been both theoretical and empirical, and has entailed numerous interviews with business executives of leading manufacturing corporations, as well as detailed statistical analysis. In this latter effort I have had access to major bodies of data regarding capital expenditure plans and actual capital expenditures. In several of my writings, including a recent monograph prepared jointly with a colleague for the Commission on Money and Credit, I have had occasion to survey critically and in detail major works by other students of business investment.

It has been argued that investment contributes to economic growth. I believe that a free society may be allowed to choose the rate of growth which it considers most desirable. I believe, however, that this choice should be undertaken within the framework of a healthy, vigorous economy. This implies, in particular, that the choice should be made under conditions of full or maximum employment. The rate of economic growth will be lessened by conditions of underemployment. It follows that the major concern expressed in many quarters with regard to the rate of economic growth in the United States in recent years can be traced directly to the consequences of a less than full employment economy. The rate of growth chosen by the saving and investment decisions of the people, granted conditions of full employment and a generally well functioning economy, may well leave nothing to be desired.

The kind of Government intervention in the economy which demands the widest possible support, therefore, and is most usually justified, is that intervention designed to bring about full employment of the Nation's resources. I do not take the ideological or political position that any further Government intervention is necessarily bad, but that any such further intervention should have a clear justification. Such further intervention on the basis of caprice, selfish interest, or untested stratagems may have serious, unfavorable consequences.

In an economy such as ours, business capital expenditures may most usefully be viewed as determined essentially by their expected profitability. There may indeed be other factors, such as the desires to reduce risk of loss and bankruptcy, to grow big for reasons of prestige, and to have fancy buildings and equipment for the pleasure of operating with them. Nevertheless, it seems clear that the major factor in the determination of capital expenditures of any firm endeavoring to survive in an even imperfectly competitive economy, must be the expected profitability of those expenditures. This means that a firm should buy new equipment or build new plant if the addition of such equipment or plant will add to its expected profits (or reduce its expected losses). It should be understood very clearly, however, that the statement that business capital expenditures are a function of the expected profitability of such expenditures is entirely different than the statement that business capital expenditures depend upon profits. One should not expect a firm already making high profits to build or acquire new plant and equipment if such additional plant and equipment will reduce the profits that this high profit firm is earning. Similarly one should expect that a firm making low profits, with an opportunity to add to its profits by the expenditure of money for plant and equipment, will incur such expenditures if it is able to raise the money. One should also expect that, unless imperfections in the capital markets are much more serious than I believe them to be, a firm with such favorable profit expectations on investment will be able to acquire the funds from investors anxious to share in profitable undertakings.

There has been a widespread view among some economists, and certainly among members of the business community, that capital expenditures depend upon profits. It can be shown that periods in our history when profits were high were periods when capital expenditures were high. It can also be shown that firms earning high profits have been the firms making heavy capital expenditures, and firms earning low profits or suffering losses have generally been firms making little in the way of capital expenditures. I am convinced, and

have been able to find substantial data to support my conviction, however, that any inference from these associations between profits and capital expenditures that profits are a determinant of capital expenditures, is misleading and in large part false. For it can be shown that periods of high profits have generally been periods when sales have been high and expected demand has been great relative to existing capacity. It can also be shown that firms enjoying high profits are generally firms enjoying increases in sales which have pressed demand against capacity. A major part of my recent research has served to indicate that the apparent relation between capital expenditures and profits can be accounted for by the relation between capital expenditures and changes in sales or pressure of sales or demand on capacity. In somewhat technical statistical terms, we may state that while there is positive simple correlation between business capital expenditures and profits, the partial correlation coefficient between capital expenditures and profits, in multiple regressions in which sales changes are also included as an independent variable, does not differ significantly from zero. In nontechnical language, this means that the positive association between profits and capital expenditures can be found to be accounted for by the fact that firms earning high profits tend to be firms that have enjoyed increases in sales. We find little or no role for profits independent of its association with increasing sales or the pressure of high demand on limited capacity.

One may note quickly the important implications of these findings for current issues of policy. The effective way to increase business capital expenditures and to bring about such an increase by the free choice of businessmen themselves is to take appropriate measures to increase the demand for their products. In an economy with any substantial amount of unemployment, the indicated measures to increase such demand are clear to all economists. While one may differ, depending on one's political point of view, as to the costs to be attached to such measures or their political wisdom, there can be no question that increases in direct government demand or cuts in taxes thereby inducing increases in private demand, would be effective measures to induce increased business investment or business capital expenditures.

This brings us to consideration of the investment tax credit that has been proposed. It should be clear that virtually any cut in taxes would release spending power. This would have an exhilarating effect upon demand and hence upon capital expenditures. Were one to consider an investment tax credit in isolation, while there might be some differences in predictions of the magnitude of the effect, there could be no question as to its direction; the investment tax credit in itself would bring about greater business investment. However, to consider an investment tax credit in isolation is surely unrealistic, as is indicated by the very bill under consideration by this committee. The committee apparently desires that any bill reported will, on balance, cause little or no change in the total tax receipts of the Treasury at a given level of income. Under the assumption that this objective is achieved, one should not expect from an investment tax credit a stimulation of investment on the basis of an overall increase in demand. The tax credit could then only stimulate capital expenditures by offering businessmen inducements to meet an unchanged demand by changed methods of production which would call for the use of greater amounts of equipment.

If, as a first approximation, we assume that the changed tax structure which leaves total tax receipts unaltered, leaves demand unchanged in the aggregate, we may argue that the tax credit for expenditures on equipment will make production with equipment subject to the tax credit relatively less costly and production without such equipment relatively more costly. This would presumably induce some capital expenditures as firms tend to produce with more equipment and less of other "factors of production." Among the other "factors of production" which firms would attempt to economize upon would be labor, plant (since plant is not subject to the tax credit),[1] materials, and services (including

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[1] To the extent that the tax credit is not applicable to all categories of firms or equipment, or is applicable unequally to different categories, there may, of course, be a tendency to favor some firms or some equipment at the expense of others. Thus if private electric utilities are only partly eligible to receive the credit while manufacturers are generally fully eligible, major consumers of electric power, might well decide to build their own powerplants, taking advantage of the full equipment tax credit available to them, rather than purchase electricity from private electric utilities which could pass on, in lower rates, only smaller or partial credits.

advertising). It is difficult to estimate the magnitude of equipment expenditures that would be induced by this kind of subsidy, but again it should be conceded that their amount under the assumptions which we have been making, should be positive. My own view is that the magnitude would not be great. It does not appear that the size of the credit, considered in relation to the existing degree of substitutability of equipment for other factors of production, will be such that a major amount of equipment expenditures will be induced.

It should be clear, however, that this argument applies only on the assumption that total demand is unchanged. Whether, in fact, total demand is unchanged depends in considerable part on the effects of the other taxes which are increased in order to compensate for the lost revenues from the investment tax credit. Suppose these other increases in taxes impinge sufficiently heavily upon demand so that total demand is in fact reduced. The effect of the deduction in demand then might be sufficiently great to outweight any of the positive effects from inducing businessmen to use more equipment in producing for a given demand.

It should be noted that I have concentrated my attention on the incentive effect, essentially, reducing the aftertax (or aftercredit) price of equipment. This will, all other things equal, increase the expected profitability of investment in equipment and hence bring about an increase in such investment. I have not argued that the billion or so dollars in increased income after taxes made available to businesses by this credit will increase equipment expenditures, or capital expenditures generally, by giving business more funds to spend. I have not made this argument because it should be clear, from my discussion above, that this argument is not sound. Businesses should not be expected to make capital expenditures merely because they have the funds, if such capital expenditures do not appear profitable or justified by profit considerations. A wise businessman, and I cannot believe that the leaders of the major sectors of American business are not wise in this regard, will not take money given to him in a tax credit and spend it to construct a building or buy a piece of equipment which is not profitable.

It must be recognized, however, that this billion dollars or more in tax credits will be a substantial gain to the owners of American business. It will probably be reflected largely in the values of common stock and hence will accrue to their owners. As an economist, and not a political citizen, I should not pass judgment upon the considerations of equity which should influence the Congress in evaluating these effects. But it should be clear that they would represent a very major gain to certain relatively small segments of the American people and, unless clear advantages for the people as a whole can be shown from such a measure, must represent correspondingly a sacrifice or loss on the part of other members of the population. What kind of proposal might be devised to increase expenditures on equipment, or capital expenditures generally, at a minimum loss of tax revenues and a minimum windfall gain to relatively small sections of the population? One such proposal might involve revision of the present measure in the direction of offering a larger percentage credit on capital expenditures or on equipment expenditures alone, but to restrict these credits to expenditures which would clearly have the effect of bringing about an increase in expenditures over what might have been achieved in any event without the credit. Thus, for example, a tax credit of 12 or 15 percent on all capital expenditures in excess of 150 percent of depreciation allowances, would have the effect of offering a very large incentive to capital expenditures beyond what might be normal for a typical firm but would offer little or nothing in the way of a windfall gain for firms spending merely their normal amount. I would suggest, arguing merely as a technician, that such a revision of the tax credit to concentrate on marginal incentives would go much further toward accomplishing the stated objectives of increasing equipment or capital expenditures, with much less of the windfall or "giveaway" characteristics of an all-inclusive credit.

This is not, however, to argue in favor of such a provision at all. I am not one of those who believes that government should never intervene in private economy. However, I do believe that any particular intervention should not be undertaken unless it is clearly justified. I do not have information nor, do I believe, has this committee or the Congress, to indicate that the American economy is using insufficient equipment as compared to other factors of production. My own judgment would be that production could be increased and our economic rate of growth enhanced by directing more of our resources into investment in human beings and in knowledge rather than in hardware. If I were asked in what way the Government might intervene to direct the allocation of resources, therefore, I should argue in favor of subsidies to education and encouragement

of expenditures for research and development rather than encouragement of expenditures for equipment. A tax credit the committee might well consider, for example, although I do not suggest this particular one as ideal, would be a credit to parents for expenditures on behalf of their children's higher education. One might say, "Let us have credits of all kinds." But I am sure that this committee is well aware that, the political process and budgetary problems being what they are, it would not be possible to give tax credits in all directions. I cannot see that credits which will result in large gains to owners of businesses making heavy equipment expenditures are at all the most desirable types of credits to be considered if any credits are to be given.

A final consideration, which has not to my knowledge been noted previously, should be added to the discussion. It relates to the effects of the proposed tax credit upon cyclical fluctuations. Economists and lawmakers have prided themselves for a number of years on the so-called built-in flexibility, however limited, of our fiscal system. What we have in mind is the tendency of tax revenues to go down in time of recession, and generally to go down by a greater proportion than the drop in national income, and similarly to rise, and to rise by a greater proportion than national income, in time of inflationary boom. In time of recession, when demand is low, the private sector of the economy pays less in taxes and hence has more left with which to buy goods and services, thus reducing or cushioning the fall in total demand. Similarly, in periods of inflationary boom, our progressive tax structure is such that the private sector of the economy is taxed relatively more heavily and finds its demand for goods and services checked by the siphoning off of its income in taxes, hence reducing the inflationary pressure. The investment tax credit, unfortunately, operates in an opposite direction. Since the amount of credit depends upon the amount of expenditures on equipment, the credit is large when equipment expenditures are large, and low when equipment expenditures are low. But it is well known that expenditures on equipment are among the most volatile components of our gross national product. In time of inflationary boom, expenditures on equipment are very high, while in times of recession they become very small. Hence the investment tax cred[illegible]uld be giving large amounts of income to taxpayers in periods of boom, wh[illegible] is not desirable from the standpoint of combating inflation, and converse[illegible]e investment tax credit would be giving relatively small amounts of i[illegible]e to taxpayers in periods of recession, when the income would be most needed to combat the shortage of demand.

I may conclude by suggesting that given a framework of full and adequate demand for product, I would not argue at this time for interference with the free market choice and free decisions of business leaders as to the amount of their resources that they should devote to equipment, land, materials, and human labor. Because so much of investment in human beings, that is, the education of our young in the Nation's schools, colleges, and universities, is a private matter, outside of the profitmaking activities of the business community, I can see a major argument for subsidies of such expenditures. But if business investment in equipment is insufficient in our more or less free market, and I do in fact believe that such investment is insufficient in view of the potential of our economy, it is insufficient primarily because businessmen, attempting to maximize profits, do not in many industries enjoy the prospect of sufficient demand to warrant the introduction of new plant and equipment. I view it as folly to attempt to induce businessmen to buy additional equipment when measures are not taken to bring about demand for what that equipment will be able to produce. Conversely, I believe that if measures to bring about such a sufficiency of demand are undertaken, businessmen can then be left free to make their own decisions as to the optimum amount of equipment to acquire. While tax reduction may well be in order as a major measure for bringing about a full employment level of aggregate demand, the investment tax credit is a particularly poor means to such an end, and a tax relief—or giveaway—of questionable equity.

I should of course be happy to discuss any of these matters further with the committee. I append a list of various of my own articles and papers which bear most closely on the issues under consideration.

Appendix

Papers and Publications by Robert Eisner Bearing Directly on Investment

"Determinants of Capital Expenditures," University of Illinois, 1956;

"Interview and Other Survey Techniques and the Study of Investment," in Problems of Capital Formation, Studies in Income and Wealth, vol. 19, National Bureau of Economic Research, Princeton, 1957;

"Expectations, Plans and Capital Expenditures: A Synthesis of Ex Post and Ex Ante Data," in Social Science Research Council volume, Expectations, Uncertainty and Business Behavior (New York, 1958);
"An Appraisal of Proposals for Tax Differentials Affecting Investment," in Income Tax Differentials, Symposium, Tax Institute, Princeton, 1958;
"A Distributed Lag Investment Function," Econometrica, January 1960;
"Capital Expenditures, Profits and the Acceleration Principle," prepared for the Conference on Income and Wealth of the National Bureau of Economic Research, February 1962;
"Investment Plans and Realizations," American Economic Review, May 1962;
"Determinants of Business Investment" (joint with Robert H. Strotz), prepared for Commission on Money and Credit, to be published by Prentice-Hall.

STATEMENT OF LOUIS PUTZE, PRESIDENT, CONTROLS CO. OF AMERICA

Mr. Chairman and members of the Senate Finance Committee, I am Louis Putze, president of Controls Co. of America, and I wish to present testimony on that part of the tax bill which is concerned with the method of taxing the income of U.S.-owned foreign subsidiaries.

Controls Co. of America is a manufacturer of controls and control systems for the aviation, missile, industrial automation, electronics, automotive, home appliance, refrigeration, air conditioning, and heating industries.

Controls Co.'s annual sales are a little less than $50 million. We have approximately 1 million square feet of floor space in 23 plants, employing about 4,500 people. Roughly, 20 percent of our facilities and personnel, at home and abroad, are engaged in export or foreign activities.

I wish to emphasize two main points in my testimony concerning the taxing of profits of U.S.-owned foreign subsidiaries:

The first point is that there should be a clear-cut distinction made between a sham setup for avoiding taxes in a tax haven country, and a true, operating base or trading company in the same country. Related to this point is the necessity to define the effect of direct investments in a foreign base or trading company involved in the same business as the U.S. company owning it, and to distinguish between such direct foreign investments and foreign portfolio investments.

The second point outlines the necessity to recognize the effects of the Trade Expansion Act on U.S. business, if competitors in foreign countries are given an advantage over U.S. companies because of the tax provisions in H.R. 10650.

Roughly speaking, a sham company set up for the purpose of evading taxes has a small staff that doesn't do much more than retype invoices at a higher price. To compare this with the operations of a legitimate base or trading company, let's look at the responsibilities of Controls A.G., our Swiss subsidiary, which has been staffed to accomplish the following:

Marketing and engineering:

1. Make sales survey and analysis.
2. Direct the sales force in the European Economic Community and European free trade area countries.
3. Handle export sales throughout the world for Controls Co. products manufactured in the United States, Canada, Holland, France, Great Britain, Brazil, Argentina.
4. Prepare all advertisements and technical papers in all languages of the marketplace.
5. Provide technical sales and application engineering assistance to apply our controls to the foreign customers' needs.
6. Accept customers' orders and prepare production schedules for our foreign factories.
7. Coordinate the new product development program for maximum effectiveness in foreign markets.

Financial and administration:

1. Coordinate with the home office in the financial planning outside of the domestic areas.
2. Prepare investment programs in foreign market areas.
3. Assist the oversea manufacturing units in preparation of their operating forecasts.
4. Coordinate cash requirements of oversea operations and prepare cash forecasts.

5. Prepare monthly financial statements.
6. Administer the licensing of foreign manufacturers.
7. Administer foreign patent activity.
8. Investigate credit and arrange for financing of export sales, including letters of credit.
9. Maintain banking and credit facilities abroad and assist in the arrangements for financing of foreign plants.

Gentlemen, our Swiss operation provides the same functions to our international business as my office in Chicago provides our domestic U.S. business. I invite you to visit our Swiss operations and see for yourselves.

Now, why did we choose Switzerland instead of some other country when we established Controls A.G.? We picked Switzerland because:

1. It is geographically located in the center of our market area.
2. The country has a long history of political stability.
3. Excellent transportation facilities exist.
4. There is a great availability of multilingual personnel.
5. The Swiss franc is one of the world's strong currencies.
6. Taxes on foreign (non-Swiss) income are low.
7. The Swiss currency is freely convertible.
8. Switzerland has tax treaties with most of the important industrial nations of the world.
9. Excellent banking facilities are available.
10. The integrity of the Swiss people is among the highest in the world.

I would like to emphasize that when Controls Co. brings profit back from Switzerland, we have paid about a 15-percent tax there. The difference between that 15 percent and the 52-percent U.S. tax rate is then payable to the U.S. Government. This is much better for the United States than if we had made this profit in Holland, France, or Great Britain where the tax rates are about the same as ours.

So far, we have been discussing foreign operations where there has been a direct investment by a U.S. company in its own foreign subsidiary involved in an activity similar to that of the parent company here in the States.

Net portfolio investments (purchases, less sales and income received) by U.S. citizens, banks, or other establishments in foreign securities sometimes create an outflow of capital, since they have only dividends or interest to offset the initial investment, except when a sale of the portfolio investment is made.

On the other hand, direct investments by U.S. companies in their foreign subsidiaries is a "horse of a different color." Here the return of money to this country consists of not only the dividends returned to the United States (less foreign taxes withheld), but also charges for engineering, service charges for U.S. "know-how" and the sales of the U.S. company to its foreign subsidiary in the form of finished goods, subassemblies, and piece parts.

Let's look at Controls Co.'s results as far as a favorable balance of trade is concerned, and then see how we achieved these results.

From 1950, when we made our first investment outside of the United States, through September of 1961, Controls Co.'s investments in its foreign operations were almost $1,400,000. During this period, we received over $9 million as dividends, license fees, service charges, and from export sales. This is a favorable balance of trade of 6½ to 1. In addition, the U.S. Federal income tax we have paid on dividends returned to the United States, on service charges, on interest, and on the estimated profit from export sales amounts to $900,000 for the same period.

I will now review for you how we got the above results, because this will demonstrate what we think is the proper use of a base or trading company.

Many of our controls go on appliances in the home heating, refrigeration and home laundry industries. When the market for oil heaters began to develop in Canada, we first exported complete controls from the United States. As the market grew, Canadian competitors, protected by tariffs, forced us to start assembly operations within that country in order to meet their prices. We then exported piece parts and subassemblies to Canada. The growing market, however, kept these shipments at a good level.

Our start in Europe was similar. We first sent finished controls into a new market. As the demand developed and foreign manufacturers entered the field, competition became tougher. To meet this competition, we built an assembly plant and exported piece parts and components from the United States. Had we not built this assembly plant, we would have lost this market completely,

including the export from the United States of piece parts and component to a captive customer, our own foreign subsidiary. This manufacturing facility, also, has been the "foot in the door" that has allowed us to start the assembly of other controls for sale in Europe which we can no longer export from the United States because of competitive prices from European manufacturers. The service charges and dividends which this operation in Holland pays our parent company here in the United States has been a big factor in the 6½-to-1 favorable balance of trade ratio I mentioned earlier.

Let's look now at a couple more specific areas involving our foreign operations. The general manager of a division of our company headquartered in Illinois wrote Senator Dirksen, indicating his opinions to the administration's recommendations for modifying the tax treatment of income derived by American firms from investments abroad. In his letter he presented some of the facts I have outlined here, to you. Senator Dirksen asked the Secretary of the Treasury for comment on the letter. Mr. Stanley Surrey replied as requested, and raised several very pertinent questions which I will answer:

His first question concerned what happened to the volume of exports from Controls Co.'s plants to other industrial countries after it established its foreign operating subsidiaries. The answer is they grew significantly since 1958 when we established our subsidiary in Zug, Switzerland, which is responsible for promoting the sale of U.S. products overseas, and we expect further growth.

Mr. Surrey said it would be relevant to know whether our foreign plants manufactured products for sale to countries in Europe or other parts of the world that would have been made in the United States if that plant had not been established abroad. The answer is, generally, "No." We export finished products from the United States to foreign countries until the competitive situation forces us to commence assembly operations overseas. We then export piece parts and components to the assembly plants as long as competition allows us to do this. This is the history of every product we make in Europe.

The final question covers whether or not a part of the output of foreign plants was exported to the United States to replace products that would have been supplied from domestic sources. The answer is "No." There is only one product that we produce in Europe and sell in the United States. This product is one model of an oil lifter which does not have sufficient volume of sales in the United States to justify manufacturing it here (less than 1,000 used a year). European production of this unit for that market is substantially greater and, due to competition from European manufacturers, we had to produce this unit abroad in order to be competitive pricewise. The added cost of freight and import tariffs made our U.S. product noncompetitive.

We have designed and produced in the United States a newer model oil lifter, which is more appropriate to the U.S. market and is in production here. However, we still have a few calls for the older model.

There is another point which I think is very important. Our operations in Europe help protect our U.S. market because our high volume of production in Europe makes it very difficult for a European manufacturer to get sufficient volume to lower his unit cost to the point where he can compete against our U.S. plants in this country.

We would be naive beyond reason if we were to claim that all base companies were created strictly for operational or administrative control, without regard to tax considerations. On the other hand, many, such as ours, are performing the necessary functions in directing the manufacturing, sales, financial, and administrative activities of foreign subsidiaries of U.S. companies.

I would like to urge that in considering the tax treatment of income from U.S.-owned foreign subsidiaries, you distinguish between the legitimate and illegitimate or sham base companies, and between portfolio investments and direct investments in an operating subsidiary in a foreign country. The legitimate base company is a bright spot, as far as our country's balance of trade is concerned, and is a real source of income, taxwise, to our Government.

The second main point which I indicated earlier I wish to cover concerns the necessity for recognizing that the Trade Expansion Act and the foreign tax problem are closely related. Incidentally, I testified before the House Committee on Ways and Means in early April favoring most of President Kennedy's program to increase trade.

There are some who feel that the tariff question and the foreign tax problem are unrelated and should be treated separately. Tariffs and taxes have such an important bearing on U.S. industry's ability to compete that they have to be

considered together. American business, with but few exceptions, should be able to adjust to the additional competitive pressure that would result from a reduction of tariffs, provided it has tariff, duty, and tax considerations similar to those under which its foreign competition operates. Given the same weight boxing gloves and rules in the form of similar tariffs and taxes, U.S. industry can go into the world market ring with foreign competitors and come out a balance-of-trade winner.

American business' position in world trade is affected, not only by its ability to sell against foreign competition in the domestic market, but also by its ability to penetrate foreign markets against both domestic and foreign competitors, many of whom have become stronger as a result of our own economic assistance programs. While we feel that the U.S. policy should support U.S. industry, at the very least it should not discriminate against American companies in favor of foreign manufacturers.

Labor rates are going to continue to be lower outside of the United States for some time to come. Historically, as I have pointed out earlier, Controls Co. has not taken advantage of lower labor rates abroad to ship goods back into the United States. It is further a matter of record that U.S. industry has shown its ability to compete in the domestic market against foreign competition in most industries, in spite of the wage differential, because of design, styling, productivity, or the higher volume of business available in the U.S. market.

American industry needs, in addition to its ingenuity and technology, the ability to accumulate capital for the continued development of new products for the expansion of manufacturing and distribution facilities where needed. We feel that the present administration is not taking a broad enough viewpoint with regard to the vital elements affecting American international business, and in sponsoring a tax policy that unduly penalizes American industry compared with its foreign competitors. The tax bill the House has sent to the Senate would tax the earnings of the foreign subsidiaries of American manufacturers, regardless of whether or not the foreign subsidiaries remitted those earnings in the form of dividends to the American parent company. Controls Co.'s foreign competitors would not be subject to this tax burden. For example, a very effective competitor, the Holzer Co. of Meersburg, Germany, has a Swiss base and trading company which would be able to accumulate capital at a faster rate than Controls Co.

If the Holzer Co. and Controls Co. should each have the same volume of sales and the same profit in Switzerland, Mr. Holzer would have approximately 85 percent of his Swiss profits available for further development of his business compared with 48 percent which Controls Co. would have if the present tax bill of the House is accepted by the Senate. Mr. Holzer is a very capable manufacturer who gives us all the competition we can handle already, without the advantage of having more capital available in the dynamic growing European market.

Let's look at present and forecast production figures for just two common American appliances in the Western European market.

Refrigeration production in Western Europe caught up with U.S. production in 1957. We stayed almost even for a year and a half, then they started pulling away from us. Last year the United States produced about 3,600,000 refrigerators, while Western Europe produced about 4,700,000. In 1965, the United States is forecast for about 4,200,000 refrigerators as compared to 6,300,000, or half again more for Western Europe.

Even more important to Controls Co. is washing machine production. In 1961, the United States and Western Europe each produced about 3,600,000 washing machines. The United States is forecast for 4,100,000 in 1970, while Western Europe is forecast for 6,700,000, over 60 percent more.

It is this growing market for home laundry controls that Mr. Holzer and Controls Co. will be fighting to get. If he has 85 percent of his Swiss profits to use to develop this market and his production in it, while we have but 48 percent of our Swiss profits for the same use, the result is inevitable.

Control of this market is important because the company that obtains the dominant position in a major market has a volume of business which gives it low unit costs and thus the potential to dominate any other of the world's markets, including the United States. If Mr. Holzer can dominate the home laundry controls market in Western Europe, which in itself is now a larger market than we have in the United States, he has the potential to penetrate our U.S. market.

We have often heard the opinion expressed by labor unions and others that if American manufacturers established foreign manufacturing operations, U.S. employment would be reduced. Our experience does not bear this out. When we began to develop a substantial export business, we found it necessary to organize a foreign trading company to handle sales contacts, engineering applications, advertising, promotion, and general administration. As foreign competition forced us into establishing manufacturing facilities abroad for some products, our foreign trading company was able to sell our other U.S. products, and thus protect the jobs of U.S. employees involved in these exports. Further, it has been our experience that the export of U.S. manufactured piece parts and finished goods to our foreign establishments remains at a substantial level because of the requirements of the foreign operations. Unless we can retain our foreign markets, American employees depending upon these foreign sales for work will lose their jobs. If some labor leaders or others were successful in making it economically unfeasible for U.S. companies to set up and operate establishments abroad in the mistaken view that such actions amount to exporting jobs, they will actually be cutting off an export market and thus destroying jobs here in the United States. This would be extremely unfair to American labor which has contributed so much to the success of our country.

In summary, I wish to emphasize that all laws and regulations concerning taxes, tariffs, and foreign commerce bear on the ability of American companies to hold their own in foreign trade. This means the President's trade expansion program and the foreign tax situation must be considered together because of the effect they have on each other.

We are in favor of the President's tariff reduction policy, but only if it is coupled with an overall tax program that will strengthen American industry's position in international commerce. The strengthing of U.S. world trade, the increasing of our exports and the improving of our balance of trade are proper goals for our Government. It is important, however, that the right steps be taken to insure these goals. Any move which weakens the ability of U.S. industry to compete in growing foreign markets at this time will not assist in the achievement of these goals, but instead will operate against them.

ISLIP, LONG ISLAND, N.Y., *April 16, 1962.*

Hon. HARRY F. BYRD,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D.C.

SIR: Herewith are my individual views on the revenue bill of 1962 (H.R. 10650).

The "investment credit" proposal (section 2) ignores the more basic need for realistic depreciation rate schedules. It would channel tax relief only to the more solvent and affluent business concerns which have reserves for new capital investment.

The proposal to tax foreign subsidiary earnings on a current basis (section 13) violates all logic and equity and vitiates prior congressional stimulus to foreign investment by domestic concerns. It ignores the risks already undertaken under long-term commitments by private enterprise as a supplement to our foreign economic aid policies. It ignores the complicated arrangements and detrimental concessions that had to be made in order to operate abroad—restrictions against retrieving foreign investment and income; mandatory requirements for reinvestment of earnings abroad, for foreign national directorates, for excessive social welfare taxes.

The proposal to tax the earnings and pensions of individuals for foreign service (section 12) similary does violence to prior congressional stimulus to foreign investment by domestic concerns. It will force such concerns to readjust foreign service compensation upward in order to continue to attract qualified personnel. If there are abnormal tax avoidance devices employed by certain individuals, other corrective devices should be developed.

If the enactment of section 12 is unavoidable, I have three modifications thereof to suggest.

I would suggest that the amendment modifying the current "bona fide foreign residency" rule (section 911 IRC) specifically indicate that foreign service prior to 1963 can be taken into consideration so that the $35,000 limitation can be applied in 1963.

I would suggest that the proposed amendment requiring the application of the preceding year's earnings limitation to amounts received in the year following that in which foreign services were rendered specifically indicate that this provision would not apply to amounts received in 1963 for 1962 foreign service—on the ground that the $20,000 or $35,000 limitation was not applicable in 1962.

I would further suggest that the proposed amendment taxing pension benefits received after 1962 for foreign service by a U.S. citizen whether he resides within or without the United States at the time of receipt specifically indicate that only a portion of that pension benefit would be includible in his gross income—only to the extent of the ratio of:

Foreign service after 1962

Total foreign service

The proposal to change the current business expense tax deductions (sec. 4) is objectionable in that: (*a*) it would disallow a deduction where a facility is used for entertainment, etc., only to a minor extent (less than 50 percent); (*b*) it would permit the Internal Revenue Service to overrule business judgment as to the reasonableness of allowances for meals and lodging expense for business travel; (*c*) it is not clear that the limitation of $25 on business gifts would not be applied to discretionary payments by an employer to the widow of a deceased employee. The first two points seem to sanctify arbitrariness by the quest for more tax revenue. The third point points up the need for further clarification of congressional intent as to the application of section 102 of the Internal Revenue Code to discretionary payments that are made with due regard to the finances, resources, and welfare of a deceased employee's family and which are not unpaid compensation for past services.

The proposal to withhold tax on dividends and interest (sec. 19) would create an administrative monstrosity. Its proponents ignore the results that can be obtained under the full-scale operation of the newly created taxpayer account number system. Little attention has been given to the discriminatory aspect involved in requiring withholding on dividends and interest but not on any other type of income payments other than wages. Little attention has been given to the inequity of forcing the status of an uncompensated trustee upon a withholding agent. There has been a clamor—and I add my voice to this clamor—against the asserted right of the Government to collect and hold money from those who have no tax liability e.g. a tax-exempt trust. Finally I would call your attention to section 19 of H.R. 10650 which in effect would require the withholding of tax on dividends paid to nonresident aliens at a rate of 20 percent notwithstanding the provisions of any treaty, and further, which gives the Secretary of the Treasury the power to vary these rates. This to my mind would be inappropriate inasmuch as it would in fact supersede United States to treaty provisions. For this reason I do not think section 19 of H.R. 10650 would be constitutional.

Respectfully submitted.

PAUL P. HENKEL.

SHREVEPORT, LA., *March 21, 1962.*

Hon. ALLEN J. ELLENDER,
Senate Office Building,
Washington, D.C.

DEAR SENATOR: It is very doubtful if anyone would dispute the statement that the Federal Internal Revenue Code is a monstrosity, incapable of being fairly and properly administered.

I have been studying the revenue bill of 1962 (H.R. 10650) and it staggers the imagination to see how the passage of this bill will do other than to confuse everyone, especially the taxpayer and his accountants.

Please allow me to give some illustrations:

(*a*) Section 4(b), traveling expenses, amends section 162(a) (2) of the present code by striking out "(including the entire amount expended for meals and lodging)" and inserting in lieu thereof "(including a reasonable amount expanded for meals and lodging)."

Who is going to decide what is "reasonable"? I am not a big eater and my meals may not run over $7 daily, whereas you might spend $10. Which is "reasonable"?

We have had too many of such phrases in our taxing laws and the courts place many interpretations thereon. It never really gets settled.

(*b*) Section 2, credit for investment in depreciable property: You may recall the President last year sent a special message to Congress on this. He advocated its enactment to encourage business to eliminate old outdated equipment and invest in new equipment. So far, so good, but under section 14 of the bill a new section of the code is proposed (sec. 1245) to tax as ordinary income sale of present (as well as new) section 1231 property and equipment.

This new section (1245) is going to make some businesses take a long hard look at selling their old machinery. Viz: a sole proprietor in the 50-percent tax bracket has an old machine, fully depreciated, leaving his cost basis zero.

He can sell the old machine for $10,000 to another firm and buy a new machine for $30,000. He immediately incurs an income tax of $5,000 (under present sec. 1231 only at 50 percent tax rate). He buys the new machine for $30,000 (life of 8 years) and receives a tax credit of 8 percent of $30,000 or $2,400. He is $2,600 in the hole.

This section 14 defeats the purpose of the investment tax credit.

(*c*) Section 19, withholding of income tax on dividends and interest.

This is a farce and will put an unrealistic burden on payor, payee, and the Internal Revenue Service.

I do not believe the Government's loss of revenue is now as great as the Treasury Department is claiming. This section should be eliminated for many reasons.

Best wishes.

Sincerely,

R. A. WORLEY.

MONTEVIDEO, *March 30, 1962.*

Senator HARRY F. BYRD,
Chairman, Senate Finance Committee,
Washington, D.C.:

We can assure you foreign provisions for H.R. 10650 are disastrous to best interest United States throughout Latin America. Failure to recognize problems of foreign competition will further weaken already poor balance-of-payments position and cause cancellation of planned commercial investment necessary to success of Alliance for Progress in Latin America. We wish to register our protest as a matter of record to this extension of U.S. tax law to foreign countries.

U.S. CHAMBER OF COMMERCE IN URUGUAY.

EVANSVILLE, IND., *April 1, 1962.*

Mrs. ELIZABETH SPRINGER,
Chief Clerk, Senate Finance Committee,
Washington, D.C.:

We are concerned that the hearings on H.R. 10650 will be taken up almost exclusively with the credit for investment in depreciable property and withholding on dividends and interest without due consideration to the portions of the bill dealing with sales or exchanges of stock in foreign corporations. We think consideration should be given by the committee to reasons why it ought to be necessary to treat sales on exchanges of stock of foreign corporations in a different manner from domestic corporations. This bill will seriously impair U.S. exports and further increase the imbalance of imports and exports about which we understand the administration is seriously concerned. Section 16 of the bill confiscates up to 91 percent of the investment of an individual in a foreign corporation in the event he liquidates the corporation or sells his stock. Question why should this be so?

A. L. DOUGHERTY, *Paoli, Ind.*

AMERICAN CHAMBER OF COMMERCE IN LONDON,
London, March 14, 1962.

Senator HARRY FLOOD BYRD,
Chairman, Senate Finance Committee,
Washington, D.C.

DEAR SENATOR BYRD: There is attached for your information a copy of this chamber's letter to the chairman of the Ways and Means Committee. It is hoped

that you will study the letter with the view to giving it due consideration in your deliberations respecting the taxation of corporate foreign-earned income.

Respectfully yours,

EMIL KEKICH, *Executive Director.*

AMERICAN CHAMBER OF COMMERCE IN LONDON,
London, February 28, 1962.

Re tax proposals on corporate foreign-earned income.

Hon. WILBUR D. MILLS,
Chairman, House Ways and Means Committee,
Washington, D.C.

DEAR MR. CHAIRMAN: The American Chamber of Commerce in London, Inc., a private nonprofit organization incorporated in the District of Columbia, has contributed to the advancement of the mutual interests of the United States and Great Britain in trade and investment ever since its foundation in 1916 at the behest of the British Government.

The membership of the chamber includes (apart from about 1,000 British associates who transact business with the United States as manufacturers, traders, investors in joint ventures, licensees or licensors) nearly 700 American manufacturing and service organizations established in the United Kingdom. These manufacturing concerns, numbering close to 500, are for the most part medium-sized or small enterprises of good repute.

The President's 1962 budget message and his 1961 tax message propose to tax American corporations on their current share of the undistributed profits of subsidiary corporations incorporated in economically advanced countries.

Opposition within the Ways and Means Committee to the President's proposals resulted in the Treasury submitting to the committee a substantially modified draft bill (July 28, 1961—D-186) which purports to tax only "tax haven" profits earned by such subsidiaries.

The proposed legislation to tax the foreign subsidiaries of the United States, as it stands at present so far as we know, would appear to be inconsistent with the President's expressed policy of encouraging freer world trade. That end would be achieved by the multilateral lowering of tariff barriers and providing incentives to American industry to operate in what can be a new era in trade and investment relations among the nations of the free world.

The American Chamber of Commerce offers serious objection to the proposed legislation for taxation of foreign subsidiaries' earnings. Its opposition is based primarily on the belief that such legislation would ultimately and inevitably corrode and even destroy the many bilateral agreements entered into by most of the nations of the free world to avoid the crippling effect of the burden of double taxation upon international trade. Our objections are no more than a plea for fair tax treatment of these subsidiaries based on their importance in America's economic and political leadership in the community of free nations.

These bilateral arrangements are described variously as conventions, agreements, treaties or arrangements, according to the relative constitutional position of the two contracting parties.

The idea of avoiding double taxation by means of bilateral agreements between states was developed over a number of years before the war by the Fiscal Commission of the League of Nations. The work of this Commission culminated in the drafting of the Model Conventions of Mexico (1943) and London (1946).

Until quite recently, the London draft has been the basis on which the United Kingdom Government has negotiated all of its double taxation agreements. In recent years, however, the Fiscal Committee of the OEEC has been working on a new Model Convention, of which the major part has been published in a series of four interim reports over the years of 1958 through 1961, and this now forms the basis of new or renegotiated agreements entered into by the United Kingdom with OEEC member countries.

Each agreement is, however, the result of free negotiation between sovereign states where opposing interests (i.e., capital importing or capital exporting, economically advanced or less advanced) have resulted in minor variations from this standard pattern. The United Kingdom has concluded agreements with 74 countries; the United States of America with 25.

This standard pattern recognizes:

(*a*) That certain classes of income are appropriate subjects for taxation in the country or origin, and, accordingly, by mutual arrangements should not be taxed in the country of residence of the recipient.

(*b*) That other sources of income are more suitably taxed in the country of residence.

Further, it recognizes that the country in which the taxpayer is resident retains the right to assess his whole income from whatever source derived, but subject to giving relief in respect of the tax which it has been agreed is appropriately charged in the country of origin.

The treaty concluded between the United States and the United Kingdom adhered closely to the standard pattern.

Under it, a United Kingdom resident corporation is not subject to U.S. tax on its industrial or commercial profits, unless it is engaged in trade or business in the United States through a permanent establishment there. If it is so engaged, then the entire income of such enterprise from sources within the United States is liable to tax in accordance with U.S. law, but such tax will, if appropriate, be allowed as a tax credit against taxes payable in the United Kingdom.

Converse provisions apply to a U.S. enterprise.

Quite apart from the protection afforded by bilateral tax treaties, the United Kingdom has never sought to tax the foreign earnings of a non-United Kingdom resident corporation, even though it may be a wholly owned subsidiary of a United Kingdom parent corporation. It recognizes that there are broadly two ways in which a United Kingdom corporation may do business abroad:

(*a*) Through a branch operation abroad.

(*b*) Through a foreign subsidiary.

In case (*a*), the United Kingdom corporation is fully subject to United Kingdom tax on branch profits, whether remitted or not. In case (*b*), it is only liable to the extent of dividends paid by the foreign subsidiary. In common with most nations, the United Kingdom recognizes that the foreign subsidiary constitutes a separate legal entity outside its jurisdiction.

Even in case (*a*), the United Kingdom has legislated some relieving provisions for oversea trade corporations (Finance Act 1957).

This extends the principle of exemptions from United Kingdom tax to income arising to a United Kingdom resident corporation from trading carried on exclusively abroad, irrespective of whether a tax treaty is in existence or not, until and unless such foreign income is distributed to a United Kingdom resident other than an OTC.

It will thus be seen that any proposal to subject to U.S. tax the undistributed earnings of a United Kingdom subsidiary is in direct conflict with the philosophy and the principles developed internationally in general, and by the United Kingdom in particular.

Should the Treasury's proposal become law, the incidence of the burden of the resulting tax payable is important. As we see the position, any such tax would need to be absorbed by the U.S. parent company, since under existing United Kingdom law a United Kingdom corporation could neither have U.S. tax enforced against it direct by the U.S. Government nor be compelled by its U.S. parent to accept an intercompany charge. Certainly, in these circumstances, the United Kingdom corporation could obtain no relief, direct or otherwise, for the U.S. tax against its United Kingdom tax (unless, as previously indicated, the United Kingdom corporation has a permanent establishment in the United States).

This chamber is also opposed to the proposed legislation on financial grounds, for the following reasons:

(*a*) It would reduce the "return" on foreign investment and thereby discourage foreign investment.

(*b*) It would reduce the capital funds available for foreign new investment.

(*c*) Where a foreign affiliate is financed by local retained earnings, the increased dividends necessary to flow back to the parent to enable the parent to meet the tax bill thereon would automatically reduce this form of finance and thereby make such foreign affiliate less competitive.

(*d*) Additional unnecessary costs, other than tax, are involved in roundtripping dividends from foreign affiliates.

(*e*) It could nullify tax incentives which a number of countries have introduced to attract new industries and to encourage capital investment locally.

(*f*) By encouraging increased dividend distribution, it could contribute to local balance-of-payment difficulties.

All American corporations doing business overseas play a far more important role in building and maintaining America's prestige abroad than may be generally

realized. They are in practical effect instruments of American foreign policy.

Americans of experience in government and private enterprise know that there is a greater need than ever for collective strength on the part of the nations of the free world. Few would dispute that during the past four decades in Britain, as no doubt in other countries, American corporations with international interests have in fact enhanced the position of U.S. foreign policy. Through constructive investment, production, labor and customer relations they have been most effective institutional ambassadors of the United States.

For example, the British economic and financial magazine of international renown, the Statist, on January 5, 1962, said: "It is salutary to find familiar names like Heinz, Hedley, Hoover, Kodak, and Ronson listed, correctly, as manufacturing subsidiaries of American parent companies. These and other names are so well established in this country that they are often regarded as Britain's own. But the fact of American ownership is softened by their contribution to Britain's exports."

Over the years American manufacturing enterprises in Britain have been fulfilling an ideal in comity between Britain and the United States by assisting the balance of payments of both countries.

The chamber is sending you, Mr. Chairman, a separate letter outlining its objections to certain features of the taxation proposals relating to personal foreign source income.

Respectfully yours,

WILLIAM E. CHANNING, *President.*

AMERICAN CHAMBER OF COMMERCE IN LONDON,
London, April 12, 1962.

Re section 12, H.R. 10650, earned income from sources without the United States.

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

DEAR SENATOR BYRD: In behalf of the directors and membership of the American Chamber of Commerce in London I wish to thank you for your courtesy in acknowledging receipt of the copy of our communication dated February 28, 1962, to the Honorable Wilbur D. Mills, chairman of the House Ways and Means Committee, in the matter of the tax proposals on corporate foreign earned income.

You may recall that in the last paragraph of the letter to the chairman of the Ways and Means Committee I mentioned that a separate letter would be forwarded in the matter of the taxation proposals relating to personal foreign source income.

Unfortunately the promised letter could not be drafted in sufficient time prior to the action of the Ways and Means Committee in reporting out H.R. 10650. Accordingly I sent you a cablegram dated March 30, copy of which is enclosed, briefly outlining the chamber's views on the pertinent proposal (sec. 12) in H.R. 10650. In amplification of the basic points outlined in the cablegram, permit me to detail some of the issues involved.

It may be noted here for the record that the chamber is a private nonprofit organization incorporated in the District of Columbia in 1916. The membership of the chamber includes (apart from about 1,000 British associates who transact business with the United States as manufacturers, traders, investors in joint ventures, licensees, or licensors) nearly 700 American manufacturing and service organizations established in the United Kingdom. These manufacturing concerns alone number approximately 500.

(1) It is the conviction of this chamber that to abolish the existing U.S. tax law, which has been in force for the past 36 years or so, would be a retrogressive step.

(2) It is the generally accepted, worldwide principle and practice that remuneration from an employment is properly taxable in the country in which the duties are performed; the proposals in H.R. 10650 are contrary to this concept.

(3) The proposals would result in no significant contribution to U.S. fiscal revenue because (*a*) in those countries where the principle of taxing at source is adopted the U.S. tax collection would be substantially offset by foreign tax credits, and (*b*) in those countries where local source income is not so taxed there would be a direct incentive to the local authorities to adopt such a tax principle in order to prevent the resultant outflow of dollars.

(4) No doubt the incentives given under the present U.S. tax law to American business executives of career in foreign service have played a part in contributing to the U.S. balance of payments, especially during 1961 and 1962. The U.S. Department of Commerce Survey of Current Business, March 1962, pages 22–23, giving the latest U.S. balance-of-payments figures, belies the emphasis placed by the U.S. Treasury on the effects of the existing U.S. tax laws; indeed, the figures just released confirm the substantial assistance given to the U.S. balance-of-payments situation by U.S. investment abroad.

(5) The withdrawal of the present U.S. tax exemption would create a serious disincentive to a foreign career. The increased difficulties and the additional cost to American companies having foreign subsidiaries in recruiting and placing top management U.S. executives abroad would be magnified to the extent that they would become less competitive in the foreign field, and, in the case of the smaller companies at least, might even result in a cessation of foreign operations. It would be unlikely, in these circumstances, that the loss in trade could be made up by direct exports from the United States since one of the main reasons for the establishment of American enterprises overseas is to maintain markets which are closed to them by way of direct exports owing to high domestic costs and foreign import restrictions. The trade loss under such disincentive would serve to add to the deterioration in the U.S. balance of payments.

(6) In this regard, the proposals in H.R. 10650 are entirely contrary to the objectives of H.R. 9900—to foster U.S. foreign trade.

(7) So far as the individual is concerned, in certain foreign countries direct income taxes are levied at relatively low rates, coupled with relatively high rates of indirect taxation, with the consequence that living costs are extremely high. If a U.S. citizen working in such countries is to be exposed to U.S. taxes (with little foreign tax credit) in addition, the total tax burden would become unmanageable.

(8) Without in any manner weakening our opposition to the proposals, the 3-year rule at a lower ceiling is inappropriate. Where a career individual has established foreign service, the higher ceiling should apply from the effective date of first commencing foreign service.

(9) It has taken the dedicated work of American business leaders, recognized as such by foreign governments, to deal adequately over the years with the trade and investment problems of the United States in the international field. The American individuals abroad who do not fall into this category represent a mere handful, and should be dealt with by our Government if they are indulging in tax subterfuges. The preponderant number of legitimate and creative American businessmen should not in all conscience be given disincentives to work abroad, especially at a time when our Government is building up new efforts to obtain the assistance of American private enterprise in developing American interests in foreign countries in a mutually cooperative spirit, e.g., H.R. 9900, the liberalization principle in which this chamber endorses with a serious reservation concerning the possible impact upon business incident to administration re section 404 of the bill, particularly the unilateral approach to the determination and extent of assistance.

Respectfully yours,

WILLIAM E. CHANNING,
President, American Chamber of Commerce in London, Inc.

MARCH 30, 1962.

Senator HARRY FLOOD BYRD,
Chairman, Finance Committee, U.S. Senate, Washington, D.C.:

Refer last paragraph our letter to chairman, House Ways and Means Committee dated February 28, copy of which you acknowledged March 17. Any tax exemption ceiling personal foreign source income becomes vulnerable to future amendment and at once seriously handicaps companies in forward planning for placement of key American personnel abroad. Enactment of ceiling proposals incorporated H.R. 10650 would either increase costs of maintaining senior executives abroad, thus decreasing competitiveness or lowering competency standards in replacements and deterring capable Americans from serving abroad. This chamber therefore asks your committee to emphasize correction of abuses that may exist rather than handicap overwhelming majority of good American businessmen who contribute so much to our Nation and host countries by their constructive work in production, and in labor, consumer, and public relations.

WILLIAM E. CHANNING,
President, American Chamber of Commerce in London, Inc.

TWIN DISC CLUTCH CO.,
HYDRAULIC DIVISION,
Rockville, Ill., March 26, 1962.

Subject: Revenue Act of 1962, H.R. 10650, taxation of foreign source income.

Hon. HARRY FLOOD BYRD,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D.C.

DEAR SENATOR BYRD: The form in which the subject bill has been promulgated by the House Ways and Means Committee, in consequence of an unaccountable last-minute reversal of position between February 23 and February 26 in apparent disregard of the mass of testimony and facts offered by informed industrial and professional witnesses, poses a grave threat to the continued ability of American business to meet foreign competition effectively.

A study of the implications of the Treasury's proposals was concluded by the American Chamber of Commerce in London and its findings were submitted in a letter dated February 28 to the Honorable Wilbur D. Mills, chairman of the House Ways and Means Committee. Unfortunately, it was too late to receive consideration by that committee, but I believe it is worthy of your serious consideration because of its thoughtful presentation of considerations which are unfortunately too little understood by members of the administration who have had no exposure to the hard realities of competition overseas.

Also enclosed, for your kind consideration, is copy of a letter I wrote to the Honorable Wilbur D. Mills on June 8 last year, presenting some basic considerations which have become obscured by demagogic verbiage playing on popular misconceptions of the objectives and pressures which have prompted American firms to incorporate overseas, to the advantage of our national economy and also of the Internal Revenue.

Very truly yours,

J. B. SCHUBELER,
Manager, Export Sales.

TWIN DISC CLUTCH CO.,
HYDRAULIC DIVISION,
Rockford, Ill., June 8, 1961.

Subject: Administration proposals on foreign source income taxation.

Hon. WILBUR D. MILLS,
Chairman, House Ways and Means Committee,
House Office Building, Washington, D.C.

DEAR SIR: As manager of export sales of the Twin Disc Clutch Co., and vice president of sales of its foreign corporation, Twin Disc Clutch AG, with situs in Liechtenstein and offices in Zurich, Switzerland, I wish to submit the following comments with particular reference to the testimony offered on June 5 by Mr. Walter A. Slowinski of the law firm of Baker, McKenzie & Hightower.

In the light of my experience in foreign business, I have been much impressed by the singularly unenlightened legislative proposals presented by the present administration and promoted by Secretary of the Treasury Dillon. Two aspects of these proposals which seem to have escaped proper recognition are, in my opinion, the following:

(1) The suggestion that the exemption from U.S. taxation of nonrepatriated foreign corporation earnings constitutes "preferential treatment" is entirely misleading. Such treatment merely enables U.S. business abroad to meet foreign competition not subject to U.S. taxation, and does not affect its domestic competitiveness except to the extent that repatriated and taxed foreign dividends provide addiional revenue. Our tax laws are only fair to the extent that they do not discriminate against U.S. business competing abroad with foreign business operating under more favorable conditions.

(2) The suggestion contained in the administration's proposals that "tax haven" operations are unsavory completely ignores the fact that such operations actually benefit the U.S. Internal Revenue, because earnings remitted to U.S. parents or associates then becoming due for taxation are not subject to the deduction of appreciable foreign tax. The "tax haven" consideration is quite irrelevant to the concept which the Kennedy administration is trying to introduce, namely, that of subjecting foreign-based U.S. corporations (whether located in "tax haven" countries or not) to taxation in the United States. The so-called tax havens are merely countries in which earnings generated externally are subject to little or no taxation.

While I am sympathetic to legislation curtailing the withdrawal from U.S. tax liability of earnings generated by domestic activities of American organizations or individuals, I am convinced that the proposed taxation of foreign source earnings would be seriously detrimental to the proven ability of American business overseas to benefit the U.S. economy.

Other testimony will have been submitted substantiating that the excess of foreign source dividend inflow over investment outflow during the past 10 years amounts to some $8.6 billion besides which vast revenue-producing operations have been developed abroad, the existence of which has stimulated direct exports; royalties and engineering fees have produced substantial taxable revenue, and incalculable benefits of an intangible nature, both economic and political, have been and are being increasingly derived from U.S. business investments overseas.

When it is considered that these benefits are being obtained with substantial advantages to the U.S. Treasury and to the national economy, for which American business has generated consistently favorable trade balances amounting to some $16.1 billion during the years 1957–60, it is little short of midsummer madness to contemplate imposing burdens on U.S. business operations overseas which could only benefit their foreign competitors and delight our Communist adversaries.

The objective of the administration to promote business investment in the less-developed, emerging countries would be more rationally served by two courses of action, namely:

(1) To offer comprehensive protection to such investments against noncommercial risks, mainly of a political nature, outside the control of the investor. The fate of U.S. investments in Cuba is a painful memory.

(2) To simplify and guarantee long-term financing at lower rates of interest than those properly reflecting commercial and political risks. The emerging countries are shopping for terms, rather than products, and competition is frequently motivated by political rather than commercial considerations.

The cost to the U.S. taxpayer of liberalized programs in these two areas would be small and the benefits large, both tangible and intangible. A repressive policy toward U.S. enterprises in the advanced countries is a poor alternative to the constructive one of improving the climate for the operation of U.S. business in the emerging countries, in order to promote its participation in these.

Trade, not aid, is our most effective foreign policy implement. It benefits us as well as our trading partners. Let us not weaken it.

Sincerely yours,

J. B. Schubeler,
Manager, Export Sales.

Garcia & Diaz,
New York, N.Y., March 20, 1962.

Senate Finance Committee,
Washington, D.C.

Dear Mr. Chairman: Your committee is studying the proposed new tax bill. We would like to call to your attention the injustice and the hardship that the treatment of foreign income in the proposed new tax law would mean to our firm.

We have been established since 1917 and our business is that of acting as steamship agents. We also have established two companies in Cuba since the year 1927, one acting as steamship agents and the other acting as terminal operators and stevedores. We, the parent company, own 100 percent of the shares of both Cuban companies.

Heretofore we would include in our income the dividends declared by our Cuban companies. The Republic of Cuba before the takeover by Castro had passed a law similar to a United States law to the effect that corporations could not acccumulate profits into their surplus account. They were obliged to declare dividends. Since Castro came to power he has seized and nationalized many companies, but for some strange coincidence neither one of our companies has been seized to date. However, the corporation laws have been changed drastically and Cuban taxes have increased tremendously. Our companies have made a small profit, but by present laws they are not permitted to transfer these profits to us.

Under the proposed new tax law we would be taxed on these profits even though, by reasons beyond our control, they could not be transferred to us. You can now realize the injustice and hardship that this would cause particularly when we, the parent company, are incurring losses due to the present depressed condition in the steamship industry.

We trust that you will bear this factor in mind when deliberating on this bill.

Very truly yours,

WILLIAM A. MARTINEZ, *Treasurer.*

McCULLOCH CORP.,
Los Angeles, Calif., March 16, 1962.

Hon. HARRY FLOOD BYRD,
Vice Chairman, Joint Committee on Internal Revenue Taxation,
Senate Office Building, Washington, D.C.

SIR: We understand a bill will be submitted to Congress shortly proposing that the current income of foreign enterprises wholly or partially owned by American firms be taxed to the U.S. parent companies in the year earned. The aim of this bill is to tax the profits of such American investments abroad immediately rather than wait until there are profits returned in the form of dividends from the foreign companies to their U.S. parents. As a medium-size American manufacturing company with substantial foreign investments, we would like to voice our opposition to this proposal prepared by the Treasury Department because, in addition to being detrimental to the long-range interest of American business, it also will reduce the total revenue to be collected by the U.S. Government on profits of American investments overseas. To explain more clearly why we are certain that this bill should be defeated, we believe it might be helpful to use our own company as a typical case of what could happen in the event this legislation is approved.

McCulloch Corp. is a manufacturer of chain saws, outboard boats and motors, and military aircraft engines. (We are enclosing literature that explains the type of products we are selling throughout the world.[1]) Our total employment in facilities in Los Angeles, Minneapolis, Toronto, Canada, Sydney, Australia, and Malines, Belgium, approximates 4,000 persons with total annual sales in excess of $50 million. Shortly after we began marketing our products in the United States, we investigated the possibilities of selling these in foreign countries through export from the United States. Although we were quite successful at first, within a few years our business began to deteriorate. Competitive foreign manufacturers were selling their products at a lower price than ours in their local markets because they enjoyed protection of tariffs plus lower labor and material costs. Moreover, we were unable to service most of our customers satisfactorily because of the long shipping time required to deliver parts to foreign countries from our U.S. factories.

It was obvious that our company had to set up facilities in other countries to remain competitive even though we had sufficient manufacturing capacity here in the United States to more than meet the total demand. Our first move in this direction was to build a factory in Toronto, Canada, to supply products to our own branches across that country. Without this investment, we could not continue to compete with the Canadian chain saw and outboard motor manufacturers already established there.

Our next activity in foreign markets was in Australia. In order to gain entry into this market, it was necessary to have our products made there by licensing a local company with manufacturing facilities. Competitive conditions in the last year or so have sharply reduced the profit margins on sales in Australia to the extent we now find it necessary to take over the manufacturing activity and apply our American know-how to reduce costs.

The rapidly expanding economy of Europe during the 1950's created an important market in that area for our products, and, once again, we found it necessary to invest in facilities to meet the competition of the dozen or more European companies who were manufacturing the same products. Our new factory in Malines, Belgium, assembles our products within the Common Market almost entirely from parts provided by our U.S. factories. The finished products, however, are Belgian in origin and, therefore, enjoy preferential lower tariffs when

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[1] Material made a part of committee files.

sold to other EEC countries. In this way, our Belgian operations have enable us to obtain a very large share of the total European market for our products. In the short period of time this factory has been in operation, sales of our products in Europe have nearly doubled. The production of parts in the United States for our Belgian company to meet this demand has actually increased the amount of labor employed here compared to the labor required previously to manufacture the finished products sold only through exporting.

The sales of our foreign subsidiaries have grown until they now constitute approximately one-third of our total corporate revenue. Since all our foreign manufacturing facilities use a very high proportion of U.S.-produced parts in the products they manufacture, this company has not exported jobs overseas. Conversely, we are now able to meet foreign competition and, by keeping these markets, have prevented the loss of jobs here in the United States.

In order to develop the necessary capital for the expansion of our foreign operations, we decided to establish a sales subsidiary, McCulloch International, Inc., of Panama. This company has a branch office in Belgium that purchases products from all of our factories and resells them to our customers in Europe, Africa, and the Middle East. No income tax is imposed on the profits generated through the sales of this Panama company, and, therefore, we have been able to provide sufficient working capital to keep up with the needs of our rapidly expanding foreign operations. It is recognized, of course, that this Panamanian subsidiary will eventually be returning dividends to the parent corporation and at that time 52 percent corporation income tax will be paid in the United States on these dividends. Through agreement with the Belgian Government, the income taxes of our manufacturing subsidiary, which is a Belgian corporation, amount to much less than those that a U.S. corporation would be required to pay.

I am sure you realize that a substantial number of American investments in Europe are set up in the same manner as ours; that is, a manufacturing plant selling through a separate sales subsidiary located in a country with low taxation on foreign revenue, usually Switzerland. If the tax advantage of maintaining an independent sales subsidiary in such a country is removed, most of these companies would logically consolidate their operation and management at their factory locations and pay the local taxes. Since these companies would then be paying much higher foreign taxes on income than formerly, the tax revenue that could be collected by the United States after foreign tax credits were deducted would be greatly reduced.

According to the revenue bill now being proposed by the Treasury, our parent corporation would be obligated to pay currently a U.S. corporate income tax on the profits realized by both the Belgian manufacturing company and the Panama company. The opportunity to develop investment and working capital necessary to keep up with our foreign expansion would be drastically affected. Therefore, to simplify our operational problems, we would then close up our Panama company and turn the sales responsibility over to our Belgian subsidiary. This subsidiary would, consequently, be taxed as other Belgian corporations at approximately a 34-percent rate on the profits generated by both manufacturing and sales. After deducting the Belgian tax on our combined profits, our U.S. tax would be only approximately 18 percent of this foreign income. This contrasts with the current 49 percent (after credit for Belgian taxes paid) that the IRS would collect from our European profits via the dividend route. In addition, the State of California will lose the franchise tax on the amount of European profits used to pay Belgian taxes.

It also seems obvious to us that, if this tax proposal is approved, the countries with low taxes on foreign-source income, such as Switzerland, Panama, the Bahamas, Luxembourg, et cetera will no longer need to maintain their relatively low taxation on local American controlled trading and holding companies since these firms could no longer defer payment of U.S. taxes on their current profits. Tax rates in these countries therefore, could be increased all the way up to the 52-percent U.S. tax without any additional expense to the companies involved but cutting directly into the revenue eventually received in the United States. Therefore, this shortsighted tax proposal could greatly reduce the amount of total revenue collected by the United States from income of U.S. subsidiaries abroad.

You are probably aware that nearly all other large countries of the world provide for deferred taxation or complete exemption from taxation of foreign-earned income, i.e., Germany, England, Belgium, Canada, et cetera. Companies located in these countries are competing with American companies for world markets and we must enjoy the same advantages to meet this stringent competition.

We urge you to become thoroughly familiar with this Treasury proposal for taxation of income of foreign subsidiaries of U.S. companies and to fully consider the impact this legislation would have on the economy of the United States before casting your vote.

If we can be of assistance in answering any further questions you might have on this matter, please feel free to contact us.

Yours very truly,

C. FRED BREER,
Vice President and General Manager.

[From the Financial Post, Mar. 10, 1962]

FINANCIAL POST REPORTS ON YOUR TAXES—HERE'S WHERE UNITED STATES AIDS RIVALS IN OTHER MARKETS

(By John G. McDonald, QC, McDonald, Davies & Ward)

The way things are shaping up, it is clear that 1962 will be an active year for tax legislators.

The British Chancellor of the Exchequer has already given notice that he will introduce a new tax on short-term capital gains derived from dealings in securities and real estate.

In the United States the House Ways and Means Committee issued another announcement last week concerning "tax haven" legislation (Financial Post, February 24) that will be included in the House bill (not yet released). General approach will be to tax U.S. shareholders currently on their "share" of the earnings of foreign subsidiaries, if at least 20 percent of the income of the subsidiaries is made up of interest, dividends, rents, royalties, income from patents and copyrghts, and "export income."

"Export income" is defined as income from the sale of goods by a controlled foreign corporation outside of the country in which it is incorporated, where the goods are not manufactured by the corporation and where more than 20 percent of such corporation's income) consists of such "export income."

Needless to say, the Republican members of the committee oppose the bill. Congressman J. W. Byrnes issued a statement, saying:

"The bill seeks to build a 'Berlin wall' in the tax laws to keep the American businessman at home. The bill would deny to American business the right enjoyed by its foreign competitors to go into any area of the free world where there might be a market, a source of raw materials, or the workers needed to make the business a success.

"The policy of the bill is a policy of * * * isolationism as to American-owned business. [It] adopts the outrageous proposition that American business should surrender to foreign competition in the world market."

It is certainly clear, in the field of foreign trade, that a foreign corporation controlled by Canadians—or an oversea trade corporation in Britain—will have a decided advantage over its U.S.-owned competitors after the "New Frontier" people in Washington achieve their ends.

The new law will also serve to trim American sails in Europe, increase the downward pressure on the U.S. dollar, and indirectly assist Britain's entry in the Common Market.

The point is, of course, that businessmen regard taxes as costs, and try to keep them down. Government taxmen, on the other hand, are indignant over foreign investment of "our" money by the businessmen who went out and earned it in the first place.

Let's hope that Ottawa encourages Canadian business to take full advantage of the mistakes south of the border.

At least it is obvious to our foreign competitors that this tax proposal will place American business at a disadvantage.—C.F.B.

ALHAMBRA, CALIF., *March 22, 1962.*

Hon. HARRY F. BYRD,
Senate Office Building:

We understand Ways and Means Committee has released proposed legislation that will subject earnings of foreign subsidiaries to U.S. tax currently and increase tax on distribution from these subsidiaries when remitted. We oppose

these changes because we feel they will make U.S. construction industry less competitive overseas. The loss of such business will reduce domestic employment and U.S. tax revenue. We respectfully urge you to vote against such proposed legislation.

C. F. BRAUN & CO.,
JOHN G. BRAUN, *President.*

CHAIN BELT CO.,
CARRIER DIVISION,
Louisville, Ky., March 19, 1962.

Senator JOHN SHERMAN COOPER,
Senate Building, Washington, D.C.

DEAR SENATOR COOPER: Recently the Ways and Means Committee has reported out a bill which will have serious effects on U.S. companies with foreign subsidiaries. The bill has a number of objectionable features, most harmful of which is a provision that Federal income taxes at the full 52-percent domestic rate will have to be paid on subsidiary earnings abroad even though these earnings have not been returned to the United States as dividends. Some of the reasons why this bill should be defeated are:

(1) Companies normally invest abroad only when foreign markets cannot be penetrated by export. Consequently most foreign subsidiaries do not harm domestic production as they are supplying markets which will not buy domestic manufactured products because of higher costs or currency, tax, or duty restrictions.

(2) Although U.S. investment abroad is made in order to supply markets which cannot otherwise be economically penetrated, tax considerations are still very important in determining whether or not such a company will make an investment. If the taxes of U.S. subsidiaries abroad are greater than the competitive subsidiaries of other foreign companies and/or local companies, it may not be economically feasible to support existing American subsidiaries, let alone establish new ones.

(3) The Treasury Department's concept of "tax neutrality" should be retailored to equalize the tax liability between American subsidiaries and the companies with which they must compete on the spot rather than equalizing taxes between American subsidiaries and the American parent company.

(4) The present level of taxes in various foreign areas is of primary importance in determining whether an American subsidiary will be located there or not. Underdeveloped countries normally have lower tax rates in order to attract industry. Under the proposed bill the level of taxes will be unimportant in determining location as long as these taxes do not exceed 50 percent. Operations will gravitate to high-tax countries rather than low-tax countries to our national detriment since foreign taxes can be credited directly and completely against U.S. income taxes paid.

(5) The long-term balance of payments has been extremely favorable because of the establishment of American subsidiaries abroad. The present favorable balance is approximately $2 billion a year which helps offset the deficit balance resulting from foreign aid and other similar programs. If this favorable balance is to continue, additional investments must be made abroad. Restriction of these investments would be shortsighted and self-defeating.

In summary, American subsidiaries by moving into high-tax areas would increase the gross national production in areas which are already self-sufficient or nearly so, and this would have the automatic corollary effect of delaying the self-sufficiency of the underdeveloped countries who need our assistance the most. From an economic standpoint the assistance of the underdeveloped countries must some day cease to be a dole, and this can only occur if these countries become self-sufficient and economically prosperous. It appears to me that this particular bill is not in the best interest of our foreign program to aid underdeveloped areas. It will tend to propagate, rather than alleviate, the burden of foreign aid now borne by the American taxpayer. It will have very little immediate effect on Federal income and over a period of time will result in less Federal income from foreign operations than now accrues when earnings of foreign subsidiaries are returned to the parent company in the form of dividends.

Our company has a substantial foreign investment. As an individual I own stock in a number of American companies with substantial foreign investments, and I am personally interested in asking your help in this instance. Thank you very much; and with best wishes, I am,

Yours truly,

J. M. MORRIS, *Division Manager.*

SAN ANTONIO, TEX., *March 23, 1962.*

Senator HARRY F. BYRD,
U.S. Senate, Washington, D.C.

DEAR SENATOR BYRD: A provision of the tax bill submitted by the Kennedy administration which comes up before the House of Representatives in the next few weeks, being section 18 thereof, would include for estate taxation by the United States any real property owned by a decedent situated outside of the United States. I am writing this to urge you to vote against such a measure and want to present for your careful consideration, the following points:

The present exclusion from taxation does not exist by virtue of a "loop hole" in our tax laws, but is founded upon a fundamental principle of international law that a sovereign alone has the power to tax and control the land situated within its borders. To invade and to dissolve such a fundamental principle of international law is to creat an additional area of uncertainty in international transactions immediately affecting carefully laid business and personal plans projected not only by American nationals but by nationals of other countries. This comes at a bad time when the United States is wholeheartedly attempting to shore up the entire field of international law, and is spending billions of dollars in the support of international stability.

Such a measure also comes at a bad time when the Government is trying to encourage American businessmen to expand into the international field. In certain unfriendly countries the presence of American investments in real property may be shaky enough as things are; where such an unfriendly government has knowledge that Americans owning property within their borders are to be taxed as if the same were situated in the United States, an additional unhealthy climate and attitude is created toward Americans, since such a gesture will be interpreted as another step by the United States to remove one more element of the sovereignty of such a country by expanding the effect of U.S. taxation into foreign lands.

The United States should not be forced, even by revenue circumstances, to assume a humiliating and ridiculous position. For illustration, suppose, as in the case of one of my good friends and sometimes client, an American citizen has only in his estate real property situated in Mexico from which he derives his livelihood. At his decease, under the proposed legislation, the full value of the Mexican situated real property would be subjected to the extraordinarily high U.S. Federal estate tax. Is the United States then to have a lien against the Mexican realty? Will the U.S. Government enter Mexico to enforce in some form, its tax lien, levy against the property, and if necessary, foreclose.

This is more than just a tax matter, and as you can see draws the United States into many international complications which can only be unsatisfactory to itself and its citizens.

If the United States is to tax for estate tax purposes, foreign realty, just think of the problems of valuation that the executors of the estate of an American decedent are faced with. For instance, ranch land in British Honduras, a coffee plantation in El Salvador, mining claims in Canada, an apartment in Paris. Whose standard of values are to be taken? Since the incidence of Ameriacn taxation, which the estate must bear, can only be translated into American dollars, an entirely new and different body of principles for appraisal will have to be adopted for the simple reason that the value of a piece of foreign realty cannot be only such value as attributed thereto in the foreign jurisdiction but the same. The executors then are faced with the enormuos difficulty and inconvenience with accompanying expenses, of at least two different market values.

I do not doubt that many clever revenue-producing arguments can be produced. However, there should be a still small voice of logic and commonsense somewhere in these tax proposals whereby at some point consideration should be given to the burden these proposals, when enacted into law, cast upon the taxpayer.

Your careful consideration of these ideas will be most appreciated and therefore it is my earnest hope that you will see your way to oppose this measure in its entirety, and that you will conclude in your voting thereon that it should be stricken from the tax bill.

Sincerely yours,

GEORGE PARKER, Jr.

SAN ANTONIO, TEX., *April 4, 1962.*

Senator HARRY S. BYRD,
U.S. Senate, Washington, D.C.

DEAR SENATOR BYRD: In my letter of March 22, 1962, I presented certain arguments in support of my request that you vote against section 18 of the omnibus tax bill concerning the taxation of foreign situated real property to which I want to add certain additional arguments:

I presented a fact situation concerning a client of mine whose principal asset consisted of foreign realty situated in Mexico; at his decease, there being practically no property in the United States, but with a considerable estate in Mexico, the high U.S. estate tax rates would call for a considerable amount in taxes to be paid out of Mexico. Suppose that in such an event the Mexican realty would be sold to pay the U.S. taxes, and suppose that Mexico instituted currency restrictions so that none of the money could be taken out of Mexico, what course of action would be open to the heirs of my client? This situation can be repeated in many countries, and the existence of currency controls and restrictions, for example, is a reality all over Latin America and Europe.

Tax legislation should, at some time, look at the realities of the subject matter and should, as a guiding principle, not impose upon loyal Americans undue hardship or any paradoxical course of conduct in their personal affairs.

Thanking you for your consideration of these matters, I remain,

Sincerely yours,

GEORGE PARKER, Jr.

TURCO PRODUCTS, INC.,
Wilmington, Calif., March 26, 1962.

Hon. HARRY FLOOD BYRD,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D.C.

SIR: Although Turco Products, Inc., has rather limited international operations, we are concerned and feel that the passage of H.R. 10650 would unquestionably result in the ultimate defeat of many of the major objectives of the bill. The adverse effects of this legislation would be felt not only by the U.S. firms engaged in international business, but also by the Nation as a whole.

Without doubt, the bill would discourage and greatly reduce the volume of U.S. investments in all foreign countries. On the surface, this might appear to be desirable since it would reduce the outflow of dollars and help to reduce our unfavorable balance of payments. However, while this might seem to be helpful in connection with immediate problems, it most certainly would work to our detriment in the years to come.

To illustrate this, if it were not for the foreign investments by U.S. industry during the past few decades, which have returned and are returning to the U.S. investors profits and dividends far in excess of the original and current oversea investments, our balance-of-payments situation would be far worse. It is an incontestable fact that returns from these foreign investments far exceed the initial capital outlays as well as the current outflow of U.S. capital for foreign investments. We certainly cannot expect to receive corresponding benefits in future years if our current investments are severely curtailed, as would result from the passage of H.R. 10650.

We have read in the March 5, 1962, issue of Newsweek that taxation of the foreign earnings of U.S. subsidiaries in low tax countries, even if such earnings were not returned to the U.S. immediately, would bring our Government at least an additional $250 million in taxes each year, according to the U.S. Treasury. However, will this immediate gain compensate for the loss of future revenue from increased foreign investments? We think not.

It must be remembered that, almost without exception, the only possible reason for any U.S. firm to invest abroad is to make profits. This means profits for the U.S. shareholders and, of course, this means more taxes to the U.S. Government. The only possible reason for accumulating profits in low tax countries is to enable U.S. corporations to expand more rapidly through investments in other foreign markets. This "snowballing" effect still is aimed at only one objective, greater profits to the U.S. corporations and shareholders, with the result that more U.S. taxes will be paid.

There is an undeniable attraction for U.S. firms to establish subsidiaries in low tax countries to enable them to expand more rapidly and meet the increasing foreign competition. H.R. 10650, as it now stands, would eliminate such in-

centives and we would certainly feel in years to come the effects of the decline of returns from foreign investments.

The U.S. Government annually is spending many billions of dollars for foreign military and economic aid. No one can question the necessity and desirability of this. On the other hand, we all know that such huge amounts cannot be disbursed without a certain amount of waste and loss. Assuredly, not all of the investments made by U.S. industry abroad are successful or profitable, but the batting average is pretty high. These successful ventures abroad unavoidably strengthen the development and economy of the nations in which they are made, which certainly seems to be in line with the objectives of the United States.

Rather than introducing legislation to impede the progress of our industrial development abroad, this should be encouraged. Such a bill was proposed by Congressman Hale Boggs in recent years, but it was defeated. This bill would have made possible the establishment of foreign business corporations in the United States with deferred taxation on foreign source income, thereby keeping the payrolls and other business activities within the United States. Of course, there are many other reasons for locating subsidiaries in lower tax countries, apart from strictly tax considerations, but undoubtedly many of the activities would have been done here in the United States rather than abroad.

Another aspect of H.R. 10650 which bears consideration is the effect which it might have on the taxation policies of some foreign governments which presently have low tax rates on foreign source income. It appears that this bill would offer an incentive for such governments to increase their tax rates so as to equalize them with the U.S. 52 percent corporate rate.

We do not deny that there have been abuses of the use of foreign base company operations by U.S. firms and we certainly agree that such abuses should be corrected. We are thinking in particular of the "paper" companies which have no actual facilities, personnel, or real reason for existence other than to accumulate tax-free or low-tax income. However, those companies, such as ours, who do have legitimate foreign operations should not be penalized for the actions of a few opportunists.

There are many other aspects of this proposed legislation which could be discussed at great lengths, but without going into further detail we merely wanted to make you aware of our very strong belief that H.R. 10650 not only would deal a terrible blow to U.S. industry in general and U.S. international business in particular, but that it also is inconsistent with our national objectives.

Respectfully yours,

WILLIAM K. MOORE,
Manager, International Division.

THE KENDALL CO.,
Boston, Mass., March 27, 1962.

Hon. HARRY F. BYRD,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D.C.

DEAR SENATOR BYRD: Like most concerns, we have been following very closely the progress, through the Ways and Means Committee, of the administration's proposals for tax changes. Major changes in the provisions of the bill have been made almost from day to day, but the committee now seems to have settled on a bill which will be voted on by the House and probably sent to the Senate for their consideration.

We have mixed reactions to the many changes contained in tax law H.R. 10650. We are sympathetic with the administration's aim to tighten tax legislation to restrict those taxpayers who at present take advantage of some of the provisions of the tax code as presently written. Unfortunately, however, many of the proposed changes impose severe restrictions on taxpayers who are not targets of the legislative changes.

Our principal concern about H.R. 10650 is related to the section devoted to U.S. taxation of income of controlled foreign corporations. Although we share the administration's stand with respect to abuses of tax haven, the proposals contained in H.R. 10650 for taxation of foreign income go much too far beyond the correction of these abuses. When a foreign corporation is created largely or entirely for tax reasons, with virtually no genuine business purpose, it seems

entirely proper to subject it to tax legislation to restrict its tax advantage over that of other taxpayers. We feel, however, that it is unnecessary and unwise to enact sweeping regulations which go beyond tightening the rules governing tax havens and which impose unnecessary and unsound restrictions on normal, business-oriented, foreign operations. It is our belief, therefore, that the changes should be limited to the area affecting tax havens and that the proposed imposition of a tax on earnings of foreign subsidiaries will introduce penalties for U.S.-controlled foreign companies which are in competition with subsidiaries of other countries.

We urge you to limit the changes in this tax bill so that it does not penalize foreign corporations established for normal, business-oriented, foreign operations.

Yours very truly,

RICHARD R. HIGGINS, *President.*

MILWAUKEE ASSOCIATION OF COMMERCE,
Milwaukee 2, Wis., March 29, 1962.

Hon. HARRY FLOOD BYRD,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D.C.

DEAR SENATOR: The board of directors of our association recently unanimously voted to vigorously oppose the House Ways and Means Committee's proposal relative to the taxation of foreign source income. We urgently request that when this bill comes before your committee that opportunity will be afforded those interested in this proposal to make personal appeals and present written statements.

We feel that the provision of H.R. 10650, relating to the taxation of foreign source income, unjustly penalizes legitimate and experienced American investors operating overseas in favor of their foreign competitors.

Many of our larger Milwaukee firms have been in the export business for several years and they have experienced an increasing amount of competition from foreign firms. It would appear that if H.R. 10650 is passed, it would be the final touch in surrendering a substantial part of the foreign markets of American firms to their oversea competitors.

We know of no other country in the world which penalizes those firms who have oversea investments—several countries actually provide tax incentives for those operating foreign plants.

Milwaukee area firms have no objection to a strong enforcement of the present laws designed to eliminate shady and sham operations. They are all in favor of the law as it now exists. The bill, as now written, would certainly tend to discourage investment overseas, particularly in the less-developed countries. We earnestly urge the support of your committee in defeating this legislation.

It is respectfully requested that this letter be placed on record as representing our position in the matter.

Sincerely,

HARRY G. HOFFMAN.

WAUWATOSA, WIS., *March 28, 1962.*

Senator HARRY F. BYRD,
Chairman, U.S. Senate Committee on Finance,
Senate Office Building, Washington, D.C.

DEAR SENATOR BYRD: As one closely associated for some years in exporting and oversea manufacturing with a Milwaukee manufacturer, I am very much concerned over the proposed new tax bill, H.R. 10650. I understand this bill would provide, among other things, a requirement that U.S. companies pay the full U.S. rate of 52 percent on earnings of most subsidiaries abroad, even though these earnings have not been returned to the United States as dividends.

Believing that we should support a strong foreign U.S. policy, including aid to underdeveloped areas, and believing that much of this can be accomplished through the expansion of American free enterprise abroad, I urge that you and your committee oppose this bill in its present form for the following reasons:

(1) Over the years, U.S. companies normally have invested abroad only when they do not feel they could penetrate the particular market due to dollar shortage, import duties, and/or foreign competition. For this reason, most of these U.S. investments abroad do not interfere with U.S. production.

(2) Tax considerations in making a foreign investment is still very important to U.S. companies, even though the investment may be strictly for the purpose of supplying a market, otherwise not reachable from the United States. If competitive subsidiaries of other foreign companies are granted tax relief at a higher level than that offered by the United States for its nationals, obviously U.S. companies abroad will not be competitive.

(3) In formulating our tax policy, we should consider at least equalizing the tax liability between U.S. subsidiaries abroad and the companies with which they must compete in the country or trading area where they are located, rather than equalizing the taxes between the U.S. subsidiary abroad and the U.S. parent company.

(4) Underdeveloped countries normally have lower tax rates in order to attract foreign investment and industry. Under the proposed Treasury bill, the level of foreign taxes will not be important in determining the location as long as these taxes do not exceed 52 percent. Therefore, operations could well be located in high-tax countries rather than low-tax countries, as previously, and to the detriment of the U.S. Government, since these foreign taxes can be credited directly and completely against U.S. income taxes paid.

(5) For the long pull, the establishment of U.S. subsidiaries abroad will strengthen our balance of payments, and certainly this is most important in view of the outward flow of dollars for foreign aid and support of our military forces on foreign bases. The present concept of restricting foreign investments in order to improve the balance of payments is very shortsighted, only temporary, and possibly a disastrous approach.

(6) Most companies are operating abroad with the use of U.S. capital, also partially supported by local capital, and the close relationship between the local nationals and U.S. nationals is perhaps one of our strongest means of establishing and maintaining good will and really durable friendships abroad. Certainly, any actions on the part of our Government should be in the direction of encouraging these relationships because they would save more for the U.S. taxpayer than the Government will gain in assessing such earnings on a 52 percent tax basis.

(7) It is the opinion of some U.S. companies that their exports to a particular country may in fact increase because of a manufacturing operation in that country because it opens up new areas of interest for other U.S. products which cannot be made economically in that particular market.

Again, I solicit your support in opposing the passage of this bill in its present form.

Sincerely,

K. P. Coan.

Varian Associates,
Executive Offices,
Palo Alto, Calif., April 2, 1962.

Re taxation of foreign income.

Hon. Harry Flood Byrd,
Senate Office Building, Washington, D.C.

Sir: Recent congressional activities with respect to the taxation of foreign income cause us grave concern. Taxation of foreign income is both a complicated statutory concept and a substantial factor in the fiscal policy of the United States. Nevertheless the Treasury seems bent on the enactment of some proposal without regard to the consequences. To us the adoption of legislation only recently proposed would not seem the result of deliberate consideration of the statutory pattern for the taxation of foreign income or the impact which it might have on American businesses operating abroad.

This company is engaged in operations throughout a great part of the world, and has every intention to expand those operations; thus we will be substantially affected by the proposed legislation. In addition to voicing our objection to the hasty adoption of this legislation, we should like to make the following specific comments on the Treasury's proposal:

To class income derived from patents and foreign sales by foreign subsidiaries engaged in real and substantial competitive enterprises abroad with passive personal holding company income is an untenable position.

To tax income accumulated other than for investment by the foreign subsidiary in its own trade or business or in a trade or business in a less developed country not only would penalize the expanding American business

in competition with both foreign and established American businesses abroad, but also would reject a fundamental principle of our Federal income tax system in taxing unrealized income.

To distinguish investments in less developed countries is to tie sound fiscal policy to the wholly unrelated problems of those countries.

To distinguish between a more and a less than 50-percent owned foreign subsidiary is an arbitrary and unrealistic determination that the former interest is one of participation while the latter is one of investment.

To penalize American business in the manner suggested by the Treasury is to move in the opposite direction taken by the principal countries from which competition to American business has emerged.

Attached are more fully detailed comments.

Varian Associates is moving forward to meet competition in the world market. Any resulting legislation will have a substantial and lasting effect on its ability to meet competition in the marketplace. We believe the Treasury's proposal to be inconsistent with that objective, and urge you to give careful consideration to the reasons herein stated for our position.

Very truly yours,

H. MYRL STEARNS.

The Treasury would "taint" the income of a controlled foreign corporation engaged in sales activities in foreign markets and the income derived by it from patents by including these types of income in the U.S. parent corporation's income. This income would be classed with personal holding company income. Taxes were imposed on personal holding companies years ago to eliminate the incorporation of such items as pocketbooks, talents, yachts, and country estates. The Treasury would place the income of a foreign subsidiary actively engaged in the business of selling products manufactured by its U.S. parent in this same category. These organizations are engaged in vigorous and varied activities in foreign markets in real competition with businesses of other countries. They are not a personal holding company sham and to treat their income in the same manner is wholly unrealistic.

The proposal to tax to the U.S. parent corporation income derived by its foreign subsidiary from patents developed in the United States or transferred from the parent to the foreign subsidiary is somewhat appalling. As we view it, a controlled foreign corporation actively engaged in the conduct of foreign manufacturing opreations, whether being conducted by the foreign subsidiary or through its subsidiaries or through joint ventures between it and other foreign business enterprises, will be adversely affected by this proposal. This is for the reason that income derived from patents in the form of royalties or from their use or exploitation will be subject to tax. The value of a foreign patent is dependent upon the income which can be secured from its use in the apposite country. If the foreign subsidiary is capable of generating substantial income from the patent, it has developed a valuable asset. The more valuable the asset it develops the greater the tax cost to the parent. The net effect of this simply is to tax unrealized income. To do this is to reject a concept long established by the courts and Congress.

In addition to tainting income derived from patents and sales, the Treasury would tax to the U.S. parent a controlled foreign corporation's other income not reinvested by the subsidiary in (i) its existing trade or business, (ii) its trade or business in a less developed country, or (iii) the stock of a more than 50-percent-owned subsidiary where all the property of the latter is necessary for the conduct of its trade or business in a less developed country. Among others, this proposal is subject to the following objections:

The Internal Revenue Code now provides a statutory scheme for the imposition of an accumulated earnings tax. Are we now to have another provision dealing with such income? To superimpose one statutory provision upon another with respect to the same subject will result in many complications and impediments in the expansion of American business throughout the world.

For all practical purposes, the only accumulation permitted will be that which is required for the conduct of an existing trade or business. Thus, this proposal would penalize the new or developing controlled foreign corporation vis-a-vis the established one in that income derived from a particular business may not be used for expanding operations without the imposition of

a tax on that income unless the proposed statutory provision is revised to afford considerable latitude as to what constitutes a trade or business. (What constitutes a "trade or business" has caused no little difficulty in the code provisions pertaining to partial liquidations and corporate divisions.) Failure to do this will prevent a growing business enterprise not only from meeting competition from its foreign competitors but also from established American businesses abroad. It seems incredible that an established business would be given such an advantage. We recommend that income be permitted to be accumulated for expansion purposes in the broad sense.

The proposal permits accumulations for investment by the foreign subsidiary in its trade or business in a less developed country. It is recognized that assistance to these countries is a desirable goal. However, the Treasury's proposal is not designed to do that; rather it would penalize foreign subsidiaries of American business. It is obvious that there is no relationship between assistance to less developed countries and the Treasury's proposal.

As for stock investments in less developed countries, the proposal would distinguish between an investment by the foreign subsidiary in a more than 50-percent owned subsidiary and one that is not. As a result of our own experience, we believe that an interest which is less than 50 percent can be more than one of investment. We urge that the proposed statutory provision be revised to permit investment in a less than 50-percent owned subsidiary. The revision still can preclude acquisition of an interest which is purely an investment. Also, the provision is objectionable in that it requires that the investment be made in a corporation organized and conducting its trade or business in a less developed country.

This proposal would tax to the American parent corporation every accumulation of earnings and profits by its controlled foreign subsidiary except where the accumulation is required to conduct the subsidiary's existing trade or business. By so doing, the Treasury will succeed in taxing to the parent the undistributed income of the subsidiary. It would be far better to propose legislation which would meet this problem head on. The tax structure already is complicated; the enaction of these provisions would compound this complication. We sincerely urge you to reject the Treasury's proposal.

Additionally, we would point out that in practice the Treasury's proposal will operate in favor of our foreign competitors. This is because one of our principal foreign competitors is a Netherlands corporation and that country imposes no tax on earnings remitted from abroad that have been taxed abroad. Moreover, you should know that Belgium reduces by 80 percent the tax on earnings remitted from abroad which are not passed on to shareholders; that Canada imposes no tax on dividends received from subsidiaries of Canadian companies which are 25-percent owned by the parent; and that the United Kingdom provides for a domestic "oversea trading company" whose profits are not taxed until a dividend is paid to its shareholders. Note also that Australia, Denmark, France, Italy, and Norway provide tax incentives to encourage business abroad.

Finally, we would observe that the taxation of a foreign subsidiary's income to a domestic parent will only result in the rearrangement by foreign countries of their tax structures to prevent revenue derived by these foreign enterprises from being diverted to the U.S. Treasury.

HARZA ENGINEERING CO. INTERNATIONAL,
Chicago, Ill., March 30, 1692.

Hon. HARRY FLOOD BYRD,
U.S. Senate, Washington, D.C.

MY DEAR SENATOR BYRD: I am writing this letter to call to your attention a provision in the proposed Revenue Act of 1962 which would be extremely punitive and unfair to those taxpayers who would be affected by the provision. I refer to proposed code section 1248(a), (b), and (c)(1) of the proposed act, which reads as follows:

"(a) REDEMPTIONS AND LIQUIDATIONS.—If a foreign corporation redeems its stock in an exchange to which section 302(a) applies, or if a foreign corporation cancels its stock in a complete or partial liquidation in an exchange to which section 331 applies, then the gain of a United States person (as defined in sec-

tion 7701(a)(30) from the exchange of such stock shall be included in the gross income of such person as a dividend, to the extent of such person's proportionate share of the earnings and profits of the foreign corporation accumulated after February 28, 1913.

"(b) SALES AND OTHER EXCHANGES.—If a United States person (as defined in section 7701(a)(30) sells or exchanges stock in a foreign corporation, then the gain recognized on the sale or exchange of such stock shall be considered as gain from the sale or exchange of property which is not a capital asset, to the extent of such person's proportionate share of the earnings and profits of the foreign corporation accumulated during the period the stock sold or exchanged was held by such person.

"(c) LIMITATIONS—

"(1) CONTROLLED FOREIGN CORPORATIONS.—Subsections (a) and (b) shall apply only if the foreign corporation the stock of which is sold or exchanged (a) is a controlled foreign corporation (as defined in section 954) at the time of the sale or exchange, or (B) was such a controlled foreign corporation at any time during the 5-year period ending on the date of the sale or exchange."

I am a stockholder in a "controlled foreign corporation" as defined in the act, and this corporation, Harza Engineering Co. International, has been operating throughout the world since 1956. The corporation provides engineering services in connection with river projects such as dams, irrigation projects, and hydroelectric projects. Most of our work has been in underdeveloped countries, and we feel that we have, in a small way, contributed to the effort of the United States to help these countries. We are presently working in Pakistan, Thailand, Iran, Iraq, Jordan, Afghanistan, Formosa, Philippines, El Salvador, Honduras, Venezuela and Uruguay.

As an example of the kind of projects we work on, I enclose a clipping from Time magazine of October 27, 1961, describing the opening of the East Ghor Irrigation Canal in the Jordan. Our firm did all of the engineering work on this project.

During the course of our operations we have, fortunately, been able to retain some of our earnings as earned surplus in the corporation. These retained earnings form a cushion to help us overcome the risks of working in underdeveloped countries. These risks are real and include such things as revolutions (Iraq, El Salvador, Honduras), slow pay (as long as 12 months), and disease.

Naturally the stockholders, who are also the engineers who provide the services the company sells, had expected to be able ultimately to recover some of the retained earnings of the company. Such recovery, by means of sale of some of the stock, would have been taxed at capital gains rates under the existing law. But the proposed law would tax such retained earnings as ordinary income even though they were accumulated prior to the enactment of the law. This would amount to confiscation, for several of the larger stockholders.

It is important to know that Harza Engineering Co. International has had its books, through 1960, reviewed by the International Revenue Service, and our operations are strictly in accordance with existing laws.

It is hard to believe that the Congress of the United States really means to change the existing laws in such a manner as to take away, in effect, earnings which were accumulated prior to the passage of the 1962 Revenue Act. This seems patently unjust, and not at all in the spirit of American fairplay.

If Congress believes that the existing law permits an accumulation of earnings overseas which is not in the best interest of our country, it would certainly be correct to change the law. But, it should be changed to apply to earnings accumulated after the law is changed, not to earnings made before the law was changed.

I most earnestly request that you attempt to have section 1248 (a) and (b) changed to read as I have indicated on the enclosed sheet. These changes do not change the future effect of the proposed Revenue Act, but merely remove the extremely punitive and unfair retroactive provisions.

I hope you will see the justice of my position, and take every step possible to correct the inequity in the proposed section 1248 (a) and (b).

Sincerely yours,

E. MONTFORD FUCIK,
Vice President.

DALLAS, TEX., *March 28, 1962.*

Re Revenue bill of 1962 (H.R. 10650).

Hon. HARRY FLOOD BYRD,
U.S. Senator,
Senate Office Building, Washington, D.C.

DEAR SIR: I represent several foreign corporations that are in the business of contract drilling of oil wells in foreign countries. Because of the depressed condition of the drilling industry in the United States, many American drilling contractors have had to move drilling rigs to foreign countries in order to survive. In order to be competitive with other foreign drilling contractors, these clients have generally formed corporations outside of the United States for the conduct of these foreign operations. There are two provisions in the revenue bill of 1962 which I feel are particularly harmful to drilling contractors operating abroad through foreign corporations and I would like to solicit your help in making these two sections of this bill less severe.

One of these is section 13, which has been made much more palatable than was so in the form originally introduced in 1961. It is now confined largely to corporations having income from insuring U.S. risks, patent income, or personal holding type income. It does contain one feature which we feel is bad and that is that U.S. shareholders are taxed on the corporation's increase in earnings which are invested in nonqualified property. Apparently loans to related entities would constitute nonqualified property and, as such, would prevent foreign corporations from financing further investments abroad by use of loans.

The second provision which I feel is unduly punitive to foreign corporations is section 16, which treats gain on liquidation of the corporation as ordinary income to the extent of all earnings of the corporation or gain on sale of its stock as ordinary income to the extent of the earnings accruing during the time the shareholder held the shares. I feel there is no occasion to single out bona fide foreign corporations for treatment of this type. Section 13 provides adequate protection against revenue losses. So long as the operation is a bona fide operation, it should receive the same tax treatment as dissolution of a domestic corporation or sales of stock of a domestic corporation. Since the amount of gain is tied into previous earnings of the corporation, in a sense the legislation is definitely retroactive. Furthermore, section 16 will take effect as of the date of enactment of the revenue bill, whereas most of the provisions in the revenue bill apply to years beginning after December 31, 1962. It would seem that if a change of this magnitude and far-reaching effect is to be made, it should certainly be confined to earnings generated after the enactment of the act as is true in section 13 and that it certainly should not come into effect prior to January 1, 1963.

I might also point out that this section 16 applies to stock sales regardless of the tax paid to the local country by the foreign corporation whose stock is sold. In Iran, for example, one of my clients pays a sizable tax to Iran on all of its gross income; so, for all practical purposes, it is very similar to the operation of a domestic corporation. Yet, this bill would treat the gain on sale of stock in a radically different manner from the manner in which sales of stock in domestic corporations are handled. We feel that section 13 gives adequate protection for so-called tax haven abuses and that there is not occasion to enact punitive legislation such as that contemplated by section 16 with respect to bona fide operating companies.

Thank you very much for your consideration of this matter.

Sincerely yours,

TOM B. RHODES.

STATEMENT WITH RESPECT TO REVENUE BILL OF 1962 (H.R. 10650) FOR THE WURLITZER CO., CHICAGO, BY E. L. HAHNE, TREASURER

SECTION 13 CONTROLLED FOREIGN CORPORATIONS

The revenue bill of 1962 proposes many new and startling changes in our normal concept of taxable income. One of the most provocative of these proposals is the taxation, under section 13, of a foreign company's normal trading profit, completely unrelated to U.S. transactions, merely because the company is owned in the United States.

The Wurlitzer Co. in 1960 organized a wholly owned subsidiary in Germany to manufacture electronic organs and phonographs. It also organized a selling

subsidiary in Switzerland. The purpose of these organizations was to compete in the European market for business which was not otherwise attainable.

After firmly establishing such companies, dividends to the parent company would, we believed, be fully taxable to the U.S. parent company as received.

However, proposed revenue bill of 1962, section 13—section 952(e)(2)—would tax the trading income of the selling subsidiary directly to the parent company in the United States as earned. The result of such taxation of income related exclusively to foreign operations would be to place U.S.-owned subsidiaries at a competitive disadvantage in the foreign market and to impose an unjust tax burden on the initiative of U.S. corporations competing abroad.

It would be our recommendation that section 13 of the proposed bill be deleted or at least amended so that normal trading profits where U.S. production or sale is not involved would be excluded from profits subject to tax in the United States.

LONDON, *April 3, 1962.*

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

MY DEAR SENATOR BYRD: I am writing to you in connection with section 12, H.R. 10650—Earned Income From Sources Without the United States. I am sure the Congress of the United States and particularly the Senate is anxious to enact laws for the benefit of the United States and its people. If this is the objective I can see no reasonable purpose served by changing the present tax law to eliminate U.S. income tax exemption for Americans living abroad on a career basis. The amount of money that would be saved for the Treasury is insignificant particularly when weighed against the incentives exemption generates to those who live abroad in the interest of American trade and the promotion of American commercial and political interests. If there are abuses in the application of existing law, they should be corrected rather than enacting the proposals contained in the bill that would handicap good American businessmen who contribute so much to our Nation and to the trade and commerce of the United States. These men, by their constructive work and that of their companies, increase American balance of trade, create a favorable American image abroad and assist very materially in furthering our political objectives.

Senior American executives who can make a real contribution to the export trade of the United States need substantial incentives to induce them to leave the comforts and pleasures of living at home with their families to live for years abroad separated from their children as they grow older and often from their families for long periods of time.

Today, local governments recognize the importance to their own economies of having American business leaders and American firms resident in their countries. This is the reason why they have been restrained in taxing American residents, thus offering an inducement to locate concentrations of executive and business ability and often American capital within their countries. Of course, the same situation applies to other nationalities as well as American and this is basically the reason why no major power taxes its citizens living and earning income abroad. They prefer to let tax concessions by foreign governments provide and pay the incentives. Should we destroy such incentives, it leaves the field open to the rest of the industrial nations to induce their best men to go abroad and gather in export sales with no effective competition from the United States. This we cannot afford to have happen.

To sum up: (1) I can see no logical reason for changing the present tax laws, which tend to encourage successful competitive businessmen to fight for and extend American exports and trades to all the world. (2) There would be no substantial increase in U.S. tax income under the proposed legislation, as foreign governments would soon make sure that the dollars involved stayed in their own countries. (3) The United States would be the only Government taxing its citizens on the basis of citizenship. This seems to me to be fraught with all kinds of complications, evident, and unforeseen. The opportunity to use every means to make a foreign career attractive to the best brains and ability would be substantially reduced. (4) The damage to organizations now operating in the foreign field would be disruptive and well-trained and experienced men would probably find it in their own interests to return home. (5) There is no benefit to anyone to disturb the present situation, which has had a substantial part in developing American business abroad. (6) The legisla-

tion proposed would work a manifest injustice upon those American citizens resident abroad in areas where income taxes are relatively low and taxation is based largely on hidden taxes such as sales tax and other indirect taxation far and above similar taxation in the United States. Venezuela, for instance, has a very low income tax but very high indirect taxes, to the point where the cost of living in Venezuela is very considerably above such costs in the United States. If the American resident had to pay all those indirect taxes and, on top of it, also pay American income taxes, he would be in serious trouble. The tax structure in Venezuela takes these factors into consideration, resulting in relatively low income tax.

I cannot believe that the administration has thought this thing through to its ultimate conclusion. If it is thought through in all its ramifications I am sure you will not do it. It would destroy morale and weaken our bitter fight to preserve the free enterprise system and to beat our enemies in the cold war.

These observations are based upon many years experience.

Yours sincerely,

GEORGE M. PARKER.

MILWAUKEE, WIS., *April 4, 1962.*

Re H.R. 10650, Revenue Act of 1962.

SENATE FINANCE COMMITTEE,
New Senate Office Building,
Washington, D.C.
(Attention Chief Clerk).

GENTLEMEN: Although H.R. 10650 makes major strides in the direction of removing tax loopholes in the use of foreign corporations, it overreaches the bounds of fairness in at least one major respect. This is in section 16 which would treat as ordinary income, effective as of the date of enactment, substantially all gain on sales or redemptions of stock in foreign corporations. The gain so taxed would be limited only to the accumulated earnings of the foreign corporation since February 28, 1913, in the case of a liquidation or redemption, or to earnings during the period the taxpayer held the stock in the case of a sale.

This provision may have been intended for the so-called tax haven corporation. But its sweeping terms and retroactive effect virtually confiscate foreign investment made in good faith, without tax avoidance motives, and in reliance on the provisions of the law in effect for many decades.

Take the case of Mr. Jones, who has owned 10 percent of the stock of Canadian Corp. since 1920. At least 50 percent of the stock of Canadian Corp. is held by U.S. shareholders. During this period Canadian Corp. has grown from insignificance to an enterprise worth $20 million (through accumulated earnings), and has paid many millions in Canadian income taxes. If Mr. Jones decides it is time to sell his interest in Canadian Corp., and he is offered $2 million for it, he will find under the provisions of section 16 that the United States will take about $1,750,000of the amount he receives. If he held the very same investment in a domestic corporation, the United States would take only $500,000. If Mr. Jones had known this during the many years he held the stock of Canadian Corp., he would not have been inclined to retain his investment. But he could not anticipate legislation with retroactive effect which would prevent him from realizing on it. He has been stripped of his worth by a law not intended to apply to him but which applies nonetheless.

If appropriate at all, at the very least, this section 16 should be applicable only to the extent that profits on sales or liquidations are generated by earnings and profits accumulated after December 31, 1962. At least then it would not confiscate investments made or retained in foreign corporations in good faith without knowledge of a law which makes realization on it impossible.

If the purpose of this bill is, as it seems to be, to plug loopholes in the use of foreign corporations, why then is it necessary to place investments in foreign corporations less than on a par with domestic corporations? The proposed remedy of section 16 is not a solution.

The chief abuse in the use of tax haven corporations comes about because no U.S. tax and little or no foreign tax is paid on current earnings. The solution to this is to tax, under given circumstances, the current earnings of the foreign corporation to its U.S. shareholders. This is the purpose of section 13 of the bill. But to tax all the earnings as ordinary income bunched into one taxable

year at the time of liquidation or sale goes far beyond this. This confiscates. It unfairly discriminates between foreign and domestic investment.

I urge this committee to reconsider section 16 of H.R. 10650.

Respectfully,

BRADY, TYRRELL & BRUCE,
By THOMAS J. DONNELLY, Jr.

PORTCO CORP.,
Portland, Oreg., April 3, 1962.

Hon. HARRY F. BYRD,
Chairman, Senate Finance Committee,
Washington, D.C.

DEAR SENATOR BYRD: I note that hearings on the new 1962 tax bill will be held before the Senate Finance Committee between April 2 and April 25. This bill, H.R. 10650, section 18, would provide that real property owned in the Virgin Islands would be taxable in the individual's gross estate. For reasons explained below, I would like to register a strong protest against this feature of the bill.

I first went to the Virgin Islands some 27 years ago, and at that time the economy of this Territory was in a deplorable state. It had been referred to as, "the poorhouse of America." I, along with other U.S. citizens, utilized my own capital to purchase land and buildings there, relying in part upon knowledge that the U.S. law, within the spirt of the Danish Convention, excluded private land investments from the gross estate of American citizens. The administration of those days even encouraged us and the effect of our invested dollar and the improvements that grew out of this were certainly noticeable over the years. This was done when the U.S. Government was pouring large sums of money into the Virgin Islands to sustain and build their economy. We believed in the integrity of U.S. regulations governing its own citizens, and if we were now faced with the changes proposed in the revenue bill of 1962 under section 18: Inclusion of Foreign Real Property in the Gross Estate, we will feel very much let down to say the least. The comparatively small benefit that the Government may obtain by changing the rules on us will certainly be more than offset by the bitterness that will be the inevitable result. The net effect of this change in the law would, quite promptly I am sure, serve to reduce the value of Virgin Islands property in a marked way.

There are those of us who have worked quietly for years to make the Virgin Islands attractive to investors from this country, and to have the "rug pulled out from under us" at this juncture is disenchanting to say the least. Lasting damage will be done and the effects of this will be irretrievable and very costly to the U.S. Government in the long run.

The inevitable effects of this bill and the feature referred to above would only serve to impede and discourage further efforts in the continuing work to create a sound economy by encouraging retired individuals and others in establishing homes and tourist facilities in the Virgin Islands. Be assured that estate planning has had much to do with the developing of the economic strength of the Virgin Islands; innumerable people have bought and improved property there and have thereby contributed to the employment and the general economy of the islands.

There is a definite inconsistency in having the administration ask Congress for huge grants and loans to depressed areas while at the same time advocating changes in the laws which would discourage private citizens from using their own resources to contribute to the growth and economy of a territory belonging to the United States.

May I suggest that your committee take into consideration the fact that when the United States bought the islands in 1917, Danish capital, in great part, was removed, and not until some years later did private American capital start to roll into the islands to improve the Danish land that had been taken out of cultivation and the largest contributing factor to this infusion of new capital was that of estate tax exemption which was provided for by law. U.S. investors, such as myself, employed native people to assist in the improvement of the abandoned sugarcane land, and through this improvement substantial cattle herds were built up. Should this long existing exemption be removed it will, without question, force comparatively large blocks of land to be placed on the market in order to pay taxes and this, you may be sure, will have an overall depressing effect upon continued improvements that are just really getting underway. Huge sums of money have been spent by the U.S. Government in the attempt to im-

prove the economy of the native residents of the islands, and only in recent years has private capital gone there in the interest of turning this territory into an attractive place for tourists and permanent residences. This development has given employment to hundreds of native people. These investments have rapidly rebuilt properties that contribute in an impressive way to tax returns in the island, and I am sure that if the Treasury Department, who are on record as supporting this feature of the new tax bill, fully realized what the net effect would be of this proposed change, they would certainly withdraw their support.

Sincerely yours,

HOWARD M. WALL.

CLEVELAND, OHIO.

Hon. HARRY F. BYRD,
Senate Office Building,
Washington, D.C.:

Subject resolution opposing portions of H.R. 10650 relative to the taxation of earnings from American-controlled foreign corporations.

By formal resolution in opposition to the proposed changes in taxation of income from foreign corporations as proposed in H.R. 10650, the board of directors of the Cleveland World Trade Association respectfully urges you to reject the portions of this legislation which will curtail our Nation's trade expansion, seriously injure American small business abroad and undermine the program of building international good will which is so vital to world peace.

Specifically, the board of directors of the Cleveland World Trade Association, an organization of more than 300 members representing segments of commerce and industry directly interested in the development of all phases of foreign trade, believes that the enactment of the proposal to change the basis for taxation of income from foreign corporations will not only destroy many small business operations and prevent trade expansion but will also be highly injurious to the domestic economy and eliminate many American job opportunities.

In further opposition to the said portions of H.R. 10650, the Cleveland World Trade Association invites your attention to a recently reported statement of the Honorable Luther Hodges in which the U.S. Secretary of Commerce said:

"While the basic aim of our tax policy is to stimulate domestic growth, we are not unmindful of the problems faced by U.S. subsidiaries abroad, including the problem of competing with foreign companies subject to different tax obligations; U.S. investment abroad is important to our export expansion program.

"To the extent that U.S. investment abroad increases the financial strength and the competitive capacity of American companies it reinforces our domestic economy.

"Our overall economic objectives require the continued expansion of U.S. investment to help develop the prosperous customers with whom we expect to establish trade."

This protest against the above-mentioned features of H.R. 10650 is presented to you by order of the board of directors of the Cleveland World Trade Association pursuant to a unanimous vote of the board on Thursday, March 29, 1962.

FRANK S. WILSON,
President, Cleveland World Trade Association.

HARTMAN & CRAVEN,
New York, N.Y., April 3, 1962.

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

DEAR SIR: I am setting forth below the contents of two letters written by me to the Honorable Wilbur D. Mills, chairman of the House Committee on Ways and Means, with respect to the pending 1962 revenue bill insofar as it deals with taxation of foreign subsidiaries of American corporations. I believe that these letters raise substantial points which have not been considered by the House Ways and Means Committee. This is borne out by the fact that the receipt of my second letter was acknowledged under date March 21, 1962, in which Congressman Mills advises me that the loan classification recommended in my second letter had not been considered by the House committee and suggested that this thought be brought to the attention of your committee.

The following are my two letters above referred to:

"JANUARY 12, 1962.

"Hon. WILBUR D. MILLS,
"*Chairman, House Committee on Ways and Means,*
"*U.S. House of Representatives, Washington, D.C.*

"DEAR SIR: While I am certain that your committee has received numerous observations concerning the tax haven provisions of your committee's discussion draft of the revenue bill of 1961, I should like to call to your attention certain inequities in the bill. It is not the purpose of this letter to explore the economic soundness of the proposed legislation as I am certain that this has been done most profoundly by other groups vitally interested in the bill. This letter is written primarily to call to your committee's attention three basic provisions which would work an injustice to the American corporations who would be affected thereby.

"A

"Tax haven income pursuant to the provisions of the bill is to be deemed dividend income of the American corporation. A closely held American corporation would be required to include such tax haven profits as dividend income not only for the purpose of the corporate income tax but also for the purpose of the tax on personal holding companies. The American corporation would have no control over the amount of such dividend income it would have to report and, accordingly, in spite of the fact that all of the income of the American corporation and of its foreign subsidiary may have been earned in strictly commercial transactions, the American corporation would find itself a personal holding company.

"As I understand, one of the reasons behind the tax haven tax bill is to place the American corporation operating abroad through a foreign subsidiary in the same position as an American corporation operating abroad through a branch. Classification of tax haven income as a dividend would clearly penalize the American corporation operating through a foreign subsidiary as opposed to the position of the American corporation operating through a foreign branch.

"This inequity could be obviated in one of two ways:

"1. By treating tax haven income as a dividend only for the corporate income tax but not for the purpose of the tax on personal holding companies; or

"2. By classifying the tax haven income for the purpose of the tax on personal holding companies in accordance with the original nature of the income when earned to produce the tax haven profit.

"B

"As your committee undoubtedly knows, there are certain countries which, because of fiscal restrictions, do not permit the transfer of funds or to a large extent limit the transfer of funds to other countries. The tax haven bill would require the American corporation to include tax haven income from such countries in its taxable income in spite of the fact that the funds are not available to the American corporation.

"This could be obviated by providing that no income was realized until such funds became transferable.

"C

"All dividends paid to a foreign subsidiary of an American corporation by a related company under the bill are deemed tax haven income. The apparent purpose of this provision is to prevent the tax-free shuttling of income between various foreign subsidiaries in foreign countries of an American corporation. It would appear, however, that if dividends are paid to a foreign subsidiary by a related company located in the same country as the foreign subsidiary the transaction sought to be taxed is not involved, but, nevertheless, such dividends would be deemed tax haven income. This would be so in spite of the fact that the dividends paid to the foreign subsidiary represented profits from normal commercial transactions which would not otherwise be deemed tax haven income.

"This could be obviated by providing an exception to the inclusion of such dividends when they are paid by a related company in the same country as the foreign subsidiary receiving the dividends.

"Respectfully yours,

"MILTON L. ROSENBERG.

"FEBRUARY 23, 1962.

"Hon. WILBUR D. MILLS,
"*Chairman, House Committee on Ways and Means,*
"*U.S. House of Representatives, Washington, D.C.*

"DEAR SIR: We refer to your committee's release of February 1, 1962, outlining the tentative decisions reached with respect to proposed taxation of foreign source income of U.S. corporations, particularly to paragraph 5.

"This particular tentative decision provided for taxation as a dividend distribution of loans made by a foreign subsidiary controlled by a U.S. corporation to the parent corporation or any of its subsidiaries. We are confident that the basic economic considerations underlying such a provision have been called to your committee's attention. We should like to point out, however, that unless a distinction is made between loans made to subsidiaries in economically or politically underdeveloped countries or any countries having currency restrictions on the one hand and subsidiaries in more highly developed countries on the other hand a great deterrent will be placed in the way of economic development by U.S. corporations of subsidiaries in such underdeveloped areas.

"The risks inherent in investments in underdeveloped countries are so well known and so extensive that few companies are willing to venture equity capital. On the other hand, financing of related companies, especially those operating in countries having currency restrictions, by way of loan affords the greatest chance of obtaining service and ultimate recovery of the loan, generally far greater than if equity capital had been contributed.

"The tentative decision which would tax such a loan as a dividend distributed to the U.S. parent would remove the hedge which the U.S. parent has against the grave risks it undertakes in establishment of subsidiaries in underdeveloped or currency restricted areas.

"It is accordingly suggested that a distinction be made in the case of loans to subsidiaries located in underdeveloped areas on the one hand and developed areas on the other."

Respectfully yours,

MILTON L. ROSENBERG.

ATLANTIC CEMENT CO., INC.,
New York, N.Y., April 23, 1962.

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

DEAR SENATOR BYRD: Atlantic Cement Co., Inc., is a $64 million enterprise presently constructing a 10 million barrel annual capacity cement plant at Ravena, N.Y., and seven distribution stations along the Atlantic seaboard.

Atlantic's construction expenditure was undertaken in May 1961, in partial reliance on the administration's statements that there would be tax credits inuring to business which did not hold back in their expansion plans.

The limitation of the proposed investment credit in H.R. 10650 to property constructed or acquired after December 31, 1961, appears to violate assurances made by the administration to the business community early in 1961. At that time, as the investment credit idea was first being publicly discussed, representatives of the administration authoritatively stated that investments made in 1961 would be eligible for the credit. This element of retroactivity was expressly intended to encourage businesses not to hold back in making investments in plant and machinery while the proposal was under consideration by the Congress.

Thus, when the President proposed this measure in his tax message to the Congress on April 21, 1961, he stated that it would "apply to eligible investment expenditures made after January 1 of this year." Similarly, the Treasury's detailed explanation of the President's tax recommendations, submitted by Secretary Dillon to the Congress on May 3, 1961, stated:

"To prevent hesitation or holding back by investors during the period the plan is under consideration by the Congress, the proposed credit would be retroactively applicable to assets acquired or constructed after December 31, 1960."

As early as March 24, 1961, the Wall Street Journal carried the headline: "Kennedy Nominee Bids To Spur Investment Now With Promise of Retroactive Tax Plan." The lead paragraphs of the article stated (p. 7, col. 1):

"WASHINGTON.—The man nominated to be the Treasury's chief tax adviser promised businessmen that the administration's tax incentive program to spur new investment would be retroactive. He apparently was trying to encourage businessmen not to wait until the program is made public before making their plant and equipment spending plans.

"Stanley Surrey, designated to be Assistant Secretary of the Treasury in charge of tax policy, said President Kennedy's tax program to spur business investment would cover any investment after March 1, of this year and the date 'could be earlier.' He indicated the effective date might be as early as January 1." (The full text of the article is annexed as exhibit A.[1])

The Wall Street Journal story was based on testimony of Stanley Surrey on March 23, before the Senate Finance Committee, which was holding hearings on his confirmation as Assistant Secretary of the Treasury. In answer to a question from Senator Hartke asking whether he was aware that business was withholding investment in capital goods while "waiting for the outcome" of the President's investment incentive recommendations, Mr. Surrey replied:

"I am glad you asked that question because I think it would be completely unnecessary for any business to hold up any investment that it was contemplating making now in plant and machinery because I think any tax incentive with respect to investments in plant and machinery would certainly cover any investment made after, say, March 1, of this year. So that any concern contemplating an investment could certainly go ahead and make that investment."

He also stated that the Treasury would give consideration to making the effective date January 1 of 1961. (The complete testimony on this point is annexed as exhibit B.[1])

It is clear from the above-quoted statements that in March of 1961, the administration was concerned that businesses were hesitating with their investment plans until the President's tax credit plan became definite. Consequently the administration, through Secretary Dillon and Assistant Secretary Surrey, gave assurances to the business community that those businesses which proceeded directly with their expansion plans without awaiting final congressional action would be protected.

When the bill was first introduced, in May 1961, it did provide for credits based upon investment after December 31, 1960. In reintroducing the bill at the 1962 session of the Congress, however, the controlling dates in the bill were changed to December 31, 1961. (Proposed Code section 48(b), H.R. 10650, pp. 18–19, the text of which is annexed as exhibit C.) The bill was passed by the House with this date limiting investments eligible for the credit.

It has been suggested that even the limited retroactivity of an effective date of January 1, 1962, does not accord with the measure's avowed purpose of stimulating prospectively the making of investments in plant and equipment. However, it is clear from the material set forth above that the business community was encouraged by the administration, more than a year ago, to act without holding back until ultimate passage of the investment credit measure, in order to stimulate a lagging economy at once. Thus the original controlling date has already had a prospective effect in stimulating investment. It should be restored to the bill in order that the investment credit will in fairness be available to businesses which, explicitly encouraged by the administration, acted on the understanding that investments made without holding back would be protected.

Yours very truly,

H. T. MCBRIDE, *Treasurer.*

SANTA FE DRILLING CO.,
Whittier, Calif., April 2, 1962.

Senator HARRY FLOOD BYRD,
Chairman, Finance Committee,
U.S. Senate, Washington, D.C.

DEAR SENATOR: Santa Fe Drilling Co. is strongly opposed to the basic provisions affecting foreign income of H.R. 10650; namely, sections 482, 951 and 958. It is our undstanding that the Senate Finance Committee has scheduled hearings on this tax bill to start today, April 2, 1962.

[1] Exhibits referred to made a part of committee files.

Our company is one of the leading U.S. oil and gas drilling contractors operating in foreign countries; this provides, in most instances a complete "turnkey" contract drilling service to many major and independent oil companies. Our operations overseas in recent years have been concentrated in the so-called undeveloped countries of Africa, the Middle East and South America. We currently employ approximately 275 Americans and Europeans; also approximately 1,000 citizens of the various foreign countries in which Santa Fe Drilling Co. is currently engaged in contract drilling operations.

In these sections of H.R. 10650, it is proposed that U.S. shareholders should be taxed on the earnings of controlled foreign subsidiaries, rather than on dividends incurred as at present. It strikes us that this would be comparable to requiring Santa Fe Drilling Co. shareholders to pay personal income tax on this company's total earnings, rather than on only the dividends they receive.

In our opinion such legislation would have a disruptive effect not only on our foreign contract drilling business, but all U.S. business overseas. It would not only change the "ground rules" under which billions of American dollars have been invested abroad, it would also place U.S. firms operating overseas at a heavy disadvantage in competing with firms of other countries outside the United States. This is particularly true in the contract drilling industry. It would provide non-U.S. contract drilling firms (mainly Italian and French) with competitive advantages which could prove insurmountable.

Santa Fe Drilling Co. is as eager as is the administration to bring the U.S. international payments into balance and to stimulate greater investment in this country as well as in the less developed countries of the world in which it operates. But we fear that in some of the proposed foreign income tax provisions incorporated in H.R. 10650, our Government would be running a great risk for the sake of little additional revenue in the short term. And, in the longer view, discouragement of U.S. investment abroad—which brings such a large flow of dollars back into this country—would, in our opinion, worsen the balance-of payment position of the United States.

Our company believes present U.S. tax laws should, if anything, be simplified to give greater encouragement to ventures overseas, rather than be made more complicated and penalizing, as would be the case with H.R. 10650.

We hope that you, Senator, will forcefully oppose this legislation.

Sincerely yours,

D. F. WEST, *Secretary-Treasurer.*

STUDIO ELECTRICAL TECHNICIANS, LOCAL NO. 728,
Hollywood, Calif., April 4, 1962.

Hon. HARRY FLOOD BYRD,
U.S. Senate, Washington, D.C.

DEAR SENATOR BYRD: All industry today is facing a crisis more serious than any that has confronted us in the past 30 years. Our existing tax laws have provided a loophole permitting a general "runaway" of American capital to foreign countries. This runaway has dried up our domestic employment and unless something is done now we all will have to begin again where we started. The chart enclosed shows what has happened to just one of our IATSE locals. In 1945 we worked approximately 2,800 men, but at the present time less than 1,000 are working.

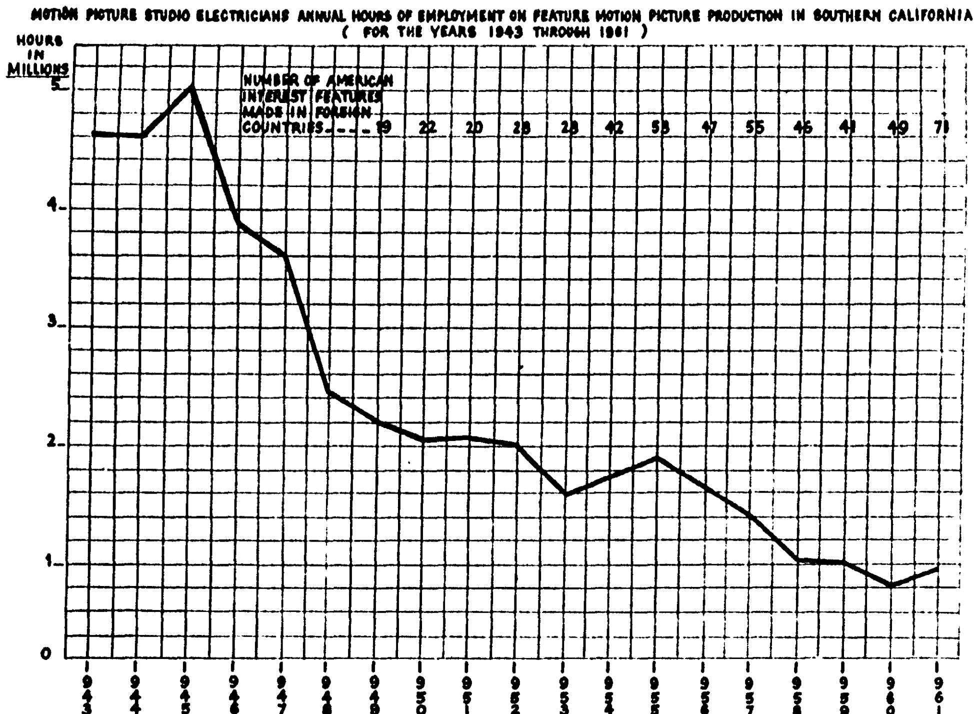
In regard to the 1962 tax bill, H.R. 10650, containing a proposed $20,000 tax exemption clause, why should American actors or producers working abroad and earning from $50,000 to $1 million be given any consideration? We feel that the tax exemption on those American citizens should be comparable to those working in the United States.

Sam Katzman, a producer at Columbia Studio, was interviewed by a news commentator on the Columbia Broadcasting station about 2 months ago, at which time he stated that if he wanted a certain actor to work in a picture, the actor would agree if it was to be made in Europe, and would also demand that he be furnished with villas, maids and chauffeurs, all at the producers' expense, which is in addition to their salaries.

The basic American right to compete for any and all available jobs is no longer an integral part of our way of life. We look and turn to you for support.

Sincerely yours,

A. T. DENNISON,
Business Representative, IATSE Local No. 728.



NEW YORK, N.Y., *April 4, 1962.*

Hon. HARRY FLOOD BYRD,
Chairman, U.S. Senate, Finance Committee,
Senate Office Building,
Washington, D.C.

SIR: As an American citizen I wish to voice my protest against section 20(b) of the revenue bill of 1962 as recently passed by the House of Representatives.

That section would require any U.S. citizen or resident to file returns giving any and all such information as the Secretary of the Treasury or his delegate might prescribe regarding the affairs of any foreign corporation of which he was an officer or director. Such returns would be required regardless of whether the foreign corporation was controlled by U.S. or foreign interests, whether it was doing or had ever done any business in or with the United States, and whether or not it had any other connection with the United States.

The result of such a requirement would surely be to deprive many Americans of the opportunity of working for non-U.S. corporations in responsible positions. In addition the action of the U.S. Treasury in seeking out information about foreign enterprises having no connection with this country would be bound to cause resentment and irritation in foreign countries to the overall detriment of our international position. Finally, there would seem to be no useful purpose in having the U.S. Treasury collect information concerning non-U.S.-controlled foreign businesses operating entirely outside our own country.

My own business career is a case in point. Although at the present time I am employed in New York by an American corporation, an affiliate of the Royal Dutch/Shell group of companies, my previous employment included working for several different companies of the Shell group engaged in various phases of the petroleum industry in Colombia, Venezuela, Turkey, and the United Kingdom, and I was a director of certain of those companies. None of them was a U.S. corporation, none was controlled by U.S. interests, and none had any income from U.S. sources, or any other connection with the United States. The time may come when I will have another opportunity to work abroad for a non-U.S. company, but it is clear to me, as I think it will be to you, that any foreign company will be extremely loath to appoint an American to a responsible position if it means that the U.S. Treasury Department will then have the right to require the production of detailed and perhaps confidential information concerning its operations which has no relation at all with the fiscal policies of the United States.

For these reasons I feel that the enactment of section 20(b) in its present form would only serve to injure the careers of the many Americans who are now working for non-U.S. corporations outside the United States and others who would otherwise have the chance to do so in the future. I respectfully urge that in their interest and in the interest of preserving good relations between our country and friendly foreign nations that it be deleted from the bill or limited to the furnishing of information which is germane to U.S. business.

Very truly yours,

GEORGE G. THOMSON, Jr.

ARDMORE, PA., *April 2, 1962.*

Hon. Senator HARRY FLOOD BYRD,
Senate Office Building, Washington, D.C.

DEAR SENATOR BYRD: Now that the House of Representatives has passed the administration's tax bill, I am asked to believe, from what I have read in the press, that Senate approval will be a mere formality—despite long, drawnout hearings, discussions, and revision efforts. This is difficult for me to comprehend, in view of the very controversial and highly inequitable nature of two of the bill's provisions. I refer specifically to the so-called 7 percent investment credit, and the 20 percent withholding provision on dividends and interest.

Insofar as the investment credit section is concerned, there appears to be no sensible or logical reason why the alternative course, of liberalization of depreciation allowances, would not serve the same purpose, without the severe inequities which the credit method would impose. I am sure that after a year or two's experience with the investment credit "gimmick" in the tax law, even the legislators might be inclined to believe that perhaps the country's business interests have a keener insight into methods for stimulating business and industry than is supposed in many quarters.

As to the 20-percent withholding provision against dividend and interest payments, it would appear that a more complex and perplexing scheme could hardly be developed. Some of the proponents of this withholding system have likened it to the withholding principle as applied to earned incomes. Such a comparison is completely worthless, and highly uninformed, as experience will most likely prove if the proposal becomes law.

Furthermore, the expenditure of billions for an electronic system of taxpayer recordkeeping is completely ridiculous if the entire taxpaying public is to have withholding applied on investment income in order to seek out the relatively few persons who neglect or avoid the reporting of such income on their tax returns. The "voluntary compliance" description, which is appropriately used with respect to the overwhelming majority of taxpayers, is to become "regimented insistence" with the new withholding proviso.

Very little has been said of the complexities which will arise in the preparation of tax returns, an area in which the average person is already bewildered and frustrated. The addition of this proposed new complexity will probably prove to be completely insurmountable by most taxpayers, and will prove to be a windfall to the professional experts in return preparation. Quite aside from the returns prepared by practitioners, there will be hundreds of thousands of instances where taxes were withheld, but which were never claimed, for either credit or refund.

I am one voter (and taxpayer) who still has hope that some maturity of thought and planning will be exercised by the Senate membership in its appraisal of the proposed withholding system. The substitution of commonsense and sound judgment, rather than the partisanship principle applied by the House, could result in the U.S. Senate restoring sanity to the enactment of legislation which will so vitally affect the Nation and its citizens.

Respectfully yours,

THOMAS F. TOOHILL.

N.B.—Although I am not a constituent of yours, I am, to say the least, one of your admirers. Had the composition of our legislative bodies been such as to reflect your views, I am certain that the socialistic trend of the past 30 years would have been averted.

T.F.T.

(Whereupon, at 4:55 p.m., the hearing was adjourned, to reconvene at 10 a.m., Wednesday, April 25, 1962.)

REVENUE ACT OF 1962

WEDNESDAY, APRIL 25, 1962

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, D.C.

The committee met, pursuant to recess, at 10 a.m., in room 2221, New Senate Office Building, Senator Harry F. Byrd (chairman) presiding.

Present: Senators Byrd, Douglas, Gore, Talmadge, Williams, and Carlson.

Also present: Elizabeth B. Springer, committee clerk; and Colin F. Stam and L. N. Woodworth, of the Joint Committee on Internal Revenue Taxation.

The CHAIRMAN. The committee will come to order.

The first witness is Mr. Fred W. Peel, U.S. Council of the International Chamber of Commerce.

Mr. Peel, take a seat, sir.

We are very glad to see you here.

STATEMENT OF ELLSWORTH C. ALVORD, CHAIRMAN, COMMITTEE ON TAXATION, U.S. COUNCIL, THE INTERNATIONAL CHAMBER OF COMMERCE, INC.; PRESENTED BY FRED PEEL

Mr. PEEL. Mr. Chairman and members of the committee, I am appearing today on behalf of the U.S. Council of the International Chamber of Commerce, and I am appearing in place of Mr. Alvord. If I have you permission, I would like to submit Mr. Alvord's statement for insertion in the record, and then comment on a few of the points in the statement.

The CHAIRMAN. Without objection the insertion will be made following your oral presentation.

Senator CARLSON. Mr. Chairman, on that point, I hope some time before this hearing, I am going to read this statement of Mr. Alvord but if he has any views on any of these particular phases that he would like to give the committee I would like to get them before we conclude the hearing.

Mr. PEEL. I will certainly pass that on to him, sir.

This statement only relates to his views and the views of the U.S. Council on the foreign income provisions of the bill because that is all the U.S. Council is concerned with.

Senator CARLSON. There are other provisions of this bill that are quite important, too, and I know he is one of our outstanding tax attorneys and I would like to get his views.

Mr. PEEL. I am sure he would be happy to comply, Senator.
(The following was later received for the record:)

ALVORD & ALVORD,
Washington, D.C., May 4, 1962.

Hon. FRANK CARLSON,
U.S. Senate, Washington, D.C.

MY DEAR SENATOR CARLSON: I understand that when my statement of comments on the foreign income provisions of H.R. 10650 was submitted to the Senate Committee on Finance on behalf of the U.S. Council of the International Chamber of Commerce, you were kind enough to request my views on the other provisions of the bill.

My statement submitted April 25 related only to the sections of the bill affecting the tax treatment of foreign income because this was the concern of the U.S. council. I have the following additional personal comments on the bill. These are my individual views on matters on which the U.S. council has taken no position.

As to section 2 of the bill, the investment credit fails to meet the basic problem for investors in depreciable assets. That problem is the decline in the value of the dollar, so that deductible additions to depreciation reserves are no longer adequate to finance replacements. Businessmen are faced with the necessity of using after-tax dollars to keep even; the result has been the recognized failure of the American industrial machine to maintain its position of world leadership. Also, I question the wisdom of putting the issue of continuing investment allowances from year to year in the area of politics.

Section 3 of the bill, allowing the deduction of some types of business expenses relating to legislation, is desirable. It would be better, however, to carry this principle to its logical conclusion and to allow all such business expenses to be deducted, as would be the case under the provisions of Senator Hartke's bill, S. 467.

Section 4 of the bill would disallow deductions of certain entertainment expenses even though they are ordinary and necessary business expenses. In effect, this provision would say that, even though the Government insists on taking its share of every business' profits, it is unwilling to allow the deductions of the travel and entertainment expenses which make the profits possible. This provision is an attempt to correct by legislation a problem which is essentially one of administration.

Section 14, which would tax gain on dispositions of some types of depreciable property as ordinary income to the extent of depreciation previously deducted, is desirable. It should, however, be accompanied by a liberalization of the rules for deduction of depreciation which will give concrete statutory recognition to the ever-increasing role of obsolescene.

The Committee on Finance is well aware that section 19, which would withhold 20 percent on dividend and interest payments, is undesirable. It is also unnecessary. It is unbelievable that we should find it necessary to institute this unfair and cumbersome procedure at the very time when the combination of taxpayer account numbers and automatic data processing promises to eliminate delinquencies in reporting dividend and interest income.

This summarizes my views of the other provisions of H.R. 10650. I am confident that the Senate Committee on Finance has the capacity and determination to convert this bill into a worthwhile contribution to the American tax system.

Sincerely yours,

ELLSWORTH C. ALVORD.

Mr. PEEL. First, I would like to speak to this question of tax neutrality which has been used as a defense of this bill and has been used by the Treasury Department as an argument in favor of its proposals.

The tax neutrality idea we have called in this statement the tax neutrality myth because, in fact, neither this bill nor the Treasury's proposals for this bill would result in tax neutrality as between foreign income and domestic income.

Now, the outstanding illustration of that point is in the investment credit. Secretary Dillon has said that if the investment credit is at 8 percent, as he proposes, the increase in profitability, he has calcu-

lated on a 10-year asset would be about 40 percent, and if it remains at 7 percent in the bill, the result would be to increase the profitability of a 10-year asset after taxes by 35 percent.

Of course, the changes are comparable in other assets with lives long enough to qualify.

But this bill does not make foreign investments eligible for the credit, and the result is that the bill discriminates in that respect against foreign investments, and the law would discriminate against them if it went into effect.

Furthermore, even in its treatment of the foreign income provisions, the bill does not achieve any ideal of tax neutrality. It discriminates between developed countries and less developed countries. It discriminates between foreign corporations and domestic corporations in that it proposes to compute the tax on the income earned by foreign corporations on the basis of the earnings and profits concept which does not take into account the same deductions as are allowed in computing taxable income on domestic taxpayers.

Furthermore, the treatment of losses is different, under the bill and under the Treasury proposals, for foreign corporations or for stockholders of foreign corporations, from the treatment provided in the present law for domestic taxpayers, because there would be no loss carryforwards and carrybacks under the usual net operating loss provisions.

I think all of these should suffice to lay at rest finally the tax neutrality myth. If these proposals are adopted it cannot be on any theory that by adopting them the tax system would become neutral between foreign and domestic investment.

I think it would also be helpful to place in perspective some of the comments that have been made, some of the attitudes that have been indicated before the committee, to the effect that there is something wrong with income earned outside this country going free of U.S. tax until it is brought back here as dividends.

As a matter of fact, the United States has for years tried to get what is, in effect, the best of two possible worlds. It follows two inconsistent theories in taxing: One is to tax the income earned here, including the income earned by citizens and corporations of other countries, and it also follows the principle of taxing the income of American citizens and American corporations wherever it is earned, throughout the world.

Now, these proposals, particularly in section 13 of this bill and the Treasury proposals, would accomplish an extension of this latter approach, which is contrary to the basic principle of most of the nations of the world, namely, that the basic right to tax should be where the income arises.

I would like to mention in connection with the competitive effects of the foreign income provisions of the bill the fact that what this amounts to is placing the American-owned foreign corporations on a different tax basis from the corporations owned by citizens of the other developed, industrialized, capital-exporting countries of the world.

We have included in this statement appendix I, which summarizes the tax treatment of foreign income of corporations by the United Kingdom, Canada, France, Italy, Belgium, Netherlands, Germany, and the Latin American countries generally.

This summary or digest in appendix I illustrates clearly that the citizens of these other countries who go outside their borders to earn income are not subject to the tax handicaps which section 13 of this bill, and which the Treasury proposals would impose on our citizens, and that is the heart of the competitive problem—the competitive handicap that would be placed on American business by section 13 or by the Treasury's proposals to make the treatment even more stringent.

I think it is important to draw a distinction here between the treatment of U.S. source income and the treatment of income arising in other parts of the world. The question is: "Is it wrong for American taxpayers to save foreign taxes through the use of foreign subsidiaries?" and we submit that it is not wrong and that as a matter of fact, the long run effect is beneficial to the United States.

It is beneficial to the balance of payments. Even Secretary Dillon recognized in his statement to this committee that, as a mater of fact, in calculating the revenue effect from the Treasury proposals, they made an allowance for the fact that in many instances the effect of the Treasury proposals would not be to increase revenues here but to cause companies to abandon their present method of doing business abroad, with the result that they would be subjected to more taxes in the foreign countries.

We have no quarrel in the U.S. Council with all the measures that may be necessary to make sure that U.S. source income is not siphoned off so as to avoid U.S. tax on it. But there is a basic difference in principle between measures designed to accomplish that and measures designed to prevent American-owned corporations from taking advantage of the most expeditious method of doing business in foreign countries, to save foreign taxes, to prevent themselves from being subjected to currency exchange restrictions, or for any number of other reasons, but to meet the issue head on, specifically, to save foreign taxes.

It is in the interest of the United States that the American-owned businesses not be hamstrung in setting up foreign corporations for this purpose. Yet that is precisely what the provisions on trading corporations in the definition of foreign base company income in section 13 propose to do. It is what is proposed in the treatment of royalty income on copyrights and patents.

We feel that there are serious problems on conflicts in this bill and in the Treasury proposals with the existing income tax treaties. We wholeheartedly endorse Secretary Dillon's recommendation that section 21 of the bill be stricken out, but we do not agree with his conclusion that the only treaty with which this bill conflicts is the estate tax treaty with Greece.

On the contrary, there are 13 income tax treaties now in effect which clearly conflict with the so-called gross-up proposal, because these are treaties in which the United States has agreed with these foreign countries that it will allow its citizens and residents foreign tax credit for taxes paid to the other contracting nations in these treaties, in accordance with the foreign tax credit provisions of our Internal Revenue Code on specific dates that are pointed up in the treaties—the date of enactment or the date of ratification, or the date on which the ratifications are exchanged and the treaty goes into effect.

There are other treaties in which the convenant to allow foreign tax credit is simply stated to be in accordance with our laws. But a

reasonable construction even of these other treaties means in accordance with our laws at that time, and clearly this gross-up proposal would cut back on the foreign tax credit benefits.

The section 13 proposals would also conflict with some of our treaties.

We have listed in appendix II the treaty provisions to which we have reference. First, we list the conflicts with section 11 in the bill, that is the gross-up provision.

Then we list three treaties which contain provisions which are plainly in conflict with section 13. For example, I will read the one from the German treaty:

> Industrial or commercial profits of an enterprise of one of the contracting states shall not be subject to tax by the other state unless the enterprise is engaged in trade or business in such other state through a permanent establishment situated herein.

That allows no room for doubt as to interpretation. That plainly means that those profits of an enterprise of a German corporation are not to be taxed by the United States unless the enterprise is engaged in trade or business here.

Now, Secretary Dillon in his testimony before this committee in saying there were no conflicts with the income tax treaties may have had in mind the fact that most of the treaties contain provisions which say an enterprise of the contracting state shall not be subject to taxation in the other. In a technical sense it might be possible to say that as to these other treaties the section 13 provisions do not result in conflict because they are not technically taxing the enterprise, they are technically taxing the shareholders who own the enterprise. But they are certainly in conflict in principle, and as to the Austrian, German, and New Zealand treaties, they are in flat conflict with the actual wording.

Furthermore, all of the treaties have provisions by which the United States promises not to tax the income from shipping and aircraft of the enterprises of the other contracting state. Those are likewise in conflict.

It may be that Secretary Dillon had in mind the saving provisions which are contained in most of the treaties, whereby the United States saves back for itself, so to speak, the right to tax its own citizens and corporations. But as a matter of fact, there are five treaties, plus the Indian treaty which is awaiting ratification, which do not contain any such saving clause, and even the ones that do contain the saving clause, in most instances, specifically make the covenant to allow foreign tax credit in accordance with the foreign tax credit provisions of our law at that time an exception to the saving clause, so clearly the gross-up provision could not be defended even in the treaties that have saving clauses, on the ground that the saving clauses make it possible for the United States to tax its own shareholders, the shareholders of these corporations, without allowing foreign tax credit that it promised to allow.

These are not merely technical objections. If you look back at the history of double taxation treaties, the principal purpose, or one of the principal purposes, was to prevent double taxation by the two contracting states agreeing to allow foreign tax credit, and those are at the very heart of these treaties.

On the section of the bill which proposes to modify and amend section 482, the U.S. Council's basic position is that we feel that sectio 482 as it now stands is sufficient if it is energetically administered. But if the committee does feel that it is necessary to amend it, the U.S. Council certainly would not raise any point of objection to that, because it is our principle that any steps that need to be taken to change the law to make sure that American source income is subject to United States income tax are proper.

We would, however, suggest two technical points in connection with the proposed amendment of section 482.

One is to make sure that the section allows for adequate court review of any reallocation of income, and the other is to avoid double taxation on the income which is reallocated to U.S. corporations. An attempt has been made in the House bill to do that by stating that the U.S. taxpayer whose income is reallocated may claim foreign tax credit for the foreign taxes paid with respect to the reallocated income, but unfortunately that won't do the job unless the bill also says that that income is treated as foreign source income.

Without that, in most instances the per-country or the overall limitation on the foreign tax credit would negate the effect of saying that the domestic taxpayer can claim the credit.

On section 13 we propose for your consideration a complete substitute proposal which is contained in appendix III. Essentially what this proposal would do would be to tax foreign personal holding company type income, investment income received by a foreign corporation, tax it to the U.S. shareholders unless the income is reinvested in an active business, either conducted by that corporation or conducted by a corporation in which the recipient corporation had a substantial stockownership.

This is essentially the proposal which the Ways and Means Committee adopted and announced in its press release on the 1st of February and then subsequently abandoned in favor of the present section 13.

We feel they were right the first time and that that provision would adequately cover any problem of U.S. source income escaping tax, or any problem of people accumulating and reinvesting in portfolio investments foreign income which would amount to an unreasonable accumulation.

That concludes my statement.

The CHAIRMAN. Senator Douglas?

Senator DOUGLAS. May I ask you first about the taxation of earned income of individual Americans abroad?

Mr. PEEL. Yes, sir.

Senator DOUGLAS. I believe you cover this on pages 24 and 25 and the top of 26 of your brief.

Am I correct in understanding that the present law now in effect provides that if American citizens have been living abroad for 17 out of the last 18 months he is exempted from taxation on the first $20,000 of annual income?

Mr. PEEL. That is correct.

Senator DOUGLAS. Earned income being defined as wages, salaries or receipts from independent businesses.

Mr. PEEL. Receipts from independent businesses which are attributable to his personal efforts, and there is a rule of thumb that sets a maximum of 30 percent of that.

Senator DOUGLAS. If he elects to be a bona fide resident of a foreign country, even though he retains his American citizenship then all of his income can escape taxation.

Mr. PEEL. Yes, sir.

Senator DOUGLAS. The fact that he is a bona fide resident can be revoked by him at any time, he can return to the United States at any time?

Mr. PEEL. Yes, a person can change his mind about his residence.

Senator DOUGLAS. He doesn't become a man without a country?

Mr. PEEL. No, sir.

Senator DOUGLAS. And he is given military and diplomatic protection of the United States?

Mr. PEEL. He is given diplomatic protection.

Senator DOUGLAS. While he is abroad, diplomatic protection and, if necessary, military protection while he is abroad?

Mr. PEEL. Well, I think his location would determine whether he gets military, but he would certainly get diplomatic protection.

Senator DOUGLAS. But he would always get diplomatic protection because he is still an American citizen and he can return at any time to the United States, and when he returns he does not have to pay any income tax on the income which he has received in prior years abroad; is that true?

Mr. PEEL. That is correct.

Senator DOUGLAS. Now, suppose he is a resident of Monaco, which, I am told, is a very pleasant place on the Riviera. Does he pay any local income tax there?

Mr. PEEL. I am not familiar with the personal income tax of Monaco.

Senator DOUGLAS. I am informed he does not pay any income tax there, and I would like to have the record show that according to my information he does not pay income tax. If I am in error I hope you will correct the record.

Suppose he has a legal residence in Nassau in the Bahamas; does he pay any individual income tax there?

Mr. PEEL. No; the Bahamas do not levy an individual income tax.

Senator DOUGLAS. As a matter of fact, are not the Bahamas one of the most notorious tax havens in the world?

Mr. PEEL. I am not sure I understand the use of the word "notorious" in that connection.

Senator DOUGLAS. Well, one of the best known tax havens in the world.

Mr. PEEL. Yes, sir.

Senator DOUGLAS. Is it not true that the late Canadian multimillionaire, Sir Harry Oaks, went there some years ago to seek sanctuary from the Canadian income tax?

Mr. PEEL. I have read that.

Senator DOUGLAS. Isn't that true?

Mr. PEEL. I don't know.

Senator DOUGLAS. In going there did he not obtain exemption from the Canadian income tax?

Mr. PEEL. Sir, I don't know whether the Canadian individual income tax would continue to apply to a Canadian or whether he would have to renounce his Canadian citizenship or whether he would have to renounce his status as a citizen of the British Commonwealth.

Senator DOUGLAS. When a Swedish financier went to the Bahamas did he pay any income tax in the Bahamas?

Mr. PEEL. He would not; there is no income tax.

Senator DOUGLAS. And would he escape from paying Swedish income taxes?

Mr. PEEL. I don't know whether Sweden——

Senator DOUGLAS. If Sweden had an income tax comparable to the United States he would escape paying taxes in Sweden, would he not?

Mr. PEEL. Yes.

Senator DOUGLAS. Are there American citizens who live in the Bahamas and are, therefore, exempt from paying American income tax and do not pay British or Bahama income tax?

Mr. PEEL. I would be sure that there are, yes.

Senator DOUGLAS. Do you know some of these?

Mr. PEEL. No, not personally.

Senator DOUGLAS. Do you think this is fair?

Mr. PEEL. Yes.

Senator DOUGLAS. You do?

Mr. PEEL. I think that is fair.

Senator DOUGLAS. You don't think we should plug this loophole? Here these people are getting large incomes. They have the diplomatic protection of the United States. They pay nothing to the American Government. They pay nothing to the local government.

Mr. PEEL. I would think in the ordinary case it would be rather difficult to earn a large income in the Bahamas.

Senator DOUGLAS. Suppose they have a corporation which is incorporated in the Bahamas, and they have a furnished room or a small cottage in the Bahamas, to which they periodically return but spend most of their business year in other locations but have legal residence in the Bahamas: would they not be exempt from income tax in the Bahamas?

Mr. PEEL. Well, the Bahamas would not impose an income tax on them but in the example that you pose I am not sure they would qualify as bona fide residents as far as our income tax is concerned. Legal residence, sir, legal domicile, is not sufficient, I don't think.

Senator DOUGLAS. They certainly can say they are not bona fide residents of the United States, and declare it as their intention that they have no immediate intention of returning. I think you will find under those circumstances that they can obtain exemption from all personal income tax. You think that is fair?

Mr. PEEL. I think that is fair, yes, Senator, because those people are not receiving the same services from our Government that the people here are receiving. They are receiving diplomatic services, but I do not believe that those are sufficient.

Furthermore, the Bahamas support their Government by heavy tariff duties on consumer goods, I am told, since they have no income tax at all.

And a person living in the Bahamas, and buying the things that he consumes in the Bahamas would have to pay those taxes; he would

bear the burden of those taxes. Those could not be credited against our income tax. So those people are paying taxes.

Senator DOUGLAS. Have you studied the tariff structure of the Bahamas?

Mr. PEEL. No, I have not.

Senator DOUGLAS. What is the comparative duty on rice as compared to champagne?

Mr. PEEL. I cannot answer that.

Senator DOUGLAS. I think you will find the duty is much heavier on rice than on champagne, and therefore, that the tariff structure operates in favor of luxuries as compared to necessities.

Mr. PEEL. Of course, if a person lives there he would have to buy necessities.

Senator DOUGLAS. Not with as large a proportion of his income.

If a person is a resident of Panama, if he is in Panama, would he be subject to income tax?

Mr. PEEL. I am sorry, which one?

Senator DOUGLAS. Panama.

Mr. PEEL. Panama does have an income tax.

Senator DOUGLAS. How much?

Mr. PEEL. It is at a progressive rate. I am not sure that I can recall how high it ranges. I think it ranges up into the low 30 percentiles, but I am not sure.

Senator DOUGLAS. At what point do you reach the 30 percent?

Mr. PEEL. I don't know, sir.

Senator DOUGLAS. What about residence in Liechtenstein, the principality of Liechtenstein? I am told that does not have an income tax.

Mr. PEEL. I don't know what Liechtenstein imposes.

Senator DOUGLAS. You are an authority on this subject. What other countries are there that don't have a personal income tax for foreign citizens resident within their borders, do you know?

Mr. PEEL. Bermuda does not.

Senator DOUGLAS. Yes, we have mentioned that.

Mr. PEEL. I can't think of any others.

Senator DOUGLAS. Monaco.

Mr. PEEL. I don't know about Monaco.

Senator DOUGLAS. Liechtenstein?

Mr. PEEL. I don't know about Liechtenstein.

Senator DOUGLAS. Would you check the laws and if I am incorrect on those two countries, would you supply a correction for the record?

Mr. PEEL. Yes, sir.

Senator DOUGLAS. Would you also be willing to look up and find the number of other countries which do not have an individual income tax?

(The following was later received for the record:)

ALVORD & ALVORD,
Washington, D.C., May 2, 1962.

Hon. PAUL H. DOUGLAS,
U.S. Senate, Washington, D.C.

MY DEAR SENATOR DOUGLAS: During the course of my testimony before the Senate Committee on Finance on April 25, I undertook, at your request, to supply for the record a list of the countries which do not impose an income tax on individuals. I undertook particularly to check on the existence of an in-

dividual income tax in Monaco, Liechtenstein, and Ghana and the other new African countries, and to check on the individual income tax rates in Panama and Liberia.

The following countries, or colonies, do not impose an income tax on individuals: Monaco, Bermuda, the Bahamas, the Sudan, and Kuwait.

There is no income tax on individuals in the northern portion of the Somali Republic, which was formerly British Somaliland. The southern portion of the Somali Republic, which was formerly Italian Somaliland, has an individual income tax. Guatemala imposes an individual income tax on investment and business income but not on wages and salaries. In the New Hebrides only British service officials are required to pay income tax.

Liechtenstein has an individual income tax. It is understood that the taxing authorities allow concessions to individuals from the standard tax rates.

The following new countries in Africa have individual income taxes:

Tunisia
Morocco (including Tangier)
Southern portion of the Somali Republic
Republic of Niger
Republic of Senegal
Sierra Leone
Republic of Togo
Republic of Upper Volta
Republic of Chad
Republic of Cameroon
Republic of Guinea
Republic of Malagasy
Central African Republic
Republic of Dahomey
Republic of Gabon
Tanganyika
Kenya
Republic of the Ivory Coast
Republic of Mali
Islamic Republic of Mauritania
Federation of Nigeria
Congo Republic
Republic of the Congo
Ghana

The individual income tax rates in Ghana range from 6 pence per pound (2.5 percent) on the first £300 of income to 14 shillings per pound (70 percent) on income in excess of £10,000.

Liberia has an individual income tax with tax rates ranging from 2 up to 35 percent on incomes of more than $100,000.

Panama has an individual income tax with tax rates ranging from 2 up to 35 percent on incomes of more than $750,000, plus a 4-percent social security tax.

Sincerely yours,

FRED W. PEEL.

Mr. PEEL. I will check. I don't think there are very many. Uruguay used to be free of individual income tax, but I believe that the 1960 income tax they imposed applies to individuals.

Senator DOUGLAS. What about Ghana?

Mr. PEEL. Ghana?

Senator DOUGLAS. Yes, Ghana.

Mr. PEEL. I do not know.

Senator DOUGLAS. What about the African countries?

Mr. PEEL. I am not familiar with the tax structures of the new African countries.

Senator DOUGLAS. What about Liberia?

Mr. PEEL. Liberia has as an individual income tax on residents.

Senator DOUGLAS. How much?

Mr. PEEL. I don't know the rates.

Senator DOUGLAS. Mr. Woodworth, would you supply the record for Liberia?

Do you know offhand?

Mr. WOODWORTH. No, I don't know offhand. I will submit a memorandum on it.

(The memorandum referred to was later supplied for the record as follows:)

Liberia individual income rates begin at 2 percent and range up to 35 percent on income of $100,000 and over.

The individual income tax structure is as follows:

Net income—	Tax rate—
Up to $1,500	2 percent.
$1,500 to $4,000	4 percent.
$4,000 to $6,000	6 percent.
$6,000 to $8,000	8 percent.
$8,000 to $10,000	11 percent.
$10,000 to $20,000	15 percent.
$20,000 to $50,000	20 percent.
$50,000 to $75,000	25 percent.
$75,000 to $100,000	30 percent.
Over $100,000	35 percent.

Source: Prepared by the Treasury Department from "Foreign Tax and Trade Briefs," by Walter H. Diamond.

Senator DOUGLAS. Panama, did you say?

Mr. PEEL. Yes, Panama has an individual income tax.

Senator DOUGLAS. Now, let us turn to corporations. Am I correct that the provision under existing law is that income earned by subsidiaries of American corporations abroad will not be taxed unless and until this income is transferred to the United States through the parent company and then it is taxed to the parent company? Is that a correct statement?

Mr. PEEL. That is correct.

Senator DOUGLAS. Yes.

Mr. PEEL. If the foreign subsidiary does not engage in business here.

Senator DOUGLAS. So that so far as foreign subsidiaries of American corporations are concerned the present taxes do not look through the parent company to the subsidiary?

Mr. PEEL. No, there is another exception, the foreign personal holding companies do.

Senator DOUGLAS. Yes, I am very glad you say that. That has been held as constitutional by the Second Circuit Court in New York, is that correct?

Mr. PEEL. That is correct.

Senator DOUGLAS. Suppose one of these corporations is incorporated in the Swiss Canton of Zug, does it pay a corporate income tax there?

Mr. PEEL. As I understand it, there are several different types of corporations that can be incorporated in that canton.

Some of the so-called domiciliary corporations which have nothing except the registered seat of the corporation in Zug, I understand do not pay.

Senator DOUGLAS. Do not pay?

Mr. PEEL. Do not pay a tax.

Senator DOUGLAS. I understand that the press has gone to Zug, the capital town, and taken photographs of some of the offices there and it is quite obvious that the locus of the corporation is nominal. There would be a large number of corporations with their nameplates on the door. I forbear to say whether this is similiar to the practice which once existed in the capital of my dear friend from Delaware—Mr. Williams. I was just saying that I forbear from saying whether the practice of incorporation in Zug is similiar to the practice that used to be found of incorporation in Delaware.

Senator WILLIAMS. If it is, they have a lot of virtue. [Laughter.]

Senator DOUGLAS. Yes.

Now, what about the corporate tax in Liechtenstein?

Mr. PEEL. I think the situation is similar to that in Zug.

Senator DOUGLAS. In other words, no tax?

Mr. PEEL. No, no tax on income earned outside the country.

Senator DOUGLAS. What about Panama?

Mr. PEEL. Panama only taxes income from Panamanian sources.

Senator DOUGLAS. So the answer is that they are exempt?

Mr. PEEL. On their income from outside the country, yes, sir.

Senator DOUGLAS. That is right.

What about the Bahamas?

Mr. PEEL. The Bahamas are completely exempt because there is no corporate income tax.

Senator DOUGLAS. What about the Virgin Islands?

Mr. PEEL. That is not true of the Virgin Islands. You mean the U.S.-owned Virgin Islands?

Senator DOUGLAS. What?

Mr. PELL. The U.S.-owned Virgin Islands?

Senator DOUGLAS. Oh, yes, we own the Virgin Islands. We bought them from Denmark.

Mr. PEEL. There are also the British-owned Virgin Islands.

Senator DOUGLAS. I am speaking of St. Thomas and St. Croix.

Mr. PEEL. It is my understanding that corporate income there, certainly from sources outside of the Virgin Islands, would be subject to U.S. income tax.

Senator DOUGLAS. Mr. Woodworth, what about that?

Mr. WOODWORTH. There is a refund provision which applies in the case of certain industries which I think Mr. Peel is referring to.

Senator DOUGLAS. Refund to whom?

Mr. WOODWORTH. Refund of the tax paid in the case of new industries locating in the Virgin Islands.

Senator DOUGLAS. Even though they don't carry on activities in the Virgin Islands?

Mr. WOODWORTH. No, this would involve only those, I believe, which do carry on activities in the Virgin Islands.

(Mr. Woodworth subsequently verified the above statement as correct. He stated that where there is only a nominal business in the Virgin Islands the tax refund provisions of their law would not apply.)

Senator DOUGLAS. Well, does that mean that if you had a mere nominal location of a corporation in the Virgin Islands it would pay an American corporation tax?

Mr. WOODWORTH. I think it would.

Senator DOUGLAS. Can we clear that point up?

Mr. WOODWORTH. Yes.

Mr. PEEL. It is my understanding that this refund provision applies to income earned in the Virgin Islands.

Senator DOUGLAS. That is the refund?

Mr. PEEL. What happens is that the corporation pays or the individual pays the tax to the United States and then there is a refund from the Virgin Islands Government.

Senator DOUGLAS. On income earned, I have had some friends who are opposed as you are to the provisions in the present bill who have very frankly said their companies had subsidiaries in Zug. That is, they have a subsidiary which has a subsidiary in Zug, let's put it that way, and let me say that they milked their subsidiary in major European countries by accounting fees, managerial fees and so forth, so

that they were able to make very large profits for these companies which escape taxation in Zug.

Now, this is in a second degree, so to speak, a subsidiary in the second degree, a subsidiary of a subsidiary.

Mr. PEEL. That is the point we are trying to meet head on with this statement; that is why one of our subheadings is "Is It Wrong To Save Foreign Taxes?"—one of the subheadings in the U.S. Council statement.

Senator DOUGLAS. Then my statement is correct, is it that in this way the subsidiaries of the subsidiaries are able to make income from the subsidiaries by charges for purely nominal services which then escape both American taxation and foreign taxation; isn't that true?

Mr. PEEL. I don't know if you could say that it is true if they were purely nominal services. But the point is that insofar as the services can be carried out by a corporation incorporated in your example in Zug, for operating companies in other countries in Europe and charges can be made for those services and those charges are deductible in computing the income in those other countries, then that income is not taxed by the European countries.

Senator DOUGLAS. That is correct, and not taxed by us.

Mr. PEEL. And not taxed by us, and that——

Senator DOUGLAS. Or by anybody.

Mr. PEEL. Until it is brought back to the United States.

Senator DOUGLAS. Do you think that is fair?

Mr. PEEL. I think that it is of no concern to the U.S. Government now. I will not propose to say that I think that in every instance the Germans, the French, the British, or whatever other developed foreign country is concerned in this is collecting all the taxes that they might. It may be that they will decide that they should cut down on deductions of companies outside.

Senator DOUGLAS. Why shouldn't we then?

Mr. PEEL. But I do not see that that is a concern of our Government except insofar as U.S. source income is concerned, and there I would want to emphasize that the U.S. Council is not opposed to any measures that might be necessary to make sure that income that actually arises in the United States, from U.S. sources, pays its proper U.S. tax.

That is the sort of thing that is attempted to be accomplished in the amendment to section 482 in this bill. It is also what the provisions relating to reinsurance of U.S. insurance risks in section 13 deals with, and in our proposed substitute for section 13 we have retained that part in our proposal.

Senator DOUGLAS. Isn't your position equivalent to this, that you are saying the reinvested corporate surplus of American subsidiaries abroad should not be taxed?

Mr. PEEL. I am not making any statement as to whether it shouldn't be taxed by any other countries, I am saying it should not be taxed by the United States, if it does not arise from American sources, until it is brought back here.

Senator DOUGLAS. Although the reinvested corporate earnings of an American company doing business in the United States are taxed?

Mr. PEEL. Yes.

Senator DOUGLAS. So, you believe that favor should be given to subsidiaries of American corporations abroad which are not given to parent companies at home?

Mr. PEEL. Well, that is why I started my statement by saying that I don't think that anybody involved in this controversy has really come up with an idea that would accomplish a pure tax neutrality as between domestic and foreign income.

Certainly the Treasury is not proposing that and this bill does not do that.

Senator DOUGLAS. But you can approach neutrality. Even though absolute purity is unattainable, can you not approach it more closely?

Mr. PEEL. This bill is moving away from it in the investment credit provision because that provision is available only for domestic investments.

Senator DOUGLAS. As a matter of fact, I tend to agree with you on this point. I think the Treasury is inconsistent. I happen to believe in general in the principle of neutrality and I think so far as the investment credit is concerned this obviously tries to direct income into investment rather than into consumption, which may be desirable, but there are a lot of inconsistencies in all our lives, you know. I know I have inconsistencies and we may even find inconsistencies in the U.S. Chamber of Commerce on occasion.

So don't be too critical of the poor Treasury at this point, don't hold them up to an excessive standard. But do you really think the subsidiaries of American corporations abroad should be given a tax privilege which is not accorded to parent companies at home?

Mr. PEEL. Yes, Senator, I do, because I think you have a problem of reconciling two completely different systems, two different competitive systems, and you also have a problem of reconciling our sovereignty to tax with that of the other countries, and the basic principle which is generally accepted by countries is that income should be taxed in the place where it is earned.

Now, it seems to me that it logically follows from that, that if the country where it is earned doesn't choose to tax then they should be free to let it go untaxed. That is the feeling on the part of the less-developed countries, and it is the reason that they have insisted in recent years on the so-called tax-sparing provisions as a condition to entering into any tax treaties with us, because that is very important to them.

Senator DOUGLAS. May I shift to another facet of this question: Have we established in general by treaty the provision that if an American corporation pays taxes abroad that these taxes are deducted from the taxes which they would otherwise pay at home?

Mr. PEEL. Yes.

Senator DOUGLAS. And reciprocal privileges are granted?

Mr. PEEL. Yes.

Senator DOUGLAS. Are you acquainted with what happened to the American oil companies in the Middle East?

Mr. PEEL. In a general way, yes.

Senator DOUGLAS. In general, the provision is a 50-50 provision, is it not? That is, half of the profits go to the local government? This started in Venezuela and then was extended, I believe, to, I forgot which country was first. I think perhaps Saudi Arabia, then extended to Iraq or extended, I guess, next to Iran and finally to Iraq.

We were excluded from Kuwait and in the neutral zones and so forth, but isn't this a general provision that half of the profits go to the local government?

Mr. PEEL. I can't say that I am any expert on that because I don't work on it.

Senator DOUGLAS. I think you will find that is true.

Mr. PEEL. But I had the impression that that 50-50 line had been breached in the last 2 or 3 years.

Senator DOUGLAS. It may have been slightly increased.

Now, do you know whether or not the payments to the local governments are credited against taxes which these companies—American taxes which these companies—would otherwise to pay to our Government?

Mr. PEEL. Some of them are and some of them are not.

Senator DOUGLAS. Which are and which are not?

Mr. PEEL. It depends on whether it is a royalty or a tax and it is sometimes very difficult to distinguish.

Senator DOUGLAS. If it is a royalty is it deducted?

Mr. PEEL. If it is a royalty, it is simply excluded in computing income which has the same effect as deducting it.

Senator DOUGLAS. And, therefore, the remaining income is taxed?

Mr. PEEL. I beg your pardon?

Senator DOUGLAS. Therefore, the remaining income is taxed?

Mr. PEEL. Yes, sir.

Senator DOUGLAS. But if it is a tax?

Mr. PEEL. It is offset against the tax, dollar for dollar.

Senator DOUGLAS. And, therefore, on a 50-50 basis, this would leave almost no tax to be paid to the United States.

Mr. PEEL. If it were all tax and no royalty, that would be correct.

Senator DOUGLAS. Well, unfortunately in hearings which we held on this matter the Finance Committee was sworn to secrecy, so I am not at liberty to identify the company, but the facts remain that in some of these very large companies they pay absolutely no tax to the United States, so they make hundreds of millions of dollars profit, and the payments to the country in which they had their wells are treated not as a royalty but as tax, and therefore, exempted the company from American taxation.

You know that, don't you?

Mr. PEEL. I don't have any clients that are concerned with this so I don't know it as a fact.

Senator DOUGLAS. Yes.

But you represent the U.S. Council of the International Chamber of Commerce; you are appearing for them this morning, are you not?

Mr. PEEL. Yes. But I don't know the details of the business affairs of all of the members.

It was my understanding, and I am simply repeating hearsay, that in Saudi Arabia the royalty was never reduced and that there is a royalty paid, but as I say I can't state that of my own personal knowledge and that later on the Saudi Arabian Government imposed a tax in addition to the royalty and that tax is credited as an income tax but the royalty is not.

Senator DOUGLAS. The Saudi Arabian tax was used as a substitute for the royalty and had the effect of reducing the tax which a company paid to the U.S. Government.

Mr. PEEL. You mean, literally as a substitute for the royalty so that the royalty went out of existence? It is my understanding that that is not so.

Senator DOUGLAS. Don't you think that there is a field that we should deal with?

Mr. PEEL. I am sorry; I didn't hear you.

Senator DOUGLAS. Don't you think that is a field which the American tax law should deal with?

Mr. PEEL. Well, I think it deals with it all right. There is a distinction between a tax and a royalty. I don't know whether there are any further standards or mechanical rules of thumb that should be written into the law.

Senator DOUGLAS. By merely calling a royalty a tax, these countries are able to free American corporations from paying taxes to the American Government.

Now, they receive diplomatic protection from the United States, do they not?

Mr. PEEL. I would presume so.

Senator DOUGLAS. Certainly.

And if trouble should break out in the Near East, would there not be a claim that American or British troops should protect their property?

Mr. PEEL. Well, I think that would be a possibility, and I think also——

Senator DOUGLAS. Yet they make no contribution to the support of the American Government.

Mr. PEEL. I would think that there would also be a possibility that United States in making up its mind as to whether to send troops to defend those properties would probably decide to, not on the basis of whether it was desirable to protect the property of the particular Americans who had investments there, but it would decide it on the basis of whether it was in the national interest to do it.

Senator DOUGLAS. Don't they owe an obligation to contribute to the support of the Government whose airplanes, whose troops, and whose marines lying right behind them help to give them security?

Mr. PEEL. Well, of course, you can have situations where the foreign country, getting away from the oil business for a moment so there is no question of royalty, simply imposes an income tax equal to our income tax. That is true of several countries.

The British income tax is just a shade higher than our income tax, so aside from just minor differences in definition of income and so on, Americans doing business in Great Britain in corporate form will credit the British income tax so that it completely offsets the American income tax on their income.

There isn't any question there of any definition problem as to whether it is a royalty or a tax. It is a tax all right, and it is a tax imposed on the British.

Senator DOUGLAS. You think it is a tax?

Mr. PEEL. But since they are paying an income tax at least equal to ours, the feeling has been, and I think this has been so since our income tax was introduced, that that was sufficient, since that income was arising from foreign sources.

Senator DOUGLAS. Well, apparently we are not speaking about the same thing. I was speaking about the American oil properties in the Middle East.

Mr. PEEL. Well, I switched to another example to get away from a difficult definitional problem between a royalty and a tax and I am saying that even when you don't have that difficult problem you can still have situations where the entire U.S. tax is offset.

Senator DOUGLAS. As I understand it, the Government retains the right to the subsurface deposits, isn't that correct?

Mr. PEEL. That is true in some foreign countries.

Senator DOUGLAS. Isn't it true throughout the Middle East?

Mr. PEEL. I do not know.

Senator DOUGLAS. Well, I think you will find that is the case.

Now, they do not have private property in the subsurface deposits.

Now, in this country where we do have private property and where royalties are paid, are the royalties paid to those who have the claims on the subsurface deposits treated as expenses or treated as taxes?

Mr. PEEL. They are treated really neither way. They are treated as exclusions which gives you the same effect as a deduction.

Senator DOUGLAS. Exactly so. So net income after royalties is what is subject to taxation here at home.

Mr. PEEL. Yes.

Senator DOUGLAS. But net income abroad, at least in the Middle East, does not have royalties and since it is called a tax this is used as a corresponding offset against the American tax. So that an oil company abroad receives a favor which an oil company at home does not receive. Isn't that right?

An oil company in the Middle East, where the right to the subsurface deposits rests with the Government receives a tax favor which oil companies here at home do not receive?

Mr. PEEL. If it is not paying a noncredited royalty equivalent to what would be paid here.

Senator DOUGLAS. Well, royalties are paid here to private holders except in those cases, of course, where the coal company, the oil company or operator owns the land himself.

Mr. PEEL. I would say it would depend probably on whether they were paying a royalty in the Middle Eastern country which is roughly the equivalent to the one-eighth normally paid here, in addition to the tax they pay in the Middle East.

Senator DOUGLAS. Well now, Mr. Peel, I am not an expert in this field and you are an expert.

Don't you know that in the Middle East what they pay to the governments is treated not as royalties but as taxes? Don't you know that?

Mr. PEEL. I do not know of my own knowledge, but it is my understanding that they pay both a royalty and a tax.

Senator DOUGLAS. How much royalty and how much tax?

Mr. PEEL. I do not know. I do not know the figures.

Senator DOUGLAS. You do not legally know this?

Mr. PEEL. No, I don't know this. I just simply do not know this, in any common-or-garden sense or in any legal sense.

Senator DOUGLAS. Would you at a subsequent time write the committee about what your understanding is?

Mr. PEEL. Yes, I would be happy to.

Senator DOUGLAS. Thank you very much.

(The following was later received for the record:)

ALVORD & ALVORD,
Washington, D.C., May 3, 1962.

Hon. PAUL H. DOUGLAS,
U.S. Senate, Washington, D.C.

MY DEAR SENATOR DOUGLAS: During the course of my testimony before the Senate Committee on Finance on April 25, I undertook, at your request, to ascertain whether American oil companies extracting oil in the Middle East, particularly in Saudi Arabia, pay both oil royalties and income taxes or pay only income taxes to the local governments.

In the case of Saudi Arabia a royalty is paid to the Saudi Arabian Government on oil production at the rate of 4 shillings gold or its equivalent per ton for onshore production. This amounts to about 21 cents per barrel. On offshore production the royalty amounts to about 26 cents per barrel.

In addition to the royalty, a tax on income from oil production is imposed at a gross rate of 50 percent. In arriving at net income to be taxed the royalties and other payments to the Saudi Arabian Government are not deducted, but instead these items are deducted from the gross 50-percent Saudi Arabian tax to arrive at the net tax payable. Only the net income tax payable is allowed as credit against U.S. income tax. The royalty is not credited against U.S. income tax.

The royalty paid on Saudi Arabian oil production was not reduced when the Saudi Arabian income tax was imposed. In fact, the royalty has never been reduced.

It is understood that the oil royalties paid in other Middle East countries are comparable to those paid in Saudi Arabia.

Sincerely yours,

FRED W. PEEL.

The CHAIRMAN. Senator Carlson.

Senator CARLSON. No questions.

The CHAIRMAN. Senator Gore?

Senator GORE. Mr. Alvord, in response to questions by Senator Douglas you made your position so unmistakably clear that you do not think that earnings abroad of subsidiaries of U.S. corporations should be a concern of the U.S. Government that I doubt if any further elucidation of your point of view is necessary by way of questions from me. You have been quite specific in your statements.

How long have you been an official or an employee of the U.S. Council of the International Chamber of Commerce?

Mr. PEEL. First, let me correct one misapprehension, I am not Mr. Alvord. I am appearing on his behalf today because he was unable to appear. My name is Peel.

Senator GORE. I am sorry. I came in after you had commenced your statement and I mistook you for Mr. Alvord.

Mr. PEEL. I am a member of the same law firm as Mr. Alvord, a Washington law firm. I am a member of the Committee on Taxation, and I am rapporteur of the Committee on Taxation, Mr. Alvord is the chairman. Neither of us is employed by the U.S. Council. To the best of my recollection, I have served on the Taxation Committee for about 5 years.

Senator GORE. Are you retained?

Mr. PEEL. No. We are not paid for this.

Senator GORE. Under what capacity do you testify today for the council?

Mr. PEEL. In my capacity as a member of the Committee on Taxation.

Senator GORE. Did you have any part in organizing the ad hoc group of 10 companies for which Mr. H. J. Heinz II spoke in testifying before the House Ways and Means Committee last year?

Mr. PEEL. No, sir, I did not.

Senator GORE. Are you acquainted with that group?

Mr. PEEL. I know there was such a group. Mr. Heinz and Mr. Nebolsine were active in it.

Senator GORE. Mr. Chairman——

Mr. PEEL. I don't know the names of all the companies.

Senator GORE. Mr. Chairman, for almost a year now, I have been trying to learn the origin of this group for which Mr. Heinz presented testimony. It is only today that I have learned, before coming to the committee meeting, that the real genesis of this organization was in the International Chamber of Commerce. I would like, with the permission of the committee, to read a letter I have addressed to Mr. Heinz and his reply.

The CHAIRMAN. Proceed.

Senator GORE. This letter is dated April 17, 1962.

DEAR MR. HEINZ: You will recall that last year you presented testimony to the House Ways and Means Committee, on behalf of some 10 companies, on the tax reform proposals of President Kennedy. Your testimony at that time seemed to have a marked effect on the committee and was widely reported in the press. Since that time, as you undoubtedly know, the House has passed the tax reform bill, H.R. 10650, and this measure is now the subject of hearings before the Finance Committee of the Senate.

Since your testimony, presented on behalf of these 10 companies, was one of the most important parts of the testimony before the Ways and Means Committee on those proposals relating to the taxation of operations abroad, I had assumed that you would appear before the Finance Committee to go over the same or similar testimony and bring the statistics you presented up to date to include the year 1961. I was keenly disappointed to learn that you will not appear before the Finance Committee.

I digress from the letter, Mr. Chairman, to say that I have publicly, in proceedings of this committee and on the floor of the Senate, expressed a desire that Mr. Heinz appear before our committee to respond to questions about his testimony before the Ways and Means Committee. There are many interesting questions raised by his testimony.

In view of the fact that you will not appear before the Finance Committee, I wonder if you would be good enough to supply certain information to me for my study in connection with this bill.

First, I would like to know who organized your group. You testified in the name of the Industry Committee on Foreign Investments. Is this a permanent organization? When was it organized, and who are its officers? Who employed Mr. Sawyer? How many other companies' books were examined in the process of selecting these 10 for which statistics were presented? Where was Mr. Sawyer employed in 1960, and where and by whom is he employed now?

Second, I note in your testimony before the Ways and Means Committee, that you were questioned about the large increase in the outflow of funds for investment abroad in 1960 over 1959. You were to furnish an explanation, but had not done so by the time the hearing went to press. I would like this information, and, further, I would like to have figures for 1961 for these companies comparable to those you presented for past years.

Third, a number of the companies in your group have licensing agreements as well as subsidiaries abroad. Could you furnish some comparison of the exports generated by subsidiaries and by licensees. Specifically, I note that Goodyear has what are called manufacturing arrangements in several foreign countries. Are these licensing agreements, and what exports do they generate, if any? Also Eastman Kodak reported sales to foreign subsidiaries in 1960 of $64 million, and sales to dealers of $40 million. What are the arrangements with these dealers, and how do they operate?

Fourth, in your own company it appears that selling, general and administrative costs are being shifted rather heavily to the parent corporation. For instance, on a gross profit of $72 million by the U.S. corporation, selling, general and administrative expense amounted to $61 million, leaving an operating profit of $11 million. On the other hand, on a gross profit earned by foreign subsidiaries of $60 million, your company showed selling, general and administrative expenses of only $40 million, leaving an operating profit of $20 million. These figures are from form 10-K for your fiscal year ending May 3, 1961. I note that you have a Swiss subsidiary, but your foreign tax was $8.9 million, certainly a substantial figure. It would be helpful to me and to the Finance Committee to have an explanation of the above figures.

Fifth, Otis Elevator changed its fiscal year in 1960 and, as a result, paid three dividends in that year amounting to $3 million from total reported foreign earnings of $4.7 million. I would like to know what the comparable figures were for 1961.

Sixth, I am unable to find any information on the Cabot Corp. except that it owns 41 percent of Texas Butadiene, another of the companies in your list of 10. Is the Cabot Corp. an industrial company? I am unable to find it listed in "Moody's Industrial Manual for 1961."

Seventh, the Texas Butadiene French sales and investment operation raises a number of questions. Is the 25 percent of sales being permanently invested in France completely free of U.S. tax? Is this being written off as a sales commission through its Canadian and other foreign subsidiaries? Also, did the export figures you gave include the full price of these French exports? What part of the price was actually remitted currently?

Eighth, Merck's report for 1960 shows $6.5 million remitted from earnings of $10.5 million. This was a considerable step-up from remittances for other recent years. Is the step-up in remittances continuing through 1961 and into 1962? There appears to be a rather large number of subsidiaries owned by a Panama subsidiary. Is this a new development, a reorganization?

Ninth, General Electric's Jelco subsidiary does a large foreign engine leasing business through a great many foreign subsidiaries. How were these earnings handled in your statistics? Is there any foreign insurance or reinsurance operation in connection with Jelco's or GE Credit Corp.'s operations, foreign or domestic?

Tenth, Pfizer's figures seem not quite to add up. That company's consolidated 10-K for 1960 shows earnings of $38.9 million by the U.S. company and its more than 60 active branches, subsidiaries, and affiliates operating in more than 40 countries, on which U.S. tax of only $6.9 million and foreign taxes of $5.8 million were paid. This seems to be a rather large earnings-to-tax ratio. Research and development expense was shown as $18 million. Was all this charged to the U.S. parent corporation? Royalties in the amount of $4 million were received. How much of this was received and retained abroad in a tax haven? There is a particularly intriguing statement in this company's 10-K to the effect that, "No provision for Federal income dividend tax in respect to the subsidiary companies' earnings retained at December 31, 1960, is included in the consolidated statements, inasmuch as it is considered that such earnings are essential to the continued operation of the subsidiaries' business." It would appear that foreign subsidiary earnings were about $24 million, of which only $4 million was repatriated. Does the above-quoted statement mean that the other $20 million is being invested in bricks, mortar, and machinery abroad, and will never become subject to U.S. tax?

Eleventh, how were operations involving mining, oil, gas, hydroelectric generation, and so on, handled in your statistics for these supposedly industrial companies? I note specifically that Union Carbide has a power-generating facility in Norway, as well as extensive mining and, perhaps, oil and gas operations; Armco has mining operations and also handles many allied products through its foreign subsidiaries; Monsanto has a large subsidiary, the Lion Oil Co.

Twelfth, four of the companies you stated you represented were either subsidiaries or divisions of larger U.S. corporations. How much of your data came from the parent corporations of these subsidiaries?

As I believe you can see from just the few brief facts and questions outlined above, your testimony before the Ways and Means Committee needs clarification and amplification in many respects. I would hope that you will be

able to appear before the Finance Committee before the end of the current hearings, now tentatively scheduled to terminate on May 3, 1962.

I shall look forward to hearing from you at an early date, and would like your permission to make your reply a part of the record of the hearings before the Finance Committee.

Senator GORE. Now, Mr. Chairman, I would like to read Mr. Heinz' reply, which I have just received. I will leave it to the committee to determine as to what extent he replied to my questions.

Dated April 24, it says:

DEAR SENATOR GORE: I have your letter of April 17 and am pleased to reply to the questions which are within my capacity.

I digress to say he didn't limit his capacity in appearing before the Ways and Means Committee. He undertook to speak quite authoritatively, in the statement he read, for these 10 companies that were doing such a great service toward the solution of the balance-of-payments problem of the U.S. Government, but now when I present these specific questions he confines his reply to less than a page and a half, with 2 short memorandums attached, and proposes to answer "within my capacity."

In your paragraph first, you have asked about the organization of the 10-company committee. I enclose herewith a brief history of this group entitled "Memorandum re 10 Companies," which I think is responsive to your questions. The ad hoc group of 10 companies which submitted its data in a joint presentation through me to the House Ways and Means Committee has performed its function of testifying and has no reason for continued existence as a committee. I have not been delegated to speak for the 10 companies on any matters outside of the statements I have presented to the Congress.

In your paragraph fourth, you raised some questions concerning the Heinz Co. You will find our answer in the memorandum entitled "H. J. Heinz Co. Reply to Senator Gore's Inquiry" attached.

In paragraphs 2d to 12th, excepting paragraph 4th, you inquire as to matters of which I have no personal knowledge.

I have asked Mr. Sawyer, the public accountant who helped present the data received from the 10 companies, for information in respect to your second question. He informs me that the increase in outflow for foreign investment from $30.5 million in 1959 to $61.8 million in 1960 was spread between 9 of the 10 companies. He also informs me that he has no data for 1961 pertaining to capital outflow.

In respect to your paragraph third, Mr. Sawyer advises me that the figures he has contain no breakdown for exports generated by licensing agreements.

In regard to paragraph 12th, Mr. Sawyer advises me that 6 of the 10 companies were international or oversea subsidiaries or divisions. In each case the data used in the 10-company study came from the subsidiary or division.

With respect to some of the general remarks that you have made in reference to the 10-company study, may I refer you to the statement I have filed today with the Committee on Finance, a copy of which I attach hereto.

I am entirely agreeable to your publishing this letter and the two annexed memorandums in the record of the Senate Finance Committee hearings on H.R. 10650.

Sincerely,

H. J. HEINZ II.

Senator GORE. I would request, Mr. Chairman, that the memorandums he attaches to his letter be made a part of the record.

The CHAIRMAN. Without objection, the memorandums attached to the letter which you read will be inserted in the record. Let me add, Senator Gore, that the Chair has just received from Mr. H. J. Heinz II a letter, with attached exhibits, which I think should appropriately be placed in the record following the discussion with Mr. Peel.

(The memorandums referred to by Senator Gore follow:)

APRIL 17, 1962.

H. J. HEINZ CO. REPLY TO SENATOR GORE'S LETTER INQUIRY

The H. J. Heinz Co. figures which you have taken from our fiscal year 1961, 10-K statement are entirely correct. These figures indicate quite clearly that selling, general, and administrative expenses for our foreign companies are relatively much lower when compared to gross profit than are similar expense to gross profit results of the U.S. company. A comparable but more inclusive analysis of these figures indicates the following:

	U.S. companies[1]	Foreign companies[1]
	Percent	*Percent*
Sales	100	100
Cost of sales	60	67
Gross profit	40	33
Selling, general and administrative expense	34	22
Operating profit	6	11

[1] These percentages have been rounded to the nearest full numbers and the dollar figures on which they are based are determined by converting foreign currencies at exchange rates at fiscal year end and are influenced by minor technical accounting consolidation eliminations. However, the percentages are essentially correct for the purpose under discussion.

These percentages indicate quite clearly that our foreign business is almost twice as profitable (at the operating profit level) as is our U.S. business. Foreign companies' cost of sales are higher than comparable U.S. company costs (by 7 percentage points), but selling, general, and administrative expenses of foreign companies are substantially below similar U.S. cost items (by 12 per-percentage points).

The assumption in your letter that selling, general, and administrative costs have been shifted from the foreign companies to the U.S. parent company is in error. Each individual company stands on its own in regard to selling, general, and administrative expense (and as to all other items of expense and income). The books of each company are audited by independent certified public accountants and their certificates are included in the fiscal year 1961 form 10-K.

Our profitable foreign operations have added significantly to the U.S. balance of payments and to U.S. Government income taxes. Perhaps you have already noticed that our fiscal year 1961 10-K form shows dividends from subsidiaries of $3,952,000. In addition to this amount, we received fees from subsidiary companies of $577,000 which figure is included as a reduction of U.S. selling, general, and administrative expense. These fees are a second avenue of getting U.S. dollars from our foreign investments.

It is important to note that while the net asset values of subsidiaries at fiscal year 1961 yearend were $73 million, the total cumulative equity investment plus outstanding loans in these companies was $17 million. The dividend and fees received by the U.S. company during fiscal year 1961 of $4.5 million represent a return of 26.5 percent on the total dollars invested, namely $17 million.

Since the start of our first foreign company, we have returned to the U.S. parent 2.8 times the cumulative investments in such companies in the form of dividends and fees alone. In every single year, since 1942, the subsidiaries' dividends and fees alone have exceeded that year's investment of U.S. dollars. In addition to the receipt of dividends and fees from subsidiaries, these companies also have purchased significant amounts of U.S. machinery, equipment, and agricultural products. The following figures summarize the balance of

payments effect of our foreign subsidiary companies for the 10-year period fiscal year 1952 through fiscal year 1961:

Funds flowing into United States:	
Dividends from subsidiaries	$22,700,000
Interest on loans to subsidiaries	300,000
Fees from subsidiaries	3,800,000
Services purchased by subsidiaries from U.S. suppliers other than parent company	1,300,000
Capital equipment purchased by subsidiaries	3,700,000
Agricultural products purchased by subsidiaries	36,700,000
Total	68,500,000
Funds flowing out of United States:	
Investment in foreign subsidiaries in the form of either equity or loans	10,700,000

It is readily apparent how our subsidiary investments have benefited the U.S. balance of payments. None of the funds flowing into the United States would have taken place had we not started and successfully operated our foreign subsidiaries and the net favorable balance of payments can be expected to increase further over the next 10 years.

Our Swiss subsidiary company was established in fiscal year 1961 and is in charge of a full-time executive domiciled in Switzerland. This company was organized for the purpose of investigating, organizing, and administering foreign business opportunities primarly in the Common Market area. To date this company does not have any earnings, but we hope that over the next 10 years it will become as profitable as have our other subsidiary companies and will be paying taxable dividends and fees to the parent company as do our other longer established subsidiaries.

The foreign income taxes of $8.0 million represent a substantial amount as you have observed. This substantial amount is the result of the very profitable, independent, operations of our foreign companies. The income tax rates of our profitable subsidiaries are approximately equal to the U.S. corporate tax rate of 52 percent. As already mentioned, these foreign subsidiaries remitted to the U.S. parent some $4 million in dividends plus almost $600,000 in fees.

We hope that this information answers your specific questions concerning the H. J. Heinz Co.

April 23, 1962.

MEMORANDUM RE 10 COMPANIES

How did the study originate?

On December 16, 1960, Mr. Ralph Reed, president of the U.S. Council of the International Chamber of Commerce, asked Mr. Heinz to chair a committee composed, in addition of Mr. H. J. Heinz II, of three other members of the executive committee of the U.S. Council: Messrs. Leo Welch (replaced later by Mr. Emilio G. Collado), Walter L. Lingle, and George Nebolsine. The subject to be considered was the problem presented by the threat of restrictive treatment of direct foreign investment of U.S. companies in view of the continuing imbalance of payments of the United States.

Mr. Heinz conferred at length and on several occasions with members of the committee and their colleagues.

It became evident at a fairly early stage that many of the statistical questions involved could not be adequately dealt with within the tax committee or the foreign investment committee of the U.S. council, nor were the committees of the NAM, of the U.S. Chamber of Commerce, and of the National Foreign Trade Council in a position to deal with them. What seemed to be lacking was a channel for expressing the concrete experience of some U.S. enterprises with substantial direct investments abroad. It was felt necessary to show in facts and figures the effects of foreign direct investment upon the balance of payments of the United States on exports, etc. Such data, it was felt, would be useful to examine the public interest in the continuance of direct investment abroad.

The project was to be limited to about 20 companies. In discussing it with a few companies having substantial foreign investments, Mr. Heinz found a receptive attitude and a meeting was called of those interested in pooling their experience in this field. At a meeting called to discuss the problem, a questionnaire was discussed to be answered by each participating enterprise. An ad hoc group was loosely organized to carry the project to a conclusion. Mr. H. J. Heinz acted as chairman.

The first questionnaire was nonstatistical in character. The results were found encouraging, but not susceptible of easy presentation in summary form.

Prof. Emile Benoit of Columbia University, an expert in this field of economics, was brought in as consultant to the project.

A second approach was tried in the form of a joint balance-of-payment balance sheet for the participating companies. This approach likewise proved to be impractical. The questionnaire was complicated and required interpretation which resulted in companies answering it in different and unreconcilable ways. Furthermore, the questions were insufficiently broken down for an analysis of the exports of the enterprises in question.

Mr. Albert E. Sawyer, a well-known independent accountant, practicing under the style of Albert E. Sawyer Co. at 84 William Street, New York, N.Y., was engaged by the ad hoc group to assemble the confidential data from the participating companies. Mr. Sawyer had no authority to select companies for inclusion in the group.

To get a further breakdown on exports, a third questionnaire, called the Supplemental Questionnaire, was circulated to the group on May 12, 1961. This supplied the bulk of the material ultimately used in the presentation.

The answers given to this questionnaire have been compared with the answers available from a number of the 19 companies given to the Department of Commerce questionnaire (Form BE 600). While the 19 company questionnaire and the Department of Commerce questionnaire each called for certain data not called for on the other, to the extent the data was similar, their correlation was virtually complete. This means that much the same data that has entered into the 19 company study entered into the Department of Commerce study.

The first time that statistical material was assembled and made available for consideration by the participating companies was in a compilation of the figures for 14 companies under date of May 25, 1961. As will be noted, all of them, except Cincinnati Milling Co., appeared in the ultimate 19-company statement. Meanwhile, several additional companies to the 14 sent in their figures and made up the total of 19.

Companies withdrawing from project

At the start of the study on foreign investment, several petroleum companies attended meetings. It soon appeared that the "extractive" industry should not be mingled with "manufacturing" and they withdrew from active participation. Standard Oil Co. of New Jersey presented its own testimony before the House Ways and Means Committee (Record, p. 2676). The United States Steel Corp., whose foreign operations turned out to be very largely extractive, also withdrew. Cincinnati Milling Co. withdrew for private reasons and elected not to participate. Raymond International withdrew before answering the statistical questionnaires and appeared with another group. Koppers withdrew before answering the detailed questionnaire of May 12, 1961. In no case did the committee reject any manufacturer's participation or request any company to withdraw.

The group was organized to present the joint data to the Congress. It had an executive committee, but no formal constitution or organization. It does not plan continued activity.

Senator GORE. I would like to observe, Mr. Chairman, that this is ample and sufficient evidence for the conclusion that this was a case of special pleading. This group of 19 companies was organized under the aegis of the International Chamber of Commerce. The statistics of various companies were studied. Nineteen companies were selected that appear to fit a pattern. Most of the companies had long had investments overseas and were receiving dividends in substantial amounts from these matured investments. According to this memorandum, "It was felt necessary to show in facts and figures the effects

of foreign direct investment upon the balance of payments of the United States on exports," et cetera. "Such data, it was felt, would be useful to examine the public interest in the continuance of direct investment abroad."

But the information given to the House Ways and Means Committee was not general information. It was untypical data, it was special pleading from a group organized for that purpose. That was why I had undertaken to examine Mr. Heinz' statement and only today learned that his group was organized under the aegis of the organization which the distinguished gentleman now before us represents. I will be glad for you to comment if you would like.

Mr. PEEL. Well, Senator Gore, I would like to comment. I am not sure what you mean by being organized under the aegis of the United States Council. Certainly the presentation was not made on behalf of the United States Council to the Ways and Means Committee. The United States Council did not collect the information from these companies. Mr. Heinz is a member of the executive committee of the United States Council.

Senator GORE. May I read you the statement upon which I base that conclusion?

On December 16, 1960, Mr. Ralph Reed, president of the United States Council of the International Chamber of Commerce, asked Mr. Heinz to chair a committee composed, in addition to Mr. H. J. Heinz II, of three other members of the executive committee of the United States Council—

and so on. The whole memorandum proceeds to outline the development of this group, and it was, according to this memorandum, Mr. Ralph Reed, president of the United States Council of the International Chamber of Commerce who asked Mr. Heinz to chair the group.

Does that satisfy your question?

Mr. PEEL. Yes, it does. I was not aware of that fact.

(Following the hearing the Chairman received the following letter from Mr. Milo G. Coerper, of Coudert Bros., written at the direction of Mr. H. J. Heinz II, clarifying the organization of the 19 company groups referred to:)

COUDERT BROS.,
Washington, D.C., May 7, 1962.

Hon. HARRY F. BRYD,
Chairman, Senate Committee on Finance,
New Senate Office Building,
Washington, D.C.

DEAR SENATOR BYRD: This is to inform you that the 19-company group headed by Mr. H. J. Heinz II was not a committee of the U.S. Council of the International Chamber of Commerce.

By way of explanation permit me to state that the occasion for the filing of this statement arose out of the questioning of Mr. Peel by Senator Gore before your committee on April 25, 1962. The impression was left by Senator Gore that the 19-company group was operating under the aegis of the U.S. Council of the International Chamber of Commerce. Both the U.S. council and Mr. Heinz have been informed of the questioning of Mr. Peel by Senator Gore and they do not wish to have this impression left uncorrected on the record.

Ordinarily, this statement would have been signed by Mr. Heinz. Unfortunately, he is presently out of the country. Under the circumstances, and in order to meet the filing deadline, I have been directed by cable to file this statement on his behalf.

With assurances of high regard, I am
Your sincerely,

MILO G. COERPER.

Senator DOUGLAS. Will the Senator yield? Are you through?

Senator GORE. Yes.

Senator DOUGLAS. May I ask my colleague if he believes that these 19 were relatively untypical of American companies, either doing business abroad or subsidiaries?

Senator GORE. Both relatively and entirely untypical.

Senator DOUGLAS. Does the Senator from Tennessee believe that quite possibly these 19 showed a much higher percentage of earnings returned to the United States and hence subject to taxation than would be true of corporations and subsidiaries at home?

Senator GORE. I do, indeed. And it was for that particular reason that I hoped Mr. Heinz would appear before the committee, but he doesn't feel it necessary to appear here. He submits a memorandum and then, in response to my questions, says he is no longer empowered to speak for the 19.

Senator DOUGLAS. Does the Senator believe that these 19 possibly generated a much larger proportionate volume of exports than the typical cross section of American corporations and subsidiaries abroad?

Senator GORE. Yes; I believe that is true. Furthermore, some of the export generation credited to direct investment was actually more directly connected with other foreign corporations.

Senator DOUGLAS. And that, therefore——

Senator GORE. In which, I should add, the U.S. corporations had only portfolio investments.

Senator DOUGLAS. Therefore, that these 19 would exaggerate the claims which the United States had upon the rest of the world in the form of exports of commodities which had to be paid by foreign exchange from abroad and by returned dividend payments which constitute American claims against foreign countries; is that correct?

Senator GORE. I think that is true. If one assumes these 19 companies are typical, then the best way to solve our balance-of-payments problem, the best way to solve our unemployment problem, is to move all of our factories and our industry and our business abroad.

Senator DOUGLAS. The Senator from Tennessee is bringing out the point that in all probability they would be untypical.

Senator GORE. Leave out the probability. They are entirely untypical. Would you like to make any comment? I am not asking you to. I know you were not prepared to testify on this and I do not wish to put you in an unfair position. I am not asking you to respond at all.

Mr. PEEL. I am simply not prepared to say at all whether those 19 companies were representative or were not representative. I don't even recall at the moment what the 19 companies were although I have seen the list.

Senator GORE. I certainly do not wish to be unfair to you and I shall not ask you to comment.

That is all, Mr. Chairman.

The CHAIRMAN. Senator Carlson?

Senator CARLSON. I shall not get into this discussion on the Heinz testimony before the House Ways and Means Committee because it has not been called to my attention before. It is the first time I heard of it.

I was listening to the discussion between the distinguished Senator from Illinois and the Senator from Tennessee and I am sure they would not want to leave the impression that they were opposed to the right of petition. If we are getting to the place where there might be some question——

Senator DOUGLAS. Not at all; I want to make that clear.

Senator GORE. I am not opposed to the right of petition or the right of people to testify. I am a little allergic to special pleading, though, or to an organized effort to mislead a committee of the U.S. Congress.

Senator CARLSON. Well, of course, the Senator from Tennessee used the word "mislead." After all, a citizen, I think, of the country should feel free to appear before any committee of the House or Senate and express his views. They may not agree with mine and they may not agree with those of the Senator from Tennessee.

As I listened to this discussion among the Senators—and I know what their feeling is; they would be the last to object to a citizen appearing before this committee or any other committee. If they want him to appear—I didn't want the record to show that there were two distinguished Senators from this committee that did have concern about people appearing before this committee. I think that is an individual right of a citizen or representative of the corporation.

Senator GORE. Would you join with me in an invitation to Mr. H. J. Heinz to testify if he desires?

Senator CARLSON. I would be happy to join in, if he wants to, and if he doesn't want to that is his perfect right as a citizen of the United States.

Senator GORE. I didn't say request, I said invite.

Senator CARLSON. That is fine with me. I would be very happy so far as I am concerned if he appeared. At the same time, if he didn't care to appear that is his privilege. The point I wanted to get in before we concluded the testimony, I heard Secretary Dillon's statement in regard to this foreign tax, and I am concerned with this one point, and that is that in his own statement he wanted to discourage investments abroad in order to encourage investments at home.

Is there any reason to believe that by discouraging investments abroad that we can encourage investments at home in order to increase our gross national production, and our employment; what about that?

Mr. PEEL. I do not believe there is any reason to believe that at this time. If I understand the economic situation, and if I understand the position of the administration on the economic situation in this country, it is that we have a situation in which there is an underutilization of resources in this country.

In other words, we are not operating at anything like full capacity. In fact, one of the basic points of the administration's economic policies, as I understand it, is to increase the degree to which we are utilizing our factors of production, and thus increase the rate of growth.

In a situation like that, it isn't a question of having just so much in the way of plant capacity or manpower and dividing it up in a certain way so that, if you invest abroad, you have to cut down your domestic investment by the same amount.

As I understand it, that is not the situation in this country today, and so there is no reason why foreign investment should result in a commensurate cutback in domestic investment. It would be perfectly possible to have both.

Senator CARLSON. It is my sincere hope that we can have both and they both be profitable to our own corporations and to our own country.

That is all, Mr. Chairman.

The CHAIRMAN. Senator Curtis?

Senator CURTIS. No questions.

The CHAIRMAN. Thank you very much. We recall your association when you were on the staff of the joint committee. We are glad to have you, Mr. Peel.

(The letter and accompanying exhibits received from Mr. H. J. Heinz II, previously mentioned by the chair, follow:)

H. J. HEINZ CO.,
Pittsburgh, Pa., April 24, 1962.

Hon. HARRY FLOOD BYRD,
Chairman, Senate Committee on Finance,
Washington, D.C.

DEAR SENATOR BYRD: May I have your permission to submit for the record of the hearings of your committee a statement in regard to the economic aspects of U.S. direct foreign investment?

The Treasury has insisted both before the House Ways and Means Committee and before your committee that direct foreign investments, particularly in Europe, have adverse balance-of-payments effects. In its presentation before the House committee the Treasury emphasized the disparity between the rate of current investment and the current dividend returns from Europe.

The Industry Committee on Foreign Investment was an ad hoc group formed by 19 prominent manufacturing companies to present a joint statement of their own experience in respect to direct foreign investment to the House Ways and Means Committee to reply to this contention by the Treasury. I represented this ad hoc group in presenting its data to the House committee on June 8, 1961, and submitted at the same time a memorandum prepared by Prof. Emile Benoit of Columbia University, who had acted as consultant to the group. These statements were printed in the record of the hearings (p. 3185).

There followed a further exchange of views. The Treasury submitted a memorandum to the House Ways and Means Committee which was printed in

the record of the hearings (pp. 3522-3534). The ad hoc group authorized me to file a reply to this memorandum with the House committee, which was done under date of January 24, 1962 (exhibit I), accompanied by a memorandum by Professor Benoit (exhibit II). These documents could not be printed in the record of the House hearings because it had already been closed.

My first request to you is that I be permitted to file these two memorandums with your committee since they in large measure answer points still being pressed by the Treasury at the hearings held by your committee on H.R. 10650 on April 2, 1962.

In addition, since Secretary Dillon introduced some new arguments in regard to the economic aspects of direct foreign investment, I would request leave to submit a further memorandum by Professor Benoit dealing with the very complex argumentation of "Treasury's Exhibit III" (appearing in the record of your committee's hearings at p. 203), which, I think you will agree, can only be handled by an economist skilled in this domain. The statement my Professor Benoit is, I think, most helpful and I submit it to your committee herewith (exhibit III).

The ad hoc group of the 10 companies, which appeared as the Industry Committee on Foreign Investment, having performed its defined function of presenting a joint statement of their experience to the Congress, is no longer active and Professor Benoit's statement is being submitted as consultant to me and the H. J. Heinz Co. in this connection.

The extended controversy with the Treasury on the very complex economic questions involved in appraising our policy toward direct foreign investment has led me to seek a more fundamental analysis of this important question. An objective analysis of the relevant economic data is generally recognized to be desirable. Accordingly, I have written on March 28, 1962, to the National Industrial Conference Board, the well-known independent research organization in the field of industrial economics suggesting that it undertake a study of the impact of direct foreign investment upon exports and imports (exhibit IV). I also have suggested that the 10 companies that participated in the ad hoc group turn over to the NICB, for confidential use, all the data that they submitted to Mr. Albert E. Sawyer, the accountant who handled the compilation of data for the 10 companies. I have a letter from the NICB (exhibit V attached), in which it declares itself favorably disposed toward the proposal and stresses the urgency of the need of such a study regardless of the outcome of the current policy issues.

Sincerely,

H. J. HEINZ II.

EXHIBIT I

DIRECT FOREIGN INVESTMENT

AND

UNITED STATES ECONOMIC POLICY

STATEMENT OF

INDUSTRY COMMITTEE ON FOREIGN INVESTMENT

January 24, 1962

Professor Emile Benoit
Columbia University, Graduate School of Business
Consultant on Economics

George Nebolsine
Coudert Brothers
of Counsel

American Machine & Foundry Co.
Armco International Co.
Cabot Corporation
Continental Can Co.
Corn Products Co.
Eastman Kodak Co.
General Electric Co.
Goodyear International Corp.
H. J. Heinz Company
Merck Sharp & Dohme International
Monsanto Chemical Co.
Otis Elevator Co.
Pfaudler Permutit Co.
Pfizer International, Inc.
Ritter Company, Inc.
Taylor Instrument Companies
Texas Butadiene & Chemical Corp.
The Procter & Gamble Co.
Union Carbide Corp.
Members

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INTRODUCTION

A number of leading American businesses with overseas operations have been seriously concerned at the drift of the Administration's thinking with respect to U. S. direct foreign investment. Such investment has, for many years, been regarded by the U. S. Government as highly desirable, not only as contributing to a better equilibrium in the balance of payments, but, more importantly, as contributing U. S. management skills and enterprise to major free-world political objectives.* Now under the impact of recent balance of payments pressures and the outflow of gold, the Administration seems to be taking the position of disapproving such foreign investment—at least in economically advanced countries.

The evidences of this new attitude and the source of this concern are two: First, a proposal for a radical change in our tax legislation with the apparent objective of lessening U. S. direct foreign investment at least in economically advanced countries; second, the use by the Administration of arguments in support of this proposal which presage the possibility of further attempts to limit direct foreign investment if the proposed tax changes fail to deter foreign investment sufficiently.

In the sincere conviction that this reversal of traditional U. S. policy would be a profound mistake because seriously harmful to our economic objectives and to our free-world political aims, the undersigned companies contributed to the making of an economic study designed to explore the economic issues involved, and in particular to explore the balance of payments effects of U. S. direct foreign investments. The results of this study showed that the notion that direct foreign investments burdened the U. S. balance of payments and contributed to the loss of gold might be mistaken. Strong evidence was adduced from the 19 company figures that the net effect of U. S. direct foreign investment might have aided the U. S. balance of payments and thereby helped to check the outflow of gold. The

*See statement by Undersecretary Douglas Dillon, August 27, 1960. "Private capital, carrying with it management techniques and abilities, not only contributes directly to economic growth; it also provides the picture of our free-enterprise system in action. . . . In short, if the free world is to stay free, if the spark of international economic progress is to be fanned into glowing health, there must be greater activity by private investors."

group of companies made no assumption that their figures were a fully accurate sample of all industry. They said:

"The data presented suggests that an analytical approach is possible and that such an approach may produce quite a different picture from that submitted by the administration. This suggests that extensive study is needed to furnish a basis for sound conclusions."*

This evidence has been dismissed as "not representative" in a Treasury rebuttal.** Since the companies which prepared this study are understandably concerned that the Treasury Department seems to have misunderstood the nature and purpose of their original study, they have felt it desirable to prepare this reply to the Treasury Memorandum by reviewing both the specific questions and the broader economic issues raised by the Treasury Memorandum.

It is necessary, by way of foreword, to emphasize that this presentation deals only with the economic aspects of the Treasury case. We disagree with the Treasury tax proposals regarding foreign income on other grounds than those presented in this statement, but rely upon other industry spokesmen for the presentation of these objections. However, we should not be understood as defending the evasion of U. S. taxes through the use of foreign subsidiaries or by any other means. What we do question is a basic change in our tax laws which will penalize and discourage foreign investment in economically advanced areas based on what we believe to be inadequate and incomplete supporting data.

1. THE DIFFERENCES BETWEEN THE ECONOMIC VIEWS OF THE TREASURY AND INDUSTRY

The Treasury's basic proposal, here under discussion, is the taxation of earnings of U. S.-owned or partly-owned foreign companies in economically advanced countries irrespective of their being declared as dividends and transferred.

The main economic motive advanced for this proposal is to reduce the incentive to make such foreign investments on the grounds that direct for-

*See Hearings before the Committee on Ways and Means, House of Representatives, President's 1961 Tax Recommendations, p. 3197 (hereinafter referred to as "Hearings"). The House Ways and Means Committee will be referred to as the "Committee".

**Hearings, pp. 3522-3534, hereinafter referred to as "Treasury Memorandum".

eign investments in economically advanced countries have a negative effect on the U. S. balance of payments and thus diminish our gold reserves.

In support of this allegation, the Treasury based its chief case on the observation that, from 1957 to 1960 inclusive, U. S. outflow of capital into direct investments in European and Canadian subsidiaries was $655 million greater than the amounts returned in dividends.

Industry testimony questioned the validity of the data so segregated; it pointed to substantial U. S. exports and receipts of royalties, management fees, etc. generated by direct foreign investments. The U. S. balance of payments situation would, industry in effect contended, actually have been worse in the absence of this foreign investment.

The Treasury sought to justify its economic argument by making a further point that exports generated by investments are offset by the displacement of American exports of goods that would otherwise have occurred and by imports of goods produced by subsidiaries abroad, thus leading to the argument that direct foreign investment in economically advanced countries exports U. S. jobs.

We believe the facts that are available controvert this largely hypothetical argument.

The two positions may be briefly summarized as follows:

THE TREASURY POSITION	INDUSTRY POSITION
A. The balance of payments effects of direct investment viewed for the economically advanced countries (Western Europe and Canada) independently show a capital outflow to such countries exceeding returns in dividends, thus burdening the U. S. balance of payments.	The segregation of the figures for economically advanced and underdeveloped areas for purposes of balance of payments statistics is unsound. Direct foreign investments yield direct returns which exceed the outflow of capital.
B. Industry's contention that direct foreign investment is responsible for large income from invisibles and direct U. S. exports is unproved.	Direct foreign investments have generated an inflow to the U. S. far larger than the outflow of capital funds. The inflow consists, apart from dividends, of royalties, fees

	and directly generated exports of capital equipment, components, intermediates and other goods.
C. Direct foreign investments reduce U. S. domestic investments.	Direct foreign investments do not generally reduce U. S. domestic investments.
D. Direct foreign investments export U. S. jobs, slow up the U. S. economy and increase U. S. unemployment.	Most direct foreign investments are made to prevent the loss of foreign markets or to develop new foreign markets. Such investments do not export but save jobs for U. S. workers. Imports from foreign subsidiaries are very limited and have had no appreciable effect on U. S. employment.

A. IS CAPITAL OUTFLOW FULLY COMPENSATED BY DIVIDEND AND PROFITS REMITTED?

The Department of Commerce figure for net inflow of dividends over and above capital outflow for the decade 1950-1960 was $7.6 billion (Hearings, p. 3523). The Treasury considers this world-wide data to be irrelevant to its proposals with respect to discouraging capital outflow only to the economically-advanced countries. It points to the figures for the short period of 1957-1960 for this area during which a net outflow of capital over inflow of dividends amounted to $655 million (Hearings, p. 3523), of which Western Europe accounted for $421 million. These are the key figures in the Treasury's economic argument.

Upon further analysis, it becomes evident, however, that it is improper to segregate Europe and Canada from the underdeveloped countries' figures. The reason for this is simple. The petroleum industry, which accounts for a very large portion of the total figures, makes closely-interrelated investments in the underdeveloped countries where oil is extracted and in the economically advanced countries where refineries are built and distribution facilities are created. The two investments complement each other but their returns appear in entirely different tabulations of dollar flow. While the refining and marketing subsidiaries of U. S. companies pay divi-

dends which appear in the Treasury's statistics on investments in Western Europe, the more important returns on the oil sold to Western Europe appear as a dollar inflow from foreign branches of U. S. companies in underdeveloped countries.

If this dollar inflow were to be correctly attributed, for balance of payments accounting, to the countries where the sales which give rise to them were made, then the figures for the Standard Oil Company (New Jersey) alone would overturn the Treasury deficit attributed to Europe for the years 1957-1959.* If the earnings of all the oil companies were similarly attributed, then they would show a large surplus inflow from Europe on investments in every year except 1960, when the balance was quite close.

B. DO DIRECT FOREIGN INVESTMENTS STIMULATE EXPORTS OF U. S. PRODUCTS AND SERVICES?

The Treasury contends that only capital outflow and dividend returns are significant figures in the balance of payments. The stimulation of substantial exports by direct foreign investment, it contends, is unproved.

The Department of Commerce takes a very different view. It has stated, in an important study of foreign investments:

> "A major result of assembling these data on the overall effects on balances of payments of direct foreign investments, is to point up the inadequacy of conclusions about these effects based solely on considerations of the relationship between net capital outflows and income receipts." (Emphasis added)**

Professor Emile Benoit stated to the Committee:

> ". . . Considering, first, the balance-of-payments aspect, it is grossly inappropriate to confine one's attention, as Secretary Dillon has done, to the outflow of capital and the inflow of earnings from capital previously invested."

He stated further:

> "I would argue, on the contrary, that a fair appraisal of the net effects of such foreign investments must take into account a variety of payments receipts, which are directly connected with the investments made in previous years. . . . The total of these receipts directly related to our foreign investments in Europe thus came [in 1957] to $779 million, which exceeded the $287 million of direct capital investment outflow by $492 million."

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*Testimony of Mr. Collado, Standard Oil Co. of New Jersey, (Hearings, pp. 2670-2676).

**U. S. Business Investments in Foreign Countries, Department of Commerce, 1960, p. 67.

The amount of the inflow from sales of goods and services attributable to direct foreign investments of manufacturers has been the subject of several surveys by the Department of Commerce as well as by industry. The 1957 Commerce study,* while admitting its incompleteness, stated that enough information was obtained to permit marking out some of the general magnitudes involved. It noted the close connection between export of capital and capital equipment exports, and in particular, that one-fourth of U. S. exports of machinery in 1957 were to subsidiaries of U. S. companies. Exports of industrial components and industrial materials to such subsidiaries amounted to about one billion dollars. Receipts from management fees and royalties (invisible exports) totalled $250 million dollars. These large export figures throw doubt on the validity of the thesis that such exports may be disregarded.

In a recent survey by the Department of Commerce which was submitted to the Committee under date of June 22, 1961, the figures on export to foreign subsidiary companies for 155 companies were collated. The total "exports to, or developed by, foreign subsidiaries" is stated as in excess of $2.1 billion in 1959 and $2.6 billion in 1960. The report states:

> "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. . ." (Hearings, p. 429)

As the Treasury Memorandum states, this is not conclusive.

To get information for the Committee on these important points, a number of manufacturing companies prepared their own survey, based on a more detailed questionnaire. This is the so-called "19-company survey", which was presented to the House Ways and Means Committee by the undersigned.

It was not claimed to be a scientific sampling of manufacturing companies. Its results were, however, exceedingly important, because they showed in absolute terms a very large export trade generated by direct foreign investment. The data relates preponderantly to the economically-advanced countries which account for 80% of manufacturing investment by U. S. companies.**

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*U. S. Business Investments in Foreign Countries, Department of Commerce, 1960, p. 67.

**Table 3, p. 22, Survey of Current Business, August, 1961.

The participating companies supplied information as to receipts from their foreign subsidiaries, broken down under several headings, set forth on the annexed chart. (Hearings, p. 3185)

Individual figures of participating companies were not disclosed but were consolidated by Mr. Albert E. Sawyer, an independent accountant. The chart, entitled "Summary of Data Presented by the '19 Companies' Relating to Balance of Payments", shows the excess of inflow over outflow of dollars for the 19 companies. These 19 companies in direct exports of capital goods and materials not for resale showed exports of over $150 million in each of the years studied amounting to $676 million for the four-year period. These exports alone exceed the complained-of imbalance in the economically-advanced areas' returns on capital outflow of $655 million upon which the Treasury relies.

In addition to the 19 companies, many individual companies testified to exports being stimulated by foreign investments. It would be impossible to do full justice to this factual testimony in a few lines. A few samples are quoted in Appendix 1A.

Thus both industry testimony and the Department of Commerce surveys are contrary to the Treasury view that substantial exports are not shown to be stimulated by foreign investments.

C. IS DOMESTIC INVESTMENT DIMINISHED BY FOREIGN INVESTMENT?

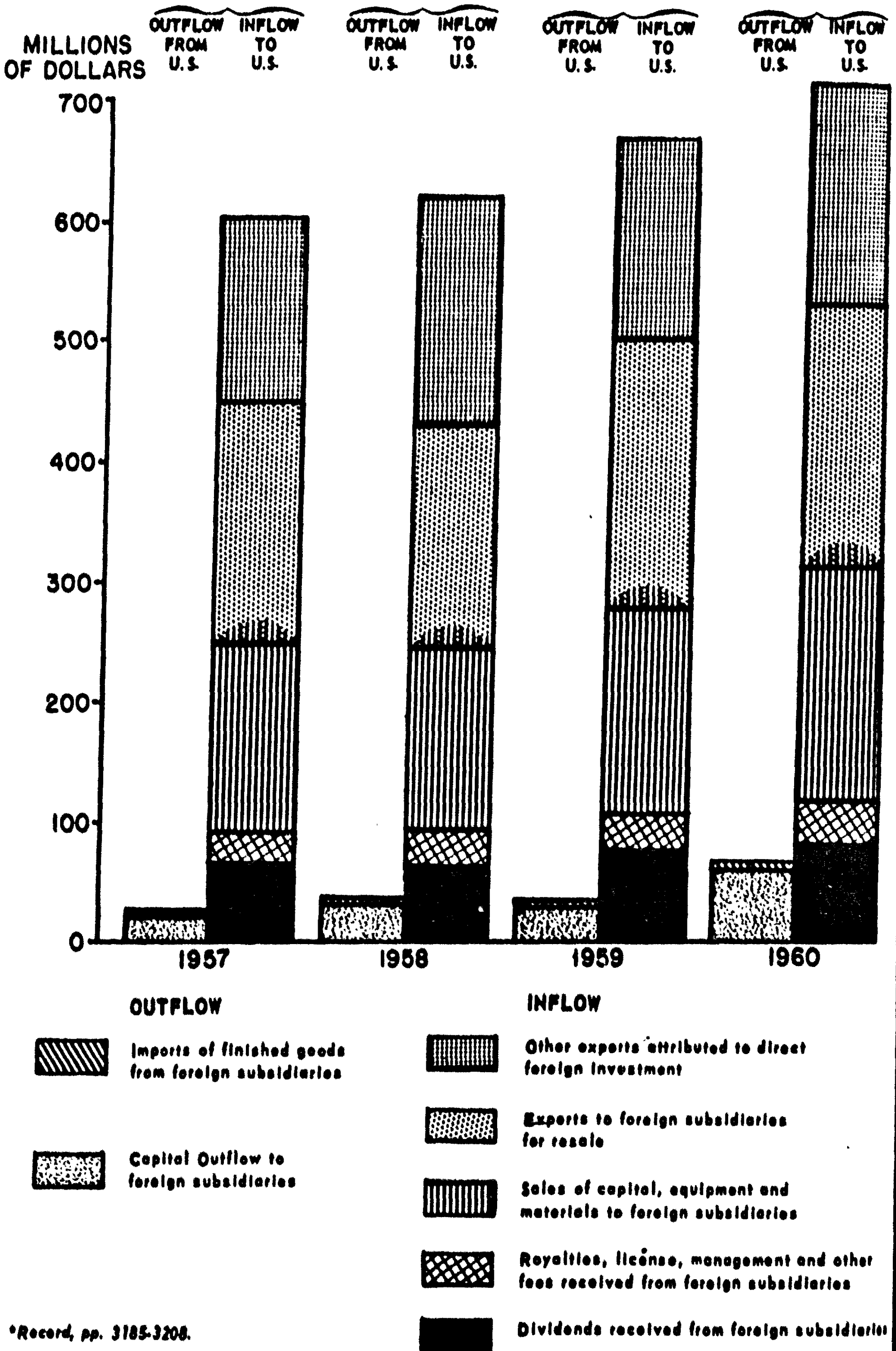
The Administration makes the point that if foreign investment in the economically-advanced countries were to be deterred, more capital would be available at home. "Are we going to export our goods and our crops, or are we going to export our capital? That is the question we are now facing."*

This reasoning proceeds on the implied assumption that an exported capital dollar is a dollar lost to U. S. domestic investment. This might be true if there were a shortage of capital for domestic investment, but there is no shortage of capital for investment in the United States.

On this point, Mr. Neil McElroy, Chairman of Procter & Gamble Co., testified as follows:

> "As far as our company is concerned, we have never been short of capital sources to do anything that we found economic justifica-

*President Kennedy's speech, Miami, December 7, 1961.


SUMMARY OF DATA PRESENTED BY THE "19 COMPANIES" RELATING TO BALANCE OF PAYMENTS *
MILLIONS OF DOLLARS
OUTFLOW FROM U.S.
INFLOW TO U.S.
700
600
500
400
300
200
100
0
1957
1958
1959
1960
OUTFLOW
Imports of finished goods from foreign subsidiaries
Capital Outflow to foreign subsidiaries
INFLOW
Other exports attributed to direct foreign investment
Exports to foreign subsidiaries for resale
Sales of capital, equipment and materials to foreign subsidiaries
Royalties, license, management and other fees received from foreign subsidiaries
Dividends received from foreign subsidiaries
*Record, pp. 3185-3208.

tion to do in this country. Our problem is not access to capital, and I believe this is true of most American companies. I mean most. Our problem is not access to capital; our problem is the development of management and the development of ideas that will justify the investment of capital. Now, we are trying to do both as rapidly as we can, but in our case there would be absolutely no substance to the point that if we did not continue to invest overseas as we are doing, we would invest more rapidly and more generously in this country." (Hearings, p. 2938)

On the overall position, Professor Benoit stated:

"Had we been experiencing a relative shortage of domestic savings, relative to profitable investment outlets for such savings, then a case could be made that conserving the capital for domestic investment might result in a higher volume of employment and economic activity inside the United States than would result from the export of such capital. This has, however, most emphatically not been the situation in the United States since 1957 . . ." (Hearings, p. 3189)

The competitive market requires investment to be made on a broad basis whether it be in warehouses, sales offices, or assembly, light manufacture or, for good reason, basic manufacturing. The American scene is full of examples of industries which are spread throughout the country for similar reasons.

D. IS THE SUGGESTION THAT DIRECT FOREIGN INVESTMENT EXPORTS JOBS SOUND?

Direct investment, in the context of its causes as well as its generating effect on export business, should not be viewed, on balance, as exporting U. S. jobs. As we have seen, exports stimulated by direct foreign investments have made or saved many jobs for U. S. workers. Moreover, many forms of foreign investment cannot, because of their very nature, displace domestic production.

(1) Activities requiring a foreign location.

Large foreign investments go into the extraction of petroleum products for marketing in foreign countries and into other extractive industries and particularly newsprint and other essential goods for the U. S. market.

Local utilities, such as power and telephone companies serving foreign markets and machines required by foreign engineering projects, such as dams and highways, require export of capital.

If the above activities were not performed by U. S. foreign investment, they would either not be performed at all or would be performed abroad by

foreign enterprise. Clearly, as to those investments, no contention can be made that they take jobs away from Americans. In this connection, International Telephone And Telegraph Corporation (engaged in the electrical and electronic equipment business) testified:

> ". . . If foreign subsidiaries sell less abroad as a result of the Treasury proposals, the gap will be filled largely by our foreign competitors, not by U. S. exports. This is quite obvious in the particular case of ITT, because many of our customers are official bodies which will not buy products manufactured outside their countries. But, given the competitiveness of rival enterprises abroad, the case also applies generally." (Hearings, p. 2969)

(2) Local activities dictated by foreign government policies.

A second type of foreign investment that could not export jobs was referred to by many witnesses citing cases of import barriers being erected to permit a local industry to replace imports.

This was testified to in respect to pharmaceuticals, soap, automobile components, mining machinery and other items. (Hearings, pp. 2851, 2922 3304). See Appendix 1B.

(3) Prohibitive freight costs.

Foreign investments have also been required because of weight-cost relationships precluding overseas shipment. Examples of this are cited in Appendix 1C.

(4) Lower Costs.

Lower production costs are also a factor. In the case of mining machinery, a witness testified:

> "When a foreign manufacturer quotes such prices in international trade as those shown in the preceding exhibit, the jobs in our factories that depend on exports of those machines have already left our shores. Joy did not export those jobs." Joy Manufacturing Co. (Hearings, p. 3246)

We have given four clear reasons for manufacturing abroad which quite obviously cannot be said to cut down on employment at home.

E. THE TREASURY REBUTTAL

The Treasury Memorandum views the Department of Commerce study of the 155 companies as "inconclusive". It speaks of the 19 company data as "not representative". We do not disagree with either of these characterizations; we believe, however, that there is enough validity in the figures presented in both studies to suggest strongly the need for thorough ex-

ploration of this fertile field of economic data to determine on an objective basis to what extent foreign investments are responsible for generating exports of capital goods, materials for processing and other goods.

The Treasury Memorandum lays considerable stress on the theoretical possibility of other factors offsetting the exports generated. While recognizing the absence of any quantitative evidence, it points, for instance, to the possibility that exports that would have been made may be displaced by the foreign investment and that imports from foreign subsidiaries add to the outflow of dollars. In our view both of these points are susceptible of further analysis. Until new data is made available indicating that these offsets are of major proportions, the large figures for generated exports in the studies above referred to should not, we believe, be regarded as irrelevant.

The existence of an urgent problem should not, in any event, lead us into taking precipitant action which may accentuate rather than alleviate the problem. While from an accounting point of view capital outflow appears as a debit in the balance of payments, the concrete business realities, we have shown, involve a close and significant relationship between direct foreign investment and large credit items in the balance of payments.

II. WHAT IS A SOUND ECONOMIC POLICY FOR THE UNITED STATES IN RESPECT TO DIRECT INVESTMENTS?

A. U. S. COMPETITIVE ABILITY IN FOREIGN COUNTRIES SHOULD NOT BE HANDICAPPED.

The Treasury rejected the policy of equalizing the taxation of U. S. foreign subsidiaries with the taxation of their foreign competitors in favor of equalizing the taxation of U. S. foreign subsidiaries with that of U. S. located enterprises (Hearings, p. 34).

The policy of burdening U. S. foreign operations with discriminatory taxes, as compared to those borne by their foreign competitors, ignores the numerous cases cited above, where the U. S. foreign subsidiary is not in competition with any U. S. based operation but solely with foreign based competitors. Instances can readily be cited of competitors of U. S. concerns in Holland or Switzerland enjoying a far lesser total tax burden on their operations in other countries than do their U. S. competitors.

It must always be recalled, furthermore, that the securities of several large foreign companies enjoying tax advantages over their U. S. competitors are now listed on the New York Stock Exchange or offered to U. S. investors over the counter. "Portfolio investment" in such securities has grown rapidly and has contributed to the outflow of dollars, without the beneficial effects attributable to direct foreign investment.

The rejection of the equalization of tax burdens between foreign subsidiaries and their foreign competitors in our judgment (a) handicaps U. S. competition in important foreign markets and (b) would reduce rather than increase U. S. exports because of the export generating nature of direct foreign investment.

B. AMERICAN ENTERPRISE RIGHTFULLY DESIRES TO PARTICIPATE IN THE COMMON MARKET.

American enterprise should not be deliberately handicapped vis-a-vis its strong competitors in any market. This is especially applicable to the Common Market, which is recognized as the fastest growing market in the free world today. Support from all branches of the nation's economy for a new trade policy with this area is being sought, yet in the same breath it is said that direct investment in this area is no longer to be encouraged. These rival policies are confusing to business, since they are essentially conflicting.

We believe the position to be that U. S. private enterprise is inextricably tied to the expanding economy of the economically advanced countries of Western Europe and that this relationship, being of mutual value, must be protected from erosion of all kinds.

C. THE BASIC POLICY OF PERMITTING FREEDOM OF CAPITAL MOVEMENT MUST BE MAINTAINED.

Capital movements within the Common Market and other parts of the world are rapidly becoming free. With this historic achievement about to be realized, it would be particularly unfortunate for the United States to discourage capital movements of its nationals in the Atlantic Community. Such an attitude would make Americans less desirable as partners in many new capital ventures abroad, as lacking their own government's support in making direct investments. It would be unfortunate if the painfully

achieved confidence that has made possible U. S. private capital participation in the rapid economic growth in the Atlantic Community should be subjected to vague and shifting threats of restriction, control or discouragement. American industry has much to contribute to capital and technological, managerial, and sales techniques to the free world economies. Such a contribution will be vitally needed if the ambitious growth goals announced recently for the OECD countries are to be met.

D. THE IMBALANCE IN OUR PAYMENTS REQUIRES BASIC, NOT PERIPHERAL REMEDIES.

Statements have been made by members of the Administration that balance of payments drains must be met by immediate measures and that a discouragement of direct foreign investment would be a helpful measure.

The basic causes of our imbalance of payments must, of course, be faced. This necessity cannot be avoided by proposals directed toward minor aspects of the balance of payments problem. Even if all the Treasury arguments were accepted at face value, such measures would not provide an adequate or lasting solution of this problem, whereas, from the standpoint of American industry and the American economy, it is quite certain that definite harm would result.

The solution of the balance of payments problem will necessarily affect a great many varied interests and may require changes in current accepted policies. We plead that such changes be soberly reviewed, since our national interest requires the adoption of a solution which will cause the least harm to our economy and to the principles of free enterprise we advocate.

(s) H. J. HEINZ II
H. J. Heinz II, Chairman
Industry Committee on Foreign Investment

APPENDIX 1 A

INDUSTRY TESTIMONY OF THE EFFECTS OF DIRECT FOREIGN INVESTMENT ON BALANCE OF PAYMENTS

Willys Motors, Inc. showed exports of $151,226,000 of components to foreign subsidiaries over a five-year period, representing approximately $30 million per year. (Hearings, p. 2681)

The Caterpillar Tractor Co. showed the inter-relationship between its foreign production and U. S. exports:

> "In the first place, none of our products is produced completely abroad; many of the components such as engines, transmissions, et cetera are produced in our U. S. plants and shipped to the foreign plant. This creates export business for the United States because - and I would like to make this very plain - if we did not manufacture our product abroad some foreign competitor would get the order and that competitor would manufacture his product without using any components manufactured in the United States." (Hearings, pp. 3033, 3034)

The Joy Manufacturing Co. testified as to the saving of U. S. jobs by its foreign investment:

> "Here you see that exports of components from this factory to our foreign manufacturing subsidiaries provide 1 day of work per week for Franklin. Did we not have Joy factories abroad, 20 percent of our present workmen there would be idle." (Hearings, p. 3247)

Eastman Kodak Co. showed exports to foreign subsidiaries in the amount of over $60 million annually:

> "During these 15 years we have received in dividends from our subsidiaries in foreign countries $101 million. Even more important than this, however, we have during the same period sold $532 million of goods manufactured in our U. S. factories by American labor to our overseas companies alone, exclusive of other overseas dealers. During this same period our purchases from our foreign subsidiaries were $29 million." (Hearings, p. 3214)

APPENDIX 1 B

INDUSTRY TESTIMONY OF THE EFFECTS OF DIRECT
FOREIGN INVESTMENT ON BALANCE OF PAYMENTS

"Our foreign investments were not made at the expense of our exports from here, but rather because exports became difficult or impossible, due to trade barriers, tariffs, legislation, or arbitrary decisions protecting or favoring local industry in foreign nations, establishment of local factories and plans by competitors, et cetera." Abbott Laboratories International Co. (Hearings, p. 2581)

As to soap and related products, it was testified:

". . . Almost every country in the world has, or is easily incited to create, protective tariffs and import restrictions which make impossible the export of any real volume of soaps and detergents from the United States for any sustained length of time.

For example, profitable export of our types of products to such industrialized European countries as Great Britain, France, West Germany and Italy is an impossibility.

* * *

. . . We have been forced by such developments either to arrange for local manufacture in those countries or to face going out of business there altogether, thereby abandoning those markets to foreign competitors." Procter & Gamble Co. (Hearings, p. 2922)

Automobile components have had similar treatment:

". . . Artificial barriers enclosing a foreign country—that is, tariffs and content-requirements regarding labor and materials - might well dictate the building of a new component plant on foreign soil in order to enable us to continue exporting other components from this country. . . . We would either have to build the plant or cease selling our products in that country." Dodge Division, Chrysler Corp. (Hearings, p. 3304)

Mining machinery has also experienced similar restrictions:

"Furthermore, certain foreign governments deny import licenses for a machine or repair parts when that machine or part is made in its own country. We have been forced by such official pressure in certain instances to manufacture abroad." Joy Manufacturing Co. (Hearings, p. 3246)

APPENDIX 1 C

INDUSTRY TESTIMONY OF THE EFFECTS OF DIRECT FOREIGN INVESTMENT ON BALANCE OF PAYMENTS

It was testified as to floor covering:

> ". . . even where the manufacturing costs are as high as, or higher than, those in the United States, as is true in the case of the products we manufacture abroad, the saving in ocean freight, insurance and duty permits prices to be maintained at competitive levels." Armstrong Cork Co. (Hearings, p. 3471)

And as to plumbing and heating equipment:

> "The products that we manufacture are essentially heavy and bulky and present a freight problem of such dimensions that it becomes a practical impossibility to compete with local manufacturers unless we also manufacture locally. . . ." American Radiator & Standard Sanitary Corp. (Hearings, p. 2894)

EXHIBIT II

CONTRIBUTIONS OF DIRECT FOREIGN INVESTMENT TO OUR BALANCE OF PAYMENTS

By Professor Emile Benoit

of the

Columbia University, Graduate School of Business

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STATEMENT BY EMILE BENOIT TO THE HOUSE WAYS & MEANS COMMITTEE, IN REPLY TO THE TREASURY MEMORANDUM OF JUNE 29, 1961*

The House Ways & Means Committee has invited those who participated in the preparation of testimony last year with reference to the proposal to tax U. S. industry for the profits of foreign subsidiaries as earned, to comment on the Treasury memorandum[1] criticizing their testimony. The following comments bear exclusively on the central issues raised by the Treasury with respect to the balance of payments effects of direct foreign investment. There are other aspects of the Treasury position which also appear to me to be mistaken but I have confined myself in this memorandum to what appeared to be the chief economic argument of the Treasury in support of its proposal for a radical revision of our foreign tax law.

BACKGROUND

The Administration last year proposed to raise the effective taxes on U. S. industry by taxing the profits of its foreign subsidiaries as earned and before their receipt by the United States taxpayer. One announced purpose was to reduce the outflow of U. S. foreign investment, at least to the developed areas, in order to strengthen the U. S. balance of payments and reduce the gold drain.[2] A number of leading U. S. businesses with overseas operations questioned this proposal on the ground (among others) that, if such tax measures did, as the Treasury hoped, result in a reduced outflow of direct investment, this might accentuate rather than benefit the balance of payments problem because of the very

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* Hearings Record p. 3522.

[1] Statistical Data and Economic Issues Involved in Treasury's Testimony on Tax Deferral, submitted by the Secretary of the Treasury to the House Ways & Means Committee under letter of June 29, henceforth referred to as "The Treasury Memorandum".

[2] "Concluding that referral damages the balance of payments, it (the Treasury) decided that the time was most appropriate to end a tax preference that could no longer contribute to national objectives. Deferral should not have been ended right after the war, as the United States was then concerned to aid in European reconsruction by promoting an outflow of private American capital. It should not be ended now for the less developed countries as the United States is now concerned to promote development in those countries. But there can be no justification for continuing deferral for the developed countries, and there is every reason to anticipate that ending it now would strengthen the balance of payments" ("The Treasury Memorandum").

large dependence of U. S. exports and invisible earnings on such investment. These company spokesmen urged that taking such exports into account, as well as the invisible earnings from dividends, royalties, management fees, etc., the net contribution of such investment to the balance of payments might be highly favorable. One group of nineteen such business concerns, accounting for upwards of 5% of all foreign direct investment in manufacturing, which I have had the honor to advise in this matter, arranged for a special study of their own experience in that regard, which showed a highly-favorable balance of payments effect arising from this direct investment.

The Treasury, in a later memorandum (June 29, 1961) reviewing the industry comments, dismissed this study as "misleading" and "irrelevant" because the company sample was "not representative" and because it failed to provide a breakdown as between developed and under-developed areas and between subsidiaries and foreign branches. The treasury also reiterated its earlier contention that any exports and invisible earnings attributable to investment might be offset by losses of U. S. exports and increased U. S. imports attributable to the competition of U. S. foreign subsidiaries.

The Validity of the Nineteen-Company Study

The contention of the Treasury that the nineteen-company sample is not representative of all industry was conceded in advance,[1] and is not really the issue. The real issue is whether the amount of investment-induced exports and invisible earnings of these nineteen companies is not large enough, all by itself, to cast considerable doubt on the Treasury's contention that direct investment burdens the balance of payments. So conceived, the study retains validity and utility. It showed investment-generated exports of $676 millions over the four years 1957-60 compared to the $655 million deficit complained of by the Treasury. At the least this study pointed up the need for a more detailed study by the government on this key issue.

A further study was in fact requested from the Commerce Department and eventually issued. This study by the Department of Commerce, which covers 80% of all U. S. foreign investment in manufacturing, confirmed the broad conclusions of the 19-company study. It showed exports to, or

[1] Testimony of Mr. H. J. Heinz, II introducing the study. (Hearings, p. 3185)

developed by, U. S. foreign subsidiaries to have reached the enormous totals of $2.1 billion in 1959 and $2.7 billion in 1960 - of which about $1.5 billion in 1960 was to Europe and Canada. These amounts are greatly in excess of the payments deficits which the Treasury attributed to foreign investment by U. S. subsidiaries.

While divergencies exist between the Commerce Department study and the nineteen-company study concerning the amounts of investment-generated exports found per dollar of direct investment, these divergencies may be, in large part, explained by the different approaches used in the two studies: These differences were (1) the nineteen-company study, unlike that of the Commerce Department, included some non-manufacturing subsidiaries (other than trading subsidiaries) of U. S. manufacturing parents; (2) the nineteen-company study included subsidiaries where U. S. participation was under 25%; (3) the investments in the nineteen-company study were probably of above-average maturity, and therefore had generated an above-average flow of exports and invisible earnings; and (4) the nineteen-company study involved a more detailed questionnaire, with interview follow-ups to assure consistency in the responses, with the result that some investment-generated exports overlooked in the Commerce study may have been brought to light in the nineteen-company study.

Irrespective of which may have produced more valid results for their respective samples, the Commerce Dept. study, being the study with the wider sample is in many respects more indicative and it is a source of satisfaction that its main conclusions closely parallel those of the nineteen-company study: namely, that large amounts of exports are generated by direct foreign investments, amounts which greatly exceeded any burdens imposed on the balance of payments through the outflow of funds associated with making these investments.

THE TIE BETWEEN EXPORTS AND DIRECT INVESTMENTS IN THE BALANCE OF PAYMENTS

The Treasury's expressed doubts about the realism of the exports attributed to direct foreign investment raise some question as to the meaning of the balance of payment analysis. Especially is this so with respect to the exports of capital equipment to be used by the investor in estab-

lishing his overseas production unit. The financing of such exports can take several forms.

(1) Dollars may be sent abroad in making the investment, and a substantial part of these dollars may be returned within a short period by the foreign subsidiary in which the investment is made as payment for capital goods to be installed in the plant which the subsidiary is building abroad.

(2) In some cases, the investment dollars, in fact, may never leave the United States but may be deposited instead in an account in the foreign subsidiary's name in a United States bank. The foreign subsidiary may then purchase the capital equiment for its foreign plant in the United States and pay for such equipment out of its New York bank account.

(3) In other cases, a United States investor may make his investment, not in dollars, but in capital equipment shipped in kind. When received in the foreign country the foreign subsidiary will issue shares of its stock equal in value to the value of the equipment.

Of these three types of financing, only the first involves any actual flow of dollars out of the United States and even this is usually of brief duration, with a reflow frequently occurring within the same year. Similarly in the second type of case, although there is a temporary flow of dollars into "foreign" accounts (i.e., of U. S. owned foreign subsidiaries) in U. S. banks, there is certainly no long-term loss of dollars to foreign countries. In the third type of case, there is no transfer of dollar funds at all. Yet, in all these cases, the value of the capital equipment shipped is included as a debit item in the Balance of Payments, offsetting the exports of this equipment. While this is perfectly sound balance of payments accounting, it can convey a seriously misleading impression to the uninitiated. The actual reality in all these cases is, after all, the export of the equipment. For balance of payment accounting reasons, it is necessary to posit a debit item which offsets the export, although in many cases, the actual outflow of funds may be transitory or entirely absent.[1] It would be paradoxical indeed to treat the accounting debit involved in the investment as the genuine reality and question the reality of the export—yet this is what the Treasury's position almost seems to come to.

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[1] Mr. Walther Lederer, Chief, Balance of Payments Division, U. S. Department of Commerce, in a speech before the American Statistical Association in New York City on December 28, 1961, discussing the balance of payments, stated as follows:

"First of all it is important to understand that balance of payments compilations are done on the principle of double entry

SEGREGATION OF INVESTMENTS IN DEVELOPED AND UNDERDEVELOPED AREAS

The Treasury has criticized the relevance of the industry testimony on the ground that it fails to segregate the investments in the economically-advanced areas from those in under-developed areas. It claims that on a segregated basis, the investments of subsidiaries in Europe and Canada show a deficit over remitted dividends of $655 million from 1957 to 1960, and that since its proposed tax changes would apply solely or primarily to the developed areas, any testimony based on world-wide figures may be dismissed as irrelevant.

As previously indicated, the inclusion in the computation of investment-generated exports would readily offset this claimed deficit. Moreover, the significance of the Treasury's attempted distinction will depend upon what legislation is finally proposed; no currently pending draft of a bill makes this distinction. Even aside from these points, the Treasury's conclusion that the over-all data are wholly irrelevant and may be dismissed seems excessively harsh. The data of the nineteen companies, and of the Commerce Department study were limited entirely to direct investment of manufacturing companies. It so happens that four-fifths of direct investment in all U. S. manufacturing abroad _is_ in the developed countries. Thus a large majority of the investment-induced exports and invisible earnings shown in these studies do in fact refer to the effects of investment in the developed areas. Similarly, it should be noted that the Commerce Department survey found that the nearly 60% of the manufacturing exports to subsidiaries were to England and Canada exclusive of the other developed countries.

There is also an additional question of importance as to the statistical validity of the overall segregation between the balance of payments

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accounts, in which each transaction is shown as a credit as well as a debit item in exactly the same magnitude.

"Consequently, the total of all transactions also results in an equality of the total credit and debit entries. The balance of payments is always in balance. This concept generally is not followed in the collection of the data and it is often forgotten in the interpretation of the account itself.

"Second, the transactions included in the balance of payments presentations are not limited to those involving international payments in 'money', usually consisting of gold, dollars, or other freely usable currencies, during any single period. The data cover all transactions involving transfers of resources, both real and financial."

in the developed and in the underdeveloped areas as shown by the Treasury when it includes the extractive industries. Thus Mr. Collado, Director of Standard Oil Company of New Jersey, noted in the hearings that the apparent deficit for the developed areas may be a statistical illusion arising from the fact that, as a result of the complex pricing structure of the international oil industry, the larger part of the earnings of certain major companies are attributed in the balance of payments accounting to the underdeveloped countries from which the oil is extracted, whereas the bulk of the actual earnings and dollar reflows arise from the heavy investments in refineries and distributive outlets in the developed countries.

Clearly then, if the figure for direct investment abroad includes investments made in the form of capital equipment or dollar deposits in United States banks for use in purchasing U. S. capital equipment, the offsetting figure in the export account cannot be ignored. While there is no official estimate of the amount of such investment-exports, the Department of Commerce estimates that from $650 million to $1 billion in the 1957 direct foreign investment total of $2.1 billion represented "Capital from the United States" used for "direct financing of capital equipment exported from this country", "for the use of the foreign enterprises". The magnitude of this figure raises the most serious question as to the soundness of the Treasury analysis which seeks to minimize the effects on exports of direct investment abroad.

Confusion may be further enhanced by the fact that the Treasury's presentation also shifts the combined surpluses with Japan, the Union of South Africa, Australia and New Zealand from the developed to the underdeveloped areas in 1960.[1]

Segregation of Subsidiary from Branch Operations

The Treasury has similarly questioned the relevance of much of the adverse data cited against its position on the ground that, since its proposed tax measures bear only on subsidiaries, any evidence concerning direct foreign investments in general, which includes branch operations, is necessarily irrelevant.

Here again, the criticism would appear to have limited validity when applied to data concerning foreign investment of manufacturing companies

[1] Thereby exaggerating the contrast between developed and under-developed areas by over $50 million. See Treasury Memorandum, Table 2.

to which, in fact, both the nineteen-company study and the Commerce Department study were confined. This arises from the fact that, based on 1957 data, over 95% of all foreign investment in manufacturing takes the subsidiary, rather than the branch form.[3] (This trend appears, if anything, to have been accentuated since 1957.)

Hypothetical Offsets

The final argument against the data on investment-generated exports, adduced by the Treasury, relates to the possibility that the favorable balance of payments effects of investment-generated exports and invisible earnings may be exaggerated or offset by displacement of U. S. exports and increases of U. S. imports resulting from the operations of U. S. foreign subsidiaries. Such a claim would be more plausible if the investment-generated exports and invisible earnings were relatively small items which could easily be offset. In fact, however, if the Commerce Department finding of $ 2.7 billion of investment-generated exports in 1960 is anywhere near right (and this, it will be remembered, was confined only to manufactures and was on the basis of an 80% sample), then it is difficult to imagine that offsetting factors of anything like this magnitude could be in existence without having some tangible manifestation.

It is no doubt true that some exports to U. S. subsidiaries would be replaced by other exports if there were no such subsidiaries; nevertheless, the extent of such hypothetical replacements could hardly be very large. Even if one entirely dismisses the sales to trading subsidiaries, the latest Commerce Department study shows on the basis of an 80% sample about $1.6 billion of sales to manufacturing subsidiaries in 1960, of which about $1 billion is accounted for by Canadian and Western European subsidiaries. It seems very unlikely that any large part of these sales would have occurred except for the existence of U. S. direct investment projects. Such new projects, if locally financed and owned, would ordinarily utilize locally produced equipment, components, spare parts and materials. It is only because the equipment costs are financed by the U. S. investor that the foreign exchange authorities have in many cases approved of the dollar imports. In other cases the availability of lower cost competitive

[3] U. S. Department of Commerce, U. S. Business Investment in Foreign Countries, Table 9, p. 97.

equipment from non-U. S. sources or the influence of banking or other business connections abroad would have resulted in a preference for utilizing locally produced equipment, etc.

As for the U. S. imports from U. S. subsidiaries, these are relatively small. The Commerce Department study shows that imports of manufacturers from European subsidiaries in 1960 were under $100 million and from Canadian subsidiaries (other than paper, pulp and foodstuffs) were $117 million. Nor does it seem at all likely that sales of U. S. subsidiaries have, to anywhere near this extent, been able to replace U. S. export markets <u>that could have been held</u> in the absence of such investments. This qualification is important since a parallel decline in export sales and increase in subsidiary sales does not by any means prove that the establishment of the subsidiaries has been <u>responsible</u> for the loss of export markets. On the contrary, in many cases, the loss, or threatened loss, of export markets has been responsible for the new investment in subsidiaries, which was intended to prevent the otherwise inevitable loss of these markets to locally-owned businesses. It is the considered judgment of the business community, as evidenced by the testimony of the witnesses at the Hearings, that the old concept of passive exporting from the U. S. in response to spontaneously emerging orders from foreign customers has been replaced under postwar competitive conditions by a need for direct and active marketing by U. S. industry in foreign markets. Recent evidence of a wide decline in the international competitiveness of certain U. S.-produced manufactures[4] suggests that losses of certain export markets would, in any case have occurred, and that U. S. investment in foreign subsidiaries has often been designed at least to hold these markets for American-owned enterprises where the competitive conditions no longer made it possible to sell from American-based producer units.

Aside from cases where changes in relative costs preclude continued exclusive reliance on exports, there are many other cases where high transportation costs, import or foreign exchange controls, administrative regulations, or other barriers to U. S. exports have made it impossible to supply given markets by means of exports. A number of such cases were

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[4] See Emile Benoit, <u>Europe at Sixes and Sevens</u>, Chapter 4. "The Dollar Crisis and American Competitiveness", pp. 137-167.

mentioned in the Hearings. It is clear that American producers would generally prefer to supply given markets via exports so long as this can be done, and have embarked on the heavy costs, risks and difficulties of setting up foreign subsidiary operations only when powerful business reasons compelled them to do so. The likelihood of some degree of tariff discrimination arising out of the formation of the European Common Market underlines the importance of our maintaining a dynamic and flexible business policy in competing for these markets, with full freedom to relocate production operations when needed to obtain the same locational, cost and tariff advantages as are available to our chief European competitors.

Nor should it be overlooked that, while many export markets have been lost, new ones have also been created—and often by the very means of direct foreign investment. Even where export markets for certain finished goods have been lost, U. S. firms by establishing assembly plants have often held the market for parts and materials. Far from positively losing export markets as a result of foreign investment, U. S. producers have this year achieved the highest level of exports in our history, and in general export markets have boomed the most in the very areas—especially Europe—where the level of direct investment has been rising most rapidly.

We conclude that the Treasury's assumption that these hypothetical offsets have been sufficient to negate the favorable balance of payment effects of investment-generated exports and invisible earnings is unproved, and even implausible. Nor has the Treasury been able to invalidate industry's argument that direct foreign investment has made a positive—and important—contribution to righting the balance of payments. Any changes in our traditional tax procedures intended to reduce the incentives for and add to the burdens of foreign direct investment can therefore not be validly supported on the basis that this would ease the balance of payments. On the basis of the evidence here reviewed, the effects would be likely to be just the opposite. We are confident that much careful study should be taken before making so drastic a step, which might have results very different from those now intended.

January 24, 1962

(s) Emile Benoit

EXHIBIT III

APRIL 23, 1962.

STATEMENT BY PROF. EMILE BENOIT IN REGARD TO TREASURY TESTIMONY OF APRIL 2, 1962, BEFORE U.S. SENATE COMMITTEE ON FINANCE

I. BACKGROUND

The occasion for the first presentation of their statistics by the 19 companies was the assertion by the Treasury to the effect that the burden imposed on our balance of payment by our foreign direct investment is never fully compensated from dividends, or at least not before 17 years, or at least that investments in economically advanced countries (such as the European Common Market) have adverse balance-of-payments effects as measured by the remission of dividend and the direct foreign investments for a recent period (app. I, pp. 3 and 4).

Statistics presented by 19 companies (record, House Ways and Means Committee hearing, 1961 Tax Recommendations, p. 3197 et seq., hereinafter referred to as "hearings") showed that sales generated by their foreign investments and sales of capital equipment and goods for processing to their foreign subsidiaries amounted to $1,368,700,000 over the 4-year period of 1957 to 1960. This was greatly in excess of the deficit in the balance-of-payment account for all foreign investment as originally measured by the Treasury figures—which wholly ignored exports generated by the investment, as well as royalties and management fees.

The Treasury filed a memorandum after the close of the House Ways and Means Committee hearings in which the figures of the 19 companies were criticized as unrepresentative, inconclusive and out of proportion to those of industry generally and, therefore, to be disregarded (hearings, pp. 3522–3534). The 19 companies in a reply statement (a copy of which is attached as exhibit I) emphasized that data on the balance-of-payments effects of their investments had never been claimed to be representative, but in themselves cast doubt on the soundness of the Treasury's conclusions.

It was further noted that the general trend of the evidence drawn from the 19-company and other industry experience was richly confirmed by the subsequently published study by the Commerce Department which showed, for 155 manufacturing companies, exports to foreign subsidiaries of $2.1 billion in 1955, and $2.6 billion in 1960.

In its recent presentation to the Senate Finance Committee, the Treasury returns to the subject with a repetition of three criticisms, and a radical revision of its basic rationale for the attack on foreign investment.

II. THE VALIDITY OF THE 19-COMPANY STUDY DATA

Once more, the criticism is repeated that the 19-company data are not representative. It seems extraordinarily difficult to convey to the Treasury critics that even though these data are not, and have never been claimed to be, typical, they are substantial enough in themselves to cast serious doubt on the original Treasury argument. The data need not be representative to be damaging; they need only to be right. Further study of the data by Mr. Sawyer, the accountant charged by the 19 companies with collecting and combining the data, tends to confirm its basic soundness. For example, the information provided for the 19-company study, seems to have been virtually identical with the data provided by the same companies for the Commerce Department 155-company study, in all cases where such comparison has so far been possible—due allowance being made for differences in the questions as between the two studies. Moreover, much of the criticism of the sample has arisen from the fact that it was assumed to cover only 5 percent of total value of foreign investments of U.S. manufacturers, whereas in certain respects (e.g., in investment-induced exports), the results seemed extraordinarily high in relation to the size of the sample. The sample had been previously described as accounting for "upwards of 5 percent" of foreign investments of U.S. manufacturing. In fact, it now turns out to be closer to 8 percent. This alone would account for a substantial share of the alleged discrepancies.

However, there is no reason, in any case, to expect that this group of relatively large, well-established companies with preponderantly mature foreign investments would show an identical pattern of foreign investment with other companies which are smaller, less experienced or with a higher proportion of their investments made only very recently. The critics of the 19-company study

have been pushing on an open door by attacking the representativeness of the figures—especially since the 19 companies have indicated that the 155-company study of the Department of Commerce fully confirms the general trend of the data found in the 19-company study.

Another criticism which is repeated by the Treasury is that the data of the 19 companies is irrelevant because submitted on a worldwide basis without any specific segregation of subsidiaries in developed countries, which would alone, it is claimed, be affected by the proposed changes in taxes. While the 19-company data was not submitted with a geographic breakdown or segregation between branches and subsidiaries, we still feel, as indicated in the 19-company statement of January 24, 1962, (app. I) that since the 19-company sample deals only with foreign investments of U.S. manufacturing companies, it seems most probable that the data do largely refer to the developed areas, and to subsidiaries. Around 80 percent of U.S. foreign investment in manufacturing is in the developed countries, and 95 percent of it assumes the subsidiary form.

One other criticism, here repeated, is that some of the investment induced exports may be offset by export displacement from the competition of U.S. foreign subsidiaries. In principle, there is an element of possible truth in this claim, but there is no statistical basis for evaluating how important such a factor might be. There is absolutely no warrant for assuming it is important enough to offset the very large amount of net exports generated by foreign investment. Indeed, there are good business and economic reasons to think that such a tendency would be of limited significance. American manufacturers testify almost invariably that they seek to hold a given foreign market by exporting to it as long as they can hope to do so, thereby avoiding the additional costs and risks of establishing an oversea foreign operation. Wherever the U.S. producer has a product with such a strong market position that it need fear no local competition, he will generally continue to export the product from his U.S. plant, thus economizing on overhead and avoiding the commitment of capital and managerial resources to a foreign operation. Therefore, when a U.S. foreign subsidiary is established, it very rarely displaces a U.S. export that could actually have been saved, or creates new competition from foreign-based producers that would otherwise have been avoided.

Furthermore, a good share of U.S. imports from subsidiaries (which the Treasury subtracts from exports to subsidiaries to determine the net export-creating influence of foreign investments) may not increase U.S. total imports, but simply displace other imports: e.g., imports of small British Fords probably displaced more Volkswagens or Renaults (with which they were in effective competition) than U.S. produced cars, which basically catered to a different category of demand. As a further mitigating factor, some imports from U.S. subsidiaries may indirectly serve to increase U.S. exports—since, in some cases, imports of components from U.S. foreign subsidiaries have reduced the costs of American products and increased their export-competitiveness. (See app. I, pp. 8 et seq., for further discussion of this issue.) Moreover, substantial amounts of imports from U.S. subsidiaries are entirely noncompetitive with U.S. production.

The Treasury has, however, introduced one entirely new criticism of the 19-company study. It is suggested that the figures on capital outflow in the study may include only stock purchases, and exclude unrepaid loans used as working capital. Fortunately, this criticism is readily answered: In fact, unrepaid loans used as working capital, increases in receivables, and trade credits were included in the 19-company estimates of capital outflow.

III. THE NEW TREASURY MODEL

The affirmative Treasury case against foreign investments has, from the beginning, rested heavily on the use of certain arbitrarily simplified "models" designed to show the year-by-year relationship between balance-of-payments outflow connected with foreign investment, and inflows arising from the earnings on such investment. The first model introduced by the Treasury purported to show that the cumulative remittances to the U.S. arising from net earnings of a typical U.S. foreign subsidiary under present legislation would not equal the original investment until nearly 10 years after the investment (chart, model A. Dillon statement before House Ways and Means Committee, May 3, 1957).

The hopeless unrealism of this earlier model has now, however, led the Treasury to develop a more sophisticated model which takes some account, as many critics of the earlier model had requested, of investment-induced exports, and

royalties and fees, as well as dividends. The model also makes a profound breakaway from the earlier one by recognizing that it is entirely inappropriate to derive the key parameters by comparing investments occurring in a limited time period with the inflows received from foreign investments during that same time period. It now acknowledges that such a comparison may give no fair picture of the balance-of-payments effects of investments made during that time period, since the reflows probably do reflect, in part, the effects of earlier investments and may not yet fully reflect the potential balance-of-payments contribution of the investments most recently made.[1]

The Treasury has now broadened its model to include key elements formerly omitted which the 19-company study urged be included for comprehensive consideration of the balance-of-payments effects of direct foreign investments. In some cases no doubt the rates of reflow may be related to total investment. However, very cautious use should be made of aggregate book values reflected in the available data because this was never compiled with this kind of use in mind and contains many conceptional and statistical limitations.

There still remain, however, two fundamental weaknesses in the model which completely invalidate the conclusion reached from the model that it will, on the average, take 7 years before the adverse balance-of-payments effects of the investment are offset.

The first weakness arises from the arbitrary exclusion of part of the relevant data. In determining the export effect of direct foreign investment, the Treasury uses the data from the Commerce Department 155-company study showing U.S. exports to manufacturing subsidiaries, plus exports on a commission basis, minus imports from subsidiaries, and concludes that averaging 1959 and 1960, the ratio of such net exports to subsidiaries to the book value of the existing investments at the time was only 4.1 percent. The data excluded in this estimate are exports of U.S. parents to nonmanufacturing subsidiaries, and which are not sold on a commission basis. The justification of any such exclusion is highly questionable. Most U.S. manufacturers, with parallel manufacturing and trading subsidiaries, will normally sell exports through the trading subsidiary even though the orders have been directly or indirectly generated by the existence of a manufacturing subsidiary which creates and maintains interest in the product line in that market, supplies the capability of servicing, etc. Another reason for including such exports as byproducts of investment is that it takes a considerable amount of investment to establish a trading subsidiary that can operate on a substantial scale. If exports to trading subsidiaries are included as well as imports from such subsidiaries, as we feel they should be, then the net effect in raising the figure for investment-induced exports as a ratio of book value of investment is dramatic. In Europe, the figure is raised from 4 percent to 17 percent.

With this one change, the Treasury's own model completely disproves its own case for the protracted balance-of-payments difficulty arising from foreign investments. Thus accepting for Europe the Treasury's own assumptions of a dividend transfer rate of 7.0 percent of book value of investment, royalties and fees at 2½ percent of investment value, and a revised figure for investment-generated exports of 17.2 percent we come up with a total of 27.6 percent of the value of total investment having a favorable effect on the balance of payments each year. Clearly, any given amount of investment would, with these parameters, generate reflows equivalent to 100 percent of the investment in something like 2¾ years. If then one were to start with an initial investment of $1,000, as the model assumes, then one should properly conclude that the total amount would be repaid in less than 4 years, and that the average outstanding amount would be something under half the original investment during this 4-year period. Beyond the 4-year period, the total inflows arising from the original investment would rapidly come to exceed that investment by substantial amounts. Thus, the slow payoff rate assumed in the Treasury model is seen as highly unrealistic. It is notable, in fact, that a payoff period between 3 and 4 years is far closer to the actual expectations, based on experience of most businesses invested in Europe today.

The model actually used by the Treasury obscures this simple relationship between initial investment and the payoff of this investment by adding on to

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[1] Incidentally, to reproach the 19-company study for having made a similar type of comparison is ill-founded since the latter study was simply trying to show that even accepting the Treasury's own method, the results would be quite different from those the Treasury claimed, if only all the relevant data—such as induced exports—were included within the reflows as favorable balance-of-payments effects.

the initial investment successive installments of further investment (assumed to be growing at a rate of 10 percent a year), and then seeking to discover at what point in the future the returns (including the investment-generated exports) earned on the original investment and on the subsequent doses of investment will achieve equality with the total value of the investment made up to that point. This model is greatly inferior to the simple model which we have proposed above, both because it is unnecessarily complicated and because it obscures the essential relationship between investment and reflows from investment, which is essential for policy determination. If investment at the present time will be fully paid off, from a balance-of-payments point of view, in less than 4 years, and if a nation can afford a temporary balance-of-payments sacrifice during this period for the balance-of-payments assistance which would be derived later, then it should feel free to make that investment. It need not, then, be concerned about how soon it will be able to get a complete balance-of-payments pay-back from next year's enlarged volume of new investment, and from the still larger volume of reinvestment that may be made 2 years hence. By the time next year comes, it will be possible to prevent next year's investment, if it becomes clear that such investment can no longer afford to be made, from a balance-of-payments point of view. But the decision on whether we can afford this year's investment should not be made to depend on the further question of whether we can also afford to make a substantially larger investment a few years hence.

The Treasury's model, even with more realistic export parameters, is still sufficiently abstract and arbitrary in its assumption so as to provide a highly unreliable guide to policy. There is an essential unrealism, for example, in starting in year 1 with an initial investment, but no body of reflows from previous investment. At least such a model is extremely different from the kind of situation to which policy would be applied today. There is a corresponding bias introduced by cutting off the analysis just at the point when reflows begin to exceed the total of investment within the period that has been artificially isolated.

The parameters used by the Treasury may also be criticized because of their heavy dependence on the years 1959 and 1960, which were characterized by a bunching up of investments relative to reflows (such as the Ford investment in the United Kingdom) and which probably leads to unrepresentatively low reflow parameters. Incidentally, the sharp contrast, even as between 1959 and 1960, should induce considerable caution in applying any parameters based on their averaging to an extended period of years in the future.

Finally, one may even raise the question as to whether a comparison of current reflows, with a base of book value of investments, constitutes a reasonable and appropriate way to measure the balance-of-payments effects. For one thing, equipment exports generated by direct foreign investments, are presumably more directly connected with the amount of investment occurring simultaneously or in the recent past, than with the total accumulated book value of such investments. As a second possibility, there may well be serious distortion introduced by measuring current reflows against a base which may be formed to a very limited extent on an original outflow of dollars, and which may represent, in its greater part, a reinvestment of profits which never were in dollar form and which may even have been generated in large part by the use of locally borrowed funds.

In light of the deficiencies and possible misinterpretations of the Treasury model, it is inappropriate to derive from it conclusions on the employment effects of foreign investment. The employment effects of foreign investment necessarily depend on the volume of exports related to that investment which, as noted earlier, are substantially understated both in the original Treasury presentation and its revised model. Thus no valid comparison with the possible stimulating effects on domestic employment from alternate investment at home is possible. In fact, the Treasury's assumption that the dollar invested abroad could instead be invested domestically is open to very considerable challenge.

In any case, the line of analysis involved in the Treasury's presentation cannot be viewed as a sufficient guide to public policy.

EXHIBIT IV

MARCH 28, 1962.

DEAR JOHN: I do not need to remind you that the economic implications of direct foreign investment both in terms of our balance-of-payments and in terms of our domestic employment have been increasingly in public debate. Your recent paper published in the Conference Board Business Record of February 1962, entitled "Controversy Over Foreign Investments" refers to this at some length and comes to the conclusion—which I personally share—that the available data is insufficient in order to make a complete evaluation of these economic implications. The public interest requires that more definite information and analyses be obtained. Industry is concerned by the allegation that direct foreign investment exports jobs and therefore should be curtailed, and feels that a thorough exploration of the data on direct foreign investments by an independent and responsible agency would throw considerable light on these urgent questions.

To this end, I would propose that the NICB undertake a study of the impact of direct foreign investment upon exports and imports on a sufficiently broad basis to yield data heretofore unavailable. It is, of course, to be assumed that the NICB select an appropriate sample of manufacturing business having interests abroad that would meet the normal tests of being representative of the total manufacturing sector of our economy and prepare the necessary questionnaire.

In order to facilitate your undertaking this task, I will urge the 19 companies, that contributed to the so-called Heinz study, to turn over to the NICB for confidential use in connection with a composite study all the data that they submitted to Mr. Albert E. Sawyer, who handled the compilation of data for the 19 companies, and to cooperate with you fully in this undertaking.

I enclose the form of questionnaire used in the 19 company study, which I introduced before the House Ways and Means Committee in the recent hearings on the administration's tax proposals, and have asked Mr. Sawyer to make available to you any thoughts he may have on how to improve and sharpen the questionnaire further if a new study is to be undertaken.

If I may add a final word, I should think that it would be entirely appropriate to seek foundation support for a project of this importance and national interest.

Sincerely,

H. J. HEINZ II.

EXHIBIT V

NATIONAL INDUSTRIAL CONFERENCE BOARD, INC.,
New York, N.Y., April 23, 1962.

Mr. H. J. HEINZ II,
Chairman of the Board, H. J. Heinz Co.,
Pittsburgh, Pa.

DEAR MR. HEINZ: We are most favorably disposed toward your proposal that the board undertake a full-scale study of the economic implications of our foreign investments. As you know, we have greatly expanded our international activities and intend to devote an increasing portion of our resources to efforts such as the International Industrial Conference and to new studies similar to those on comparative costs and foreign-base corporations we issued during the past year.

But over and above the specifics of our program, your suggestion also goes directly to the board's fundamental role of an independent factfinding institution. There are few topics today in greater need of additional knowledge than those involving the future of our international economic relations and of the vast changes now taking place in world markets.

I think particularly that there is a great need to pursue the pioneering work begun last year by the group of 19 companies under your leadership. Secretary Dillon's recent presentation before the Senate Finance Committee has further added to the urgency of this need. Regardless of the outcome of the current policy issues, a deeper understanding of the role and implications of private foreign investment has become essential.

While it is too soon to determine all the specifics of an adequate research project, we can foresee very considerable advantages in at least two alternative types of study. One of these would expand the approach of the 19 companies to a more representative base. The other would be a more intensive inquiry, going beyond the accounting categories of the 1961 inquiry into both their individual components and into the underlying business considerations and experience they reflect.

It would seek, for example, not only broader based estimates of company imports from overseas subsidiaries but also valuable new knowledge of their composition, the portion of them which actually competes with domestic products, and explore their future trend. Further valuable information could also be assembled at the same time on corporate policies, objectives, and motivations. This would go far to dispel some of the present uncertainties and test the validity of some of the assumptions commonly made concerning our foreign investments.

An intensive study of this nature would clearly have lasting value. Our present lack of concrete information on many key issues hampers proper discussions of problems of adjusting to rising worldwide competition and of methods of meeting the challenges and opportunities that the success of the European Common Market has raised.

A thorough examination of these issues and the collection of the necessary new data would obviously be a major project. Its financing would have to be secured from an external source, whether it be a foundation as you suggest or from some other means. Perhaps the next step should be a meeting in which we might jointly explore the many possibilities and attempt to draw up a preliminary course of action.

I look forward to your reply to these comments.

Cordially yours,

CLYDE L. ROGERS, *Vice President.*

(The prepared statement and appendixes of the United States Council of the International Chamber of Commerce, Inc., follows:)

UNITED STATES COUNCIL
OF
THE INTERNATIONAL CHAMBER OF COMMERCE, INC.

CABLE: USAINTCHAM 103 PARK AVENUE NEW YORK 17, N. Y. MURRAY HILL 6-3181

STATEMENT OF ELLSWORTH C. ALVORD
CHAIRMAN, COMMITTEE ON TAXATION,
ON
H.R. 10650
APRIL 25, 1962

Mr. Chairman and Members of the Senate Committee on Finance:

This statement is submitted on behalf of the United States Council of the International Chamber of Commerce. The U.S. Council is a private organization which is the United States affiliate of the world-wide International Chamber of Commerce. The U.S. Council has some 350 members, including business firms in virtually every field of enterprise and from all parts of the country.

The U.S. Council has requested this opportunity to appear before the Senate Committee on Finance because the operations of its members, and the operations of virtually every other American firm doing business abroad, would be affected -- adversely affected -- by the provisions of H.R. 10650 and by the Treasury recommendations with respect to the bill.

The Tax Neutrality Myth

At the outset, I want to correct the erroneous notion that the foreign income provisions of this bill and the Treasury's recommendations in the foreign income area would make the United States

income tax neutral in the choice between domestic and foreign investment. This bill would not make the tax system neutral. On the contrary, its provisions were conceived and designed to discriminate against and to discourage foreign investment.

The bill contains a credit against tax equal to 7% of the cost of new investment in machinery and equipment. The Treasury has recommended that the Committee increase the credit to 8%, the figure originally adopted by the Ways and Means Committee. Secretary Dillon pointed outin his statement to this Committee that an 8% investment credit will increase the rate of return after taxes on a 10-year asset from 5% under straight line or 5.6% under double declining balance depreciation to 7.9% per year. As he pointed out, this would represent an increase in profitability of more than 40%. If the credit is left at 7%, the effect on a 10-year asset will be to increase the profitability of the investment after taxes by 35%.

Under the bill and under the Treasury's proposals, the investment credit would not be available for investments made outside the United States. Even investments in the underdeveloped countries would not be eligible.

The effect on foreign investment of limiting the investment credit to domestic investments is obvious from the Treasury's own figures. Furthermore, this effect has been recognized by the Treasury. Secretary Dillon told this Committee that the investment credit closely complements the foreign income proposals because, in his words, "if we make investments in the United States more attractive, and at the same time we are making

investment abroad somewhat less attractive, I think the chances are much greater that they will make additional investments here."

This is not tax neutrality. It is incredible that the Treasury has not heretofore been challenged on its pretentions of tax neutrality in the foreign income field in view of its policies on the investment credit.

Furthermore, the ostensible tax neutrality ideal is flatly contradicted by the provisions in the bill, and by the Treasury proposals, which would discriminate between investment in developed countries and investment in less-developed countries.

Even the foreign income tax proposal itself -- to tax the United States shareholders as though they had received as dividends the income earned by controlled foreign corporations -- is inconsistent with the concept of tax neutrality. This would not produce the same results as taxing the income earned abroad by a branch of a domestic corporation.

The deductions taken into account in computing earnings available for dividends are not the same as the deductions to arrive at the taxable income of a branch operation. A loss incurred by a controlled foreign corporation cannot be used under the bill to offset other income, either foreign or domestic, of the United States shareholder. Under the bill a loss incurred by a controlled foreign corporation cannot even by carried back or carried forward to offset current earnings of the same

corporation in other years.

This should suffice to lay at rest, finally, the tax neutrality myth. Neither this bill nor the Treasury proposals would make the United States income tax neutral between foreign and domestic investment. If these proposals are to be defended, they must be defended on some grounds other than that of tax neutrality.

Taxation of Foreign Income, In Perspective

The impression has been conveyed to the Committee that foreign corporations with American shareholders are getting away with something or in some manner avoiding a United States tax which they should be paying with respect to their income earned in other countries. To place these insinuations in their proper perspective, let us look at the relationship between the United States income tax and foreign income.

The United States taxes the income of foreigners when that income arises from United States sources. At the same time, the United States taxes the income of Americans even though that income arises from sources in foreign countries. Thus, with blithe unconcern for consistency, the United States has embraced two contradictory principles of taxation. It taxes on the basis of source of income, and it also taxes on the basis of its sovereignty over the recipient of the income, when it is to its advantage to do so.

The principle of taxing income arising from sources within the country is universally accepted among nations. Therefore, what the United States says, in effect, to the other countries

is, "What is mine is mine, and what is yours is also mine."

The U.S. Council has long taken the position that neither the United States nor any other foreign country should tax income which has its source in another country. While we recognize that, as a practical matter, the United States is unlikely to recede from its position of taxing American corporations on their income from foreign countries, we must protest against the present proposals that the United States reach out and tax income earned by foreign corporations in foreign countries.

The Economic Effects

The Treasury defends the proposed tax on earnings of U.S. subsidiaries abroad on the grounds (a) that it would improve the balance of payments, (b) that it would increase the domestic level of investment and national income, and (c) that it would not impair the competitive position of U.S. enterprise abroad. These contentions, however, are based upon an inadequate and inconsistent analysis and on dubious assumptions and unwarranted inferences.

The Effect on the Balance of Payments and the Domestic Economy. Secretary Dillon has assured this Committee that the proposed tax on earnings of foreign subsidiaries particularly on the earnings of manufacturing subsidiaries, would improve the U.S. balance of payments for two reasons: it would deter the outflow of new direct-investment capital and it would accelerate the inflow of foreign earnings. These conclusions

are based upon a hypothetical "model" as set forth in Exhibit III attached to his statement before this Committee.

It is assumed in his Exhibit III that the elimination of tax deferral will at least retard the outflow of new capital by reducing the rate of return after taxes on foreign subsidiary operations. It is also assumed that the availability of foreign earnings after reinvestment abroad would be reduced, partly because of the need to meet higher current tax payments to this country, and partly because a higher proportion of such earnings would be remitted in dividends.

These assumptions imply that the proposed tax provisions of section 13 would have an adverse impact on the long-run balance of payments as shown clearly in the Treasury's analysis in Exhibit III. It is there recognized that a cumulative reduction in capital outflow would be largely offset by a cumulative reduction in receipts from exports generated by or related to direct investments abroad and from income (including royalties and fees) earned from such operations. Indeed, on the basis of the Treasury's analysis of the so-called "deterrent effect" resulting from the elimination of tax deferral in the industrially advanced countries (as set forth in Exhibit III, Table A-7), the incremental reduction in total receipts would exceed the annual reduction in direct capital outflow within about five or six years.

Similarly, the beneficial effects upon the balance of payments supposedly attributable to the accelerated repatriation of earnings

would be cumulatively offset by a loss in net export and other receipts. The Treasury in its analysis of the so-called "switch effect" (Exhibit III, Table A-7), in contrast to its analysis of the so-called "deterrent effect," assumes that the capital outflow in direct investment would continue to increase at an annual rate of 10 per cent. Even so, the cumulative loss in net export and other receipts would eventually exceed the cumulative gain in dividend receipts as the level of direct investment without deferral would be reduced below the corresponding level under existing law because of a substantial cumulative reduction in the availability of foreign earnings for reinvestment.

The Treasury's analysis shows that on net balance in the long run the cumulative loss of receipts in the balance of payments accounts would exceed the possible gains from the retarded outflow of capital and the increased dividend remittances. The factors causing this cumulative deterioration in this country's balance of payments position would bring a corresponding deterioration in our direct investment position abroad and a reduction in total earnings drawn from such investment. Indeed, this fact is apparently recognized by the Treasury, as evidenced, for example, by the statement in Exhibit III that foreign investment "may contribute positively to our balance-of-payments' liquidity position in the very long-run."

Clearly then, the supposed beneficial effects resulting from the elimination of tax deferral would be gained at the expense of a long-run decline in the investment and trading position of this country in the foreign markets of the industrially advanced

countries of West Europe. During the next year or two when improvement in our balance of payments position will be most urgently needed the maximum potential gains shown by the Treasury's analysis would be relatively insignificant. Thus, for example, the maximum gains which Secretary Dillon has assured his Committee can be confidently expected would, at an annual average rate during the first two years following the elimination of tax deferral, amount in his "model" to appreciably less than $200 million a year as compared with an annual deficit of about $3.9 billion in 1960 and about $2.4 billion in 1961.

Hypothetical gains of such a magnitude would be small even compared with the essentially fortuitous month-to-month variations in the components of capital movements and merchandise exports. This fact alone should indicate the need for caution in asserting whether the proposed tax provisions would in the short run have a favorable or unfavorable impact upon the balance of payments.

Additional uncertainties are suggested by the Treasury's analysis of the effects of these tax provisions on the competitive position of U.S. enterprise abroad. Indeed many statements in this analysis are inconsistent with the Secretary's assurances concerning the balance of payments.

The Treasury concedes that the elimination of tax deferral may reduce the foreign subsidiary's after-tax rate of return below the corresponding level of its foreign competitors and that in such a case the subsidiary could retain its share of the foreign market only

by reducing the dividend payments to U.S. shareholders *or* by borrowing additional funds and thus incurring a differentially higher interest cost. If the share of the market in such a case is maintained by an off-setting reduction in dividend payments to this country, clearly there would be no gain for the balance of payments. If the increased tax payments were made by borrowed funds, the precise effects upon the balance of payments would depend in part on whether the funds were obtained from domestic or foreign sources. If, for example, the payments were made by the parent company as the Treasury suggests, then the balance of payments would not show a gain but the availability of capital for domestic investment may be reduced. These and other possibilities as suggested in the Treasury's statement are sufficient to exemplify the contradictions and inconsistencies running through so much of its contentions. These possibilities indicate, furthermore, the uncertainties underlying the Treasury's assumptions, particularly concerning the effects of the proposed tax provision in retarding the outflow of capital.

Such uncertainties are greatly enhanced by the inadequate "model" on which Secretary Dillon based his testimony concerning the effects of tax-deferral elimination on the outflow of direct-investment capital and on U.S. "net exports" generated by such capital flows. This "model" is offered by the Treasury as a basis for its attack on the testimony of many witnesses presented during the Hearings last Spring on the tax proposals considered by the Ways and Means Committee of the House. Without getting into many technical questions which are mainly of interest to statistical

and other experts, this "model" is conceptually defective in some respects and is based on inadequate data.

(1) Specifically, Secretary Dillon concedes that the inflows from export receipts and dividend income related to direct investments abroad normally exceed the new capital outflow. He contends, however, that these two flows "are not related one to another" on the ground that such receipts are related to the accumulated capital built up from past investments and that the current outflows of capital are not related to such inflows. This contention is conceptually defective. Clearly the amount of income receipts and exports sold to or through U.S. manufacturing subsidiaries during any given year would reflect in large part the levels of business activity abroad and thus the rate of utilization of the plant and equipment of such subsidiaries. The higher the levels of such business activity abroad, the larger will be the level of earnings of such subsidiaries available for dividend payments to this country and for reinvestment abroad and the larger will be the demand for U.S. exports of capital goods and industrial materials.

Similarly, as the levels of business activity and plant utilization expand abroad the demand for capital funds for plant and equipment and for working capital will expand, and this expansion will lead to a larger outflow of direct investment capital and/or to increased reinvestments of larger foreign earnings. If the Secretary wishes to remind us that there is a difference

between the stock of accumulated capital at any one time and the rate of additions to such capital and the flow of income earned by it, then of course, he is quite right. Both of the current flows (rates of addition to capital and of income drawn from it) reflect, nonetheless, conditions of long-term economic growth and cyclical fluctuations here and abroad. It is necessary, therefore, to reject the Secretary's contention that these two rates of flow are not related one to the other.

(2) The Treasury also insists that exports sold to or through U.S. subsidarires should be "netted" against imports purchased from such subsidiaries. "Net exports" to subsidiaries are then used to measure the impact of their operations on domestic production and employment and to project the long-term "net export" effects on the balance of payments. This proposition is essentially defective. Given relative prices and possible alternative sources of supply, the level and composition of U.S. demand for imports will depend chiefly on the corresponding components of GNP (including changes in business inventories) while U.S. exports will respond to similar demand and supply factors abroad. Thus, even if annual exports to subsidiaries were uniquely related to the book value of direct-investment capital abroad at the beginning of the year, the inference would not be warranted that imports are so related. Partial evidence for this conclusion is the fact that while exports and imports trend in the same direction, the rates frequently diverge under the impact of cyclical and other factors. This fact is shown in the data used by the Treasury.

(3) The foregoing conceptual defects are obvious from the Treasury's computation of the "net export" ratios. Even if the basic approach were adequate, the specific application by the Treasury would not yield reliable results, as data for a mere one or two-year period cannot be an adequate basis for projecting long-term changes in the balance of payments or domestic production. For example, the ratio between (a) 1959 "net export" to European manufacturing subsidiaries and (b) outstanding direct investments would yield a negative value - a result which would contradict the clear and admitted fact that such investments do give rise to substantial exports.

(4) Furthermore, the impact of direct-investment activity on such long-term developments involve many inherent uncertainties which are not subject to quantitative measurement. The fact is that such investments have greatly increased the quantity and quality of resource supplies available to the domestic economy and have proably reduced their cost and thus contributed to the expansion of domestic output and employment. Secretary Dillon apparently means to ignore or minimize this fact in his discussion concerning the supposed beneficial effects on domestic output resulting from the elimination of tax deferral. He also apparently overlooks the contribution that direct investments have made to the level of income of U.S. dividend recipients, inasmuch as he limits his discussion of the income and employment effects to the influence of net exports. It is also an admitted fact that direct-investment activity has contributed substantially to the development of U.S. export markets and has also made substantial

contributions to the building of the industrial strength of the free world.

Despite such inadequate analytical groundwork, Secretary Dillon insists that we should rely firmly on the "parameter values" computed in his Exhibit III model, and assures us that the elimination of tax deferral will stimulate investment and promote employment in this country. This assurance is given despite the fact that no evidence was offered to show that domestic investment has been impeded by a shortage of funds attributable to the outflow of long-term capital to subsidiaries overseas or to the reinvestment of their earnings.

American-Owned Corporations in Competition. Secretary Dillon argues that the privilege of tax deferral has operated as a substantial subsidy inducing the flow of direct investments abroad and causing an uneconomic allocation of resources and that the elimination of this privilege would not impair the competitive position of U.S. enterprises abroad. These contentions are not correct.

There are many economic factors affecting the flow of direct investments to the industrially advanced countries. U.S. business must compete in foreign markets by both exporting and investing. In some cases these modes of competition may be substitutive for each other, but they are also complementary as evidenced by the demand for exports generated by or related to such investments. The large increase during recent years in direct-investment activity, particularly in manufacturing subsidiaries in Western

Europe, is in a large part attributable to cost advantages that may be obtained from the location of operations in those countries. While the choice of the most advantageous location is influenced by many other factors, the fact stands that the increased investments in these manufacturing subsidiaries has moved partly in response to more favorable production costs and the opportunity for the more efficient coordination of production and distribution activities. To this extent, direct investments have permitted U.S. firms to compete through their subsidiaries more favorably with foreign firms in domestic and foreign markets.

The rise in such investments in West-Europe has also resulted in part from the rebuilding of the industrial economy of these countries and their high growth rates during the past decade, reinforced by unusually strong boom conditions during the more recent period. Another important factor has been the rapid and successful development of the Common Market with its prospects for further enlargement and increased freedom of movement for labor and capital. At the same time American businessmen are faced with the external tariff barrier. In this context the Treasury itself seems to concede that tax deferral has not been an important factor causing the outflow of new direct investments from the U.S. to these countries as evidenced by the statement in Exhibit III that "presumably only a small proportion of new capital outflow over this period was actually tax induced." Tax deferral has, however, enabled our subsidiaries to participate in this expansion on a larger scale than would have otherwise been possible.

What the privilege of deferral has done is to permit U.S. subsidiaries to operate under conditions more nearly equal to their rivals in the West European countries by permitting them to finance a larger part of their investments out of retained earnings. It is in this sense that the competitive position must be understood. Whatever the dimensions of competition, they must be defined in respect to the activities of rival firms operating under similar market conditions. In respect to relative prices and cost, the reinvestment of earnings has enabled American firms to establish and enlarge their operations under more favorable cost conditions and with more efficient management, without any drain on this country's balance of payments. In this connection the fact should be noted that the amount of reinvested earnings in manufacturing subsidiaries in West Europe has exceeded the net outflow of capital to such subsidiaries every year for about the past decade (including 1960 if the large non-recurrent $370 million purchase of outstanding equity securities in the U.K. is not counted).

Competitive survival in the long run depends not only on the relative prices at which given products are sold in given markets. It depends also in large part on the capital resources available for financing research and development programs, technological innovations and other investment opportunities (including new and diversified product-lines and the development of new sources of industrial supplies). The reduction in retained subsidiary earnings in advanced countries would most surely impair the competitive responses of U.S. manufacturing subsidiaries in West

Europe relative to those of their foreign rivals. Finally, the freedom of capital to move in response to the relative profitability of investment opportunities and the relative availability of funds here and abroad, and to perform abroad under conditions more nearly comparable to their foreign rivals, contributes to the more efficient allocation of resources within the free world.

The proposals of the Treasury and some of the provisions of this bill are virtually unprecedented among economically advanced countries. Indeed, most countries of the world actually encourage foreign investment through their tax laws. If these proposals become law, the American businessman will find his foreign subsidiary struggling to compete with businessmen from countries which levy no tax at all on foreign income, or grant preferential rate differentials to foreign income, or include in their laws provisions which explicitly recognize and permit the use of foreign base companies incorporated in other jurisdictions.

It is important that the Committee be aware of the tax treatment received by our competitors abroad. The attached Appendix I contains a digest of the tax treatment of their corporations on income arising outside the national borders in the case of Canada, England, France, Germany, Netherlands, Belgium, Italy and the Latin American countries generally.

It is apparent that these countries are moving in precisely the opposite direction from the Treasury's proposals. They want their businessmen to succeed in the competitive struggle for world markets.

Is It Wrong to Save Foreign Taxes?

The U.S. Council would have no objection to any measures which are necessary to prevent the diversion of United States source income to foreign corporations to avoid the United States income tax. This is not, however, the objective of the Administration, and it is not the objective of section 13 of the bill. Instead, section 13 and the Treasury's recommendations are primarily designed to prevent Americans from using foreign corporations to save foreign income taxes.

The proposals are not limited in their application to income from United States sources or to administrative provisions to assist in determining what income is from United States sources. The bill would impose our income tax as a penalty on Americans who have either utilized a two-tier system of foreign corporations or have utilized a corporation incorporated in one foreign country to trade in other foreign countries. This may have been done to minimize income taxes in foreign countries; it may have been done to minimize foreign excise taxes; or it may have been done to avoid risking investments in a country where currency devaluation or expropriation is a possibility.

For all of these reasons and many more, American businessmen have utilized foreign corporations to trade in other foreign countries, to own stock in operating foreign subsidiaries in other countries, and to license, service, and lend money to operating subsidiaries in other countries. None of this is, or should be, of concern to the United States Treasury except in cases involving transactions carried out between two foreign

corporations whose stock ownership connection is through a United States taxpayer.

If United States investors abroad set up a system of foreign subsidiaries owned by a foreign holding company or if they set up a foreign subsidiary to trade in other foreign countries, and if the effect of this arrangement is to reduce the taxes paid to foreign countries, the Americans should be congratulated by the United States, not penalized. This will help our balance of payments, not harm it.

Yet the admitted result of the Treasury proposals would be to wipe out the foreign tax savings which American-owned foreign corporations have succeeded in achieving. Secretary Dillon told this Committee that the Treasury had estimated a relatively low figure as the revenue yield of the so-called tax haven legislation in the bill, "because one of the things that this may do is simply make tax havens less attractive in Europe. Companies may operate more normally in the country in which they are manufacturing, in which their manufacturing concern is located, and pay taxes there, so we will not get the actual tax."

Surely forcing American-owned corporations to pay higher foreign taxes cannot be justified as helping our balance of payments.

Treaty Obligations and the Bill

Section 21 of the bill would order the United States to renege on all of its treaty obligations with other nations which conflict with provisions of the bill. Secretary Dillon has recommended that this section be deleted from the bill,

and we warmly second his recommendation.

We do not, however, share the Secretary's opinion that none of our income tax treaties are affected by the bill. The foreign income provisions of the bill are replete with conflicts with treaty provisions.

Section 11 of the bill, which would require dividends received from foreign corporations to be "grossed-up" by the foreign income taxes paid by the foreign corporation and attributable to the dividends paid, as a condition to obtaining foreign tax credit, would violate the income tax treaties with 13 nations. These are the countries to whom the United States has promised to allow taxes of the treaty country as a foreign tax credit in accordance with the provisions of our income tax law at a time when our law permitted the crediting of foreign taxes paid by foreign corporations without grossing-up. These 13 nations are Australia, Austria, Belgium, Finland, Germany, Honduras, Ireland, Japan, New Zealand, Norway, Switzerland, the Union of South Africa, and the United Kingdom.

If the references to the foreign tax credit provisions of our law in treaties which do not specify that the tax credit provisions referred to are those in effect on a particular date are construed as references to our law in effect at the times the treaties were agreed to -- and this is certainly a reasonable construction -- section 11 would likewise conflict with our obligations under the income tax treaties with Canada, Denmark, France, Greece, and Italy.

Section 13 of the bill, by taxing income earned by foreign corporations of treaty countries which do not have permanent establishments in this country, would conflict with a provision of general application in the income tax treaties with Austria, Germany, and New Zealand. Each of these three treaties provides explicitly that industrial or commercial profits of an enterprise of the treaty country shall not be subject to United States tax unless the enterprise is engaged in trade or business in the United States through a permanent establishment situated here.

Section 13 would likewise be contrary to the spirit, if not the letter, of all of the other income tax treaties. All of them provide that an enterprise of the contracting nation shall not be subject to taxation by the United States except inrespect to profits allocable to a permanent establishment in this country. It could be argued by the Treasury that, since section 13 taxes the United States shareholders, it does not literally tax an enterprise of the treaty country. However, section 13 would clearly contravene the principle of these treaty provisions. Even this technical defense would not be available to the Treasury in the case of the treaties with Australia, Germany, and New Zealand, since the United States contracted there not to tax the profits of an enterprise of another country -- not merely the enterprise itself.

Every income tax treaty to which the United States is a party provides for the exemption by the United States of income derived by an enterprise of the other contracting nation from the operation

of ships, or aircraft, or both. None of these treaty provisions limit the exemption to an enterprise of the other contracting nation. Instead, the exemptions apply to income derived by an enterprise of the other country. Thus, section 13, by taxing United States shareholders on the income of corporations of the treaty countries derived from operating ships or aircraft, would be in conflict with these treaty provisions.

The Treasury's proposals for separate application of the limitations on the foreign tax credit to foreign income taxes on portfolio investments will conflict with the same treaty provisions as does section 11 of the bill. It will cut down on the foreign tax credit for income taxes of the treaty countries, contrary to the covenants in the treaties to allow a foreign tax credit under the law then in effect.

The provisions of the various treaties which are in conflict with the bill are contained in the attached Appendix II.

In making his sweeping assertion that none of the income tax treaties are affected by any section of the bill, Secretary Dillon may have relied on a provision contained in many of our income tax treaties to the effect that, notwithstanding other provisions of the treaty, the United States, in determining the taxes of its citizens, residents, or corporations, may include in the base upon which the taxes are imposed items of income taxable under its revenue laws as though the treaty had not come into effect.

In the first place, no such saving clause is contained in the income tax treaties with Australia, Ireland, New Zealand, Pakistan, and the United Kingdom or in the income tax treaty

with India which is awaiting ratification.

While the treaties with Austria, Denmark, Finland, France, Germany, Honduras, Italy, Japan, Norway, Sweden, Switzerland, and the Union of South Africa contain saving clauses, in these treaties the covenant to allow a foreign tax credit for the taxes of the other contracting nations is an exception to the saving clause. Thus, the saving clause is, by its terms, not applicable to a reduction in the benefits of the foreign tax credit. In the remaining treaties which contain saving clauses, these clauses are written in terms of the right of the United States to include income in the base upon which its taxes are imposed, so the clauses do not relate to the promises in the treaties to allow foreign tax credit against United States tax.

Furthermore, in all of the income tax treaties which contain saving clauses relating to the taxation of American nationals, the clauses refer to inclusion of items of income taxable under the revenue laws of the United States as if the treaty had not come into effect. The most reasonable construction of this language is that it relates only to items which were included in income under the revenue laws of the United States in the form in which those laws were written when the treaties went into effect. Under this construction, the saving clauses would have no application to income included in the base of the tax of United States shareholders for the first time under section 13 of this bill.

SECTION BY SECTION COMMENTS

Section 6 (Amendment to Section 482 of the Code)

If the present section 482 of the Internal Revenue Code needs to be strengthened to preventavoidance of tax on income from United States sources through the use of foreign corporations, then such an amendment should by all means be enacted. It would appear, however, that section 482 in its present form is fully broad enough to reach any abuses through deflection of United States source income into foreign subsidiaries. The section now provides:

> "In any case of two or more organizations, trades or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled, directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses."

If the Committee decides that amendment of section 482 is needed, two serious deficiencies should be corrected in the proposed amendment now contained in the bill.

First, the scope for judicial review of discriminatory administrative action under the proposed section 482(b) is not clear. There is a danger under the present wording of the bill that court review of administrative reallocations of income might be defeated by a simple recitation in an administrative finding that all of the factors listed in the statute had been taken into consideration.

Second, the reallocation of foreign income to a domestic taxpayer under proposed section 482(b) may result in an unconscionable burden of double taxation. The problem is recognized in the bill,

and provision is made for the domestic taxpayer to claim credit for foreign income taxes which have been paid with respect to the reall cated income. However, in most cases this provision will not be effective because the per country or the overall limitation on the foreign tax credit will make it impossible for the domestic taxpaye to credit the foreign income taxes which the bill attributes to it. To avoid the double tax burden and make the foreign tax credit full effective, the reallocated income which has borne foreign income ta should be treated as foreign source income for purposes of the limit tions on the foreign tax credit.

Section 11 (The Gross-up Proposal)

The U. S. Council has consistently opposed the proposal that dividends received from foreign corporations should be grossed-up by the foreign income tax paid with respect to the earnings from which the dividends are paid. As explained above, the proposal is in conflict with most of our income tax treaties. If enacted with section 21 of the bill the result will be the deliberate abrogation of treaty provisions, with all that that implies for the United States' international reputation. If enacted without section 21 the result will be hopeless confusion as to the scope of the provis-ion and discrimination between taxpayers who are protected from grossing-up because of the treaty provisions and those who are not.

Section 12 (Earned Income of Americans Abroad)

It is the position of the U.S. Council that Americans who are bona fide residents of foreign countries should be permitted to continue to exclude all of their earned income from foreign sources, without limitation as to amount and regardless of whether they live in developed or undeveloped countries. We strongly oppose the Treasury proposal that the earned income exclusion be terminated

completely both for bona fide residents and for persons physically present for 17 out of 18 months in the developed countries.

It would be unfair to impose United States income tax on the earned income of an individual who goes abroad to work on the same basis as though he were here where he could take advantage of the Government-financed benefits which are available to domestic residents. It would be particularly unfair to change the rules now for individuals who accepted foreign employment in reliance on the existing foreign tax treatment. The Treasury proposal will cause a serious morale problem among American employees abroad. It is another instance of the roadblocks which the Treasury is attempting to throw up to block the future progress of American businesses abroad.

Allowing credit for income taxes paid to the foreign country of residence is not a full solution for the American living abroad. Frequently, the foreign government does not furnish services equivalent to those provided by this Government for residents of the United States. Also, if the foreign tax system depends primarily on excise taxes which are not eligible for credit against our income taxes, the American living in the foreign country will be subjected to an unfair double tax burden because these foreign excise taxes will be passed on to him and borne by him as a consumer.

If the dollar limitations on the earned income exclusion of bona fide residents is retained in the bill, the logical treatment of pensions would be to exempt the portion of the pensions which is a return of employer pension plan contributions which, had they been paid to the employee as currently earned, would have been excluded from the employee's taxable income because they would have been within the dollar limitations on the foreign-earned income exclusion.

Section 13 (Controlled Foreign Corporations)

The treatment of United States shareholders in foreign corporations which is proposed by section 13 of the bill is an attempt to reach beyond the boundaries of our normal taxing jurisdiction to hamper and discourage the conduct of American-owned businesses abro The United States Council strongly urges the Committee to reject section 13 in its present form.

Section 13 would tax income of four different sorts. Only one of these -- the insurance or reinsurance of United States risks -- is directed at an asserted avoidance of tax on United States source income.

The bill would tax American shareholders on the income of forei corporations from patent and copyright royalties, regardless of the disposition made of this royalty income and regardless of whether it is from developed or undeveloped countries. The proposed treatment is contrary to the long-established rules in the Internal Revenue Code defining the source of income.

It is not clear why royalty income has been singled out for this discriminatory treatment. If enacted, the effect will be to discour age American business from giving technical help to the less-develop countries.

Section 13 would not merely tax royalties received by foreign corporations. It would also impute royalties to foreign corporation if they make any use of patents, royalties, or exclusive formulas or processes either developed in the United States or purchased from related United States persons.

Taxing imputed royalty income where none is actually paid will result in fantastic administrative problems. These are precisely the sort of problems which the Treasury Department has complained that it cannot handle under the present provisions of section 482.

If the proposed tax on imputed royalties is enacted, it will make the Revenue Service's present difficulties with section 482 seem mild by comparison. At least, section 482 creates administrative problems only in the cases in which it is invoked by the Revenue Service. The proposed tax on imputed royalties would apply every year to every instance in which a controlled foreign corporation makes any use of patents, copyrights, or formulas developed in the United States or acquired from related United States persons.

The third category of income tax to American shareholders under section 13 is called foreign base company income. It includes interest, dividends, rents, mineral royalties, and merchandise trading income of controlled foreign corporations. This portion of section 13 has the objective of penalizing American shareholders who use foreign corporations to save foreign taxes or to facilitate or protect their foreign operations.

American firms with operating subsidiaries in a number of foreign countries have frequently found it expedient for sound management reasons (having nothing to do with the United States income tax) to centralize their ownership in a principal affiliate in one country. Typically, this will be done where the group of operating foreign subsidiary companies are within one large economic unit or geographical area covering several foreign countries -- for example, the European Common Market. This can result in a high degree of cooperation among the affiliates, and it tends to make planning more effective and operations more efficient. This benefits the American owners and thus, indirectly benefits the United States as a whole. Nonetheless, the dividend

and interest income of the foreign holding company would be taxed under the bill as foreign base company income.

Secretary Dillon is apparently recommending that the broad definition of foreign base company income already contained in section 13 of the bill be further broadened to include income from the performance of services for other affiliated foreign corporations. This would strike another blow at the efficient operation of American-owned businesses abroad. It is another illustration of the proclivity of the Treasury to substitute its judgment on the proper form of business organization for that of the businessmen who know what is involved and whose money is at risk.

Section 13 would include in the taxable foreign base company income of American-owned foreign corporations their income from the purchase and sale of property produced outside the country of incorporation and sold for use outside that country, if the property is either purchased from or sold to an affiliate. The provision is not limited to transactions with related domestic taxpayers where there might be a possibility of channeling United States source income into foreign corporations. That problem is adequately covered by the changes proposed in section 482.

This provision is apparently designed primarily to penalize the use of foreign corporations which sell in countries other than the country of incorporation. United States shareholders would be confronted with a virtually impossible burden of proof in attempting to show that goods, after their sale, will not be used in another country.

The discrimination against foreign corporations engaged in

business outside their country of incorporation is typical of the approach in section 13, which is to force American-owned businesses into a competitive strait jacket. Keying tax consequences to whether income is earned inside or outside the country of incorporation would force a policy of senseless and inefficient fragmentation -- the creation of a separate corporation in each country where business is done.

A foreign corporation may be used to sell products in a number of foreign countries simply because this is more efficient than setting up separate selling subsidiaries in each foreign country. In fact, for many small or medium-sized American firms the cost of setting up and staffing a separate foreign corporation in each country would be prohibitive.

Section 13 of the bill would apparently dictate the creation of a costly number of local affiliates, with a resulting decrease in profits to the United States shareholders. It is unreasonable for national boundaries between foreign countries to be such a decisive factor on the United States income tax. A country such as Canada might support more than one affiliate, but the sum total of operations within the several governmental units of the Windward Islands and the Leeward Islands, for example, would dictate only one affiliate if the decision is made on business grounds and not to comply with section 13.

At a time when American-owned businesses need all the help they can get in establishing themselves in the new common markets, section 13 proposes to impose tax penalties on trading across national borders. It is as though our Federal tax law were to penalize a Delaware corporation for doing business in the other

49 states. The emphasis in the bill on national boundaries between foreign countries is particularly ironic since the United States has actively encouraged foreign countries to enter common market arrangements to reduce the barriers between them.

The proposed definition of foreign base company income is largely keyed to transactions by controlled foreign corporations with related persons. If enacted, it would place a premium on having foreign subsidiaries buy from outside sources instead of buying from the United States parent corporation. Also, the provision will be an inducement to set up manufacturing operations in the various foreign countries in which products manufactured in the United States are now sold through a foreign trading subsidiary. These consequences are the direct opposite of the balance of payments objectives of the bill.

These provisions in section 13 would impose tax penalty without regard of the many non-tax reasons which dictate the use of separate operating foreign subsidiaries owned or serviced by a foreign holding company or which dictate that trade in a given foreign country be conducted by a subsidiary incorporated in another foreign country.

For instance, one foreign corporation may be used to market in another country to save the cost of local incorporation or because of currency controls. In other cases a corporation organized under local law may be undesirable because of a requirement that a certain percentage of the stock of a local corporation must be owned by nationals.

The fourth category of income which would be created for American shareholders by section 13 is the increase in investments

by their foreign corporations in the United States or in different businesses not located in the less-developed countries. The taxed amount would not be limited to the earnings of the foreign corporation for the year. Instead, the tax could apply to the total earnings accumulated in years after 1962.

Reinvestment of profits in a developed foreign country would be limited to the same trade or business in which the foreign corporation is already engaged. This is an incredible requirement. It serves no apparent policy or equity purposes, yet it places a tax penalty on dynamic and progressive business practices. It penalizes switching to new products. It could conceivably be interpreted as penalizing the opening of new branches of the corporation's old business. It is unbelievable that Congress would saddle this sort of a restriction on American-owned businesses in the European Common Market at the very time when this area is on the threshold of the greatest growth in economic activity and competition that it has ever experienced.

Irrational as the present provisions in section 13 are, they would not be quite as bad as the Treasury's proposals. The Treasury would tax all earnings of American-owned foreign corporations in the developed countries, even though the earnings are reinvested in the same trade or business.

Even in developed foreign countries which have income tax rates which are as high or higher than our own, either the present section 13 or the Treasury proposal would be extremely burdensome because of the accounting requirements they would impose. Regardless of how high the foreign tax rate is, it would be necessary to compute the income of a controlled foreign corporation each

year under American accounting concepts and in accordance with the definition of earnings and profits in our tax law.

Accounting principles in nearly all foreign countries differ markedly from those we are accustomed to in this country. Rules of inventory valuation for tax purposes in countries of Continental Europe are more liberal than they are in the United States. Some countries have permitted asset revaluation for tax purposes in prior years. In two countries great latitude in establishing depreciation rates for tax purposes is permitted. These are only a few of the significant variations from our concept of income.

Attempts to translate foreign concepts of earnings and profits into the United States tax law concept are further complicated by the problem of what to do about elections, or options, provided in the United States tax law for United States taxpayers. There are no mechanics provided either in the present law or in the bill whereby a foreign corporation which does not file a United States tax return can make such basic elections as installment sales treatment, treatment of research and development expenditures, or use of LIFO inventories.

Tremendous administrative costs would be incurred in trying to determine the basis, for United States tax purposes, of assets of foreign corporations.

The failure to take into account loss carry-overs, which under our tax law do not offset current earnings and profits, would result in indefensible double taxation situations.

On the question of whether section 13 of the bill or the Treasury proposal is constitutional, the opinion which the Treasury General Counsel gave last year does not provide a complete answer. The June 12, 1961 memorandum by the General

Counsel of the Treasury, Robert H. Knight, on the constitutional power to tax shareholders on undistributed income of foreign corporations, took the position that the original Treasury proposal last year with respect to shareholders of existing foreign corporations would not differ constitutionally from the tax on foreign personal holding company income "when the congressional purpose is to prevent avoidance by U.S. taxpayers of paying U.S. income taxes." Mr. Knight's memorandum advanced an alternative defense of the Treasury proposals under the 16th amendment which did not rest on the premise of prevention of avoidance of United States income taxs. However, his defense of the Treasury proposals under the due process clause of the fifth amendment was based on this premise:

> "Accordingly, since the proposed legislation is designed to prevent tax avoidance by the use of foreign corporations 'controlled', within the meaning of the proposed legislation, in the United States, I believe that the Supreme Court under established doctrine would find the tax consonant with the due process requirements of the fifth amendment." (emphasis supplied)

In the principal area of their proposed application, neither section 13 nor the Treasury proposals can be defended as being designed by Congress to prevent avoidance of United States tax. Where is the avoidance of United States tax if a Swiss corporation is used, for example, to minimize German or French income taxes?

The U.S. Council strongly urges the Committee to strike out section 13 of the bill and to substitute in its place a provision designed to correct abuses in the use of foreign holding companies without hampering or discouraging the operations of legitimate American-owned businesses abroad. Such a provision was tentatively

adopted by the Ways and Means Committee and announced by that Committee on February 1. Briefly, it would have taxed United States shareholders on unreasonable accumulations of income by their foreign corporations. This provision would not, however, have penalized the reinvestment of foreign earnings in legitimate active businesses, whether these businesses were carried on directly or through subsidiaries of the controlled foreign corporation.

This concept is embodied in the attached Appendix III, which contains legislative language designed to carry out the proposal adopted tentatively by the House Ways and Means Committee on February 1, 1962. It offers a reasonable solution, as contrasted with the unbridled attacks on American-owned businesses abroad which are contained in section 13 of the present bill and in the Treasury proposals. We strongly recommend adoption of the proposal contained in Appendix III in lieu of the present section 13.

Section 16 (Ordinary Income on Sale or Liquidation of Foreign Corporations)

Section 16 of the bill would tax gain on the sale or redemption of stock of foreign corporations, in certain circumstances, as ordinary income to the extent of the stockholder's share of the earnings and profits of the foreign corporation. A stock redemption is treated as a dividend so that an American corporate shareholder is entitled to foreign tax credit for a proportionate share of the foreign income taxes paid by the redeeming foreign corporation. However, the bill makes no such provision for foreign tax credit if the United States shareholder sells his stock instead of causing the foreign corporation to

redeem it. There does not appear to be a valid basis for this distinction. The U.S. Council, therefore, recommends that foreign tax credit for foreign income taxes paid by the foreign corporation be made available to the United States shareholder who has ordinary income under the bill by reason of selling his stock in the foreign corporation as well as the United States shareholder who redeems his stock.

Section 20 (Information on Foreign Entities)

The U.S. Council does not object to authorizing the Revenue Service to obtain any information it needs to prevent tax abuses through the use of foreign corporations. We do not think, however that any purpose would be served by requiring duplications of effort in complying with the information requirements or by assembling a vast file of information returns which the Revenue Service will not use.

Section 20 of the bill in its present form is susceptible to these abuses. Furthermore, the severe penalties imposed for failure to comply with the information return requirements should be modified. Much of the information which would be required by the bill may prove impossible to obtain in accurate form. In such cases, penalties should not be imposed where there has been a bona fide attempt to comply to the best of one's ability.

United States Council

of the

International Chamber of Commerce

April 25, 1962

Appendix I

Digest of Tax Treatment by Other Countries of Foreign Income of Corporations

United Kingdom

Except in the case of Overseas Trade Corporations, resident corporations are taxed on their foreign earnings by the United Kingdom. If a resident corporation is a subsidiary, its losses may be consolidated with its parent corporation's earnings for profits tax purposes.

A non-resident corporation is taxed on its business income only when the income is remitted to the United Kingdom -- that is, only when the income is actually received in the United Kingdom.

A corporation is resident in the United Kingdom if its central control and management is located there. This is determined primarily on the basis of the place of meeting of the board of directors.

The place of incorporation is irrelevant for purposes of determining whether or not a corporation is resident in the United Kingdom. Thus, the place of incorporation is irrelevant for determining when business income is taxed. However, the place of incorporation determines the domicile of the corporation, and this, in turn, determines when the corporation's investment income is taxed. If the corporation is domiciled in the United Kingdom, it is taxed currently on its foreign investment income. If the corporation is domiciled outside the United Kingdom, it is taxed on its foreign investment income only when it is remitted to the United Kingdom.

Capital gains and returns of capital from abroad are not taxable. The foreign income of a non-resident subsidiary which is distributed on dissolution of the subsidiary will

be received by the parent corporation in the United Kingdom as tax-free capital profits.

A foreign tax credit is allowed, either by treaty or by law, for foreign taxes comparable to the United Kingdom income or profits taxes.

Corporations managed and controlled in the United Kingdom but operated entirely abroad may qualify as Overseas Trade Corporations. Qualifying corporations are not taxed on their trading profits until either these profits are distributed in the United Kingdom or the corporation ceases to qualify for Overseas Trade Corporation treatment.

To qualify for Overseas Trade Corporation treatment, a corporation must either carry on its trade wholly outside the United Kingdom or it must be a holding company owning more than a 50% interest in an Overseas Trade Corporation subsidiary and not owning stock in any subsidiary which trades in the United Kingdom. Overseas Trade Corporation status is not available to corporations engaging in banking, money lending, dealing in securities, selling insurance, shipping, or air transport, or if its business receipts are mainly payments for professional or similar services of United Kingdom residents or are royalties on works of authors who are residents.

Investment income of an Overseas Trade Corporation does not receive tax deferral.

Closely held Overseas Trade Corporations are subject to the surtax on unreasonable accumulations of profits.

Corporations pay the standard tax of 38.75%. The recipient of a dividend of a corporation is treated as having received the dividend before the payment of the standard tax and may credit against his own tax liability the standard tax which has already been paid by the corporation.

In addition, corporations are subject to the profits tax at the rate of 15%.

(Source: Taxation in the United Kingdom, World Tax Series, Harvard Law School.)

Canada

With the exception of Foreign Business Corporations, corporations which are resident in Canada are taxable on their income worldwide.

The test of residence is where the corporation's central management and control is located. As a general rule, central management and control will be found in the country where the corporation's directors reside and hold their meetings. A corporation incorporated in Canada is deemed to be a resident if it carries on business in Canada during the year.

Resident corporations, in computing their taxable incomes, may deduct the dividends they have received from non-resident corporations or from corporations qualifying as Foreign Business Corporations, if the dividend recipients own over 25% of the stock in the corporations paying the dividends.

Capital gains are not taxed.

Canadian resident corporations are not taxed if they qualify as Foreign Business Corporations.

A Foreign Business Corporation must carry on its business outside Canada, and all its property except securities and bank deposits must be situated outside Canada. A Foreign Business Corporation can engage in business operations of an industrial, mining, commercial, public utility, or public service nature. If its stock is listed on an exchange it can carry on business of an investment or financial nature. A Foreign Business Corporation cannot derive over 10% of its gross revenue from leasing or operating ships or aircraft. Closely-held investment companies, called "personal corporations," are not eligible for Foreign Business Corporation treatment.

Foreign Business Corporation treatment applies only to corporations which have qualified since before 1959.

The Canadian corporation tax rate is 50%, including a 3% Old Age Security tax.

(Source: Canadian Tax Reporter, Commerce Clearing House.)

France

France follows the principle of territoriality -- that is, corporations are taxed only on income arising from within French territory. The company tax is not payable on profits earned outside France through a branch or permanent establishment.

The 24% withholding tax payable on distributions by a corporation to its shareholders applies both to profits earned at home and to profits earned outside France.

While capital gains realized by corporations are taxable, those realized by individuals ordinarily are not. However, an individual stockholder is taxable on the profit from sale of a major participation in a business if he or a relative is on the board of directors.

(Sources: European Taxation, Sept. 15, 1961 and Oct. 15, 1961; and Taxation in Western Europe (2nd ed.), Federation of British Industries Taxation Studies.)

Belgium

In general, Belgium taxes the foreign income of corporations which have either their registered office or their principal administrative office in the country. However, some new surcharges and temporary taxes imposed by the Loi Unique of February 14, 1961, apply only to Belgian source income.

Belgium does not tax foreign income at the same rates as domestic income. Business income from other countries is taxed at one-fifth the rate for Belgian business income. Investment income from foreign sources is taxed at 12%, compared with tax rates on various types of investment income from Belgian sources ranging from 14% to 21%.

The tax of 24% on corporations distributing business income from Belgian sources in the year earned is reduced to 4% if the distribution is of foreign business income.

Dividends paid by a Belgian corporation from Belgian source profits are, in the case of "earned" income, taxed

to the shareholders at the rate of 30% plus a 5% temporary surcharge, while dividends paid by a Belgian corporation from foreign source profits of the same sort are taxed to the shareholders at 12% plus a 5% temporary surcharge. Dividends from foreign corporations are taxed at 12%, without any surcharge.

(Sources: European Taxation, Oct. 31, 1961; and Taxation in Western Europe (2nd ed.), Federation of British Industries Taxation Series.)

Netherlands

Dutch corporations are taxable on their income from foreign as well as domestic sources. However, relief from double taxation is provided in the case of the following types of income from foreign sources:

(a) business income carried on through a permanent establishment or a permanent representative outside the country;

(b) income from foreign real estate; and

(c) income from debts secured by mortgages on foreign real estate.

The relief provided is computed by first computing the Dutch tax on the corporation's total income and then reducing this by an amount which bears the same ratio to the total tentative tax as the foreign income bears to the total income. To qualify for this relief the foreign income must be subject to an income tax levied by the foreign country in which the income arises.

Both portfolio holding companies and holding companies with substantial holdings in subsidiaries are eligible for exemption on dividends received from non-resident corporations (as well as from resident corporations) if the corporations distributing the dividends are subject to a tax similar to the Dutch corporation tax.

Capital gains realized by corporations are taxed. Capital gains by individuals on the sale of stock are taxed if the shareholder is selling a major participation in the corporation.

The maximum corporate tax rate is 47%, which has been reduced to 45% effective in 1963.

(Source: European Taxation, May 1, 1961, May 31, 1961, and Jan. 31, 1962.)

Italy

Income earned outside Italy is exempt from the company tax and also from the personal income tax. Income produced abroad but brought into Italy is subject to the progressive surtax on personal incomes.

Capital gains realized by corporations are taxable, but capital gains realized by individuals on corporate securities are not taxable except for speculative gains in some circumstances.

The income tax on company profits is approximately 30%. In addition, the company tax is a combination of a tax of 0.75% on issued capital plus reserves and a tax of 15% on income in excess of 6% of capital and reserves. Dividends are not again subjected to income tax, but they are subject to the progressive surtax on personal incomes.

(Sources: European Taxation, Sept. 15, 1961; and Taxation in Western Europe (2nd ed.), Federation of British Industries Taxation Studies.)

Germany

Corporations which have their management or their registered offices in Germany have "unlimited tax liability" -- that is, they are taxed on their income both from within and outside of Germany.

"Management" means the center of effective management of the corporation. The standard applied is where the decisions are made which are important to the conduct of the corporation's business. As a rule, this is the place where the offices of the management are located.

The corporation tax on corporations with unlimited tax liability is 51%, reduced to 15% on profits distributed as dividends. Non-resident corporations, taxable only on their German-source income, are taxed at the rate of 49% on both their distributed and their undistributed profits.

The trade tax, an income tax levied by the communal authorities, generally at a rate of about 13%, does not apply to income which arises from a place of business outside Germany.

Capital gains realized by corporations are taxable at normal income rates. Capital gains realized on corporate securities by individuals are taxed if the individual is selling part of a major participation (over 25%) in the corporation's stock which has been held by him or his family.

(Source: Taxation in Germany, by Dr. Rudolf Mueller and Dr. Ernest Steefel.)

LATIN AMERICA

Brazil

Corporations are not taxed on their income from sources outside Brazil.

(Source: Taxation in Brazil, World Tax Series, Harvard Law School.)

Mexico

Resident corporations are taxed on their income from foreign sources. They may credit foreign income taxes up to the amount of Mexican income tax computed separately on the foreign income.

A corporation is a resident of Mexico if it is organized under Mexican law. Other corporations which regularly engage in taxable transactions through permanent establishments in Mexico are treated as residents only to the extent of the operations of their Mexican establishments.

(Source: Taxation in Mexico, World Tax Series, Harvard Law School.)

Venezuela

Venezuela taxes income from Venezuelan sources only.

(Source: Investment in Venezuela, U. S. Department of Commerce.)

Uruguay

The income tax applies only to income arising from activities developed, property situated, and rights financially exploited in Uruguay. Nationality, domicile, or residence are not material in determining whether or not income is subject to tax, except that for purposes of the complementary progressive tax on income of individuals, income obtained abroad by persons domiciled in Uruguay is taxed if it is brought into the country.

(Source: Diario Official of Uruguay, Dec. 16, 1960.)

Others

The Latin American countries generally impose income taxes on the principle of territoriality -- that is, they tax only income arising from sources within their territories.

United States Council

of the

International Chamber of Commerce

April 25, 1962

Appendix II

Income Tax Treaty Provisions
Which Conflict With H.R. 10650

CONFLICTS WITH SECTION 11

Australia

"(1) Subject to section 131 of the United States Internal Revenue Code as in effect on the date of signature of this Convention, Australian tax shall be allowed as a credit against United States tax.

"(2) * * *"

(Article XV)

Austria

"(1) . . . The United States shall, however, subject to the provisions of sections 901-905, Internal Revenue Code of 1954, as in effect on the entry into force of this Convention, deduct from its taxes the amount of Austrian taxes specified in Article I of this Convention.

"(2) * * * "

(Article XV)

Belgium

"(2) In accordance with the provisions of section 131 of the United States Internal Revenue Code as in effect on the day of the entry into force of the present Convention, the United States agrees to allow as a deduction from the income taxes imposed by the United States the appropriate amount of taxes paid to Belgium, whether paid directly by the taxpayer or by withholding.

"(3) * * * "

(Article XII)

Finland

"(1) It is agreed that double taxation shall be avoided in the following manner:

"(a) . . . The United States shall, however, subject to the provisions of section 131, Internal Revenue Code, as in effect on the date of the entry into force of this Convention, deduct from its taxes the amount of Finnish taxes specified in Article I of this Convention.

"(b) * * * "

(Article XV)

Germany

"(1) It is agreed that double taxation shall be avoided in the following manner:

"(a) . . . The United States shall, however, subject to the provisions of section 131, Internal Revenue Code, as in effect on the date of the entry into force of this Convention, deduct from its taxes the amount of Federal Republic taxes specified in Article I of this Convention. It is agreed that by virtue of the provisions of subparagraph (b) of this paragraph the Federal Republic satisfies the similar credit requirement set forth in section 131 (a)(3), Internal Revenue Code.

"(b) * * * "

(Article XV)

Honduras

"(1) It is agreed that double taxation shall be avoided in the following manner:

"(a) . . . The United States shall, however, subject to the provisions of sections 901 to 905, inclusive, of the Internal Revenue Code of 1954 (as in effect on the date of signature of the present Convention) deduct from its tax the amount of the tax of Honduras. For this purpose, the compensation received by a citizen or resident of the United States for services aboard ships flying the Honduran flag while on the high seas shall be deemed to be income from sources within Honduras.

"(b) * * * "

(Article XVI)

Ireland

"(1) Subject to section 131 of the United States Internal Revenue Code as in effect on the day on which this Convention shall have come into effect, Irish tax shall be allowed as a credit against United States tax. For this purpose, the recipient of a dividend paid by a corporation which is a resident of Ireland shall be deemed to have paid the Irish income tax appropriate to such dividend if such recipient elects to include in his gross income for the purposes of United States tax the amount of such Irish income tax. For the purposes only of this Article income derived from sources in the United Kingdom by an individual who is resident in Ireland shall be deemed to be income from sources in Ireland if such income is not subject to United Kingdom income tax.

"(2) * * * "

(Article XIII)

Japan

"(1) It is agreed that double taxation shall be avoided in the following manner:

"(a) . . . The United States shall, however, subject to the provisions of section 131 of the Internal Revenue Code as in effect on the first day of January 1954, deduct from its tax the amount of the tax of Japan. In determining the credit under the said section 131 of the Internal Revenue Code, any interest received from an enterprise of the United States with a permanent establishment in Japan shall be treated as income from sources within Japan to the extent so treated under the laws of Japan, if the debt with respect to which such interest is paid is made in connection with the business of such permanent establishment of such enterprise.

"(b) * * * "

(Article XIV)

New Zealand

"(1) Subject to section 131 of the United States Internal Revenue Code as in effect on the date of signature of this Convention, New Zealand tax shall be allowed as a credit against United States tax.

"(2) * * * "

(Article XIII)

Norway

"(1) It is agreed that double taxation shall be avoided in the following manner:

"(a) . . . The United States shall, however, subject to the provisions of section 131, Internal Revenue Code, as in effect on the date of the entry into force of this Convention, deduct from its taxes the amount of Norwegian taxes specified in Article I of this Convention.

"(b) * * * "

(Article XIV)

Switzerland

"(1) It is agreed that double taxation shall be avoided in the following manner:

"(a) . . . The United States shall, however, subject to the provisions of section 131, Internal Revenue Code, as in effect on the date of the entry into force of this Convention, deduct from its taxes the amount of Swiss taxes specified in Article I of this Convention. It is agreed that by virtue of the provisions of subparagraph (b) of this paragraph, Switzerland satisfies the similar credit requirement set forth in section 131 (a)(3), Internal Revenue Code.

"(b) * * * "

(Article XV)

Union of South Africa

"(1) . . . The United States of America shall, however, deduct from the taxes thus computed the amount of Union income tax paid. This deduction shall be made in accordance with the benefits and limitations of Section 131 of the United States Internal Revenue Code as in effect on the day of the entry into force of this Convention. It is agreed that by virtue of the provisions of paragraph (2) of this Article the Union of South Africa satisfies the "similar credit" requirement set forth in subsection (a)(3) of that section.

"(2) * * * "

(Article IV)

United Kingdom

"(1) Subject to Sections 901 to 905 of the United States Internal Revenue Code as in effect on the 1st day of January 1956, United Kingdom tax shall be allowed as a credit against United States tax. For this purpose

"(a) the recipient of a dividend paid by a corporation which is a resident of the United Kingdom shall be deemed to have paid the United Kingdom tax appropriate to such dividend, and

"(b) the recipient of any royalty or other amount coming within the scope of Article VIII of the present Convention shall be deemed to have paid any United Kingdom tax legally deducted from the royalty or other amount by the person by or through whom any payment thereof is made,

if the recipient of the dividend or royalty or other amount, as the case may be, elects to include in his gross income for the purposes of United States tax the amount of such United Kingdom income tax.

"(2) * * * "

(Article XIII)

* * * *

Canada

" * * *

"As far as may be in accordance with the provisions of the United States Internal Revenue Code, the United States of America agrees to allow as a deduction from the income and excess profits taxes imposed by the United States of America the appropriate amount of such taxes paid to Canada."

(Article XV)

Denmark

"It is agreed that double taxation shall be avoided in the following manner:

"(a) . . . The United States shall, however, subject to the provisions of section 131, Internal Revenue Code,

deduct from its taxes the amount of Danish taxes specified in Article I of this Convention.

"(b) . . ."

(Article XV)

France

"It is agreed that double taxation shall be avoided in the following manner:

A.--As regards the United States of America:

> " . . . The United States of America shall, however, deduct from the taxes thus computed the amount of French income tax paid. This deduction shall be made in accordance with the benefits and limitations of Section 131 of the United States Internal Revenue Code relating to credit for foreign taxes.

B.-- . . ."

(Article 14)

Greece

"(1) . . .

"(2) Subject to section 131 of the United States Internal Revenue Code, Greek tax shall be allowed as a credit against United States tax.

"(3) * * * "

(Article XIV)

Italy

"(1) It is agreed that double taxation shall be avoided in the following manner:

"(a) . . . The United States shall, however, subject to the provisions of sections 901, 902, 903, 904, and 905, Internal Revenue Code of 1954, deduct from its taxes the amount of Italian income taxes.

"(b) * * * "

(Article XV)

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CONFLICTS WITH SECTION 13

Exemption of Industrial and Commercial Profits

Austria

"(1) Industrial or commercial profits of an enterprise of one of the contracting States (including gains derived from the sale of any of the assets used by that enterprise) shall not be subject to tax by the other State unless the enterprise carries on trade or business in such other State through a permanent establishment situated therein. If it is so engaged, such other State may impose its tax upon the entire income of such enterprise from sources within such State and will limit its taxation of the enterprise to income from such sources.

"(2) . . . (4) . . ."

(Article III)

Germany

"(1) Industrial or commercial profits of an enterprise of one of the contracting States shall not be subject to tax by the other State unless the enterprise is engaged in trade or business in such other State through a permanent establishment situated therein. If it is so engaged, such other State may impose its tax upon the entire income of such enterprise from sources within such State and will limit its taxation of the enterprise to income from such sources.

"(2) . . . (5) . . ."

(Article III)

New Zealand

"(1) * * *

"(2) The industrial or commercial profits of a New Zealand enterprise shall not be subject to United States tax unless the enterprise is engaged in trade or business in the United States through a permanent establishment situated therein. If it is so engaged, United States tax may be imposed on the entire income of such enterprise from sources within the United States.

"(3) . . . (6) . . ."

(Article III)

Exemption of Enterprises of the Treaty Country

Australia

"(1) An Australian enterprise shall not be subject to United States tax in respect of its industrial or commercial profits unless it is engaged in trade or business in the United States through a permanent establishment in the United States. If it is so engaged, United States tax may be imposed upon the entire income of that enterprise from sources within the United States.

"(2) . . . (6) . . ."

(Article III)

Belgium

"(1) An enterprise of one of the Contracting States is not subject to taxation by the other Contracting State in respect of its industrial and commercial profits except in respect of such profits allocable to its permanent establishment in such other State.

"(2) . . ."

(Article III)

Canada

"An enterprise of one of the contracting States is not subject to taxation by the other contracting State in respect of its industrial and commercial profits except in respect of such profits allocable in accordance with the Articles of this Convention to its permanent establishment in the latter State."

(Article I)

Denmark

"(1) An enterprise of one of the contracting States shall not be subject to taxation in the other contracting State in respect of its industrial and commercial profits unless it is engaged in trade or business in such other State through a permanent establishment situated therein. If it is so engaged such other State may impose its tax upon the entire income of such enterprise from sources within such other State.

"(2) . . . (3) . . ."

(Article III)

Finland

"(1) An enterprise of one of the contracting States shall not be subject to taxation in the other contracting State in respect of its industrial and commercial profits unless it is engaged in trade or business in such other State through a permanent establishment situated therein. If it is so engaged such other State may impose its tax upon the entire income of such enterprise from sources within such other State.

"(2) . . . (4) . . . "

(Article III)

France

"An enterprise of one of the contracting States is not subject to taxation by the other contracting State in respect of its industrial and commercial profits except in respect of such profits allocable to its permanent establishment in the latter State."

(Article 3)

Greece

"(1) An enterprise of one of the Contracting States shall not be subject to taxation by the other Contracting State in respect of its industrial or commercial profits unless it is engaged in trade or business in the other Contracting State through a permanent establishment situated therein. If it is so engaged the other Contracting State may impose the tax only upon the income of such enterprise from sources within such other State.

"(2) . . . (4) . . . "

(Article III)

Honduras

"(1) An enterprise of one of the contracting States shall not be subject to the tax of the other contracting State in respect of its industrial or commercial or agricultural profits unless it has a permanent establishment situated in such other State. If it has such permanent establishment such other State may impose its tax upon the entire income of such enterprise from sources within such other State.

"(2) . . . "

(Article III)

India

"(1)(a) An Indian enterprise shall not be subject to United States tax in respect of its commercial or industrial profits unless it is engaged in trade or business in the United States through a permanent establishment situated therein. If it is so engaged, United States tax may be imposed upon the entire income of such enterprise from sources within the United States.

" (b) . . . (2) . . ."

(Article III)

Ireland

"(1) An Irish enterprise shall not be subject to United States tax in respect of its industrial or commercial profits unless it is engaged in trade or business in the United States through a permanent establishment situated therein. If it is so engaged, United States tax may be imposed upon the entire income of such enterprise from all sources within the United States.

"(2) . . . (4) . . ."

(Article III)

Italy

"(1) An enterprise of one of the contracting States shall not be subject to tax by the other contracting State in respect of its industrial and commercial profits unless it is engaged in trade or business in such other State through a permanent establishment situated therein. If it is so engaged such other State may impose its tax upon the entire income of such enterprise from sources within such other State.

"(2) . . . (5) . . ."

(Article III)

Japan

"(1) An enterprise of one of the contracting States shall not be subject to the tax of the other contracting State in respect of its industrial or commercial profits unless it has a permanent establishment situated in such other State. If it has such permanent establishment such other State may impose its tax upon the entire income of such enterprise from sources within such other State.

"(2) . . . (5) . . ."

(Article III)

Netherlands

"(1) An enterprise of one of the Contracting States shall not be subject to taxation by the other Contracting State in respect of its industrial or commercial profits unless it is engaged in trade or business in the other Contracting State through a permanent establishment situated therein. If it is so engaged the other Contracting State may impose the tax only upon the income of such enterprise from sources within such other State.

"(2) . . . (4) . . ."

(Article III)

Norway

"(1) An enterprise of one of the contracting States shall not be subject to taxation in the other contracting State in respect of its industrial and commercial profits unless it is engaged in trade or business in such other State through a permanent establishment situated therein. If it is so engaged such other State may impose its tax upon such profits of the enterprise from sources within such other State.

"(2) . . . (4) . . ."

(Article III)

Pakistan

"(1) * * *

"(2) A Pakistan enterprise shall not be subject to United States tax in respect of its industrial or commercial profits unless it is engaged in trade or business in the United States through a permanent establishment situated therein. If it is so engaged, United States tax may be imposed upon the entire income of such enterprise from sources within the United States.

"(3) . . ."

(Article III)

Sweden

"An enterprise of one of the contracting States is not subject to taxation by the other contracting State in respect of its industrial and commercial profits except in respect of such profits allocable to its permanent establishment in the latter State. The income thus taxed in the latter State shall be exempt from taxation in the former State."

(Article II)

Switzerland

"(1) (a) A Swiss enterprise shall not be subject to taxation by the United States in respect of its industrial and commercial profits unless it is engaged in trade or business in the United States through a permanent establishment situated therein. If it is so engaged the United States may impose its tax upon the entire income of such enterprise from sources within the United States.

"(1) (b) . . . (5) . . ."

(Article III)

Union of South Africa

"(1) An enterprise of one of the contracting State is not subject to taxation by the other contracting State in respect of its industrial and commercial profits except in respect of such profits allocable to its permanent establishment in the latter State, Provided that if such enterprise is a private company having a permanent establishment within the Union of South Africa nothing in this paragraph shall affect any provisions of the law of the Union of South Africa regarding the imposition upon the shareholders of that private company of the taxes payable in respect of its income.

"(2) . . . (3) . . ."

(Article V)

United Kingdom

"(1) A United Kingdom enterprise shall not be subject to United States tax in respect of its industrial or commercial profits unless it is engaged in trade or business in the United States through a permanent establishment situated therein. If it is so engaged, United

States tax may be imposed upon the entire income of such enterprise from sources within the United States.

"(2) . . . (4) . . ."

(Article III)

Exemption of Income From
Operation of Ships and Aircraft

Australia

"(1) Profits which an Australian resident derives from operating ships or aircraft registered in Australia shall be exempt from United States tax.

"(2) . . ."

(Article V)

Austria

"Profits derived by an enterprise of one of the contracting States from the operation of ships or aircraft shall be exempt from tax by the other State."

(Article V)

Belgium

"(1) Income which an enterprise of one of the Contracting States derives from the operation of ships or aircraft registered in that State shall be exempt from taxation in the other Contracting State.

"(2) . . ."

(Article VII)

Canada

"Income which an enterprise of one of the contracting States derives from the operation of ships or aircraft registered in that State shall be exempt from taxation in the other contracting State.

" * * * "

(Article V)

Denmark

"(1) Income which an enterprise of one of the contract ing States derives from the operation of ships or aircraft registered in that State shall be exempt from taxation in the other contracting State.

"(2) . . . "

(Article V)

Finland

"(1) Income which an enterprise of one of the contracting States derives from the operation of ships or aircraft registered in that State shall be exempt from taxation in the other contracting State.

"(2) . . . "

(Article V)

France

"Income derived by navigation enterprises of one of the contracting States from the operation of ships documented under the laws of that State shall continue to benefit in the other State by the reciprocal tax exemptions accorded by the exchange of notes of June 11 and July 8, 1927, between the United States of America and France.

"Income which an enterprise of one of the contracting States derives from the operation of aircraft registered in that State shall be exempt from taxation in the other State."

(Article 6)

Germany

"Profits derived by an enterprise of one of the contracting States from the operation of ships or aircraft, shall be exempt from tax by the other State."

(Article V)

Greece

"(1) Income which an enterprise of one of the Contracting States derives from the operation of ships or aircraft registered or documented in that State shall be exempt from tax by the other Contracting State. Income

derived by such an enterprise from the operation of ships or aircraft not so registered or documented shall be subject to the provisions of Article III.

"(2) . . ."

(Article V)

Honduras

"Profits derived by an enterprise of one of the contracting States from the operation of ships or aircraft or from the operation of motor vehicles for hire between the United States and Honduras by way of the Inter-American Highway, shall be exempt from tax by the other contracting State, if such ships, aircraft or motor vehicles are registered under the laws of the former State."

(Article VI)

India

"Income derived by an enterprise of one of the territories from the operation of aircraft registered or documented in that territory shall not be taxed in the other territory."

(Article V)

Ireland

"(1) Notwithstanding the provisions of Articles III and IV of the present Convention, profits which an individual resident of Ireland or an Irish corporation derives from operating ships documented or aircraft registered under the laws of Ireland, shall be exempted from United States tax.

"(2) . . . (3) . . ."

(Article V)

Italy

"(1) Income which an enterprise of one of the contracting States derives from the operation of ships or aircraft registered in that State shall be exempt from taxation in the other contracting State.

"(2) . . ."

(Article V)

Japan

"(1) Notwithstanding the provisions of Article III and Article IV of the present Convention, income which an enterprise of one of the contracting States derives from the operation of ships or aircraft registered

"(a) in such State, or

"(b) in a third country which exempts (A) such enterprise and (B) an enterprise of the other contracting State, from its tax on earnings derived from the operation of ships or aircraft, as the case may be, registered in the respective States

shall be exempt from the tax of such other contracting State.

"(2) . . ."

(Article V)

Netherlands

"(1) Income which an enterprise of one of the Contracting States derives from the operation of ships or aircraft registered in that State shall be taxable only in the State in which such ships or aircraft are registered. Income derived by such an enterprise from the operation of ships or aircraft not so registered shall be subject to the provisions of Article III.

"(2) . . . (3) . . ."

(Article VI)

New Zealand

"(1) Notwithstanding the provisions of Articles III and IV of the present Convention, profits which an individual resident of New Zealand or a New Zealand corporation derives from operating ships or aircraft shall be exempt from United States tax.

"(2) . . ."

(Article V)

Norway

"(1) Income which an enterprise of one of the contracting States derives from the operation of ships or

aircraft shall be exempt from taxation in the other contracting State.

"(2) . . ."

(Article V)

Pakistan

"Profits derived by an enterprise of one of the contracting States from the operation of aircraft registered in such State shall be exempted from tax by the other contracting State, unless the aircraft is operated wholly or mainly between places within such other contracting State."

(Article V)

Sweden

"Income which an enterprise of one of the contracting States derives from the operation of ships or aircraft registered in that State is taxable only in the State in which registered. Income derived by such an enterprise from the operation of ships or aircraft not so registered shall be subject to the provisions of Article II."

(Article IV)

Switzerland

"Income which an enterprise of one of the contracting States derives from the operation of ships or aircraft registered in that State shall be taxable only in the State in which such ships or aircraft are registered."

(Article V)

Union of South Africa

"(1) * * *

"(2) Profits derived by a Union enterprise from the operation of aircraft registered in the Union of South Africa or ships whose port of registry is in the Union of South Africa shall be exempt from United States of America tax."

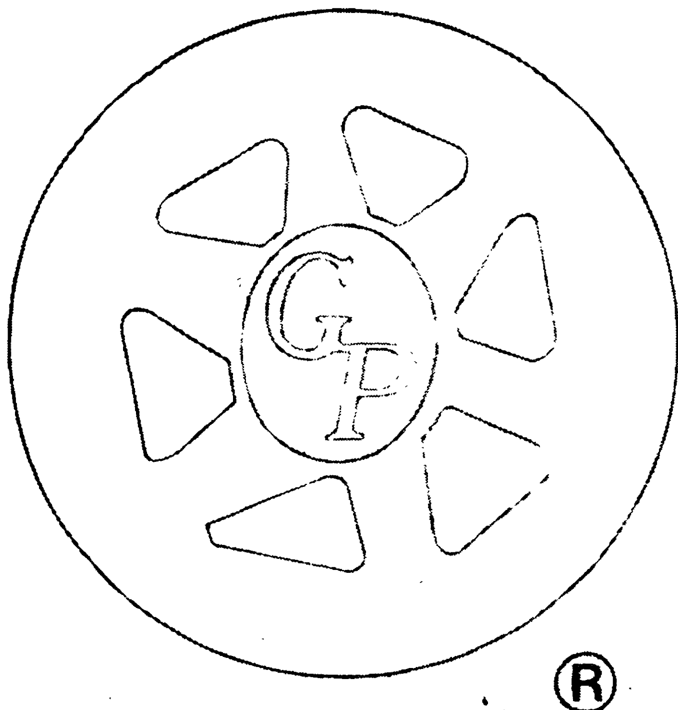
(Article I)

United Kingdom

"(1) Notwithstanding the provisions of Articles III and IV of the present Convention, profits which an individual (other than a citizen of the United States) resident in the United Kingdom or a United Kingdom corporation derives from operating ships documented or aircraft registered under the laws of the United Kingdom, shall be exempt from United States tax.

"(2) . . . (3) . . ."

(Article V)



United States Council

of the

International Chamber of Commerce

April 25, 1962

Appendix III

Proposed Substitute for Section 13 of H.R. 10650

SEC. 13. CONTROLLED FOREIGN CORPORATIONS.

(a) IN GENERAL.--Part III of subchapter N of chapter 1 (relating to income from sources without the United States) is amended by adding at the end thereof the following new subpart:

"Subpart F--Controlled Foreign Corporations

"Sec. 951. Amounts included in gross income of United States persons.
"Sec. 952. Subpart F income defined.
"Sec. 953. Investment of earnings in nonqualified property.
"Sec. 954. Controlled foreign corporations.
"Sec. 955. Rules for determining stock ownership.
"Sec. 956. Exclusion from gross income of previously taxed earnings and profits.
"Sec. 957. Special rules for foreign tax credit.
"Sec. 958. Adjustments to basis of stock in controlled foreign corporations and of other property.

"SEC. 951. AMOUNTS INCLUDED IN GROSS INCOME OF UNITED STATES PERSONS.

"(a) AMOUNTS INCLUDED.--

"(1) In General.--If a foreign corporation is a controlled corporation on any day of a taxable year beginning after December 31, 1962, every United States person (Including a citizen or resident of the United States, and a domestic partnership, corporation, estate, or trust) who owns (within the meaning of section 955(a)) stock in such corporation on the last day, in such year, on which such corporation is a controlled foreign corporation shall include in his gross income, for his taxable year in which or with which such taxable year of the corporation ends--

"(A) his pro rata share (determined under paragraph (2)) of the corporation's subpart F income for such year, and

"(B) his pro rata share (determined under section 953(a)(2)) of the corporation's increase in earnings invested in nonqualified property for such year (but only to the extent not excluded from gross income under section 956(a)(2)).

"(2) Pro Rata Share of Subpart F Income.--The pro rata share referred to in paragraph (1)(A) in the case of any United States person is the amount--

"(A) which would have been distributed with respect to the stock which such person owns (within the meaning of section 955(a)) in such corporation if on the last day, in its taxable year, on which the corporation is a controlled foreign corporation it had distributed pro rata to its shareholders an amount (i) which bears the same ratio to its subpart F income for the taxable year, as (ii) the part of such year during which the corporation is a controlled foreign corporation bears to the entire year, reduced by

"(B) the amount of any distribution received by any other United States person during such year as a dividend with respect to such stock.

"(3) Limitation on Amount of Pro Rata Share of Investment in Nonqualified Property Included in Gross Income.--For purposes of paragraph (1)(B), the pro rata share of any United States person in the increase of the earnings of a controlled foreign corporation invested in nonqualified property shall not exceed an amount (A) which bears the same ratio to his pro rata share of such increase (as determined under section 953(a)(2)) for the taxable year, as (B) the part of such year during which the corporation is a controlled foreign corporation bears to the entire year.

"(b) LESS THAN 10-PERCENT OWNERSHIP.--No person shall be required to include any amount in gross income under subsection (a) unless he can be considered, by applying the rules of ownership of section 955(b), as owning, directly or indirectly, on any day during the taxable year of the corporation on which it was a controlled foreign corporation, 10 percent or more of the total combined voting power of all classes of stock, or of the total value of shares of all classes of stock, of such corporation.

"SEC. 952. SUBPART F INCOME DEFINED.

"(a) IN GENERAL.--

"(1) Items Taken into Account.--For purposes of this subpart, the term 'subpart F income' means, in the case of any controlled foreign corporation, the sum of--

"(A) income derived from insurance of United States risks (as determined under subsection (b)), and

"(B) the net foreign base company income (as determined under subsection (c)), except that this subparagraph shall apply only in the case of a controlled foreign corporation in which 5 or fewer United States persons own, by applying the rules of ownership of section 955(b), more than 50 percent of the total combined voting power of all classes of stock entitled to vote.

"(2) Exclusion of United States Income.--Subpart F income does not include any item includible in gross income under this chapter (other than this subpart) as income derived from sources within the United States of a foreign corporation engaged in trade or business in the United States.

"(3) Not to Exceed Earnings and Profits.--The subpart F income of any controlled foreign corporation for any taxable year shall not exceed the earnings and profits of such corporation for such year.

"(b) INCOME FROM INSURANCE OF UNITED STATES RISKS.--

"(1) General Rule.--If a controlled foreign corporation receives premiums or other consideration in respect of any reinsurance or the issuing of any insurance or annuity contract--

"(A) in connection with property in, or residents of, the United States, or

"(B) in connection with property not in, or nonresidents of, the United States as the result of any arrangement whereby another corporation receives a substantially equal amount of premiums or other consideration in respect of any reinsurance or the issuing of any insurance or annuity contract in connection with property in, or residents of, the United States,

then for purposes of subsection (a)(1)(A), the term 'income derived from the insurance of United States risks' means that income which (subject to the modifications provided by subparagraphs (A), (B), and (C) of paragraph (2)) would be taxed under subchapter L of this chapter if such corporation were a domestic corporation.

"(2) Special Rules.--For purposes of paragraph (1)--

"(A) In the application of part I of subchapter L, life insurance company taxable income is the gain from operations as defined in section 809(b).

"(B) A corporation which would, if it were a domestic corporation, be taxable under part II of subchapter L shall apply paragraph (1) as if it were taxable under part III of subchapter L.

"(C) The following provisions of subchapter L shall not apply:

"(i) Section 809(d)(4) (operations loss deduction).

"(ii) Section 809(d)(5) (certain non-participating contracts).

"(iii) Section 809(d)(6) (group life, accident, and health insurance).

"(iv) Section 809(d)(10) (small business deduction).

"(v) Section 817(b) (gain on property held on December 31, 1958, and certain substituted property acquired after 1958).

"(vi) Section 832(b)(5) (certain capital losses).

"(D) 'Gross amount' to the extent provided in section 809(c) (1) and (2), less 'increase in certain reserves' as defined in section 809(d)(2), and 'premiums earned' as defined in section 832 (b)(4) shall be taken into account only to the extent they are in respect of any reinsurance or the issuing of any reinsurance or the issuing of any insurance or annuity contract described in paragraph (1).

"(E) All items of income (other than those taken into account under subparagraph (D)) and all items of expenses, losses, and deductions shall be properly allocated or apportioned under regulations prescribed by the Secretary or his delegate.

"(c) NET FOREIGN BASE COMPANY INCOME.--For purposes of subsection (a)(1)(C), the term 'net foreign base company income' means--

"(1) the foreign base company income for the taxable year, determined under subsection (d), reduced by

"(2) the increase in investment in qualified property for the taxable year, determined under subsection (e).

"(d) FOREIGN BASE COMPANY INCOME.--

"(1) In General.--For purposes of subsection (d)(1), the term 'foreign base company income' means the foreign personal holding company income (as defined in section 553) for the taxable year, modified and adjusted as provided in this subsection.

"(2) Insurance Income Excluded.--The term 'foreign base company income' does not include any income derived from insurance of United States risks (as determined under subsection (b)).

"(3) Income of Certain Banks and Bank-Controlled Corporations Excluded.--The term 'foreign base company income' does not include--

"(A) the income of any corporation described in section 552(b) (relating to exception for banks and exempt corporations), or

"(B) the income of any foreign corporation if 50 percent or more of the fair market value of its outstanding stock is owned directly or indirectly by a domestic corporation which is either organized under section 25(a) of the Federal Reserve Act (12 U.S.C., secs. 611-631), or has an agreement or understanding with the Board of Governors of the Federal Reserve System under section 25 of the Federal Reserve Act (12 U.S.C., secs. 601-604), if all of the stock (except qualifying shares) of the domestic corporation is owned by a National or State bank which is a member of the Federal Reserve System.

"(4) Rule for Determining Foreign Base Company Income.--For purposes of this subsection if the foreign base company income (determined without regard to paragraph (5)) is less than 80 percent of gross income, no part of the gross income of the taxable year shall be treated as foreign base company income.

"(5) Deductions to be Taken into Account.--The foreign base company income for the taxable year shall be reduced so as to take into account deductions (including taxes) properly allocable to such income.

"(e) INVESTMENT IN QUALIFIED PROPERTY OUTSIDE THE UNITED STATES.--

"(1) General Rule.--For purposes of subsection (c)(2), the increase in investment in qualified property for any taxable year is the amount by which--

"(A) the aggregate amount of property described in sections 953(b)(2) held at the close of the taxable year, exceeds

"(B) the aggregate amount of property described in subparagraph (A) held at the close of the preceding taxable year.

"(2) Investments After Close of Year.--Under regulations prescribed by the Secretary or his delegate, a controlled foreign corporation may elect to make the determinations under subparagraphs (A) and (B) of paragraph (1) as of the close of the 75th day after the close of each taxable year.

"(3) Amount Attributable to Property.--The amount taken into account under paragraph (1) with respect to any property shall be its adjusted basis, reduced by any liability to which the property is subject.

"SEC. 953. INVESTMENT OF EARNINGS IN NONQUALIFIED PROPERTY.

"(a) GENERAL RULES.--For purposes of this subpart--

"(1) Amount of Investment.--The amount of earnings of a controlled foreign corporation invested in nonqualified property at the close of any taxable year is the aggregate amount of such property held at the close of the taxable year, to the extent such amount does not exceed the sum of (A) the earnings and profits for the taxable year, and (B) the earnings and profits accumulated for prior taxable years beginning after December 31, 1962.

"(2) Pro Rata Share of Increase for Year.--In the case of any United States person, the pro rata share of the increase for any taxable year in the earnings of a controlled foreign corporation invested in a nonqualified property is the amount determined by subtracting--

"(A) his pro rata share of the amount determined under paragraph (1) for the close of the preceding taxable year, reduced by amounts paid during the taxable year to which section 956(c)(1) applies, from

"(B) his pro rata share of the amount determined under paragraph (1) for the close of the taxable year.

"(3) Amount Attributable to Property.--The amount taken into account under paragraph (1) or (2) with respect to any property shall be its adjusted basis, reduced by any liability to which the property is subject.

"(b) NONQUALIFIED PROPERTY DEFINED.--For purposes of this subpart--

"(1) General Rule.--The term 'nonqualified property' means any money or other property (tangible or intangible) acquired after December 31, 1962, which is not qualified property.

"(2) Qualified Property.--The term 'qualified property' means--

"(A) Any money or other property which is located outside the United States and is ordinary and necessary for the active conduct of a trade or business carried on almost wholly without the United States by the controlled foreign corporation.

"(B) Property which would qualify under subparagraph (A) except for the fact that it is located in the United States, but only if such property is--

"(i) obligations of the United States, money, or deposits with persons carrying on the banking business;

"(ii) property purchased in the United States for export to, or for use in, foreign countries; or

"(iii) any loan arising in connection with the sale of property if the amount of such loan outstanding at no time during the taxable year exceeds the amount which would be ordinary and necessary to carry on the trade or business of both the lending corporation and the borrowing United States person had the sale been made between unrelated persons.

"(C) Stock owned by the controlled foreign corporation in another controlled foreign corporation in which it owns at least 10 percent of the voting stock and 10 percent of the value of all classes of stock; but this subparagraph shall apply only if substantially all of the property of such other controlled foreign corporation is ordinary and necessary for the active conduct of a trade or business engaged in by it almost wholly without the United States.

"(D) Any investment which is required because of restrictions imposed by a foreign country, and any investment which, when made, was so required and which would result in substantial losses if withdrawn.

"(3) Situs of Certain Property.--Property which is an obligation of, or pledges and guarantees made with respect to obligations of, United States persons shall be considered as property located in the United States.

"SEC. 954. CONTROLLED FOREIGN CORPORATIONS.

"(a) GENERAL RULE.--For purposes of this subpart, the term 'controlled foreign corporation' means any foreign corporation of which more than 50 percent of the total combined voting power of all classes of stock entitled to vote is owned, directly or indirectly (within the meaning of section 955(b)), by United States persons on any day during the taxable year of such foreign corporation.

"(b) SPECIAL RULE FOR INSURANCE.--For purposes only of taking into account income described in section 952(a)(1)(A) (relating to income derived from insurance of United States risks), the term 'controlled foreign corporation' includes not only a foreign corporation as defined by subsection (a) but also one of which more than 25 percent of the total combined voting power of all classes of stock is owned, directly or indirectly (within the meaning of section 955(b)), by United States persons on any day during the taxable year of such corporation, if the gross amount of premiums or other

consideration in respect of reinsurance or the issuing of insurance or annuity contracts in connection with property in, or residents of, the United States, exceeds 75 percent of the gross amount of all premiums or other consideration in respect to all risks.

"SEC. 955. RULES FOR DETERMINING STOCK OWNERSHIP.

"(a) FOR PURPOSES OF SECTION 951(a).--

"(1) General Rule.--For purposes of section 951(a), stock owned means--

"(A) stock owned directly, and

"(B) stock owned with the application of paragraph (2).

"(2) Stock Ownership Through Foreign Entities.--For purposes of subparagraph (B) of paragraph (1), stock owned, directly or indirectly, by or for a foreign corporation, foreign partnership, or foreign trust or foreign estate shall be considered as being owned proportionately by its shareholders, partners, or beneficiaries. Stock considered to be owned by a person by reason of the application of the preceding sentence shall, for purposes of applying such sentence, be treated as actually owned by such person.

"(3) Special Rule for Mutual Insurance Companies.--For purposes of applying paragraph (1) in the case of a foreign mutual insurance company, the term 'stock' shall include any certificate entitling the holder to voting power in the corporation.

"(b) OTHER PROVISIONS.--For purposes of sections 951(b), 952(a)(1)(C), and 954, section 318(a) (relating to constructive ownership of stock) shall apply to the extent that the effect is to subject a United States person to the requirement of section 951(a), to treat 5 or fewer United States persons as owning more than 50 percent of all classes of stock entitled to vote of a controlled foreign corporation, or to make a foreign corporation a controlled foreign corporation under section 954, except--

"(1) In applying paragraph (1)(A) of section 318(a), stock owned by a nonresident alien individual (other than a foreign trust or foreign estate) shall not be considered as owned by a citizen or by a resident alien individual.

"(2) In applying the first sentence of subparagraphs (A) and (B), and in applying clause (i) of subparagraph (C), of section 318(a)(2)--

"(A) if a partnership, estate, trust, or corporation owns, directly or indirectly, more than 50 percent of the total combined voting power of all classes of stock entitled to vote of a corporation, it shall be considered as owning all the stock entitled to vote, and

"(B) if a partnership, estate, trust, or corporation owns, directly or indirectly, more than 50 percent of the total value of shares of all classes of stock of a corporation, it shall be considered as owning the total value of all of the outstanding stock of such corporation. The application of this subparagraph shall not have the effect of increasing voting power of a partner, beneficiary, or shareholder, for purposes of subparagraph (A).

"(3) Stock owned by a partnership, estate, trust, or corporation, by reason of the application of the second sentence of subparagraphs (A) and (B), and the application of clause (ii) of subparagraph (C), of section 318(a)(2), shall not be considered as owned by such partnership, estate, trust, or corporation, for the purposes of applying the first sentence of subparagraphs (A) and (B), and in applying clause (i) of subparagraph (C), of section 318(a)(2).

"(4) In applying clause (i) of subparagraph (C) of section 318(a)(2), the 50-percent limitation contained in subparagraph (C) shall not apply.

"SEC. 956. EXCLUSION FROM GROSS INCOME OF PREVIOUSLY TAXED EARNINGS AND PROFITS.

"(a) EXCLUSION FROM GROSS INCOME OF UNITED STATES PERSONS.--For purposes of this chapter, the earnings and profits for a taxable year of a foreign corporation attributable to amounts which are, or have been, included in the gross income of a United States person under section 951(a) shall not, when--

"(1) such amounts are distributed to, or

"(2) such amounts would, but for this subsection, be included under section 951(a)(1)(B) in the gross income of,

such person (or any other United States person who acquires from any person any portion of the interest of such United States person in such foreign corporation, but only to the extent of such portion, and subject to such proof of the identity of such interest as the Secretary or his delegate may by regulations prescribe) directly, or indirectly through a chain of ownership described under section 955(a), be again included in the gross income of such United States person (or of such other United States person).

"(b) EXCLUSION FROM GROSS INCOME OF CERTAIN FOREIGN SUBSIDIARIES.--For purposes of section 951(a), the earnings and profits for a taxable year of a controlled foreign corporation attributable to amounts which are, or have been, included in the gross income of a United States person under section 951(a), shall not, when distributed through a chain of ownership described under section 955(a), be also included in the gross income of another controlled foreign corporation in such chain for purposes of the application of section 951(a) to such other controlled foreign corporation with respect to such United States person (or to any other United States person who acquires from any person any portion of the interest of such United States person in the controlled foreign corporation, but only to the extent of such portion, and subject to such proof of identity of such interest as the Secretary or his delegate may prescribe by regulations).

"(c) ALLOCATION OF DISBRIBUTIONS.--For purposes of subsections (a) and (b), section 316(a) shall be applied by applying paragraph (2) thereof, and then paragraph (1) thereof--

"(1) first to earnings and profits attributable to amounts included in gross income under section 951 (a)(1)(B) (or which would have been included except for section 956(a)(2)),

"(2) then to earnings and profits attributable to amounts included in gross income under section 951 (a)(1)(A) (but reduced by amounts not included under section 951(a)(1)(B) because of the exclusion in section 956(a)(2)), and

"(3) then to other earnings and profits.

"(d) DISTRIBUTIONS EXCLUDED FROM GROSS INCOME NOT TO BE TREATED AS DIVIDENDS.--Except as provided in section 957(a) (3), any distribution excluded from gross income under subsection (a) shall be treated, for purposes of this chapter, as a distribution which is not a dividend.

"SEC. 957. SPECIAL RULES FOR FOREIGN TAX CREDIT.

"(a) TAXES PAID BY A FOREIGN CORPORATION.--

"(1) General Rule.--For purposes of subpart A of this part, if there is included, under section 951 (a), in the gross income of a domestic corporation any amount attributable to earnings and profits--

"(A) of a foreign corporation at least 10 percent of the voting stock of which is directly owned by such domestic corporation, or

"(B) of a foreign corporation at least 50 percent of the voting stock of which is directly owned by a foreign corporation at least 10 percent of the voting stock of which is in turn directly owned by such domestic corporation.

then, under regulations prescribed by the Secretary or his delegate, such domestic corporation shall be deemed to have paid the same proportion of the total income, war profits, and excess profits taxes paid (or deemed paid, if, paragraph (4) applies) to a foreign country or possession of the United States for the taxable year which the amount of earnings and profits of such foreign corporation so included in gross income of the domestic corporation bears to the entire amount of the total earnings and profits of such foreign corporation for such taxable year.

"(2) Taxes Previously Deemed Paid by Domestic Corporation.--If a domestic corporation receives a distribution from a foreign corporation, any portion of which is excluded from gross income under section 956, the income, war profits, and excess profits taxes paid or deemed paid by such foreign corporation to any foreigh country or to any possession of the United States in connection with the earnings and profits of such foreign corporation from which such distribution is made shall not be taken into account for purposes of section 902, to the extent such taxes were deemed paid by such domestic corporation under paragraph (1) for any prior taxable year.

"(3) Taxes Paid by Foreign Corporation and Not Previously Deemed Paid by Domestic Corporation.--Any portion of a distribution from a foreign corporation received by a domestic corporation which is excluded from gross income under section 956(a) shall be treated by the domestic corporation as a dividend, solely for purposes of taking into account under section 902 any

income, war profits, or excess profits taxes paid to any foreign country or to any possession of the United States, on or with respect to the accumulated profits of such foreign corporation from which such distribution is made, which were not deemed paid by the domestic corporation under paragraph (1) for any prior taxable year.

"(4) Taxes Paid by a Foreign Subsidiary.--If subparagraph (A) of paragraph (1) applies with respect to an amount included in gross income under section 951(a) for a taxable year, then such amount shall be considered a dividend for purpose of the application of section 902(b).

"(5) Inclusion in Gross Income.--

"For inclusion in gross income of amount equal to taxes deemed paid under paragraph (1), see section 78.

"(b) SPECIAL RULES FOR FOREIGN TAX CREDIT IN YEAR OF RECEIPT OF PREVIOUSLY TAXED EARNINGS AND PROFITS.--

"(1) Increase in Section 904 Limitation.--In the case of any taxpayer who--

"(A) either (i) chose to have the benefits of subpart A of this part for a taxable year in which he was required under section 951(a) to include in his gross income an amount in respect of a controlled foreign corporation, or (ii) did not pay or accrue for such taxable year any income, war profits, or excess profits taxes to any foreign country or to any possession of the United States, and

"(B) chooses to have the benefits of subpart A of this part for the taxable year in which he receives a distribution or amount which is excluded from gross income under section 956 (a) and which is attributable to earnings and profits of the controlled foreign corporation which was included in his gross income for the taxable year referred to in subparagraph (A), and

"(C) for the taxable year in which such distribution or amount is received, pays, or is deemed to have paid, or accrues income, war profits, or excess profits taxes to a foreign country or to any possession of the United

States with respect to such distribution or amount,

the applicable limitation under section 904 for the taxable year in which such distribution or amount is received shall be increased as provided in paragraph (2), but such increase shall not exceed the amount of such taxes paid, or deemed paid, or accrued with respect to such distribution or amount.

"(2) Amount of Increase.--The amount of increase of the applicable limitation under section 904(a) for the taxable year in which the distribution or amount referred to in paragraph (1)(B) is received shall be an amount equal to--

"(A) the amount by which the applicable limitation under section 904(a) for the taxable year referred to in paragraph (1)(A) was increased by reason of the inclusion in gross income under section 951(a) of the amount in respect of the controlled foreign corporation, reduced by

"(B) the amount of any income, war profits, and excess profits taxes paid, or deemed paid, or accrued to any foreign country or possession of the United States which were allowable as a credit under section 901 for the taxable year referred to in paragraph (1)(A) and which would not have been allowable but for the inclusion in gross income of the amount described in subparagraph (A).

"(3) Cases in Which Taxes Not to be Allowed as Deduction.--In the case of any taxpayer who--

"(A) chose to have the benefits of subpart A of this part for a taxable year in which he was required under section 951(a) to include in his gross income an amount in respect of a controlled foreign corporation, and

"(B) does not choose to have the benefits of subpart A of this part for the taxable year in which he receives a distribution or amount which is excluded from gross income under section 956(a) and which is attributable to earnings and profits of the controlled foreign corporation which was included in his gross income for the taxable year referred to in subparagraph (A),

no deduction shall be allowed under section 164 for the

taxable year in which such distribution or amount is received for any income, war profits, or excess profits taxes paid or accrued to any foreign country or to any possession of the United States on or with respect to such distribution or amount.

"(4) Insufficient Taxable Income.--If an increase in the limitation under this subsection exceeds the tax imposed by this chapter for such year, the amount of such excess shall be deemed an overpayment of tax for such year.

"SEC. 958. ADJUSTMENTS TO BASIS OF STOCK IN CONTROLLED FOREIGN CORPORATION AND OF OTHER PROPERTY.

"(a) INCREASE IN BASIS.--Under regulations prescribed by the Secretary or his delegate, the basis of a United States person's stock in a controlled foreign corporation, and the basis of property of a United States person by reason of which he is considered under section 955(a)(2) as owning stock of a controlled foreign corporation, shall be increased by the amount required to be included in his gross income under section 951(a) with respect to such stock or with respect to such property, as the case may be, but only to the extent to which such amount was included in the gross income of such person.

"(b) REDUCTION IN BASIS.--

"(1) In General.--Under regulations prescribed by the Secretary or his delegate, the adjusted basis of stock or other property with respect to which a United States person receives an amount which is excluded from gross income under section 956(a) shall be reduced by the amount so excluded.

"(2) Amount in Excess of Basis.--To the extent that an amount excluded from gross income under section 956(a) exceeds the adjusted basis of the stock or other property with respect to which it is received, the amount shall be treated as gain from the sale or exchange of property."

(b) TECHNICAL AND CLERICAL AMENDMENTS.--

(1) Section 551(b) (relating to foreign personal holding company income included in gross income of United States shareholders) is amended by adding at the end thereof the following new sentence: "The amount included in the gross income of any United States shareholder for any taxable year under the preceding sentence shall be reduced by such shareholder's proportionate

share of the undistributed personal holding company income which is included in his gross income under section 951(a)(1)(A) (relating to amounts included in gross income of United States persons) for such taxable year as his pro rata share of the subpart F income of the company."

(2) Section 901 (relating to foreign tax credit) is amended by striking out "section 902" and inserting in lieu thereof "sections 902 and 957".

(3) Section 902(e) is amended to read as follows:

"(e) CROSS REFERENCES.--

"(1) For application of subsections (a) and (b) with respect to taxes deemed paid in prior taxable year by a United States person with respect to a controlled foreign corporation, see section 957.

"(2) For reduction of credit with respect to dividends paid out of accumulated profits for years for which certain information is not furnished, see section 6038."

(4) Section 904(f) is amended to read as follows:

"(f) CROSS REFERENCES.--

"(1) For increase of applicable limitation under subsection (a) for taxes paid with respect to amounts received which were included in the gross income of the taxpayer for a prior taxable year as a United States person with respect to a controlled foreign corporation, see section 957(b).

"(2) For special rule relating to the application of the credit provided by section 901 in the case of affiliated groups which include Western Hemisphere trade corporations for years in which the limitation provided by subsection (a)(2) applies, see section 1503(d)."

(5) The table of subparts for Part III of subchapter N of chapter 1 is amended by adding at the end thereof the following:

"Subpart F. Controlled foreign corporations."

(6) Section 1016(a) (relating to adjustments to basis) is amended--

(A) by striking out the period at the end of paragraph (18) and inserting in lieu thereof a semicolon; and

(B) by adding after paragraph (18) the following new paragraph:

"(19) to the extent provided in section 958 in the case of stock in controlled foreign corporations (or foreign corporations which were controlled foreign corporations) and of property by reason of which a person is considered as owning such stock."

(c) EFFECTIVE DATE.--The amendments made by this section shall apply with respect to taxable years of foreign corporations beginning after December 31, 1962, and to taxable years of United States persons within which or with which such taxable years of such foreign corporations end.

The CHAIRMAN. The next witness is Mr. Joseph B. Brady of the National Foreign Trade Council.

Take a seat, Mr. Brady, and proceed.

STATEMENT OF JOSEPH B. BRADY, VICE PRESIDENT, NATIONAL FOREIGN TRADE COUNCIL, INC., ACCOMPANIED BY DONALD F. HEATHERINGTON, VICE PRESIDENT, NATIONAL FOREIGN TRADE COUNCIL, INC.

Mr. BRADY. Mr. Chairman and members of the Committee on Finance, my name is Joseph B. Brady. I am a vice president of the National Foreign Trade Council, Inc., and secretary of its tax committee. I am accompanied by Mr. Donald F. Heatherington, a vice president of NFTC, and secretary of its balance-of-payments group.

The National Foreign Trade Council, which was founded in 1914, is composed of U.S. corporations engaged in all aspects of foreign trade and business. Its basic function is the protection and promotion of American foreign trade and business.

NFTC is iterested in those sections of H.R. 10650, the Revenue Act of 1962, and amendments thereto suggested by the Secretary of the Treasury which directly affect U.S. foreign trade and business. The National Foreign Trade Council has prepared a written statement which it is respectfully requested be inserted in the record.

I offer the written statement for inclusion in the record, Mr. Chairman.

The CHAIRMAN. Without objection, it will appear in the record following your oral presentation.

Mr. BRADY. In this statement we have commented on the following sections:

Section 5, amount of distribution where certain foreign corporations distribute property in kind.

Section 6, amendments to section 482.

Section 11, domestic corporations receiving dividends from foreign corporations.

Section 12, earned income from sources without the United States.

Section 13, controlled foreign corporations.

Section 16, gain from certain sales or exchanges of stock in certain foreign corporations.

Section 20, information with respect to certain foreign entities.

Section 21, treaties.

We also have commented upon the amendments to the bill concerning taxation of income from foreign trade and business suggested by the Secretary of the Treasury in his testimony before this committee, including his proposal that there should be enacted into law "general elimination of deferral in the taxation of foreign subsidiaries." Because of shortness of time available today we will limit our oral remarks to a summary of some of our views set forth in the written statement.

NFTC is most concerned that all segments of U.S. business operate at the highest economic level possible. However, it is urged that the overall economy will not be benefited by depressing foreign trade and business which represent an extremely important sector of our total

economy. If any action should be taken in the fiscal area in respect to foreign trade and business, it is that burdens should be made less onerous.

The overwhelming majority of U.S. businesses abroad are carried on solely for sound business reasons. Their operations and the form in which they are carried on are, with possible minimal fringe exceptions, planned and executed without any attempt to avoid U.S. taxation.

Foreign trade and investment complement each other, both with reference to individual companies and the U.S. economy as a whole. In other words, investment is an essential factor in the ability of business to maintain and extend its exports.

In many instances, a single company is engaged in one or more of the following activities: exporting from the United States, producing abroad, marketing of U.S. and foreign products, exporting of technical information, and related financial activities. In complex operations different forms of organization and various types of transactions are required for business purposes.

There is no certainty that any foreign trade and business which would be curtailed because of the enactment into law of this bill will be balanced either by trade and investment in different form in foreign countries, or that any income remitted will be invested in the United States. Frequently, the choice is not between exports from the United States and investments abroad, but between investments abroad and loss of trade. Similarly, the choice is not between investments abroad and investments in the United States. The investment must be made abroad or no investment will be made. Frequently because of legal and business reasons not connected with U.S. tax considerations the trade of investment must be made through a particular form of corporate arrangement.

Other aspects of American foreign economic policy should be considered in connection with the provisions in this bill including the trade bill, H.R. 9900, and the balance-of-payments effects.

The President has announced on a number of occasions that exports must be stimulated. It seems likely that to some extent, at least, the proposals in H.R. 10650, particularly those in section 13, will hamper exports.

Further, the provisions of this bill seem to be contrary to the purposes of the Alliance for Progress, commercial activities in and with underdeveloped countries, and especially activities in and with the Common Market.

The report of the House Committee on Ways and Means and the statements of the Secretary of the Treasury indicate that the provisions of this bill proposing changes in the taxation of income from foreign trade and business have as a principal purpose the correction of tax haven abuses.

The National Foreign Trade Council is in sympathy with the desire of the administration to eliminate abuses in connection with tax havens which have as their principal purpose improper avoidance of Federal income tax.

However, we wish to emphasize that in our opinion the foreign income provisions of the bill go far beyond curbing tax haven abuses.

Further, the proposal to tax U.S. shareholders on all or most of the undistributed income of foreign corporations should not be confused with or adopted to solve the tax haven problem.

Statements of Treasury Department representatives indicate that they believe that tax haven corporations have the following five characteristics:

(1) A tax haven corporation is organized in a country which imposes little or no tax on foreign income allocated to or routed through entities incorporated under the laws;

(2) A tax haven corporation is designed to minimize the impact of taxes on its foreign activities;

(3) Its activities normally are with related entities;

(4) Its income is generated from sources outside of the country in which it is incorporated: and

(5) Its activities are generally not substantial in nature.

BASIC POSITION CONCERNING POSSIBLE TAX HAVENS LEGISLATION

The basic position of the National Foreign Trade Council concerning possible legislation with reference to tax havens may be summarized as follows:

(1) Present statutory provisions, if properly enforced, should prevent tax haven abuses.

(2) If new legislation is deemed to be essential it should not penalize legitimate foreign business.

(3) If legislation is adopted it should not provide for the taxing to U.S. shareholders of profits of foreign corporations which have not been distributed to the shareholders.

(4) Complex and extensive legislation should not be enacted to correct a problem that to a considerable degree at least has been attributed to administrative difficulties.

SECTION 13—CONTROLLED FOREIGN CORPORATIONS

Section 13 of H.R. 10650 is a lengthy and complicated section set forth on 35 pages.

The overall thrust of this section has been briefly summarized as follows:

> Shareholders of controlled foreign corporations are to report for tax purposes the undistributed earnings of these corporations to the extent they represent income from insuring U.S. risks, income from patents, copyrights, and exclusive formulas or processes developed in the United States, passive types of income generally, and income from certain sales. In these latter two cases reductions in the income tax to the shareholders are allowed for investments of the income in certain businesses in less developed countries. To the extent that the shareholders are not taxed on the income of the controlled foreign corporation under the above provisions, they are to be taxed on the undistributed earnings of controlled foreign corporations which are not invested in substantially the same trade or business or invested in less developed countries in new trades or businesses or in certain controlled subsidiaries (H. Rept. No. 1447, p. 3).

Roughly, the effect section 13 would tax to the U.S. shareholder of certain foreign corporations:

(*a*) Certain types of profits of the foreign corporation even though such profits had not been distributed to the U.S. shareholder. The types of profits so taxed would include certain income of the foreign

corporation from: (1) insurance; (2) patents, exclusive formula, etc.; (3) "passive income"; for example, dividends, interests, and rents; (4) sales income.

(*b*) In addition section 13 would tax to the U.S. shareholder all other types of profits of controlled foreign subsidiaries if they were not invested in certain ways.

The National Foreign Trade Council urges that this section should not be enacted into law because: (*a*) It constitutes a drastic and undesirable departure from tax principles which have been consistently followed in U.S. income tax law; and (*b*) a number of adverse business consequences to legitimate foreign operations would result from this section and would far outweigh any advantages in curtailing the tax haven problem.

A. LEGAL REASONS FOR REJECTING PROPOSAL

The proposal to tax the U.S. shareholders of a foreign corporation on the undistributed income of such corporations is contrary to basic tax principles which have been followed since 1913.

A departure from these principles would constitute a drastic change in this fundamental area of tax policy. It would constitute a deviation from the recognition of the separate entity of the corporation, without which concept it would be impossible to conduct much of modern business. It would raise serious constitutional questions and questions in the international field.

Possibly one of the most important questions that should be considered would be the precedent that enactment of such a proposal might constitute for tax U.S. shareholders on the undistributed income of U.S. corporations.

It is a fundamental principle of all aspects of American domestic and international law that a corporation is regarded as an entity separate from its shareholders.

With reference to tax jurisdiction, since the enactment of the 1913 act the United States has claimed jurisdiction to tax only on the basis of either citizenship and residence, or source of income in the United States. It is undesirable, if not improper, for the United States to tax foreign corporations directly on their foreign income. These same considerations should apply to taxing this income indirectly by taxing the shareholders of such corporations.

The principles referred to above are reflected in all income tax treaties to which the United States is a party. If this proposal were adopted, the United States would, in effect, invade the jurisdiction of the other party. Extraterritorial taxation of this type would certainly violate the intent, spirit, and basic principles of the 21 tax treaties which are in effect.

The Treasury's proposal to tax shareholders on the undistributed income of foreign corporations, which is earned outside the United States, is a principle which has no counterpart in the tax systems of the major industrialized countries of the world.

B. ADVERSE EFFECTS OF SECTION 13 ON U.S. LEGITIMATE FOREIGN TRADE AND BUSINESS

The proposal to tax to the U.S. shareholder certain undistributed profits of controlled foreign corporations will have unfavorable effects on U.S. foreign trade and business as a whole. Although it is our understanding that the Treasury officials intended to penalize tax haven operations, apparently there has not been adequate consideration of the adverse effects of the proposals on the overall economy and on legitimate foreign business. These adverse consequences would be substantial both to the affected shareholder and also to the economy as a whole.

The U.S. shareholder would be adversely affected in all cases where such profits are earned in foreign countries whose income taxes are lower than comparable U.S. income taxes on such profits.

In many foreign countries the concept of income varies from that in the United States; for example, requirements for legal reserves, depreciation on revalued assets, etc., and, also, many foreign countries rely more heavily for revenues on taxes other than income taxes.

In addition to suffering a tax disadvantage, all U.S. foreign subsidiaries would have to take into consideration novel and artificial factors in determining their course of action.

For example, any foreign subsidiary which bought goods from outside the country in which it is incorporated, processed them, and then sold such goods outside the country, would have to be mindful that the purchased goods have to be substantially transformed in order that the sale of the goods outside the country would not be regarded as giving rise to "foreign base company income." In implementing this and other novel concepts, time-consuming and expensive analysis and recordkeeping would have to be instituted.

The indirect effects of section 13 of the bill on shareholders might be several. It is likely that foreign nationals would hesitate to participate with U.S. nationals in the ownership of foreign operations because the income from such operations might be regarded as "Subpart F income or an increase in earnings in nonqualified property" for purposes of U.S. law and thereby adversely affect the reinvestment policy of the enterprise.

In addition, U.S. shareholders, who might have reached the conclusion that the most efficient method of operation in several countries was through a single foreign subsidiary, might decide because of the provision of this section that they must operate in the more inefficient method through a number of corporations.

The provisions of this section are so broad that they would label as "tax haven transactions" many operations which were established for sound business reasons not related to U.S. tax considerations.

Frequently, the operations which would be adversely affected have been carried on for many years in the normal course of business. In many cases they existed prior to the time the present U.S. parent acquired its interest in the foreign company.

Further:

(1) The provisions of section 13 are lengthy and complicated.

(2) Apparently, if section 13 were enacted, there would be conflict between U.S. and foreign accounting concepts.

(3) Section 13 will prevent diversification.
(4) Section 13 does not contain provisions similar to those in earlier drafts which excluded legitimate operations.

SECTION 11—"GROSS-UP"

The National Foreign Trade Council urges that the provisions in this section should not be enacted into law because:

(1) The present tax treatment of dividends from foreign subsidiaries has been in effect for some 40 years. It has been reenacted in all revisions of the income tax law, including the revisions of 1939 and 1954.

(2) It was considered by the Supreme Court in 1942.

(3) The present provisions are not the result of inadvertence.

(4) The present statutory system does not allow both a deduction or exclusion and a credit for the same foreign taxes. There is no inequality in the present law when viewed from the standpoint of income received from foreign corporations.

(5) Equating of tax burdens between foreign branches of U.S. corporations and foreign subsidiaries is not as simple as is assumed by the comparative computations which are used for the purpose of showing that use of a branch may result in a greater total tax burden. There are some situations where foreign branches have distinct advantages over foreign subsidiaries from a tax viewpoint. For example, losses of a branch can be deducted from U.S. source income; losses of a foreign subsidiary cannot.

(6) This provision of the draft bill conflicts with the tax treaty program. Many of the treaties now in existence generally provide that the United States will allow credit for foreign income taxes in accordance with the provisions of the Internal Revenue Code in effect on the date of ratification of the treaty.

SECRETARY'S PROPOSAL TO TAX UNDISTRIBUTED INCOME TO FOREIGN CORPORATIONS

The Secretary of the Treasury in his appearance before this committee on April 2, 1962, urged far-reaching amendment to the bill namely that:

> The privilege of deferring U.S. taxes until income is repatriated as dividends should simply be eliminated for our subsidiaries in advanced industrial countries.

REASONS FOR REJECTING PROPOSALS

The legal arguments against taxing to the U.S. shareholder undistributed profits of foreign subsidiaries are fully developed above in connection with our discussion of section 13 and have been summarized. The economic arguments are developed at length in our memorandum.

In particular, attention is invited to our discussion concerning the balance of payments. Our memorandum states:

While the National Foreign Trade Council is itself deeply and urgently concerned by the continuing serious deficit in the U.S. balance of payments, it questions whether this is the moment to undermine, discourage, or impede the international flow of private capital. The council is convinced that private direct investments are a consistent and substantial source of longrun strength to the balance-of-payments position of our country. It disagrees with the premise that the proposed tax changes are necessary to meet the balance-of-payments problem. It believes, on the contrary, that the fiscal devices now proposed, if adopted, would contribute little or nothing toward the shortrun solution of the problem and that in the long run could have extremely adverse effects on the balance of payments.

The CHAIRMAN. Thank you very much, Mr. Brady.

(The prepared statement of the National Foreign Trade Council, Inc., follows:)

REVENUE ACT OF 1962 (H. R. 10650)

Statement on Behalf of National Foreign Trade Council, Inc.

Before

The Committee on Finance

United States Senate

87th Congress

April 25, 1962

National Foreign Trade Council, Inc.

111 Broadway New York 6, N. Y.

April, 1962

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I. INTRODUCTION

The National Foreign Trade Council, which was founded in 1914, is composed of United States corporations engaged in all aspects of foreign trade and business. Its basic function is the protection and promotion of American foreign trade and business. NFTC is most concerned that all segments of United States business operate at the highest level possible. However, it is urged that the overall economy will not be benefited by consciously depressing foreign trade and business which represent an extremely important sector of our total economy. If any action should be taken in the fiscal area in respect to foreign trade and business, it is that burdens should be made less onerous.

A. Sections of Particular Interest to NFTC

NFTC is particularly interested in those sections of the proposed "Revenue Act of 1962", (H. R. 10650, 87th Congress), and the amendments thereto suggested by the Secretary of the Treasury, which directly affect United States foreign trade and business. As pointed out by other witnesses, the sequence used in the bill does not group related subjects together, but rather sets forth sections in accordance with the order in which, if enacted, they will appear in the Internal Revenue Code. In our comments related subjects will be considered together.

These subjects include:

Section 13 — Controlled Foreign Corporation;[1]

Section 6 — Amendment of Section 482;[1]

Section 16 — Gains from Certain Sales or Exchanges of Stock in Foreign Corporations;[1] and

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[1] See Pages 57 and 58 of House Report No. 1447 for a summary of the interrelationship and general scheme of Sections 13, 6, and 16, copy attached Appendix B.

Section 5 -- Amount of Distribution Where Certain Foreign Corporations Distribute Property in Kind.[2]

A brief summary of these various sections is discussed in the Report of the Committee on Ways and Means. (See Pages 2, 3 and 4 of House Report No. 1447 excerpt attached, Appendix A.

Section 11 -- Domestic Corporations Receiving Dividends from Foreign Corporations.

Section 12 -- Earned Income of United States Citizens.

Section 20 -- Information With Respect to Certain Foreign Entities.

Section 21 -- Treaties.

B. Amendments Proposed by the Secretary of the Treasury

The Secretary of the Treasury in his statement before the Senate Finance Committee on April 2, 1962, suggested amendments to several of the sections referred to above. Specifically, he urged the following:

Section 11 - "Gross-Up" - Foreign Tax Credit

In connection with Section 11 he stated that: "The House Bill postpones the effective date of this provision in two ways". (Page 40)[3] "I *** urge that this change be made applicable to all distributions after December 31, 1961." (Page 41).[3]

In connection with the foreign tax credit computation, the Secretary also urged a new amendment, the effect of which would be "that the foreign tax credit for certain investment income be computed apart from the foreign tax credit for all other foreign income". (Page 53).[3]

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2 See Page 27 of House Report No. 1447 indicating that Section 5 "is a companion provision to Section 16".

3 Reference is to pages in the Statement of the Secretary of the Treasury before the Committee on Finance, April 2, 1962.

Section 12 -- Earned Income of Individuals

In connection with Section 12 the Secretary urged that the President's original recommendation on this subject be adopted, i.e., "elimination of the exemption privilege for American citizens living in economically developed countries *** also *** exemption for our citizens who qualify as foreign residents of *** less developed countries *** but only to the extent of $20,000 a year". (Page 36).[3]

Section 13 -- Controlled Foreign Corporations

In connection with Section 13 the Secretary urged that "the exemption of 'tax haven' profits invested in less developed countries should be limited to earnings generated in the less developed countries". (Page 42).[3] He also recommended the "general elimination of deferral in the taxation of foreign subsidiaries". (Pages 43-51).[3]

C. Provisions of Limited Interest

It is noted that provisions in other sections are of some, but more limited, interest to American companies engaged in foreign trade and business. For example, in connection with the proposed credit for investment in certain depreciable property, (Section 2 of the Bill), it is provided, in general, that this incentive will not affect property which is used predominantly outside the United States. Also in the proposed amendment affecting withholding income tax at source on interest and dividends (Section 19), there are exceptions affecting foreign corporations, non-resident aliens, etc. Further, the following sections are of limited interest to certain companies mainly in connection with portfolio investments.

Section 7 -- Distributions of Foreign Personal Holding Company Income;
Section 9 -- Distributions by Foreign Trusts; and
Section 15 -- Foreign Investment Companies.
Section 18 -- Inclusion of Foreign Real Property in Gross Estate.

The National Foreign Trade Council is not commenting on the provisions mentioned in this paragraph.

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[3] See Footnote 3 above.

II. GENERAL STATEMENTS CONCERNING THE TAXATION OF UNDISTRIBUTED PROFITS VS. TAXATION OF SO-CALLED "TAX HAVEN" PROFITS

As stated in House Report No. 1447 accompanying H. R. 10650, four of the sections of the bill (Sections 13, 6, 16, and 5) are directed in whole or in part to what have been called "tax havens". The proposals set forth in Section 13 would be to tax the undistributed income of foreign subsidiaries with certain limited exceptions. The provisions in this section are contrary to basic concepts of our tax law which have been in effect since 1913. Accordingly, the proposed changes should not be adopted by Congress without complete hearings and consideration of their impact on our economy, and our future business prospects in the foreign field. This is particularly important in view of the "Common Market" evolving in both Europe and Latin America.

The National Foreign Trade Council would like to emphasize, generally, the following three points before commenting on the specific provisions of the bill:

1. The current hearings before the Committee on Finance concerning the "tax haven" proposal is the first public hearing on the particular proposals contained in the sections of the bill or, for that matter, on any proposals in bill form.

2. Any proposal to tax to United States shareholders the undistributed profits of foreign subsidiaries arising from legitimate transactions in the foreign field should be clearly distinguished from any proposals which might be necessary to resolve the so-called "tax haven" problem.

3. It has been stated that the bill, as passed by the House, "does not eliminate tax deferral in the case of operating businesses owned by Americans which are located in the economically developed countries of the world". (See excerpt from House Report No. 1447, Appendix B.) The National Foreign Trade Council strongly disagrees with this statement. Section 13 of the bill, by its terms, applies to all "foreign controlled corporations" in all parts of the world. The practical effect of its limitation on the use of patents, etc. and the limitation on the use of any profits earned by the foreign corporation is to eliminate tax deferral even in the case of operating businesses.

A. First Public Hearing on "Tax Havens"

With reference to the first point, it will be recalled that the proposals of the Treasury concerning "tax havens" were not available in bill form at the hearings on this subject before the Ways and Means Committee last spring. As a result, non-governmental witnesses were required to surmise what might be proposed. (See NFTC Statement, Volume 4, Hearings before the Committee on Ways and Means, House of Representatives, 87th Congress, on the President's 1961 Tax Recommendations, Page 2650.) The first proposal in draft bill form was made available by the Treasury on July 28, 1961. Another version was released on January 31, 1962. Some indication of the confused legislative picture is indicated by the fact that the proposals on this subject tentatively adopted by the Ways and Means Committee on February 1, 1962, differed drastically from those finally adopted, and included in H. R. 10650, as introduced on March 12, 1962.

B. Need for Definition of "Tax Haven" Problem

With reference to the second point, no definition of "tax havens" is set forth in the bill or in the Committee Report. The Secretary of the Treasury in his testimony both before the Committee on Ways and Means last April and before this Committee on April 2, 1962, discussed this subject, (Page 41 of the Secretary's statement before the Senate Committee on Finance). Additional comment concerning "tax havens" was made in the Treasury memoranda submitted to the Ways and Means Committee last June, (see Volume 4, Hearings on the President's 1961 Tax Recommendations, Pages 3522 to 3551). Also, this subject was discussed in the release of the Treasury Department, January 31, 1962, explaining the draft bill on this subject released that date. From these releases and this testimony, it would seem that "tax haven" companies and their operations have certain characteristics. A typical "tax haven" corporation:

1. Is organized in a country "which imposes little or no tax on foreign income allocated to or routed through entities incorporated under their laws"; and,
2. Is "designed to minimize the impact of U. S. and foreign taxes on their foreign activities; and,
3. Its activities are normally with related entities; and,
4. Its income is generated or derived from sources outside of the country in which it is incorporated; and,
5. Its activities are generally not substantial in nature.

A January 31 Treasury release stated in part:

" *** On the other hand, tax haven companies do not typically carry on substantial activities such as manufacturing, or processing, assemblying, or other production that is substantial in nature. Such activities are not considered to give rise to tax haven profits ***. Still other *** transactions which do not typically reflect tax haven company operations [are]

a. The resale of agricultural or mineral products purchased by a controlled foreign corporation in its country of incorporation;

b. The resale of purchased products for use in a country of incorporation; or

c. The receipt of dividends and interest by a holding company incorporated in the same country as the payor corporation.

Also, transactions *** which give rise to profits that do not escape normal tax burdens by reason of the country of incorporation, would not be included [as tax haven transactions]. Construction would not in general be directly affected ***. Shipping activities are also not covered."

At least in the early discussions of the "tax haven" problem, the typical examples suggested as needing correction were those involving:

1. exports from the United States to industrialized countries sold through subsidiaries incorporated in "tax haven countries", and,

2. holding companies in "tax haven countries" which accumulate income earned by U. S. subsidiaries in countries other than the "tax haven" country.

Even a cursory examination of the pertinent sections in H. R. 10650 indicate that they cover many situations beyond the "tax haven problem" and in effect they unjustly penalize legitimate foreign enterprises. The arguments in support of these provisions advanced by the Administration have been based in large measure on administrative difficulties. These provisions, if enacted into law, would add immeasurably to the difficulties of administration and compliance.

C. The "Tax Haven" Problem Should Be Distinguished From The Proposal to Tax Undistributed Profits of Foreign Subsidiaries

The "tax haven" problem which is complicated and controversial in itself should be separated from another more fundamental change in tax law proposed by the Treasury, i.e., the proposal which would effectively tax all profits of foreign subsidiaries to the United States shareholder whether or not distributed, except in limited instances.

The net effect of many of the proposals advanced as being necessary to solve the "tax haven" problem would be to tax to the United States shareholder, with very few exceptions, the profits of all foreign subsidiaries whether or not distributed to the United States shareholder. The radical change in tax concepts which have been interwoven in the proposals concerning "tax havens" probably have not received the consideration which they warrant. It is urged that this committee safeguard legitimate business from the harsh penalties which may be imposed on them in an attempt to solve what has been labeled the "tax haven" problem.

Assuming that a "tax haven" problem exists, undoubtedly its solution involves a number of complex interrelated factors which under the best circumstances are difficult to resolve. Any consideration given to curing "tax haven" abuses should not be confused with the far-reaching proposal to eliminate tax deferral generally, which would be the practical effect of H. R. 10650. Such action would be to the detriment of United States foreign enterprise and the United States economy, of which foreign trade and business is a vital part.

D. Basic Position of NFTC Concerning The Taxation of The Undistributed Profits of United States Foreign Subsidiaries as Contrasted With Measures Needed to Curb "Tax Haven" Abuses

The National Foreign Trade Council is in sympathy with the desire of the Administration to eliminate abuses in connection with "tax havens" which have as their principal purpose improper avoidance of Federal income tax. However, any legislative action to curb such abuses should be carefully drafted in order not to penalize the legitimate trade and business of United States subsidiaries. Further, the long-established legal principles upon which the present system of taxation is based should not be subject to radical change merely to eliminate a relatively few tax abuses.

The Internal Revenue Code presently contains provisions which through effective enforcement should be adequate to enable the Treasury to correct abuses such as the diversion of taxable income to foreign corporations. Furthermore, well-established judicial doctrine permits the disregard of corporate shams.

Since 1960, the Internal Revenue Service, is in the process of obtaining more detailed information regarding transactions between domestic corporations and their foreign subsidiaries. Further the Office of International Operations of the Internal Revenue Service has increased its staff and its scope of activities. NFTC believes that the expanded information now being received by the Treasury should make possible the enforcement of existing corrective provisions.

If it is decided that some legislation is required in connection with "tax haven abuses", the proposal contained in Section 13 of H.R. 10650 that certain profits of controlled foreign subsidiaries should be taxed to

United States shareholders, even though not distributed as dividends, should not be enacted into law because this concept is contrary to basic United States tax policy. This proposal would constitute a drastic and undesirable departure from tax concepts which have been consistently reflected in Federal income tax law, including the following:

(1) The corporation is an entity separate from its shareholders, and the shareholder has not been taxable on the undistributed income of the corporation.

(2) Taxpayers are only subject to tax on realized income.

(3) The treatment of a foreign corporation as an entity distinct from its shareholders is recognized as a fundamental principle in 21 tax treaties, affecting some 44 foreign jurisdictions, to which the United States is a party.

(4) Even in the absence of tax treaties the United States has recognized foreign corporations as separate entities and has never claimed tax jurisdiction over them simply because they were owned in whole or in part by U. S. shareholders.

(5) The practical effect of this proposal is essentially the same as an attempt to tax the foreign corporation directly. This proposed policy of taxing by indirection is questionable from the standpoint not only of domestic policy, but also of international comity.

(6) The Constitutionality of taxing American shareholders of foreign corporations on their shares of the income of those corporations before the income is distributed, has been seriously questioned.

(7) U. S. shareholders are not taxable on the undistributed income of U. S. corporations from domestic sources; similarly, U. S. shareholders should not be taxable on the income of foreign corporations from sources outside the United States before it is distributed.

In addition, no other economically advanced country ignores the corporate entity.

All of the above points are discussed more completely in our comments concerning Section 13 of H. R. 10650.

The provisions of H. R. 10650 are so broad that they would adversely affect many aspects of American foreign business operations.

Decisions as to whether or not an operation should be undertaken, and the form in which it should be undertaken are made in response to a broad and complex range of considerations covering every related aspect of a firm's operations. Frequently the operations which would be adversely affected have been carried on for many years in the normal course of business. In many cases they existed prior to the time the present United States parent acquired its interest in the foreign company. H. R. 10650 would tax many operations which have been established for sound business reasons not related to United States tax considerations.

It is urged that the following excerpt from the statement of the National Foreign Trade Council on the "Trade Expansion Act of 1962" (H. R. 9900) is most pertinent.

"The National Foreign Trade Council on many occasions has emphasized the importance of a large and expanding volume of international trade to the security and economic well-being of the United States and the free world. It believes, in general, that the legislative proposals embodied

in H. R. 9900 would lead toward these goals, provided it is clearly recognized that international trade cannot be stimulated to the desired ends if at the same time other measures are adopted which would hamper or restrict the expansion of such trade, or the freedom of international investment. In a practical sense, expanding trade and expanding international investment are interdependent and continually complement one another. Of prime importance, therefore, is the need for tax and other measures which consistently promote both international trade and the international investment of private enterprise capital."

The principal objections to the bill are those referred to above: (a) taxing to United States shareholders (under certain conditions) the undistributed profits of foreign corporations; and (b) treating as "tax haven transactions" the legitimate operations of United States foreign businesses which were not established to avoid U. S. tax. There are also many technical defects in H. R. 10650.

In connection with any proposal to change the taxation of income from United States foreign trade and business it is urged that several important general considerations should be kept in mind. Foreign trade and business is an extremely important sector of the United States economy and any action which would hamper it should be most seriously considered. The choice generally is not between operating abroad and operating in the United States but rather between operating abroad in a particular manner or losing the particular market for American business.

The National Foreign Trade Council opposes the taxation of United States shareholders on the undistributed profits of foreign corporations. From a business and economic point of view any such proposal would place American foreign trade and direct investment in a less favorable position to compete with local nationals and nationals of third countries and to

meet the threat of Soviet economic penetration. Thus, to deliberately and consciously hamper American enterprise in our view is against the best interests of the United States. In addition, this proposal, if enacted into law, would constitute a drastic and undesirable departure from tax principles which have been consistently followed in the Federal Income Tax Law.

Accordingly the National Foreign Trade Council urges that:

(1) Present statutory provisions, if properly enforced, should prevent "tax haven" abuses.

(2) If legislation is adopted it should not provide for the taxing to U. S. shareholders of profits of foreign corporations which have not been distributed to the shareholders.

(3) Complex and extensive legislation should not be enacted to correct a problem that to a considerable degree at least has been attributed to administrative difficulties.

(4) In any event, any legislation should not penalize legitimate foreign trade and business.

III. COMMENTS ON SPECIFIC SECTIONS OF BILL OF PARTICULAR INTEREST TO NFTC

As noted in our introduction, the National Foreign Trade Council is particularly interested in certain sections of the bill concerning which comments will be made, including the following sections: Sections 5, 6, 11, 12, 13, 16, and 20. Because of their interrelationship we will first comment on the sections dealing with "tax havens", in the following order, namely, Sections 13, 6, 16, and 5.

A. Section 13 - Controlled Foreign Corporations

1. Introduction

Section 13 of H. R. 10650 is a lengthy and complicated section set forth on thirty-five pages (Pages 103 to 137 of the bill). It is discussed at some length in House Report No. 1447 which accompanied H. R. 10650 at the following pages: Pages 57 to 66; Pages A89 to A106; Page B6; Page B21 to Page B27; and Pages B33 to B35.

The overall thrust of this section has been briefly summarized as follows: "Shareholders of controlled foreign corporations are to report for tax purposes the undistributed earnings of these corporations to the extent they represent income from insuring U. S. risks, income from patents, copyrights, and exclusive formulas or processes developed in the United States, passive types of income generally, and income from certain sales. In these latter two cases reductions in the income tax to the shareholders are allowed for investments of the income in certain businesses in less developed countries. To the extent that the shareholders are not taxed on the income of the controlled foreign corporation under the above provisions, they are to be taxed on the undistributed earnings of controlled foreign corporations which are not invested in substantially the same trade or business or invested in less developed countries in new trades or businesses or in certain controlled subsidiaries." (House Report No. 1447, Page 3).

It is claimed that Section 13 is directed primarily to "tax haven" transactions, (see Page 57 of House Report No. 1447, attached, Appendix B). The Secretary of the Treasury in his statement before this Committee discussed Section 13 as a "tax haven" proposal. He stated that it "deals only peripherally with tax deferral of foreign income." As mentioned above, Section 13 has adverse effects on legitimate business operations and, in our opinion, goes far beyond a "tax haven problem."

The National Foreign Trade Council urges that this section should not be enacted into law because it constitutes a drastic and undesirable departure from tax principles which have been consistently followed in United States Income Tax Law. A number of adverse business results to legitimate foreign operations would result from this section and would far outweigh any advantages in curtailing the "tax haven problem."

2. <u>Legal Reasons for Rejecting Proposal to Tax U. S. Shareholders on Undistributed Profits of Foreign Corporations</u>

The legal reasons for rejecting the proposal to tax to the United States shareholder undistributed profits of foreign corporations, as provided by Section 13, are discussed below.

(a) <u>History and Reasons for Present Law</u>

The basic provisions of United States law relating to taxation of income from foreign sources have been in existence for nearly fifty years. All United States foreign investments have been made with these provisions as a background. In addition, important foreign investments have been made under an announced policy of the United States Government to encourage such investment.

Under the 1913 Act income received by foreign corporations from sources outside the United States was not taxed. United States shareholders were taxed only on the dividends from such corporations. These basic provisions have been retained in all subsequent reenactments of the Income Tax Law, including the 1939

and 1954 versions. Contrary to the impressions of some persons, no provisions were introduced into United States tax law after World War II to encourage investment and trade in Europe by United States companies.

Like most features of tax law these provisions reflect both theoretical and practical considerations. These considerations generally fall either within the fiscal area, or the combined area of public policy and trade. The recognition of the importance of foreign trade and investment, a recognition that income from foreign sources is initially subject to tax in the foreign country, and the need for revenue, all form a part of the background for the enactment of our tax laws on income from foreign trade and investment.

The concept that a corporation is an entity separate from its shareholders has always been recognized as fundamental in every phase of the law. The principle of the non-taxability of the shareholder on the undistributed income of a corporation has been one of the pillars on which our tax system has been constructed. In addition, considerations of international law and comity, as well as United States constitutional and administrative problems, are among the wide variety of factors that have affected the formulation of the basic United States tax provisions.

(b) Proposal is Contrary to Basic United States Tax Policy

It is a fundamental principle of all aspects of American and international law that a corporation is regarded as an entity separate from its shareholders. Thus the shareholder is not obligated by the contract of the corporation, and is not responsible for its wrongful acts. This principle has been incorporated in the Federal Income Tax Law. A corporation is taxed on its income, and the shareholders are taxed only on dividends distributed to them. Any proposal to tax the United States shareholders on the income of the corporation would be an exception to this basic principle, which has been followed consistently by Congress, the Treasury Department and the Supreme Court. The basic principle has been reflected in United States tax treaties and in the claims of tax jurisdiction which the United States has made in the absence of tax treaties.

Both in the domestic and foreign field, taxpayers are only subject to tax on income actually realized. Corporations and individuals owning shares of stock are not taxable because of accumulated earnings of the companies issuing the shares, nor are they taxable in respect of increases in the quoted market prices of those shares. Holders of corporate securities are not entitled to deduct from their taxable income any decreases in quoted market price or generally any operating losses of the companies which may dissipate their surplus or even impair their capital. The United States income tax system recognizes fully the corporate entity. A United States parent corporation is taxed upon the dollar dividends received from a foreign subsidiary, because that is the correct measure of its realized income.

The principle that income must be realized before it is taxable has frequently been upheld by the Supreme Court. In 1918 the Supreme Court drew a distinction between corporate accumulations and distributions, treating only the latter as taxable income. The Court stated: "It is evident that Congress intended to draw and did draw a distinction between a stockholder's undivided share or interest in the gains and profits of a corporation, prior to the declaration of a dividend, and his participation in the dividends declared and paid; treating the latter in ordinary circumstances, as a part of his income for the purposes of the surtax, and not regarding the former as taxable income unless fraudulently accumulated for the purpose of evading the tax". (Lynch v. Hornby, 247 U. S. 339 at page 343). The fact that income must be "realized" is clearly set forth in Eisner v. Macomber, 252 U. S. 189, 40 Sup. Ct. 189 (1920) and has never been reversed.

The Treasury Department has followed the concept that income must be realized in order to be taxable, e. g. Regulations 1.61-1 provides in part: "Gross income includes income realized in any form". (Underscoring added)

Furthermore, the treatment of a foreign corporation as an entity distinct from its shareholders is recognized as a fundamental principle in 21 tax treaties, affecting some 44 foreign jurisdictions, to which the United

States is a party. Even in the absence of tax treaties the United States has recognized the foreign corporation as a separate entity and has never claimed tax jurisdiction over them, because it was owned in whole or in part by U. S. shareholders.

Since the enactment of the 1913 Act, the United States has claimed jurisdiction to tax on the basis of (1) citizenship and residence, and, (2) source of income in the United States.

To expand this jurisdictional claim, so as to tax, directly the income of foreign corporations because of American ownership of shares in such corporations would run counter to all U. S. jurisdictional claims and might well bring about conflicts with the jurisdictional claims of foreign governments. It is undesirable, if not improper, for the United States to tax foreign corporations directly on their foreign income. These same considerations should apply to taxing the foreign corporation indirectly by taxing the shareholders.

The jurisdictional claims of the United States reflects the recognition that other sovereign nations have rightful claims to the primary jurisdiction of income earned by their corporations in their home country and in all countries other than the United States. The jurisdictional concepts of the United States are formally reflected in tax treaties between the United States and foreign countries which are discussed below.

The Secretary's explanation of his proposal states that "precedent for this tax treatment may be found in the provisions of existing law dealing with U. S. shareholders of foreign personal holding companies". These provisions are not an adequate precedent for such a broad departure from established tax policy. The provisions were enacted on the assumption that foreign personal holding companies were "created with the sole purpose of avoiding or evading the imposition of the surtax on their shareholders" and the legislation was intended "to encourage the prompt dissolution of existing companies of this type", which were regarded as "spurious" (Report of the Joint Committee on Tax Evasion and Avoidance, August 5, 1937, 75th Cong. 1st Sess.,

House Document No. 337, pp 21 and 22). However, these provisions were never intended to, and do not by the definition of foreign personal holding companies in the Internal Revenue Code, affect bona fide foreign business companies.

The foreign personal holding company provisions are strictly limited to the case where the foreign company is controlled by not more than five U. S. citizens or residents and derives 50% or more of its gross income from certain categories of income, such as dividends, interest and capital gains (Secs. 551-557, I.R.C.). The proposed recommendation by the Secretary, is addressed to a situation which is quite different from that of the foreign personal holding company. With relatively few exceptions the foreign subsidiaries which will be affected are operating companies that would not be within the purview of the foreign personal holding company provisions. These foreign corporations have not been "created with the sole purpose of avoiding or evading the imposition of [a tax] on their shareholders". Rather these subsidiaries were formed to carry on United States trade and business in a part of the world most important from the viewpoint of national as well as business considerations. Further, it is not believed that "the prompt dissolution of existing companies of this type" is intended even by the Treasury. Therefore, it is urged that the foreign personal holding company provisions should not be regarded as a precedent for the proposed legislation. An additional point which should be considered is that the foreign personal holding company provisions are primarily an extension to foreign companies of a punitive provision which previously was in effect domestically, namely, the personal holding company provisions.

The proposal to tax a shareholder on unrealized profits is, in effect, taxation by indirection of the current earnings of the foreign corporation and is designed to tax indirectly what could not be taxed directly. This policy of taxing by indirection is at least questionable from the standpoint not only of domestic tax policy but also of international comity. Probably any attempt by the United States to tax directly or indirectly foreign corporations on income not earned in the United States would be

objected to by foreign countries. In the past, foreign countries have objected to the extraterritorial effect of other U. S. laws, for example, the extension of the antitrust and export control laws.

The proposals of the Secretary to impose taxes on U. S. shareholders of foreign corporations measured by the earnings of the foreign corporations as they accrue will result in a nullification of tax incentive programs designed by foreign countries to attract investment and reinvestment by foreign corporations. It would defeat the purpose of provisions under foreign tax laws, such as investment allowances, accelerated depreciation, and tax exemptions designed to promote economic development in the foreign country. It would also ignore requirements of the foreign country that legal and statutory reserves be set aside before dividends can be paid. It would be contrary to the practice in some countries which impose through private agreement restrictions on dividend distributions.

Foreign competitors of U. S. business would still enjoy the benefit of these incentives. Where American investments are an important factor the foreign country might revise its incentives program, and attempt to bring its tax rates up as high as 52% in order that it may obtain taxes which otherwise would redound to the benefit of the United States.

The proposal will have an adverse effect both on the corporations and shareholders. In many instances, shareholders may not have funds available from other sources to pay the taxes. This, of course, will place pressure on the foreign corporation to remit income to pay such taxes. Where local nationals are also shareholders and have a controlling voice in the company this pressure to distribute funds which otherwise would not be distributed in order to pay U. S. tax will be resisted. From a long-range point of view, it may deter local participation in companies in which American capital is invested. Furthermore, the individual shareholder who in most instances would have no control over the foreign corporation whatsoever could receive no foreign tax credit and would be required to pay such income tax out of his capital. Many foreign incorporated subsidiaries have incurred long-term financial commitments on the reasonable assumption that neither the

subsidiary nor the shareholder would be subject to United States tax on the undistributed income of such subsidiaries. The proposed imposition of United States tax on U. S. shareholders might affect drastically the ability of the subsidiary to meet its financial obligations.

The proposal to tax the United States shareholder of a foreign corporation on the undistributed income of such corporation is contrary to basic tax principles which have been followed since 1913. A departure from these principles would constitute a drastic change in this fundamental area of tax policy. It would constitute a deviation from the recognition of the separate entity of the corporation without which concept it would be impossible to conduct much of modern business. It would raise serious questions in the international field. Possibly one of the most important questions that should be considered would be the precedent that enactment of such proposal might constitute for taxing United States shareholders on the undistributed income of United States corporations.

(c) <u>Constitutionality</u>

Under the proposal, American shareholders of foreign corporations would be taxed on their shares of the income of those corporations, even though it is not distributed. It has been held to be a violation of the due process clause of the 14th Amendment to the Constitution for a state to measure the tax on one person's income by the income of another. <u>Hoeper v. Tax Commission</u>, (1931) 284 U. S. 206. It would seem equally a violation of the due process clause of the 5th Amendment for the Federal Government to measure the proposed tax on the American shareholder by the income of another person, the foreign corporation.

Under the 16th Amendment Congress may tax incomes, from whatever source derived, without apportionment. It should be noted, however, that the 16th Amendment is applicable only to true income taxes and that a tax cannot be brought within the scope of that Amendment merely by calling it an income tax.

Eisner v. Macomber (1920) 252 U. S. 189, 206, held that income consists not in a growth or increment in value of an investment, but something of exchangeable value proceeding from the property, severed from the capital and coming into, or received by, the taxpayer, and that a stock dividend was not income within that definition because it did not accomplish an actual distribution of corporate earnings. The Court refused (page 214) to "indulge the fiction" that the stockholders "have received and realized a share of the profits of the company which in truth they have neither received nor realized" and held that the corporation must be treated as a substantial entity separate from the stockholder. It went on to say that "enrichment through increases in value of capital investment is not income in any proper meaning of the term" and (page 217) that to tax the shareholders upon their property interest in the stock of the corporation would be taxation of property because of ownership, and would require apportionment under Article I of the Constitution. The Court expressly stated (page 219) that "what is called the stockholder's share in the accumulated profits of the company is capital, not income". It follows from the holding in this case that the proposed tax on American shareholders of foreign corporations, measured by their shares of the undistributed income of those corporations, which they have not received as dividends, would be a direct tax on the shareholders because of ownership of shares and would not be a tax on income within the meaning of the 16th Amendment. Under Article I of the Constitution direct taxes must be apportioned among the states according to population. In Pollock v. Farmer's Loan & Trust Co. (1895) 158 U. S. 601 it was held that taxes on personal property, or on the income of personal property, are direct taxes.

In connection with the question of the constitutional power to tax shareholders on undistributed income of the corporation, the Council has noted and subscribed to the comments and conclusions on this subject contained in the memorandum submitted to the Ways and Means Committee by Colin F. Stam, Chief of Staff, Joint Committee on Internal Revenue Taxation, May 4, 1961. (Volume 1, Hearings before the Committee on Ways and Means, House of Representatives, 87th Congress, on the President's 1961 Tax Recommendations, Pages 311 - 313 inclusive).

(d) The Major Developed Countries Do Not Tax Earnings Derived Abroad by Foreign Incorporated Companies

The proposal to tax shareholders on the undistributed income of foreign incorporated companies which is earned outside of the United States is a principle which has no counterpart in the tax systems of the major industrialized countries of the world. An analysis by local fiscal experts of the tax systems of Australia, Belgium, Canada, Denmark, France, Germany, Italy, Japan, Netherlands, Norway, Sweden, and the United Kingdom indicates that none of them applies such a principle. In 1939 the German Government enacted a provision under which a foreign subsidiary which is dominated by a German company may be regarded as resident in Germany and taxed on all its income. Such tax would be imposed on the subsidiary and not on the shareholder. It is understood that this provision has been rarely applied in the past and that it is not anticipated that it will be enforced in the future. The United Kingdom and Japan also have in exceptional cases treated a foreign corporation as a resident for tax purposes if its mind and management are within the country, but this means that the corporation itself becomes liable for tax and not its shareholders. Under present practice the mind and management of a company will

not be located in the country if the administrative office, directors' meetings and general managerial functions are conducted outside the country.

The proposal attempts to expand the jurisdiction of the United States, beyond that normally considered by any other country, so as to tax the shareholder, solely by reason of his ownership on his share of the earnings of a foreign corporation before such earnings are distributed. Inasmuch as such a policy, if adopted by United States, would add a new principle in the international tax field we do not believe that the Congress will wish to attempt to expand its taxing jurisdictions to such extremes.

(e) Tax Treaty Obligations

In his appearance before the Committee on Ways and Means the Secretary of the Treasury stated in discussing the proposal to tax to the U. S. shareholder the undistributed income of foreign corporations:

"This method of taxing would eliminate possible conflicts with U. S. treaty obligations, which might occur if the tax were imposed directly on the income of foreign corporations".

He considers that treaty obligations would not be violated if the domestic shareholders were required to "include in gross income each year that portion of the undistributed earnings and profits of the foreign corporation which they would have included in gross income had the foreign corporation distributed its entire profits for the year". Nevertheless, the tax is levied on the basis of income that belongs to the foreign corporation and not to the shareholder.

Treaties are founded on respect by one party for the laws of the other, except insofar as the treaty limits their respective jurisdiction to avoid double taxation. They respect the principle that the corporations

of the other country may conduct their affairs in accordance with the laws of the other contracting party. Treaties are founded on reciprocity and if the United States invades in effect the jurisdiction of the other party to levy a tax, even if it collects the tax from its own resident shareholders, the United States could not object if the other foreign government levied a reciprocal tax based on the undistributed income of U. S. corporations. This initiation on a wholesale basis of extraterritorial taxation of this type could seriously damage international investments and business relations conducted through subsidiaries and would certainly violate the intent, spirit and basic principles of the 21 tax treaties which are in effect vis-a-vis some 44 foreign governments.

The principle that a tax can be levied generally on the basis of a foreign corporation's income or a portion thereof, but collected from the shareholder is absolutely contrary to long-established principles of international tax treaty law as well as American jurisprudence. It has been argued that, under the treaties, the United States, in determining its taxes in the case of its citizens, residents or corporations, may, regardless of any other provision of the treaties, include in the basis upon which such taxes are imposed all items of income taxable under the revenue laws of the United States as if the treaties had not come into effect. This is the so-called saving clause. However, the doctrine of Eisner v. Macomber, that the income tax is imposed on realized income, pervaded at the time of entering into the treaties and since that time in U. S. tax law. This doctrine must be considered as reflected in the meaning of the treaty provisions. The saving clause should therefore be read to refer only to items of realized income, including dividends from a corporation of the treaty country, and not to unrealized income.

Our first tax treaty was entered into with France. The primary objective of the treaty was to prevail upon France to give up its tax on dividends distributed by U. S. corporations which were deemed to be paid out of income from French sources. Because of this tax the United States adopted the provision for a retaliatory tax against discriminatory or extraterritorial taxation now found in Section 891, I.R.C. The French agreed to waive their extraterritorial dividend tax in consideration of a treaty provision authorizing the French government to collect tax from the French company on any income shown to have been diverted from it to an American corporation. However, when this convention with France and each subsequent convention was negotiated, no other country sought to tax shareholders resident in its territory on undistributed income of a foreign corporation because of control or ownership.

It will be observed that the United States reacted sharply to an extraterritorial imposition of tax by France. In effect the Treasury proposal would tax income of foreign corporations derived from foreign sources. The treaties specifically limit the jurisdiction of the United States over a foreign corporation to income from sources within the United States, and therefore the United States is obligated not to tax the income of a foreign corporation from sources without the United States. Would it be too much to expect that foreign countries in general, and treaty countries in particular, would react sharply by similar retaliatory taxes to United States taxation of the income of their corporations before it is paid out in dividends?

Congress has, through the enactment of two provisions in the Code, clearly expressed its policy to be against the violation of tax treaty obligations. Sec. 894 requires that 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 tax under this subtitle.

This should include the foreign income of a foreign corporation to the extent it is not distributed to U. S. shareholders.

Section 7852(d) provides that no provision of this title shall apply in any case where its application would be contrary to any treaty obligation of the United States in effect on the date of enactment of this title, and respect for international comity would require a similar provision be incorporated in any future tax legislation with international implications.

There is another provision in a number of tax conventions and executive agreements that would also be violated by the proposed amendment namely, the provision for exemption from U. S. tax, on condition of reciprocity, of income derived in the United States from the operation of ships and aircraft which provides that such income shall not be included in the gross income of a foreign corporation and shall be exempt from taxation. Yet, if the foreign corporation which benefits from this exemption happened to be within a developed country or to be classified as a tax haven corporation, the recommendation would tax the income that is thus not includible in the gross income of the foreign corporation.

The Supreme Court has declared: "The principles which should control the diplomatic relations of nations and the good faith of treaties as well, require that their obligations should be liberally construed so as to effect the apparent intention of the parties to secure equality and reciprocity between them". (Jordan v. Tashiro, 278 U. S. 123). Obviously, all our tax treaties were concluded with reference to the United States and foreign laws in effect when the treaties were negotiated, and it was not contemplated that the United States might some day tax U. S. shareholders on the profits of foreign corporations before they are distributed. This it is believed, violates the spirit and intent of tax treaties.

3. Effect of Section 13 of H. R.10650 on United States Foreign Trade and Business

(a) General Discussion

The proposal to tax to the United States shareholder certain undistributed profits of "controlled foreign corporations" will have unfavorable effects on United States foreign trade and business as a whole. Although it is our understanding that the Treasury officials intended to penalize only "tax haven" operations, there has not been adequate consideration of the adverse effects of the proposals on the overall economy and on legitimate foreign business. These adverse consequences would be substantial both to the affected shareholder and also to the economy as a whole. This proposal seems to conflict with other features of United States foreign economic policy, i.e., the proposed Trade Expansion Act, the Alliance for Progress program, the stimulation of exports, and the stimulation of investment in underdeveloped countries generally.

The United States shareholder would be adversely affected in all cases where such profits are earned in foreign countries whose income taxes are lower than comparable United States income taxes on such profits. The total income tax payable in a number of foreign countries in many cases is lower than that which would be imposed by the United States in accordance with the bill. This may exist because of a number of different factors: (1) the income tax rates of some countries are not as high as those of the United States; (2) other countries apply lower taxes to income from exports, while others do not tax income from export; (3) preferential rates are sometimes granted to income from new investment; (4) in many foreign countries

the concept of income varies from that in the United States, e.g. requirements for legal reserves, depreciation on revalued assets, etc.; and, (5) foreign countries rely more heavily for revenues on taxes other than income taxes. If Section 13 were enacted into law, it would place United States private enterprise abroad in a much less favorable position to compete with local nationals and nationals of third countries.

In addition to suffering a tax disadvantage, all United States foreign subsidiaries would have to take into consideration novel and artificial factors in determining their course of action. For example, any foreign subsidiary which bought goods from outside the country, processed them, and then sold such goods outside the country, would have to be mindful that the purchased goods have to be "substantially transformed" in order that the sale of the goods outside the country would not be regarded as giving rise to "foreign base company income". In implementing this and other novel concepts time consuming and expensive analysis and record keeping would have to be instituted and maintained.

The indirect effects of Section 13 of the bill on shareholders might be several. It is likely that foreign nationals would hesitate to participate with United States nationals in the ownership of foreign operations because the income from such operations might be regarded as "Subpart F income or an increase in earnings in non-qualified property" for purposes of United States law and thereby adversely affect the reinvestment policy of the enterprise. In addition, United States shareholders who might have reached the conclusion that the most efficient method of operation in several countries was through a single foreign subsidiary might decide because of

the proposed change that this efficient method would be more expensive than the less efficient method of establishing individual companies in each country.

The long-range effects of the proposed changes are also difficult to evaluate. They would curtail to some extent exports from the United States and participation by United States companies in the marketing abroad of foreign source commodities. Investments abroad would be curtailed. There is no certainty that trade and business which would be curtailed because of the enactment into law of the provisions in Section 13 will be balanced either by trade and investment in different forms in the foreign country, or that any income remitted will be invested in the United States. Frequently, the choice is not between exports from the United States and investments abroad, but between investments abroad and loss of trade. Similarly, the choice is not between investments abroad and investments in the United States. The investment must be made abroad or no investment will be made. If the latter eventuates, there will be long-range adverse effects on the United States economy and loss of U.S. tax revenue. A curtailment of U. S. investment abroad will deprive the United States of a ready market for the export of goods and equipment to United States subsidiaries abroad.

As noted above, Section 13 seems to conflict with other aspects of American foreign economic policy. The President has announced on a number of occasions that exports must be stimulated. It seems likely that to some extent, at least, this proposal will hamper exports. Further, the provisions of this section seem to be contrary to the purposes of the "Alliance for Progress", and commercial activities in and with underdeveloped countries, and especially activities in and with the Common Market.

The provisions of this Section are so broad that they would label as "tax haven transactions" many operations which were established for sound business reasons not related to United States tax considerations. Frequently, the operations which would be adversely affected have been carried on for many years in the normal course of business. In many cases they existed prior to the time the present United States parent acquired its interest in the foreign company.

(b) Patents, etc.

The Ways and Means Committee in their report concluded that it was desirable to tax income from patents, copyrights, etc. developed or created in the United States but transferred to foreign corporations. It is provided in H. R. 10650 that a 10% United States shareholder of a "controlled foreign corporation" would include in taxable income his ratable share of the income from patents, copyrights, etc., not only where the foreign corporation receives a royalty or similar payment for use of the property, but also where the foreign corporation itself uses the patent, copyright, or exclusive formula or process in the manufacture of goods and derives income from the sale of the manufactured articles.

This provision is predicated on the assumption that if it were not for lower taxes abroad, the domestic company would retain the rights and merely license their use by the foreign corporation.

There certainly has been no public testimony to this effect in any hearings on the taxation of foreign income. It is urged that there are a number of business reasons aside from taxation that induce United States companies to assign their patents to foreign corporations in a form other than licensing. One obvious reason is that the United States company may desire to enter into an ownership relationship with an existing foreign corporation and such corporation may demand the United States patents in return for ownership rights. Further, there may be situations where the value of the patent is unknown at the time of transfer and the only possible way of fully exploiting its value is through exchanging it in return for ownership in a foreign corporation.

This provision is an extreme example of the over-zealous attempt to hit the occasional tax evader resulting in the penalizing of normal and legitim transactions. While it maybe true that in some cases lower taxes have been a factor in the transfer of patents or processes to foreign corporations, it is equally true that such is not so in the vast majority of cases. For example, one of the most common cases is where a U. S. company, having developed a patent or process, wishes to embark on a broad scale licensing program in Western Europe. This takes a lot of time, effort and money - not only to sell the licenses, but to police the patent against possible infringers and to render technical assistance to licensees. For sound legal and business reasons, this may be best done by a foreign company. Thus, in France, where a suit for infringement must be brought by the patent owner, there are obviously many good reasons why the patent should be transferred to a local subsidiary.

Another very common example is the case where a license to use is granted without a cash consideration, but in lieu thereof, the licensee is expected to carry out further research and development on the process and it agrees to grant back to the licensor a royalty-free license under any patents or inventions it may develop. Or there may be an outright exchange of patent licenses.

Tax avoidance is also obviously not a factor where there is a substantial foreign minority of shareholders in the foreign corporation, since any reduction in taxes would be offset by the income given over to the minority shareholders.

Still another common situation in which tax avoidance is patently not a factor is found where a patent or process is transferred to a controlled foreign corporation for stock pursuant to rulings under Sections 367 and 351 of the Internal Revenue Code, which rulings hold that the transfer is not for the purpose of avoiding U. S. tax and that the transfer shall be free of tax. And yet, even in these cases, the proposed tax measure would apparently impute taxable income to the U. S. shareholder.

Furthermore, it should be unnecessary to point out that the overwhelming majority of controlled foreign corporation acquiring patents or processes which are developed in the U. S. are located in such highly developed countries as Canada, Great Britain, Germany, France, Netherlands, Norway, Sweden, Finland and Japan. Yet the taxes borne by these companies are substantial and in most cases as great or greater than those borne by U. S. taxpayers. Surely it cannot be said that tax avoidance is a motivating factor in these cases.

There is yet another case where tax avoidance cannot be a motive in the transfer of such property or right to a controlled foreign corporation and in which it would be manifestly unfair to impose a tax upon imputed income of the U. S. shareholder. This is where, as in Thailand, the government may not approve for exchange remittance an agreement by a Thailand company to pay a royalty or service fee to its majority shareholder. Where the foreign government will not permit the payment, an imputed payment is clearly unjustifiably harsh and arbitrary.

It should be clear from the above that there are a great many cases where tax avoidance plays no part in the transfer to or acquisition

by a controlled foreign corporation of patents or processes, etc., developed in the U. S. If the proposed tax cannot be justified in these cases under the cover of "tax avoidance", then they should be excluded from the proposed tax measure.

In addition to the objections to the proposal based on the considerations set forth above, there are a number of provisions the meaning of which are not clear including the following.

1. "Exclusive formulas and processes"
2. "Ordinary and necessary expenses" incurred in the "receipt or production"
3. "Taxes and any amortization or depreciation of the cost... of such property or rights"
4. "Substantially developed, created or produced in the U.S."

   For example, suppose a British company develops a new product or process which is patented and licensed to a controlled foreign corporation. If the U. S. parent of the controlled foreign corporation supplies the controlled foreign corporation with a modification or improvement of the basic invention, how would one determine the income attributed to the U.S. improvement. This problem has an infinite number of variations, all of which would be most complex and difficult of solution.
5. If a royalty being paid were held by a revenue agent to be inadequate, would additional royalty be attributed to U. S. shareholder? If so, would the attributed royalty include the royalty actually being paid? Would a foreign tax credit under proposed Section 957 be available with respect to the entire amount?

6. How would one be able to determine what an "arm's length" royalty would be? Patent and process licensing, for example, are frequently extremely complicated and diverse. It would be a rare case to find any two substantially alike. Such things as the nature of the obligations assumed by the licensee, the state of technical development of the process, the importance of the specific process to the end product, the size of the market, the amount of technical assistance required, etc., are but a few of the very difficult things to evaluate.

7. This section would apparently have the unfair result of imputing income in the case of a U. S. shareholder who may have had absolutely nothing to do with the transfer or development of the U. S. patents or exclusive processes, etc. - even though the controlled foreign corporation may have acquired such U. S. property in an arm's length transaction. At least, only the shareholder from whom the property was acquired should be affected by this provision.

8. How would income from the use of such property rights by a controlled foreign corporation be determined?

If an existing royalty agreement is in effect, would the royalty rate in such agreement be acceptable? If not, would the royalty actually paid be allowed as a deduction in figuring the net amount includible under Section 952 (c)?

9. If the U. S. corporation and the controlled foreign corporation have an agreement for exchange of patents, processes, and know-how, would such a reciprocal agreement be considered in determining income from the use of U. S.-developed patents, etc.?

10. Where, under existing agreements, royalties are being received from a foreign affiliate, which royalties are now subject to U. S. income tax without any credit for foreign income taxes paid by a foreign subsidiary, would income attributable to the U. S. parent under Section 952 (c) include the income actually received under the existing royalty agreement?

If such royalty income would be included, does Section 957 provide credit for foreign tax with respect thereto?

(c) Purchase and Sale of Property

The bill provides, in general, that the purchase and sale of personal property "derived in connection with the purchase of personal property from a related person and its sale to any person, or the purchase of personal property from any person and its sale to a related person", (Page 112, Lines 22 to 25) gives rise to foreign base company income if the property which is purchased is manufactured, etc. outside the country under the laws of which it is incorporated.

Many varied business reasons may exist for decisions to carry out marketing operations for several countries through a single foreign subsidiary which subsidiary in turn may or may not have branches or subsidiaries. The advantages of efficiency in management, accounting and finance frequently indicate such a procedure.

Marketing in a general geographic area, such as the Central American or the European Common Market areas, might be best handled by one foreign subsidiary. Marketing operations designed to take advantage of certain tariff considerations has been another reason for the establishment of foreign subsidiaries. Classical examples of this consideration were reflected in the formation in Canada and the United Kingdom of subsidiaries of American companies because of the "Imperial Preference" plan (now generally referred to as "Commonwealth Preference"). These two factors, namely, the close proximity of several countries, and the reduction of tariff barriers have been combined in a number of instances, e.g., the European Common Market. Undoubtedly, a number of marketing operations established or set up in Europe during recent years have reflected the actual and anticipated results flowing from the development of the Common Market.

In a number of cases foreign corporations purchase goods in one foreign country and sell them in another. No economic contact with the United States arises in situations such as this. To impose U. S. tax on income arising from such activities hardly can be regarded as preventing "diversion of U. S. income".

Proposed Section 952(e)(2)(B) refers in part to "*** property *** sold for use, consumption or disposition outside such foreign country". This provision is one of the tests for determining whether or not certain income from sales is to be treated as "foreign base company income". Frequently at the time of sale it is not possible to determine whether or not property may be used etc. outside a particular foreign country, and yet it would seem that the enactment into law of this provision would introduce an additional test which would have to be considered in connection with the sale of goods abroad. It should be stressed that here again the taxpayer, even if certain sales income is excluded because of this provision, must keep records and otherwise take additional time-consuming and expensive steps to be certain he is complying with the particular exemption.

(d) Passive Income

The N.F.T.C. is opposed to that portion of Section 13 providing for the current taxation of U. S. shareholders on the income of controlled foreign corporations which is designated as "foreign base company income". Such provision would include passive income such as dividends, interests, royalties, gains from the sale or exchange of stock or securities, amounts received under personal service contracts, and all rents. It would also include certain sales income from property purchased, and sold, outside the foreign country of incorporation. If the foreign base company income constitutes more than 80% of gross income, the entire gross income of the controlled foreign corporation is to be considered foreign base company income and is to be attributed to the U. S. shareholders. If the foreign base company income constitutes 20% to 80% of gross income, then such portion of the foreign base company income will be attributed to the U. S. shareholders.

This provision could seriously affect United States companies which have foreign subsidiaries which in turn have subsidiaries. In many cases, subsidiaries of foreign subsidiaries have been in existence many years and were established for sound and valid business reasons not connected with United States tax laws. Frequently there is substantial ownership participation by local nationals in the various levels of foreign subsidiaries and the form of organization has reflected the decision of the foreign owners. Frequently, products manufactured abroad by United States subsidiaries are marketed by foreign incorporated subsidiaries of the manufacturing company.

In a number of cases foreign subsidiaries may have been established in order to comply with local law. The laws of some countries provide that only locally incorporated companies with local citizens on the boards of the local company may engage in certain activities, or in certain geographic areas, e.g., companies operating ships, companies engaged in activities within a certain number of miles from the border.

This provision would result in unjustly penalizing and, in many cases, rendering noncompetitive legitimate foreign operating subsidiaries which, for sound business reasons, and in accordance with local laws and customs, have in turn established operating subsidiaries in either the same or other foreign countries. Dividend receipts by the parent foreign subsidiary could be greater than 20% of its gross income with the result that the U. S. parent would then be taxed on income which it had not received.

It is common business practice in all parts of the world for foreign operating corporations to establish subsidiary financing corporations within the same country for the purpose of providing the necessary financing for sales of consumer products. In some foreign countries this is required to comply with local banking laws. The financing activities of such subsidiaries clearly constitute the active conduct of a trade or business, and the income derived from active financing operations can in no proper sense be considered as passive income. In any case where the financing corporation is a controlled foreign corporation within the meaning of Section 13, the total profits of the corporation would be immediately subject to U. S. tax since all of its income would consist of interest income.

These provisions disregard principles long held inviolable in the law of taxation and corporate-shareholder relationships. It has always been held that a corporation and its shareholders are separate and distinct entities whether tho shareholder is an individual or corporation. Shareholders are not taxed on the earnings and profits of a bona fide corporation until they are distributed in the form of dividends. This principle has been disregarded only in the rarest of circumstances involving "paper" or sham corporations.

The foreign personal holding company provisions now existing under the Internal Revenue Code constitute a narrow exception to the principle that the corporation and its shareholders are, for tax purposes, separate and distinct. However, it is clear that such provisions were enacted with a specific background of glaring tax avoidance and were expressly designed to preclude the frequent use of incorporate pocketbooks. Even in such cases, however, the constitutionality of these provisions have never been considered by the Supreme Court.

Under the existing foreign personal holding company provisions the passive income test is 60%, and under the domestic personal holding company provisions the passive income test is 80%. Under section 13, these long existing passive income tests are now being substantially altered, and an unrealistic test of 20% is to be imposed. It would appear that the use of a 20% test is open to serious doubts from the standpoint of constitutionality. This 20% test is so low as to constitute in its effect an attribution of undistributed earnings to the shareholder - exactly the type of approach which was considered legally unsupportable last year by the Chief of Staff of the Joint Committee. (Hearings, Vol. 1, page 311).

The attribution of undistributed income to one entity upon being earned by a bona fide operating foreign corporation, having no semblance of tax avoidance or evasion, could be considered as a prelude to application of the same concept to the domestic area.

The effect of Section 13 seems to be that a United States shareholder may be taxed on "imputed " income from a sub-subsidiary even though the sub-subsidiary did not declare dividends to the subsidiary. It obviously can work considerable hardship on U. S. shareholders in view of the fact that the complicated rules for determining stock ownership could as a practical matter give any one U. S. shareholder little effective control.

The Treasury Department itself has announced in the January 31st release that the receipt of dividends and interest by a holding company incorporated in the same country as the payor corporation would not be considered as income of a passive nature.

It appears inappropriate to consider rentals which are normal to the active conduct of a trade or business as passive income when such rentals are an integral part of the company's business.

In its present form, Section 13 of H. R. 10650 would have a serious adverse impact upon U. S. shareholders of foreign corporations engaged in active commercial shipping operations abroad. To the extent that such an impact should result, it would seem clearly to thwart the intended purposes of the Bill, as expressed by the Ways and Means Committee itself.

In its Report, the Committee stated its intention to tax U. S. shareholders currently on two types of income of controlled foreign corporations:

(1) Investment-type income not reinvested in less developed countries, and

(2) Income arising from the active conduct of a trade or business if the income is not reinvested in the same trade or business outside of the United States.[4]

These proposals were submitted because the Committee saw "no need to maintain deferral of U. S. tax where the investments are portfolio types of investments, or where the company is merely passively receiving investment income".[5] At the same time, however, the Committee acknowledged "the need to maintain active business operations abroad on an equal competitive footing with other operating businesses".

While it is indeed questionable whether such a result was ever contemplated by the Committee, it appears that Section 13 could result in taxing shipping income as if it were passive rather than active business income. We believe that, to the extent such a result where to ensue, the overall aims of the Bill would be thwarted rather than futhered.

For example, it is conceivable that proposed Section 952 (e) (3), which includes "all rents" as foreign base company income, might be construed to reach certain income received by shipping companies as charter fees on its vessels. This possibility is presented, notwithstanding the distinct difference between the fees earned by an active shipping business and the traditional low-risk, portfolio type of rent presumably contemplated by the Committee, because of a provision in the existing U. S. Treasury Regulations under another section of the Code (Sec. 543) wherein the term "rents" is defined to include "charter fees". However contrary such an interpretation might be to the intent of Congress in the present Bill, the possibility of such an inadvertent application of the law cannot be overlooked.

4 House Report No. 1447, 87th Congress, 2nd Session; 58
5 Ibid.; 62

The application of Section 13 to U. S. controlled foreign shipping companies would, in many cases, totally ignore the fact that subsidiaries of American industrial or commercial companies have been incorporated in, and their vessels registered under the flags of, foreign countries for important legal and commercial reasons. For example, the law of a number of countries requires that certain goods imported into the country or transported in its coastwise trade be carried in vessels registered locally. In other countries, strong expressions of national sentiment have indicated the economic and political advantages of following such a course. Foreign currency controls have likewise exerted an influence over business decisions as to the place of registry of a vessel and the place of incorporation of the shipping company.

To the extent that such dispositions resulted in a transfer of control of ships registered under the laws of countries which permit agreements by the owners pledging their vessels to the United States in the event of war or national emergency, the defense posture of our country would be weakened. Our Government has officially encouraged the buildup of this "effective control" fleet, and it would be unfortunate if this encouragement were now to be negatived by H. R. 10650.

The Ways and Means Committee has acknowledged the desirability of maintaining active American business operations abroad on a plane of competitive equality with other operating business concerns in the same foreign countries. There is certainly no lesser reason for maintaining active American shipping operations abroad on an equal competitive footing with competitors in the same maritime waters.

Section 13 would impose a particularly severe financial burden upon owners of stock in foreign shipping corporations. In numerous cases, such independent corporations have pledged their entire charter income over a period of years to lending institutions as security for the payment of amortization and interest on their vessel mortgages, and have contractually restricted their right to declare dividends during the amortization period. If these owners are placed in a position where they are called upon to pay U. S. taxes currently, on income which they have not only not received but which they are contractually prohibited from receiving for a period of years, they could be forced to dispose of their controlling interest in the foreign corporation to non-U.S. interests.

(e) Manufacturing

House Report No. 1447 tends to indicate that income from operating businesses, which are located in the economically developed countries, is not subject to taxation to the United States shareholder. However, this seeming exception is subject to a number of qualifications. The income from manufacturing, for example, which certainly would seem to qualify as "operating business" income, is subject to the following limitations among others:

1. Such operations now must be the subject of new and complicated record keeping and management must be aware of the imposition of the U. S. accounting and legal concepts which, until the present time, would not have to be taken into consideration.

2. Most frequently in foreign manufacturing operations there may be use of U. S. patents, exclusive formula, or processes. As pointed out in our discussion concerning patents, etc., this would introduce an entirely new concept into the tax law. It could as a practical matter constitute a serious limitation on various manufacturing activities.

3. Certain sales income will be taxable to U. S. shareholders. The House Report indicates that the type of sales income is that of certain selling subsidiaries which have been separated from the manufacturing operations of a related company. Undoubtedly, this again in practice places a limitation on a corporate complex centered around manufacturing operations. As indicated in our discussion of purchase and sale of personal property, many selling operations may be separated off from the manufacturing operations for sound business reasons. Again in connection with the possible indicated effects of so-called "foreign base company sales income", the penalty will not apply in cases where "significant amount of manufacturing

*** is carried out." On the other hand, "minor" activity would not be sufficient in such cases.

4. As noted above, even if the income arises from manufacturing, such income must be used in certain ways, e.g., invested in "qualified property" or it will be subject to U. S. tax. Undoubtedly, this factor will have to be taken into consideration in any long-range financial planning, e.g., the sale of shares of stock, both to United States and foreign nationals. This is due to the adverse effect that would flow from the shift in the ownership between U. S. individuals or foreign nationals under the requirements of Section 13.

(f) Qualified Investments

It is generally conceded that diversification of activities of a corporation may be a necessary element of maintaining a profitable enterprise. Usually, such diversification is for other than tax reasons. It is to maintain a market and to meet competition from local and third country companies.

Under Section 13, certain earnings of a foreign corporation will not be considered as foreign-base company income subject to immediate taxation to the United States stockholder, if such earnings are invested in "qualified property". The definition of "qualified property", however, is so limited that it would only permit investment in (1) the same trade or business; (2) an 80%-owned subsidiary; (3) an active trade or business in a less-developed country, and (4) in at least 10% of the stock of a company more than 50% owned by no more than five United States persons, and engaged in an active trade or business in a less developed country and incorporated therein.

There can be no doubt that these requirements for investment by foreign corporations under threat of United States taxation to their United States stockholders are a serious limitation on the concept of freedom to use and dispose of property. The narrow definition of "qualified property" will seriously discourage the diversification of foreign corporations, and hamper their participation in the foreign trade program of the United States, especially in the Common Market area. If they are to be limited to "the same trade or business", the result could be diminution of United tates private enterprise overseas.

The requirement of Section 13, that an investment in companies engaged in trade or business in the developing areas must be limited to a stock participation in a locally incorporated company, does not give recognition to the accepted methods employed by United States private enterprise in financing new industries. Limiting the investment in the developing areas to companies with only a stock capitalization, and with a further requirement that not more than five United States citizens may own

more than 50% of the voting stock, will greatly discourage the flow of capital funds from the developed areas of the world. It would seem that the aims of the United States to help these emerging nations would best be served by not so narrowly restricting the type of investment that can be made by foreign corporations in these areas. Whether an investment is made in stock or other securities, including debt, would seem to be immaterial as long as the company in which the funds are invested is engaged in actual operations in the less-developed countries. Further, a foreign corporation should be permitted to meet the "qualified property" test if it invests in a company incorporated in the United States but conducting an active trade or business in a less developed country or countries.

Another possible source of difficulty in connection with qualified investment might arise under proposed Section 953(b). To meet the test of qualification, it must be shown that the property in question is located, and the trade or business carried on, "outside the United States". It is conceivable that the position might be taken that a vessel which touched a U.S. port from time to time was not, for that reason, a "qualified" property and that the trade or business was likewise not a qualified one. However inconsistent such an interpretation might be with the legislative intent in approving the quoted language, the possibility of its being adopted is a source of concern.

(g) <u>The Distinction Between Underdeveloped and Developed Countries can Produce Undesirable Results</u>

The National Foreign Trade Council supports the exceptions granted in Section 13 to U. S. activities carried on in underdeveloped countries. It is our basic position that the same treatment should be given to operations in developed countries. However, one unfortunate limitation in the bill is that it, apparently, would tend to impose tax burdens on subsidiaries incorporated in developed countries and carrying on activities in both developed and underdeveloped countries. In a number of instances, businesses do operate across a number of geographical boundaries. To draw distinctions between developed and underdeveloped countries, leads to undesirable restraints on the companies which in the long run, may hamper what otherwise would be normal business developments. In addition, there is no certainty as to the areas which will be considered developed or underdeveloped in a future year or the criteria to be used in such a determination. This uncertainty as to the future classification of a country will add another risk to the hazards of investing in the underdeveloped countries.

4. General Disadvantages of Section 13

Some general disadvantages of Section 13 are the following:

(a) The Provisions are Lengthy and Complicated

Even if the proposals contained in Section 13 were desirable from a policy viewpoint, serious consideration should be given to the desirability of enacting into law such complicated and complex provisions as are found in this section. It is urged that these provisions, noted above, (first made available to the public on March 12 of this year) which present major problems of interpretation, administration, and compliance, should not be enacted at the present time.

An indication of some of the complexities of the bill is the following quotation from the "explanation" of the bill set forth on page A103:

> "In this connection, although amounts taxed once under section 951 (a)(1)(A) as subpart F income may offset amounts representing an increase in earnings in nonqualified property under section 951 (a)(1)(B) (so as to avoid taxing the same earnings twice) such offset does not affect the amount of earnings and profits attributable to amounts representing the increase in earnings in nonqualified property for purposes of paragraph (1). The amount of earnings and profits under paragraph (1) includes earnings and profits attributable to amounts includible in gross income under section 951 (a)(1)(B) as well as earnings and profits attributable to amounts which would have been included under such section except for the availability of the offset by reason of the inclusion of amounts under section 951 (a)(1)(A) as subpart F income. Earnings and profits attributable to amounts included in subpart F income, but used to offset an increase in earnings invested in nonqualified property are not, however, included in paragraph (2) since they are already included in paragraph (1). Thus, there is no duplication in the amounts attributable

to paragraph (1) and (2), and, from the standpoint of the shareholder, the amount of earnings and profits allocable to him under paragraphs (1) and (2) is always equal to the amount of income he has been taxable on under section 951 (a) (and for which he has not received an actual distribution)."

(b) Conflict of U. S. and Foreign Accounting Concepts

The bill by its terms applies to all "controlled foreign corporations". It will be necessary as a result for the U. S. shareholders of each "controlled foreign corporation" to keep new and elaborate records in order to determine whether or not the "foreign controlled corporation" has any subpart F income, whether or not it is invested in "non-qualified" property, and whether it is distributable income. The bill, in effect, would attempt to impose U. S. tax accounting concepts with relation to income derived through "controlled foreign corporations". Briefly, some of these which would be pertinent, if this bill were enacted into law, are the following:

The bill in a number of instances refers to income which has been distributed:

(1) The term distribution is referred to in a number of sections of the Internal Revenue Code particularly those in Sub-Chapter C. In general, the terms distribution, as such, is not defined in the Code, although several definitions relating thereto are contained in Section 316 and 317 of the Code. Certain very broad characteristics of the term are clear, however, namely that a distribution is to a shareholder "with respect to its stock"; also that a distribution is either a dividend or not a dividend; that a dividend is a kind of distribution. The Code itself contains a number of complicated inter-related provisions involving distributions and, in addition, the courts have further refined the term. For example, a number of cases have been concerned with the concept of "disguised dividends".

(2) Will U. S. tax and accounting concepts be imposed on calculating the income of foreign subsidiaries without respect to either the absence of local laws on these concepts, or local laws which vary from the United States concepts, e. g. that no distribution may be made out of current year's earnings.

(3) One anomaly of the draft is that it will now treat as a distribution in the nature of a dividend certain profits of a subsidiary which by definition are undistributed. On the other hand, when an actual distribution is made in the form of a dividend to the parent, this is to be regarded as a distribution which is not a dividend (955 (a)).

(4) Throughout the bill the term "earnings and profits" is referred to frequently. Although it is to be used in measuring the "qualified investments" and "unqualified investments" to be made by controlled foreign corporations, it is a concept probably unknown to foreign accounting procedures. In fact, frequently it is difficult to determine even in the United States what actually constitutes the "earnings and profits" of a corporation. Many questions will arise on the calculation of rates of return, profit determinations, exchange requirements and even the taxation of income within the foreign country.

The complicated revisions of accounting procedures in these foreign countries which will be required to comply with the provisions of Section 13 will be extremely costly and the administration of this Section will raise U. S. tax problems for years to come.

5. Variations from Earlier Treasury Drafts on Tax Havens

Section 13 apparently is intended primarily to be directed against tax haven activities but, by its terms, it adversely affects a number of business operations which obviously are not tax havens. It even penalizes profits from activities which were not included in Treasury drafts of bills previously released. For example, the present provision would tax "the receipt of dividends and interest by a holding company incorporated in the same country as the payor corporation". The former proposal did not tax such dividends and interest.

Further, Section 13 as contrasted with earlier drafts does not permit "an offset of losses in previous years against tax liabilities. A three-year loss carryback and five-year loss carryforward would be permitted".

Again, the bill as compared to earlier drafts, does not "permit earnings from existing 'tax haven corporations' to be taxed in the same manner as those of ordinary domestic corporations, if desired by the companies

Finally, Section 13 as contrasted with earlier drafts does not provide "that a specific company which can establish that it is not avoiding taxes by reason of its place of incorporation and which should not, therefore, be subject to the provisions of the legislation, will not be covered".

B. Section 6 - Amendment of Section 482

This section provides, in effect, that where goods are purchased or sold by a domestic corporation to a related foreign corporation the income received from these transactions is to be allocated between the parties on the basis of the location of the assets used in the operations, the payroll attributable to them and the related selling expenses. This is one of the provisions directed at so-called "tax haven" situations. Serious consideration should be given to eliminating from the proposal the allocation of income arising from the sale of goods originating in one foreign country but purchased in another foreign country. While it may seem desirable that appropriate rules be set forth in case of goods originating in the United States or sold in the United States serious question is raised about the propriety of imposing U. S. allocation rules with respect to goods bought and sold in foreign countries which do not touch the United States.

The purpose of Section 6 of H. R. 10650 is to amend Section 482 of the Internal Revenue Code so as to make it easier for the Treasury Department to allocate sales prices between a U. S. taxpayer and a related foreign organization. No additional power is given the Secretary of the Treasury by this new subsection, except that rules for allocating sales are provided and definitions of "arm's-length" price are added. The Secretary is empowered to determine intercompany prices under present Section 482, the addition of the proposed Section 482(b) may create more problems than it will solve.

If any revision of Section 482 is enacted, the legislation should satisfactorily cover the following problems:

1. Section 482 (b) (8) is defective in that any sale adjustment is not treated as foreign income for purposes of figuring foreign tax credit, even though the amount of the adjustment may already, in effect, have been included in net income of the foreign organization and have been subjected to foreign tax, thus subjecting such income to double taxation. The Code should provide that, for purposes of figuring the foreign tax credit under Section 482 (b) (8), the amount of the income adjustment shall, to the extent it has been included in the taxable net income of the foreign organization, be treated as income from foreign sources.

2. There is no provision under Section 482, or other provisions of the Code, such as Section 956 (a) for the exclusion from dividend income of an amount equivalent to the income adjustments previously required to have been included in gross income of a U. S. taxpayer under Section 482. If an adjustment is made under Section 482, the law should provide that an equivalent amount should be treated like a receivable from the foreign organization, without being again includible in gross income as a dividend.

3. If the Treasury would apply present Section 482 without recourse to arbitrary definitions or formulas, reasonably just apportionments could be determined. The theoretical allocations in Section 482 (b) may lead to arbitrary results which would not be as representative as could be arrived at under present law.

4. If any suggested allocation formula is to be provided, the definition should recognize price level differences between the United States and foreign countries, and the effect of such price level differences on wages, asset bases, and on costs and expenses used as allocation factors.

C. Section 16 - Gain from Certain Sales on Exchanges of Stock in Certain Foreign Corporations

Section 16 of H. R. 10650 adds a new Section 1248 to the Internal Revenue Code. Section 1248 would tax, as a dividend to a U. S. shareholder owning 10% or more of the voting stock of a foreign corporation in which U. S. persons own more than 50% of the voting stock, the gain on the redemption of stock in an exchange to which Section 302(a) applies or the gain in complete or partial liquidation in an exchange to which Section 331 applies. If such stock is sold or exchanged, the gain from the sale or exchange is treated as gain from the sale or exchange of property which is not a capital asset. The amount treated as a dividend in the case of a redemption or liquidation is the taxpayer's proportionate share of the earnings and profits of the foreign corporation accumulated after February 28, 1913. The amount treated as gain from the sale or exchange of property, which is not a capital asset, is the amount of the taxpayer's share of the earnings and profits of the foreign corporation accumulated during the period the stock was held by the taxpayer. Appropriate provision is made to exclude from the amount treated as a dividend or as gain from the sale or exchange of property which is not a capital asset, amounts already included in taxable income under Section 13 of H. R. 10650.

The effect of Section 16 would be to tax, at ordinary income rates, the gain realized on sale of the stock of a foreign corporation it would tax at ordinary income rates the gain on redemptions in liquidation. In the case of a liquidation, the foreign tax credit would be allowed as if a dividend had been paid. However, in the case of a sale, no such credit would be allowed. In the case of a redemption of stock in

liquidation, the gain would be taxable to the redeeming corporation as a dividend to the extent of the earnings of the corporation accumulated since 1913. In the case of a sale of the stock, the gain would be taxable at ordinary income rates to the extent of the earnings accumulated during the period the seller held the stock. No allowances would be made for losses.

The National Foreign Trade Council is opposed to Section 16 of the bill in its present form for the following reasons:

(1) Section 16 proposes radical changes in the concepts, applicable to both liquidations and sales of stock, which have prevailed in our tax laws for 40 years. It is unfair and unreasonable to change the rules retroactively with respect to earnings already accumulated. The effect is to tax, retroactively, earnings accumulated over many years in a manner different from that which prevailed at the time of the accumulations. Such a tax law will result in inequitable treatment to taxpayers who would be similarly situated taxwise except for the fortuitous date of the sale or liquidation of their subsidiaries. It is therefore proposed that the application of Section 16 should be limited to earnings accumulated after December 31, 1962, and that the amount taxed as a dividend or treated as ordinary income on a sale should be limited to the lesser of the gain or the earnings accumulated after that date.

(2) The portion of the gain taxed as a dividend at the time of liquidation should be limited to earnings accumulated while the stock of the liquidated company was owned by the shareholder to whom the dividend is paid.

(3) Section 16 is inequitable in that the taxpayer is required to treat gains incurred on transactions covered by this section as ordinary income while, at the same time, losses incurred on similar transactions must be treated as capital losses. It can result in ordinary income taxes being paid twice on the same amount of income.

(4) Credit for foreign taxes is allowed with respect to liquidations of foreign corporations but such foreign tax credits are not allowed with respect to the sale of a foreign corporation.

It is not clear why such a distinction is made and a provision might be made to permit a foreign tax credit allowance in the case of a sale to the extent of the credit that would be allowed had an actual distribution been made.

(5) Appropriate provision is not made for reducing the accumulated profits of a foreign corporation for the amount treated as gain from the sale or exchange of property which is not a capital asset, and for eliminating a deficit in accumulated earnings and profits to the extent that a taxpayer has been allowed to deduct as an ordinary loss the taxpayer's proportionate share of the accumulated deficit in earnings and profits of a foreign corporation accumulated during the period the stock sold or exchanged was held by such taxpayer.

D. Section 5 — Amount of Distribution Where Certain Foreign Corporations Distribute Property in Kind

Under existing law, dividends paid in appreciated property by domestic or foreign corporations are taxed to U. S. corporate recipients at the adjusted basis (usually cost) of the particular asset in the hands of the distributing corporation (Section 301(b)(1)(B)). This is in accord with other provisions of the law which require use of adjusted basis for purposes of determining remaining earnings and profits of the distributing corporation (Section 312(a)(3)), and also for computing foreign tax credit allowances under Section 902.

The new Bill would unfairly penalize U. S. corporate shareholders receiving distributions in kind from a foreign corporation after December 31, 1962; first, by amending Section 301 so as to tax such dividends at fair market value; second, by amending Section 902 so as to require that foreign tax credit applicable to any such dividend in kind be computed on the adjusted basis of the asset distributed; and third, by making no change in the rule of Section 312(a) that earnings and profits of the distributing corporation shall be reduced only by the adjusted basis of property distributed as a dividend.

Thus, the U. S. corporate shareholder receiving a dividend in appreciated property from a foreign corporation as distinguished from a domestic corporation is subjected to maximum U. S. tax, minimum foreign tax credit, and the likelihood of being subjected to a double tax on an amount equal to the unrealized appreciation of the asset distributed. This is illustrated in the following example, which assumes that the foreign subsidiary pays to its domestic parent a dividend in property having a $50 fair value but a $10 cost basis, and thereafter pays a second cash dividend of $90 equivalent to its remaining surplus (foreign tax credits are ignored).

Foreign Subsidiary

	Before Dividends	After Dividend No. 1	After Dividend No. 2
Cash	$100	$100	$ 10
Asset (Fair value $50)	10	-0-	-0-
Other Assets	140	140	140
Total	$250	$240	$150
Capital Stock	$150	$150	$150
Surplus	100	90	-0-
Total	$250	$240	$150

Domestic Parent

	Amount of Taxable Dividend	U. S. Tax Rate	U. S. Tax Amount	Reduction in Surplus of Foreign Subsidiary
Dividend No. 1	$50.00	52%	$26.00	$ 10.00
Dividend No. 2	90.00	52%	46.80	90.00
Total	$140.00		$72.80	$100.00

It is respectfully submitted that it is unconscionable to exact a tax of almost 73% from a U. S. parent corporation upon payout of its foreign subsidiary's surplus merely because the subsidiary is a foreign corporation and not a domestic corporation.

By limiting the reduction in accumulated earnings and profits of the paying corporation to the adjusted basis of the appreciated dividend property, the net effect is to tax the same earnings twice. This vicious result is then compounded by minimizing the foreign tax credit by requiring that such credit be computed by valuing the dividend at the lesser of the adjusted basis or the fair market value. If the paying corporation happens to be incorporated in a so-called underdeveloped country, the result achieved is completely contrary to the stated purpose of the Administration, which is to encourage private investment in the less developed countries of the world.

It would appear that the application of Section 5 of the bill would be discriminatory and that there should be no tax on property distributions which remain in corporate solution.

If the Senate believes it necessary to adopt this method of taxing foreign dividends in kind, we recommend (1) that the earnings and profits of the paying foreign corporation should be reduced by the fair market value of the property distributed, and (2) that the foreign tax credit should also be computed on the same basis.

E. Section 11 — Domestic Corporations Receiving Dividends from Foreign Corporations

It is again proposed to require an American corporation claiming foreign tax credit with respect to dividends from a foreign corporation to add to its actual income the amount of foreign taxes claimed as a credit. The present law taxes the actual dividend and allows credit for only the appropriate part of the foreign taxes paid by the subsidiary on its after-tax income; the proposal would base the credit on the foreign tax paid on the entire income of the subsidiary. The resulting U.S. tax on the dividends would be larger except when there is no foreign income tax or when the foreign income tax equals or exceeds the U.S. rate.

Thus the proposal would increase the United States income tax on dividends received by American corporations from many of their foreign-incorporated subsidiaries, including those located in underdeveloped countries. This would be in conflict with Administration recommendations for the encouragement of American investment in underdeveloped countries and increasing exports of American products.

The justification given for the proposal is that it will correct what has been expressed as a lapse in legislative draftsmanship 39 years ago, which it is implied, has been overlooked by Congress in the subsequent re-enactments of the provision. This has been described as a duplication or overlapping of both a deduction and a credit for foreign taxes and is illustrated by arithmetical examples representing that this results in some cases in an overall tax burden on foreign-source income of less than the United States rate. It is urged that this defeats the policy of subjecting all foreign-source income to the United States rate as an overall minimum.

The fact is that the statutory system which has been in effect for this long period does not in any case actually allow both a deduction or ex-

clusion and a credit for the same foreign taxes. In the case of dividends received from foreign subsidiaries there is no deduction or exclusion from the American corporation's actual income of any foreign taxes paid by the foreign subsidiaries, and credit is allowed for only part of those taxes. No credit is allowed for the foreign tax on the income which is not received as dividends because it was used by the subsidiary to pay its foreign tax. There is no overlap or duplication.

Computations illustrating that more United States tax would be paid if a United States corporation or its branch were substituted for the foreign subsidiary prove only that recognition of the separate entity of the foreign corporation prevents application of the United States tax to income which never comes within its jurisdiction.

The long-standing method of taxing dividends and allowing foreign tax credit with respect to them was thoroughly considered and was described with approval by the United States Supreme Court in 1942 in the case of American Chicle Company v. United States, 316 U.S. 450. The court said:

> "If, as is admitted, the purpose is to avoid double taxation, the statute, as written, accomplishes that result. The parent received dividends. Such dividends, not its subsidiary's profits, constitute its income to be returned for taxation. The subsidiary pays tax on, or in respect of, its entire profits; but, since the parent receives distributions out of what is left after payment of the foreign tax, -- this is, out of what the statute calls 'accumulated profits', it should receive a credit only for so much of the foreign tax paid as relates to or, as the Act says, is paid upon, or with respect to, the accumulated profits".

Thus the existing system assures that the full United States rate

will be applicable with respect to the full amount of income received as dividends by the United States parent. The proposal would require the United States parent to add to its own actual income a portion of the foreign subsidiary's income which it has not received and never can receive as dividends. As a comment on the philosophy of this proposal, the following quotation from the opinion of the Court of Claims, affirmed by the Supreme Court, in the American Chicle Company case, 41 Fed. Supp. 537, is interesting:

> "It is hard to see why the American tax authorities should be interested in that portion of the foreign corporation's income which was taken away from it by the foreign government as taxes, either for the purpose of taxing it, which the statute does not purport to do, or for the purpose of giving credit for taxes paid upon it, which is what the plaintiff seeks to have done. The taxes paid upon that portion of income are in no sense taxes paid upon American income, and there is no reason why they should be credited upon American income tax."

Thus the merits of the existing system were thoroughly considered by our courts 19 years ago. The arithmetical result of the existing provision was clearly understood. The construction of the statute by the courts was the construction which was urged by the Treasury Department. It is more reasonable to view the new proposal as a novel and unwarranted extension of the scope of the United States income tax than to criticize the present sys

The "deemed credit" provision was enacted to improve the competitive position of U.S. corporations having foreign subsidiaries. There is no basis for an assumption that the benefit given was greater than was then intended. The fundamental legislative policy is better inferred from 39 years of history than from pure supposition that the true policy should have been to tax income never accruing to a U.S. taxpayer.

Before any amendment is made which would change the established method of computing foreign tax credit on dividends from foreign corporations, consideration must be given to the effect on the existing tax treaties between the United States and twenty-one foreign nations. These treaties obligate the United States to allow credit for foreign income taxes in accordance with the Code as in effect on the date of ratification of each treaty.

Section 7852 (d) of the Internal Revenue Code of 1954 provides that no provision of the Code shall apply in any case where its application would be contrary to a treaty obligation of the United States in effect on the date of enactment of the Code.

It is evident that unilateral action by the United States to amend its foreign tax credit provisions adversely would either be ineffective as to a treaty country under section 7852 (d), or else would supersede and abrogate the treaty, a bilateral obligation entered into by the United States after careful negotiation and consideration, and involving many valuable safeguards for our citizens and corporations with businesses in the other country.

The matter of equalizing tax burdens as between foreign branches of United States corporations and foreign subsidiaries is not so simple as is assumed by the comparative computations which are used for the purpose of showing that use of a branch may result in a greater total tax burden. The United States tax law gives various advantages to the use of branches of domestic corporations or domestic subsidiaries operating abroad which are not available if foreign subsidiaries are used. Losses of a branch or domestic subsidiary can be deducted from United States-source income; losses of a foreign subsidiary can not. Thus the savings from the use of a branch during initial development periods, or during later years of loss operations, may easily outweigh whatever tax differential may arise at

other times in favor of dividends from a foreign subsidiary. When the foreign income includes a substantial amount of capital gain or income treated by U.S. law as a capital gain, the branch operation may have an advantage over the subsidiary. Some depreciation methods permitted by the U.S. law may favor the use of a branch.

These are some of the situations in which the foreign branch operation may pay less taxes than a foreign subsidiary operation. The sole argument for the proposal is that in certain situations the taxes of a foreign subsidiary operation are less than those of a branch operation. We have shown that this is not the case in a number of situations. To increase the taxes of the foreign subsidiary operation, as proposed, would merely aggravate disparity between the two types of operations which exist under present law in these situations.

The present U.S. tax treatment of dividends from foreign subsidiaries is a part of the background against which American enterprise has built up its foreign investment over the past 39 years. At a time when national policy dictates the encouragement of investment in the underdeveloped countries and when the Administration is urging measures to foster increased exports from the United States, it seems ill advised to pass a measure which would penalize the use of existing foreign subsidiaries in such countries as well as the formation of new ones.

It should not be assumed that foreign subsidiaries are chosen solely for the purpose of saving taxes. A locally incorporated company is frequently regarded as most appropriate for a foreign operation, and in many cases it is required by local law. If local capital is to participate in the venture, local incorporation is usually necessary. Particularly in the marketing abroad of American exports, the necessary good-will and public acceptance is increased by the use of a local subsidiary

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Foreign subsidiaries are common for operations in Europe and other highly developed areas where the supposed tax advantage of foreign subsidiaries does not exist, because income tax rates are high and the arithmetic of the foreign tax credit computation produces little or no difference between branches and subsidiaries.

The effect of the proposal would be most felt where the foreign income tax rate is in the median range of the U. S. rate, as is likely to be the case in less developed countries. Not only would the proposal place U.S. investment at a further competitive disadvantage in these countries, but it would furnish an incentive for those countries to increase their income taxes, since it would remove the residual advantage accruing to American investment from the lower foreign rate.

The proposal would increase the tax burden on U.S. corporations with foreign subsidiaries used in the sale, distribution and servicing of American exports.

The supposed inequality attacked by the proposal does not exist when all factors are considered. It would unfairly penalize a long-established method of doing foreign business, by making an unwarranted change in the consistent legislative policy of 39 years. It runs counter to national policy in favor of American investment in underdeveloped areas and the increase of American exports to all areas.

F. Section 12 — Earned Income From Sources Without the United States

This provision passed by the House would impose an arbitrary limitation on the excludable income of a U. S. resident of a foreign country. In doing so, it seems to go too far in its attempt to correct alleged abuses in this area. Any abuses that exist in this area appear to be few in number. This is shown in the Treasury's own testimony before the Ways and Means Committee last year.

The $20,000 limitation is unreasonably low. This amount was established in 1951 as a limitation for individuals who meet the "physical presence" test. Living costs, particularly abroad, have soared since 1951. The $20,000 limitation presently in the law for individuals physically present abroad should be increased to take cognizance of this fact.

We must recognize that no other economically advanced country of the world seeks to tax the employment income of its overseas citizens. We must recognize that we have to compete with foreign owned companies and that in order to compete effectively, particularly in the less developed countries, our companies must be able to attract skilled managers and technicians from the United States. If Americans are to be subject to a significantly higher tax than their foreign counterparts, we will either not be able to attract them in sufficient numbers or we will be forced to compensate them at a significantly higher rate. Any combination of these two will hamper our efforts to compete effectively.

We wish to emphasize what we stated last year in our testimony be- the Ways and Means Committee. There are several countries, in underdeveloped

areas, which provide income tax incentives to induce experts with certain skills to come to their countries for limited periods of time. To impose United States income tax on the compensation of these experts will defeat the domestic policies of foreign governments designed to develop their economies. Further, we believe the present provisions of Section 911 should be continued for the following reasons.

1. The principle of excluding from gross income the total compensation earned by U. S. citizens working abroad, who are bona fide foreign residents has been in the U. S. tax law since 1926.
2. U. S. citizens working abroad should be on the same basis as local citizens and citizens of other countries working locally; that is they should be subject only to the local tax.
3. An arbitrary income ceiling which does not recognize the wide range of additional costs to U. S. citizens employed in foreign countries could produce great inequities. It is customary for U. S. companies to provide necessary allowances to cover such costs. Among the more common allowances made when costs in foreign countries are higher than U. S. costs are the following:

    (1) For cost of living
    (2) For rental allowances
    (3) For education

4. In many foreign countries, particularly in Latin America, the local law provides that in the case of termination of service as an employee, the employer is required to make a termination payment in a lump-sum based on length of service. The proposed change in section 911 (a) (1) by the addition of a monetary ceiling might

work a considerable injustice to these U. S. citizens if the termination payment places them over the ceiling in one year irrespective of the fact that such payment may have been earned over a long period of years.

For these reasons we conclude that a monetary limitation on excludable income is undesirable. If it is determined that one is necessary to curb alleged abuses it should be so designed that it will not affect those who are not perpetrating the abuses. It should not be less than $35,000 per year, regardless of the number of years resident overseas.

There is insufficient logical ground for the three year "seasoning" period and dual exclusion limitations found in the provision passed by the House. If there were to be a "seasoning" period, once an employee qualified he should not be required to start the period again if his bona fide residence overseas is interrupted by a temporary assignment in the United States.

Under the provision passed by the House no exclusion would be allowed for annuities attributable to employer contributions for overseas service after 1962. We believe that employer contributions to the cost of annuities should be considered as employee costs to the extent that they are below the annual limitation.

If a monetary ceiling is put into section 911 of the Code, there will be no need to change the pension section of 72 (f). For example, if a $35,000 ceiling were established in section 911, employer contributions to company pension plans would be considered as part of the employee's cost only to the extent that amounts contributed, when added to compensation, are below the ceiling provided.

G. Section 20 — Information with Respect to Certain Foreign Entities

Under section 6046 of the present law, U.S. citizens or residents who are officers or directors of a foreign corporation within 60 days after its creation, organization or reorganization, and U.S. persons who, within the the same 60 day period, own 5% or more of the stock of the foreign corporation, must supply information. It is possible to avoid giving this information where these United States relationships to the foreign corporation are deferred until after the 60 day period expires. The bill requires that all U.S. persons who are officers, directors or 5% shareholders must file a return with respect to their relationships on January 1, 1963 and with respect to such relationships arising thereafter. The bill would also impose a penalty for failure to file the return within the time required, which is 90 days after the creation, organisation or reorganisation or after becoming a 5% shareholder.

It is believed that the requirement that a return be filed within the 90 day period is unnecessary, and that a single annual return should be adequate. A single annual return has been found adequate with respect to the gift tax, even where there are numerous gifts at various times during the year, and there seems to be no reason why it should not be adequate in the case of the information required by section 6046. It is therefore proposed that a single annual return be permitted.

Under the bill, it is necessary to report stock ownerships of 5% or more, whether directly or indirectly owned, and without regard to the number of intervening corporations, or to whether these corporations are controlled. For instance, if a United States person owned 30% of the stock of a foreign corporation, and that foreign corporation owned 30% of the stock of a second foreign corporation, which

in turn organized a 60% owned third foreign corporation, the United States person would be required to file a return. The information to be given in the return is not specified in the bill and is such as the Secretary may deem necessary. In such a situation it is not at all unlikely that the United States person would never know about the organization of the third foreign corporation since the United States person would not control the operations of the intermediate companies. It is believed unnecessary to the adequate operation of the income tax laws for the bill to require reports in such a situation. As a practical matter, the necessary information may very well not be forthcoming from the majority owners of the intermediate foreign corporations, particularly if they are not United States persons. It is therefore proposed that this provision be limited to requiring a report by each United States person of the creation, organization or reorganization of foreign corporations which are directly or indirectly controlled by him, and of his acquisition, directly or indirectly, of a controlling interest in a foreign corporation.

Under present law, and under the bill, a return must be filed by each United States shareholder, officer or director. It is believed that there is no need for a requirement for separate returns by each of them, with the same information being given in each return. The Internal Revenue Service has provided in its instructions on the return form used under the present law (no regulations having been issued) that a single return will be adequate, provided it is signed by all persons required to make the return. It is believed that no real purpose is served by requiring the signature of all persons on one or more returns, and that it should be possible for a single return to satisfy the legitimate needs of the Treasury. It is therefore proposed that the bill be amended so as to provide that, if a return is filed by any one of the persons obligated to file the returns, the others need not file.

H. Section 21.— Treaties

Section 21 of the bill provides that the provisions contained in H. R. 10650 are to have precedence over any existing treaty obligation. Specifically it provides that Sec. 7852(d) I.R.C. shall not apply in respect to any amendment made by this act.

In addition to Section 7852(d) there is a provision in Section 894 I.R.C. that 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 the subtitle of the Code relating to income taxes.

In his statement to the Senate Finance Committee on April 2, 1962, the Secretary said he wished to dispel the impression that "we are overriding our treaty obligations" and recommended the elimination of Section 21 "to make it clear that we are honoring" them.

As we have indicated above, we believe that any provision which would tax to U. S. shareholders undistributed income of corporations in countries with which the United States has income tax conventions would be contrary to the intent and spirit of these conventions.

As pointed out in the recent study of "Legislative History of United States Tax Conventions", prepared by the staff of the Joint Committee on Internal Revenue Taxation, "the United States, being a full member of the OECD, is obliged by the terms of the resolutions to notify the OECD of the reasons why provisions of the model tax convention recommended by the OECD have not been adopted in any bilateral tax convention concluded between the United States and another country which is a member of the OECD."

In view of this, attention is invited to the recommendations of OECD in regard to dividends.

The Commentary on Article XX, Concerning the Taxation of Dividends states, inter alia, that: "Under the laws of all European Countries, ... joint stock companies are legal entities with a separate juridical personality distinct from all their shareholders or members." The shareholder "is not a trader and the company's profits are not his; so they cannot be attributed to him. He is personally taxable only on those profits which are distributed by the company .... From the shareholders' standpoint, dividends are income from the capital which they have made available to the company as its shareholders." [6]

It is indicated by the foregoing that the basic principles of the laws of all European countries regarding recognition of the separate identity of a corporation and its shareholders are the same as those which exist in the United States.

Against this background, the significance of paragraph 5 of Article XX is clear. This paragraph reads:

> "Where a company which is a resident of a Contracting State receives profits or income from the other Contracting State, such other State may not levy any tax on the dividends paid by the company to persons who are not residents of that other State, or subject the company's undistributed profits to a tax on undistributed profits, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in such other State." [7]

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6 OEEC, Fourth Report of the Fiscal Committee, 1961; 37
7 Ibid.; 25

According to the commentary: "Paragraph 5 adopts a provision already contained in a number of Conventions. It rules out extraterritorial taxation of dividends and further provides that non-resident companies are not to be subjected to special taxes on undistributed profits."[8]

Yet Section 13 of H. R. 10650 would tax undistributed income of corporations organized in other OECD countries which would obviously contravene the spirit of paragraph 5 even if the tax were collected from U. S. shareholders.

The United States has income tax convention with 14 of the 19 other members of the OECD, i.e., Sweden, United Kingdom, Germany, France, Netherlands, Denmark, Norway, Switzerland, Austria, Italy, Belgium, Greece, Ireland and Canada. It has carried on negotiations with Luxembourg and Portugal. The remaining 3 members are Iceland, Spain and Turkey.[9]

The conventions entered into by the United States with the members of the OECD are all predicated upon respect by the United States for the existence of a corporation of the other contracting State as a legal entity with a separate juridical personality distinct from its U. S. and other shareholders. Consequently, the U. S. shareholders as well as other shareholders "are taxable only on those profits which are distributed by the company."

8 Ibid.; 46
9 Ibid.; 11

IV. SECRETARY'S PROPOSAL TO TAX UNDISTRIBUTED INCOME TO FOREIGN CORPORATIONS

The Secretary of the Treasury in his appearance before the Committee on Finance on April 2, 1962 urged that several amendments be made to H. R. 10650, as passed by the House of Representatives. He also urged a far-reaching amendment to the bill, namely that: "The privilege of deferring United States taxes until income is repatriated as dividends should simply be eliminated for our subsidiaries in advanced industrial countries".

In support of this suggestion, he introduced a number of arguments of an economic and business nature. Closely related to this proposed amendment of the Secretary of Treasury is his suggestion that Section 13 be amended so that "the exemption of tax haven profits invested in less developed countries should be limited to earnings generated in the less developed countries".

Our comments concerning the legal, business and economic reasons why this proposal should not be enacted into law are set forth below.

A. Legal Reasons for Rejecting Proposals

The legal arguments against taxing to the U. S. shareholder undistributed profits of foreign subsidiaries are fully developed above in connection with our discussion of Section 13 (Pages 17-29)..

These reasons include:

1. History and Reasons for Present Law
2. Proposal is Contrary to Basic United States Tax Policy
3. Constitutionality
4. The Major Developed Countries Do Not Tax Earnings Derived Abroad By Foreign Incorporated Companies
5. Tax Treaty Obligations

B. Economic and Business Considerations

The "Privilege of Tax Deferral" is a Misleading Characterization

It is incorrect to refer to "profits earned abroad by American firms operating through foreign subsidiaries" as enjoying "tax deferral". The proper time for imposing a United States tax on shareholders of corporations, whether domestic or foreign, is when those shareholders receive the income, i.e., when a dividend is received. Under the present system, the tax is imposed at the proper time. Any attempt to impose it at an earlier point of time, i.e., when income is earned by the corporation but not distributed, is an improper imposition of tax, and certainly would be a drastic change in the fundamental concept of U. S. and international law, i.e., the separate identity of a corporation and its shareholders.

The proposal assumes that it is plausible to argue that the treatment of income earned by a foreign subsidiary of a United States corporation should be the same as the treatment of branch income. This is based upon the erroneous assumption that the profits of a corporation are income to the United States shareholder before distribution, and an inference that the U. S. shareholder has escaped taxation through the inadvertence of the Congress since 1913. It seems clear, therefore, that the use of the words "privilege of tax deferral" is a misleading characterization. The proposal is to "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 phrasing indicates an awareness that the U. S. Government must look to the American corporation as being the one properly subject to its taxing jurisdiction, whereas the proposal in reality would impose tax on a mere equity in a corporation's undistributed profits.

True deferral would exist only if the United States permitted a taxpayer to postpone the payment of United States tax on its own income to a time after the year in which such income was actually realized.

Taxing U. S. Shareholders on Undistributed Profits

If so-called "tax deferral" were a significant factor unduly stimulating U. S. private direct investments in Europe, and reducing remittances, it is curious that this did not occur in other years long before 1957-1960. After all, such income has not been taxed by the United States for nearly fifty years. Over the years the tax aspect has been only one factor among the considerations that have had to be taken into account in arriving at decisions to invest abroad. Such decisions are made in response to a much broader and more complex range of considerations, covering every related aspect of a firm's operations and requirements in the production, distribution, sale and servicing of its product. Particularly is this the case in regard to developments since 1957 in respect to Europe. What is happening there, in integration of that economy and in recasting its diverse markets into single common market or free trade areas, is unprecedented in the whole history of the European Continent, and in the history of U. S. trade relations with the European markets. The progressive elimination of tariff and other barriers within large sections of Europe, and the stimulus thereby given to expansion of productive facilities, has also -- to an unprecedented extent -- called for rapid and effective adjustments on the part of U. S. companies if they are to continue to compete both in Europe and in other markets of the world.

During recent years, in which the United States Government has actively supported and encouraged the establishment of the European Common Market, American business has moved to anticipate and adjust to the new patterns of trade and investment which the progress in Europe toward economic integration requires. It is no longer a question of increasing U. S. direct investments in Europe for the purpose

of aiding in "post-war reconstruction". Even during the Marshall Plan Years — it should be emphasized — when the U. S. Government sought to encourage U. S. direct investments for reconstruction purposes, no special incentives were provided to promote such investment by modification of existing U. S. tax laws. Accordingly, it is not now a question of the U. S. Government withdrawing any temporary or special tax incentives relating to the Marshall Plan period of reconstruction. It is a question of the U. S. Government avoiding any action which might hamper or penalize U. S. business in making whatever adjustments are necessary to preserve and increase the sale of its products and services within the now large and increasingly mass-producing and mass-consuming European market. This has been the compelling reason for the expansion in recent years of U. S. direct investments in Europe, and American business has had no effective alternative. Moreover, in the future, any negotiated reductions in the Common Market's external tariff are unlikely to keep pace - at least in the immediate critical years at hand - with the internal reductions, so that many U. S. firms will be hard pressed to maintain sales of their products within the area except as they move to produce them there.

Even if it were possible to show by how much so-called "tax deferral" has increased the outflow of investment or deterred the inflow of income, there would be no justification for singling out this particular item or result as a cause of the serious balance of payments problem which our nation has been facing. The deficit in the U. S. balance of payments is not due to any single cause. It results from the relationship which exists between the totality of the outpayments and inpayments in our international accounts, from whatever source, whether in goods and services; tourist expenditures; all forms of capital movements including government and private, direct and portfolio, short or long-term; government assistance programs; or whatever.

Balance of Payments Implications

While the National Foreign Trade Council is itself deeply and urgently concerned by the continuing serious deficit in the U. S. balance of payments, it questions whether this is the moment to undermine, discourage or impede the international flow of private capital. The Council is convinced that private direct investments are a consistent and substantial source of long-run strength to the balance of payments position of our country. It disagrees with the premise that the proposed tax changes are necessary to meet the balance of payments problem. It believes, on the contrary, that the fiscal devices now proposed, if adopted, would contribute little or nothing toward the solution of the problem and that in the long-run could have extremely adverse effects on the balance of payments.

First, with respect to the investments which in recent years have been made in Europe and in Canada, it is conceded in Treasury Exhibit III, submitted to this Committee, that insofar as the years 1952 through 1960 are concerned "presumably only a small proportion of new capital outflow over this period was actually tax induced". Further, it is elsewhere stated that with the exception of Belgium and Italy statutory corporate income tax rates in most developed countries appear to be at least fairly near the existing U. S. rate. In this connection, it might be noted that neither Belgium or Italy have been the leading European recipients of U. S. direct investment in recent years. Rather, the major European areas where investments have been made are the United Kingdom, West Germany and France, all with corporate tax rates roughly comparable to those of the United States. This would seem to cast some doubt on the estimated amount by which the outflow would be reduced. Moreover, to the extent that such a reduction did take place, it could very well have an adverse effect on export sales, transportation earnings and other miscellaneous receipts in the balance of payments by a comparable or even greater amount. To the extent that the reduction in capital outflow would not offset by these other reductions, the

current balance of payments position could be improved. Exactly the same result would ensue were there to be a reduction of military outlays abroad, curtailment of foreign aid or a curbing of imports. In other words, there would be in each instance apparent short-run gains in the balance of payments. At the same time, there very well might also be in each instance serious long-run disadvantages created so that the over-all political and economic position of the United States in the world would be irreparably damaged.

The Secretary of the Treasury in his testimony before this Committee also stressed the gains to the balance of payments from increased remittance of income. The expectation seems unrealistic on at least two counts. First, as noted earlier, the developed countries where much of the U. S. direct investment has been made have corporate tax rates closely comparable to those which apply in the United States. Secondly, in those other instances where the rate may be lower, it is altogether probable that prompt action would be taken to collect additional tax should there be a change in U. S. taxation of income.

In other words, it is incorrect to assume that the projected "savings" could or would occur without affecting, adversely and promptly, other items in the balance of payments, and without forcing U. S. companies here and their subsidiaries abroad to take other actions to protect their participation in overseas markets. If an American subsidiary in a growing and highly competitive market is unable because of a lack of capital to expand and move forward, this could mean an ultimate falling behind its local competitors and a less profitable operation. The subsidiary would then have less to remit to the United States with a consequent reduction in the income contribution to the U. S. balance of payments.

With respect to the present situation, it is quite true that current dividend inflows relate to and arise out of past investments and do not derive from those now being made. Thus, for the time being, the dividend inflows would

conti... irrespective of the size of the current capital outflows. At the same time, however, it is clear that the dividend inflow will cease to grow unless investment abroad can be maintained at a pace consistent with the economic growth there taking place.

In addition to this long term effect, there is also a short-term relation between the size of the capital outflow and the dividend inflow. Thus, while Treasury Exhibit III notes that a large amount of the new capital outflow to Europe and Canada has consisted of "short-term credits for working capital", it fails to distinguish between the income generating effects of fixed and working capital. In other words, additions to working capital undoubtedly have a much quicker and more immediate impact on earnings and on income than would the equivalent amount of fixed capital investment, so that there would be a much more direct relationship between the amount of dividend inflow and any reduction in capital outflow.

In its Exhibit III the Treasury Department has developed what it refers to as the "net export factor" and has made elaborate statistical calculations based thereon. Much of the argument advanced is highly conjectural, inasmuch as there are serious statistical gaps in the evidence, a fact which the Treasury Department concedes. In subtracting imports from foreign subsidiaries from exports to subsidiaries to arrive at the "net export factor", however, there is also a failure to differentiate between the different types of imports and exports and to take into account the general benefits to the American economy which such trade may offer. In this same connection, the implicit assumption seems to be that the so-called export displacement effect of foreign subsidiaries can be avoided. This assumes both that the particular exports could continue to enjoy a market in the absence of a subsidiary and that the secondary market created for other American products by the establishment of the subsidiary would also develop independent of this investment.

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While it is vitally important that exports from the United States be greatly expanded, this is not going to be accomplished by hampering or impeding U. S. direct investments in developing countries. If the Treasury is correct in its contention that there is a low ratio between current investments and exports, does this not confirm the fact that in many instances American exports already are either non-competitive in these markets or are faced with serious disadvantages in finding outlets. Most subsidiaries of American firms would prefer to purchase machinery and equipment from established parent company suppliers in the United States. If for cost and other reasons they can not afford to do so, it is unlikely that foreign competitors will be attracted to these products. In any event, it is not the amount of exports to foreign subsidiaries that is significant, it is the broader benefits to our entire export trade that is the important contribution which foreign investment makes to the balance of payments.

The Fiscal Device Proposed Subjects Business to the Uncertainties of Arbitrary and Discretionary Authority

The whole proposal, as presented, seems to be based on the idea that American corporations are under a compulsion to invest some place, and therefore if by a fiscal device investment can be made less attractive in certain overseas areas, then the investment will be made in other overseas areas or, preferably, in the United States. This is not a reasonable or practical concept. Business does not make investments anywhere for the sole purpose of saving taxes. The proposed enterprise must offer the opportunity for profit in the first instance and must fit in with over-all company requirements and objectives within its intended fields and areas of operation. Otherwise, management of a company is doing something contrary to the interests of its stockholders and its employees.

What is being proposed essentially is for Congress to place in the hands of the Executive Branch a fiscal device by which private investment in some measure can be impeded from flowing to certain countries or markets and encouraged to flow to others.

If the President of the United States declares a country to be "less developed", the so-called deferment of U. S. income tax on earnings of a foreign corporation with respect to that country will be continued; but any area or country not so designated would be considered as "developed" solely on the President's judgment. Such delegation of authority by Congress would leave American business completely in the air as to what taxation they might be subjected to in their foreign operations in many parts of the world — and especially in respect to the less developed countries in which the interest is to encourage private investment. Countries initially not declared as "less developed" could conceivably later be declared such because of political, strategic, or other reasons; and currently less developed countries as they are developed — and it is assumed every effort will be made to develop them — could at any time be declared in effect as "developed" and therefore subject to different tax treatment. This scarcely is a proposal to encourage private foreign investment. It is a substitution of discretionary authority for the certainty of law. It is contrary to the principles of conduct which American investors consistently have advised must be adhered to if less developed countries are to attract foreign investment.

Direct Investments and the "Export of Jobs"

It must be now recognized that U. S. enterprise — if it is to compete in world markets — no longer has a choice in deciding whether it will compete by producing within the United States or by producing abroad. Due to improvements in mass production methods abroad, increasing efficiency and cost reductions in the foreign field, as well as close proximity to markets and the accompanying reduction in costs of transportation and selling, the only choice left to U. S. enterprises in many cases is whether to continue to sell U. S. goods in overseas markets by producing them abroad, or to withdraw from the foreign field and not to produce at all.

As recently stated in the staff report on the "Overseas Investment Problem" to the Committee on Interstate and Foreign Commerce of the United States Senate:

> "The question, therefore, is really not whether these products will be manufactured abroad, but by whom. * * * Thus, for example, if the Fruehauf Company had not decided to build a new trailer truck factory in Auxerre, France, it is just possible that the EEC trailer truck market might have been supplied by exports from Detroit. But it is far more likely that a French or British or German plant would have been erected in France instead of an American one."

If for any reason, U. S. enterprise is unable to export goods into a foreign area on a competitive basis, the jobs in the U. S. dependent on this export are lost. Some of the reasons favoring foreign competition are higher relative production costs in the U. S., the imposition of high U. S. income tax rates on foreign operations, and those restrictions which can be and are imposed by foreign countries on U. S. importations, to name a few. The setting up of an operation overseas in competition with nationals of that country or with nationals of other countries does not mean that jobs have been exported; it means that we are taking advantage of trade preferences otherwise unavailable, that we are maintaining U. S. products in the foreign market, that we are selling U. S. know-how in these areas, that the stockholders of these foreign corporations are receiving a benefit and that the Treasury is receiving tax revenue which might otherwise have been lost forever. Furthermore, this investment overseas will engender exports by U. S. enterprises in the form of machinery, component parts, replacement parts, and other related products, so that total U. S. exports, and total U. S. jobs depending on such exports, will increase instead of decline.

Direct Investments and U. S. Imports

The question arises of possible interference or competition within the U. S. economy from imports of manufactured goods produced in U. S. direct investment enterprises overseas. A point to be emphasized is that such products can be

and are being manufactured in foreign countries by our foreign competitors; and that such products will continue to be manufactured abroad for the American market whether or not U. S. controlled enterprises participate in such manufacture. The mere fact that imports from American subsidiaries or branches enter the U. S. market does not mean that investment abroad is damaging to the American economy, and is not proof that these imports would not have been manufactured abroad by foreign competitors and sold in this country if a U. S. investment had not been made in the foreign country.

If it should develop that individual U. S. industries are damaged by such imports, then protection should be applied through existing procedures and safeguards to all of the imports in question, whether manufactured by U. S. subsidiaries or their foreign competitors. U. S. tax policy should not be used to favor foreign owned enterprises over U. S. enterprise operating abroad in competing in the U. S. market.

World Economic Development and
Private Direct Investments

Private foreign investment is inherently a phenomenon of the free enterprise system. As such, it is also a reflection of the inherent confidence which the business community has in the benefits of that system, and in the sustained growth potential of the world economy. Toward this growth private capital has in recent years contributed much, and, given the opportunity, will make an even larger contribution in the future. Direct foreign investment acts as a multiplier, stimulating higher levels of economic activity which is of mutual benefit to both the capital supplying and capital receiving countries.

But it is worth noting that private investment abroad is not undertaken as an act of charity, nor as one that is politically motivated, but rather that it constitutes a part of the continuing response of private enterprise to economic needs and forces. The investment of private capital should not be regarded as

an arbitrary process which can be turned on and off at will or convenience, or as a supply of funds which can be channeled without proper profit motivation into areas where conditions do not attract nor warrant private capital investment. What the world needs is free open, capital markets, coupled with an international climate favorable to the maximum feasible movement of productive private capital investment to all parts of the Free World -- where it is needed, when it is needed, coupled with a tax system that enables U. S. enterprise to compete in those markets at local tax rates, unhampered by a U. S. tax rate which is appropriate only to the U. S. domestic economy.

V. "INVESTMENT INCOME" PROPOSAL

The Secretary's recommendation for a new provision requiring separate foreign tax credit computations for "investment income" and other income are based on an example showing that a taxpayer having business income from Canada, with a higher corporation tax rate than the United States, can make a temporary interest-producing investment in Canada and receive a limited amount of interest income at the cost of the Canadian withholding rate of 15%.

The proposed amendment to meet this situation extends to all interest income, whether from a temporary or a long-term investment and whether or not induced by tax-saving motives.

It also extends to dividends except from a more than 10% owned foreign corporation. It is difficult to see how the type of situation described by the Secretary would lead to investment in Canadian stocks, since domestic dividends can be received by a U. S. corporation at a tax cost of 7.8% as compared with the Canadian withholding tax of 15%. Considering the risks of stock investment, it is implausible that any U. S. corporation would make temporary foreign stock investments for the purpose of getting dividends at a lesser cost than the U. S. intercorporate dividend tax.

The proposal discriminates against investments in the stock of domestic corporations with most of their operations abroad, since the exemption of stock investments of 10% or more is limited to stock of foreign corporations.

The Secretary's proposal recognizes that if a U. S. corporation has both foreign operating income and dividends from substantial foreign stock investments, it should be allowed to apply the principle of combining and averaging the foreign taxes under the existing limitations. It fails, however, to recognize that permanent and substantial foreign investments are often made in the form of interest-bearing loans to the same companies in which stock is held. It wrongly assumes that all interest from foreign sources is the fruit of temporary tax reduction plans. The proposal should not apply to interest received from corporations of which at least 10% of the stock is held by the taxpayer.

In its application to dividends and interest from investments made in the past, the proposal has an inequitable retroactive effect. Especially since it is aimed at "short term" investments, it can have no reasonable application to the continued holding of past investments.

APPENDIX A

Shareholders of controlled foreign corporations are to report for tax purposes the undistributed earnings of these corporations to the extent they represent income from insuring U. S. risks, income from patents, copyrights, and exclusive formulas or processes developed in the United States, passive types of income generally, and income from certain sales. In these latter two cases reductions in the income tax to the shareholders are allowed for investments of the income in certain businesses in less developed countries. To the extent that the shareholders are not taxed on the income of the controlled foreign corporation under the above provisions, they are to be taxed on the undistributed earnings of controlled foreign corporations which are not invested in substantially the same trade or business or invested in less developed countries in new trades or businesses or in certain controlled subsidiaries. [Section 13]

Where goods are purchased or sold by a domestic corporation to a related foreign corporation, the income arising from these transactions is to be allocated between the parties on the basis of the location of the assets used in the operations, the payroll attributable to them and the related selling expenses. This rule will not be used where an arm's-length price can be established for the purchases or sales. [Section 6]

Where there is a redemption or liquidation of the stock of a controlled foreign corporation or where stock in such a corporation is sold, then any gain to the extent this gain represents earnings and profits of the corporation accumulated abroad is to be taxed to the principal shareholders as ordinary income or as dividends. [Section 16]

Distributions in kind from foreign corporations are treated as having a value equal to the fair market value of the property (and not the adjusted basis of this property in the hands of the distributing corporation where this is lower.) [Section 5]

Where a domestic corporation receives dividends from a foreign corporation, the amount included in its tax base if it elects the foreign tax credit is to be, not only the dividend itself, but also the tax paid by the foreign corporation as well. [Section 11]

The unlimited exclusion from U. S. tax of income, earned abroad by U. S. citizens who are bona fide foreign residents is reduced to $35,000 ($20,000 for the first 3 years). In addition the contributions which employees make hereafter toward employee pensions based on foreign employment will be taxable to the employee when received. [Section 12]

Additional information is to be provided the Treasury Department by corporations and other businesses engaged in foreign operations. [Section 19]

APPENDIX B

REVENUE ACT OF 1962

XIV. CONTROLLED FOREIGN CORPORATIONS

(Sec. 13 of bill and secs. 951–958 of code)

A. Reasons for provision

Under present law foreign corporations, even though they may be American controlled, are not subject to U.S. tax laws on foreign source income. As a result no U.S. tax is imposed with respect to the foreign source earnings of these corporations where they are controlled by Americans until dividends are paid by the foreign corporations to their American parent corporations or to their other American shareholders. The tax at that time is imposed with respect to the dividend income received by the American shareholder, and if this shareholder is a corporation it is eligible for a foreign tax credit with respect to the taxes paid by the foreign subsidiary. In the case of foreign subsidiaries, therefore, this means that foreign taxes are paid currently, to the extent of the applicable foreign income tax, and not until distributions are made will an additional U.S. tax be imposed, to the extent the U.S. rate is above that applicable in the foreign country. This latter tax effect has been referred to as "tax deferral."

The President in his tax message last year questioned the desirability of providing tax deferral with respect to earnings of U.S.-controlled companies except in the case of investments in less developed countries. However, his primary emphasis was on removing tax deferral in the case of what have been called "tax havens." In this respect he stated:

> 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 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.

In this area the President recommended the:

> * * * 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.

Your committee's bill does not go as far as the President recommendations. It does not eliminate tax deferral in the case of operating businesses owned by Americans which are located in the economically developed countries of the world. Testimony in hearings before your committee suggested that the location of investments in these countries is an important factor in stimulating American exports to the same areas. Moreover, it appeared that to impose the U.S. tax currently

on the U.S. shareholders of American-owned businesses operating abroad would place such firms at a disadvantage with other firms located in the same areas not subject to U.S. tax.

Nevertheless, the testimony before your committee did convince it that many have taken advantage of the multiplicity of foreign tax systems to avoid taxation by the United States on what could ordinarily be expected to be U.S. source income. In part your committee has met this problem elsewhere in this bill (sec. 6) through the addition of a new subsection to the existing section 482 setting up specific factors to be taken into account in more accurately allocating income from purchases and sales of goods between American corporations and their controlled foreign subsidiaries. However, certain of the provisions set forth in this section are also designed to meet this problem of diversion of income from U.S. taxation. This is true, for example, of the provisions taxing to the U.S. shareholders foreign income arising from controlled foreign corporations in the case of insurance on American risks. This is also true of the provision taxing income derived by controlled foreign corporations from patents, copyrights, etc., developed in the United States.

Your committee has also concluded that U.S. tax should be imposed currently, on the American shareholders, on income which is held abroad and not used in the taxpayer's trade or business unless, in accord with the policy enunciated by the President, it is invested in businesses in less developed countries. Because of this your committee's bill taxes to U.S. shareholders investment-type income not invested in less developed countries and also income which may arise from the active conduct of a trade or business if the income is not reinvested in the same business (outside of the United States) or in a less developed country.

A third objective of the tax measures described below is to prevent the repatriation of income to the United States in a manner which does not subject it to U.S. taxation. This accounts for section 16 of this bill which gives assurance that upon the liquidation of a corporation, the redemption of stock, or the sale of stock in a controlled foreign corporation the earnings and profits of the corporation—not previously subject to tax by United States—are to be so taxed to the extent of the excess of the U.S. tax over the foreign tax. This objective also accounts for some of the features of this provision, which deny tax deferral where funds are brought back and invested in United States in a manner which does not otherwise subject them to U.S. taxation.

Your committee also has ended tax deferral for American shareholders in certain situations where the multiplicity of foreign tax systems has been taken advantage of by American-controlled businesses to siphon off sales profits from goods manufactured by related parties either in United States or abroad. In such cases the separation of the sales function is designed to avoid either U.S. tax or tax imposed by the foreign country.

B. General explanation of provision

1. In general.—The bill provides that certain undistributed income of controlled foreign corporations is to be included in the income of U.S. shareholders in the year the income is earned by the foreign corporation, whether or not it is distributed. In these cases, the share-

The CHAIRMAN. Mr. John J. Powers, Jr., president and chairman of the board, Pfizer International.

STATEMENT OF JOHN J. POWERS, JR., PRESIDENT AND CHAIRMAN OF THE BOARD, PFIZER INTERNATIONAL, ACCOMPANIED BY WILLIAM C. RITTMAN

Mr. POWERS. With your permission, Mr. Chairman, may I have my assistant, Mr. Rittman, with me?

The CHAIRMAN. Without objection.

Mr. POWERS. Thank you, sir.

My name is John Powers; I am president and chairman of the board of Pfizer International which consists of subsidiaries wholly owned by Charles Pfizer & Co., Inc., a 113-year-old American company.

One of these subsidiaries is an American company handling our export of direct shipments to customers abroad. The other is a Panama company which, in turn, operates through its own branches and subsidiaries all over the world.

This form of organization is the result of a decision, taken near the beginning of our real entrance into international trade, to build a pharmaceutical and chemical organization throughout the world out of the profits made in that operation.

As a result, in the past 11 years in which Pfizer International has existed, we have established Pfizer organizations in 47 countries. We also have manufacturing facilities in 25 countries, which are the principal recipients of our exports from the United States of bulk material, semifinished goods, finished goods, and equipment.

I am addressing myself to the provisions of H.R. 10650 relating to the taxation of foreign business income, and as well to the broader concepts which have persistently been urged by the Treasury Department.

Since my allotted time does not permit me to discuss the provisions in detail, I shall confine my oral remarks to a number of salient aspects of the issues under discussion, all of which are amplified in my separate written statement, which I respectfully request be made part of this record.

The CHAIRMAN. Without objection, it will follow your oral presentation.

Mr. POWERS. Thank you, sir.

At the outset I should like to comment that I find it difficult to accept the term "tax deferral" when there is no tax to defer. I have also been disturbed by implications that "tax deferral" means "tax abuse" when what it really means is that the United States has never extended its jurisdiction to tax income unreceived either actually or constructively. It is dismaying to see the term "tax haven," with its implications of "tax abuse," used so broadly as to cast a cloud over even the most reputable of foreign-based company operations. I have no argument with the application of the term to paper companies.

Regarding the effect of direct investment abroad on the U.S. balance of payments, it should be observed, I believe, that the Department of Commerce figures overstate the outflow on direct investment by including noncash items and understate the inflow because they

show only dividends and interest and do not include related exports, royalties, fees, and so forth. But even with the overstate outflow and the understated inflow figures, such investment abroad has resulted in a substantial net inflow of dollars in 39 of the past 43 years that such records have been kept.

As spelled out in my written statement, after adjusting overstatement of outflow and the understatement of inflow, I have estimated that the inflow related to direct foreign investments of all U.S. industry for the year 1961, for example, exceeded the year's outflow by $4 billion.

I was interested to note that in a press release 2 days ago the Office of Business Economics of the Department of Commerce stated that as compared with annual capital outflows now running at about $1.6 billion, such investments abroad "remit about $3 billion to the United States annually as income, royalties, and fees."

Since this does not include a figure for net related exports (which, based on available Government figures, I estimate at about $3 billion), it would seem amply to support my estimate of a $4 billion net inflow.

Indeed, the net inflow resulting from direct business investment overseas has a substantially better effect on our balance of payments than our trade surplus if the latter is reduced, as it should be, for this purpose, by amounts financed by Government funds and direct investment itself.

May I now refer to my own company's experience. Pfizer International has really been in operation only since 1951. In the period 1951 through 1961, Pfizer operations have resulted in a net inflow to the United States of about $250 million.

This is despite the fact that it is only in very recent years that we have begun to pay substantial dividends to the parent company. Prior to that time nearly all profits earned abroad were reinvested. In the fact of such a circumstance we nevertheless achieved this highly favorable balance because we exported almost $200 million of U.S.-made goods to Pfizer foreign subsidiaries and because we brought home some $50 million additional in dividends, royalties, fees, etc.

Now that our investment has begun to mature and large dividends are being brought home we are returning dollars at an annual rate of about $40 million. The parent company has not made any direct dollar investments abroad in many years and it is the policy of our company that its international organization provide its own financing.

Against the hard realities of the foregoing figures of my own company, and, of even broader significance, of the Department of Commerce for all industry, it is difficult to accept Treasury's new approach to an evaluation of the effect of direct investment upon the balance of payments, as shown in exhibit III of the Secretary's testimony before this committee.

I have dwelt on this at some length in my written statement so I will only add here that I believe that the Treasury's 13-year projections into the mid-1970's are based on inadequate data and dubious assumptions.

In my written statement I have shown the effect of continuing the projection to 20 years, which demonstrates the overwhelming long-

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term advantage of direct business investment, far outweighing any alleged short-term harm, using Treasury's own assumptions.

I should now like to turn to the administration's new concept of "tax neutrality" which to them means tax equality among different tax jurisdictions. This is not the traditional principle in U.S. law of tax equality within any one tax jurisdiction. The professed objective to divert to the United States, capital which is now being invested overseas is based upon what I believe to be fallacious assumptions, both because its implication of a shortage of capital at home is not supported by the evidence and because income tax considerations are by no means determinative of investment decisions.

The proposal, in the name of "tax neutrality," to tax unreceived foreign business income as if it had been earned or received at home, is unique in the world and would place American business abroad at a competitive disadvantage.

The contention that such competitive disadvantage is offset by the fact that Western European countries still have exchange control laws on their books is hardly relevant, because such controls do not result in competitive burdens comparable to those which would be imposed by the proposed tax.

A brief comment on the allegation that there has been an "export of jobs." Direct business investment overseas in prospering manufacturing countries has not displaced American jobs because only an insignificant proportion of goods manufactured in these facilities is sold to the United States.

Furthermore, no evidence has been submitted to support the repeated allegation that sales abroad from foreign subsidiaries of American companies displace any significant amount of exports from the United States. The evidence submitted by businessmen as to their reasons for investing abroad indicates that the charge is untrue.

This latter view was concurred in by a special study staff of the Senate Commerce Committee last year. Quite contrary to the implications of the slogan "export of jobs," direct investment overseas has provided additional American jobs by creating new markets for materials, components, and machinery manufactured in American plants, as well as finished American goods.

H.R. 10650 seems mainly aimed at tax abuse, but what is a tax abuse in the use of a foreign corporation? It seems to me it simply comes down to this:

(1) Diverting to a foreign corporation in another country income earned in this country; and

(2) Changing the form of what is really intended to be a foreign subsidiary dividend to its U.S. parent company to an untaxable form, such as a loan.

My principal concern about H.R. 10650 is that its provisions are not specifically aimed at tax abuses and would penalize normal operations and regular transactions with those that may be abusive in character.

In addition this is an unnecessarily complicated and difficult bill to administer. My reasons for opposition to specific provisions of H.R. 10650 are set forth in my written statement. Rather than dwell on them, I should like to conclude by stating what actions I think should be taken to curb abuses of U.S. tax law. I would like to de-

viate from that for just one moment to say I certainly am opposed to the provisions respecting gross-up, which are based on grounds that I think fallacious that now in computing the foreign tax credit the U.S. taxpayer receives both a deduction and a credit. I have analyzed that statement further, sir, in my written statement.

With respect to the improper diversion of income abroad, I agree with the principle of the proposed amendments to the Internal Revenue Code, section 482 (contained in section 6 of H.R. 10650) primarily because their thrust is mainly against "paper company" operations, and secondarily because there is a need for clarification of the intercompany pricing problem.

It is urged, however, that this principle first be made part of Treasury regulations under section 482 and that Government and industry try, over the next few years, to arrive at a lasting solution to this problem, which might then be enacted into law.

Diversion of income abroad by intercompany transfer of patents, secret processes and other intangible assets raises the same problem as intercompany sale of goods. This suggests that they should be handled in a similar manner, but it is not clear that this would be entirely practicable.

It is, therefore, recommended that such transactions should be reported annually to the Treasury by the U.S. taxpayer in order that Treasury may consider each transaction in the light of its specific circumstances and perhaps later develop an approach which can be enacted into law.

With respect to the second area of potential abuse, in which profits intended as dividends are brought home in some other nontaxable form such as loans, definite action should be taken. This can be achieved, I think, by assuring that Treasury has full information on such loans.

Further, it should be provided that such loans will be taxed as dividends unless repayment is made within a reasonable period or unless the taxpayer can demonstrate the bona fide nature of such loans, to the Treasury.

Such measures would strike at the root of the abuse of U.S. tax law in the use of foreign corporations. Nevertheless, there still hangs over American business activities abroad, a shadow cast by repeated charges that foreign subsidiaries of American companies deliberately retain abroad excess funds, simply to avoid the U.S. tax which would apply to them if remitted home.

The accumulation of liquid assets abroad by a foreign subsidiary of an American company in excess of the needs of the business is opposed to sound business practice, as well as to the national interest. It is difficult to believe that this is a major problem but to the extent it exists such an accumulation should be considered, as far as I am concerned, as amounting to a constructive dividend.

It is recommended that it be curbed by appropriate application of measures such as those in Internal Revenue Code section 531-7.

Finally, it is recommended that the entire subject of taxation of foreign business income in relation to the U.S. balance of payments and the rôle of direct investment abroad should receive continuing active study, not only to eliminate tax abuse but also to achieve—

under fair principles of law—results best suited to the national interest.

Such study will also help resolve any new intercountry tax problems which we may encounter as we become more closely related economically to the developing North Atlantic trading community.

I thank you, Mr. Chairman.

The CHAIRMAN. Senator Gore.

Senator GORE. Mr. Powers, Pfizer International was one of the 19 for which Mr. H. J. Heinz spoke in his testimony before the House Ways and Means Committee; is that correct?

Mr. POWERS. That is correct.

Senator GORE. Do you object to telling the committee what statistics your company furnished to Mr. Heinz or Mr. Sawyer for inclusion in Mr. Heinz's statistics which he presented to the Ways and Means Committee last year?

Mr. POWERS. I will be glad to furnish a copy, Senator.

Senator GORE. Do you have it with you?

Mr. POWERS. No; I do not.

Senator GORE. But you will supply it?

Mr. POWERS. I certainly will.

(The information referred to will be made a part of the committee files when received.)

Senator GORE. Were these statistics relating to dividends received from foreign subsidiaries, capital outflows, royalties and fees, and exports applicable to Charles Pfizer & Co., Inc., or to Pfizer International as Mr. Heinz stated?

Mr. POWERS. No. This was, this report, as I recall it, and I haven't read it for some time, was based on the questions addressed to the parent company, Charles Pfizer & Co. But I would rather let the report speak for itself, if I may, Senator.

Senator GORE. You may.

You spoke in your testimony of paper organizations. I wonder if you would be willing to state to the committee what is the relationship between Charles Pfizer & Co., Inc., on the one hand, and Pfizer Corp. of Panama, Pfizer Overseas, Inc., which is a Delaware corporation, Hopmar Realty Corp., a New York corporation, and Pfizer International, Inc., another New York corporation?

Mr. POWERS. The three corporations that are doing business abroad are wholly owned by Charles Pfizer & Co. Hopmar Realty Corp., I believe, is also owned by Charles Pfizer & Co., but its business is confined completely to real estate in the United States, I think just the problems raised by the purchase and handling of real estate for company use in its operations.

Senator GORE. What does the Panama corporation do?

Mr. POWERS. Well, the Panama corporation operates throughout the world, through branches and through subsidiaries of its own.

Senator GORE. What are the subsidiaries of your Panama subsidiary?

Mr. POWERS. Well, there is a list of, it must be close to 40, subsidiaries. We have—maybe I can explain it this way: Most of our——

Senator GORE. First, would you mind reading us the list of the subsidiaries of the Panama subsidiary?

Mr. POWERS. I don't have a written list here. I can do a good part of it from memory if you wish me to.

Senator GORE. I would be glad to have it from memory, and then supplement your memory with the full list.

(The information referred to will be made a part of the committee files when received.)

Mr. POWERS. Well then, I can put it this way: That we have attempted strongly to decentralize all of our operations, and most of our field people to whom we would look to make this decision favor completely nationalizing the operation, including registering as a domestic corporation of the country concerned.

As a result of this, we have developed quite a few of these subsidiaries. They cover most of the countries of Europe, many of the countries of the Far East.

Senator GORE. You are speaking now of subsidiaries of your Panama company?

Mr. POWERS. That is correct.

Senator GORE. Is your Panama subsidiary wholly owned by Charles Pfizer?

Mr. POWERS. In all but a few cases; we have jointly owned companies in France——

Senator GORE. I am speaking now of the Panama subsidiary. Is it wholly owned by Charles Pfizer?

Mr. POWERS. Oh, yes, sir; yes, sir.

Senator GORE. Now you were going to give me the list.

Mr. POWERS. Yes; and I will be glad to furnish it.

Senator GORE. From your memory.

Mr. POWERS. That is right. That would include United Kingdom, Belgium, Netherlands, Norway, Sweden, Finland, Switzerland, jointly owned company in France; Germany; Austria; Italy; a jointly owned company in Spain; Portugal; Greece; a jointly owned company in Turkey; India; Ceylon; Pakistan; jointly owned company in Japan; Philippines; Hong Kong; I think Malaya; Australia; New Zealand; and throughout most of the—well, I should not say most of the countries in Africa any more, but the Union of South Africa; Mozambique; Kenya; Angola; the Federation of the Rhodesias and Nyasaland; Ghana; Nigeria; and in Latin America we tend to have more branches than subsidiaries.

I think we have a subsidiary only in Chile or Argentina.

Senator, that is about the best I can do at the moment.

Senator GORE. These are all subsidiaries?

Mr. POWERS. Yes.

Senator GORE. Of your Panama subsidiary?

Mr. POWERS. That is correct, sir.

Senator GORE. Now tell me why you would organize a subsidiary in Panama in order for it to own these 40-odd other subsidiaries.

Mr. POWERS. Well, as I said in my opening statement, when we made the decision to really build abroad along the lines that we have actually carried out, meaning that we were going to reinvest for a time all of our profits, it would hardly seem wise to bring money which we were going to reinvest abroad home and then send it out again. So we chose that form of organization at that time.

Senator GORE. Which means that you decided to take advantage of the U.S. tax laws to reinvest all your profits and build your business abroad instead of repatriating any substantial profits, which would subject you to U.S. tax liability.

Mr. POWERS. That is correct, sir.

Senator GORE. That is certainly a frank statement.

Now, do any of the subsidiaries of the Panama subsidiary, in turn, have subsidiaries?

Mr. POWERS. I am pretty sure not.

Senator GORE. What do you mean by "pretty sure"? Wouldn't you know?

Mr. POWERS. This is, as I have already indicated, a large complex of companies. Whether for some unusual reason somebody found the need to form a further subsidiary I do not recall, but I do not think so.

Senator GORE. Would you supply that for the record?

Mr. POWERS. I would be glad to do that, Senator.

(The information referred to will be made a part of the committee files when received.)

Senator GORE. Now, you also referred in your statement a few moments ago to branches of the Panama subsidiary. What are those branches and where are they located?

Mr. POWERS. Well, these branches at present, I believe, are mainly in Latin America.

Senator GORE. Would you name them.

Mr. POWERS. In Brazil, Guatemala, I believe in Colombia and Venezuela. We are out of business in Cuba. There are a number of others, Senator, but I just do not recall.

Senator GORE. Would you supply that for the record?

Mr. POWERS. I would be glad to do so.

(The information referred to will be made a part of the committee files when received.)

Senator GORE. What other holdings in addition to subsidiaries and branches does the Panama subsidiary have?

Mr. POWERS. I believe no other holdings.

Senator GORE. Does the Panama subsidiary own any part of a U.S. corporation?

Mr. POWERS. No, it does not—yes, pardon me.

Senator GORE. I think you are overlooking something.

Mr. POWERS. Well, we have a management company. For convenience in the early days of setting this up, we formed an American company called Pfizer International, Inc., which is owned in turn by Pfizer Corp., Panama Company, and by Pfizer Overseas, the Delaware corporation.

Senator GORE. All right. Give us the details of that. What part of this corporation does your Panama subsidiary own?

Mr. POWERS. I believe it is a 50-50 ownership between the two companies, but I do not recall.

Senator GORE. You would not recall? Aren't you chairman of the board?

Mr. POWERS. Well, this is not a very significant matter, Senator. It is a service organization for convenience. It lends its name to the whole group. It gives us a single payroll. Rather than having to divide everybody in the New York office up among several corpora-

tions, they can be on the payroll of Pfizer International and that, in turn, is charged to the two owners.

So it is purely a convenience, this corporation. There is no question of profits or losses within it.

Senator GORE. Yes, it is a convenience, and a tax convenience.

Mr. POWERS. That is not true, Senator.

I wish you would describe what you mean by that.

Senator GORE. Well, you have just said, Mr. Powers, that—a few moments ago, in response to my questions, you answered affirmatively that you decided in the beginning to organize your international operations, your foreign operations, in such a way that all of your profits would be reinvested abroad and not repatriated to the United States because they would be subjected to tax liability if repatriated.

I asked you that, and you said, yes.

Why do you say now that my statement that this is a tax convenience—maybe I used the wrong word "convenience"—tax advantage, is untrue?

Mr. POWERS. Because we are not talking about Pfizer Corp. now, if I understand your questions. We are talking about why we created a service company called Pfizer International.

The creation of this company, Senator, is what I was referring to when I said it is not true that this was formed for tax purposes or tax convenience.

Senator GORE. If I made an incorrect statement then I certainly am willing to be corrected.

I do not yet quite understand why your Panama subsidiary would be a part owner or, perhaps, a majority owner, of Pfizer International. What is the degree of the ownership of Pfizer International by your Panama subsidiary?

Mr. POWERS. I would have to supply that. As I said before, I do not recall. It may be 50–50 with Pfizer Overseas, but I simply do not recall.

(When received the information will be made a part of the committee files.)

Senator GORE. Could it be more than 50–50 owned by the Panama corporation?

Mr. POWERS. It is possible.

Senator GORE. Then what does Pfizer International do?

Mr. POWERS. Well, as I said, it is a service company.

Senator GORE. I know you said that for the third time. What does it do specifically?

Mr. POWERS. All the employees in our New York headquarters office are on the payroll of Pfizer International.

Senator GORE. Why?

Mr. POWERS. For convenience purposes.

Senator GORE. What convenience now?

Mr. POWERS. Because we would otherwise have had to put them on a payroll of several companies, these two, and this is an inconvenience. There were problems that had nothing to do with a lower or higher tax rate, Senator, but simply this sheer matter of convenience of handling the employees in the office.

Senator GORE. What do these employees do?

Mr. POWERS. Well, these people are concerned with the—there is finance department that is concerned with—correlating the figures and establishing a consolidated profit-and-loss statement and balance sheet for the whole operation and——

Senator GORE. These are not functions exclusively of Pfizer International?

Mr. POWERS. Yes. These functions are performed by Pfizer International exclusively for international companies.

Senator GORE. What fee is paid?

Mr. POWERS. Simply—there is no fee, but the expenses of Pfizer International are charged to the two companies, Pfizer Corp. and Pfizer Overseas.

Senator GORE. And none to Panama?

Mr. POWERS. Well, Pfizer Corp. is a Panama company; in that sense, yes.

Senator GORE. You mean your Panama subsidiary, you are referring to it as Pfizer Corp.?

Mr. POWERS. Yes; that is correct.

Senator GORE. Not Charles F. Pfizer?

Mr. POWERS. No, sir.

Senator GORE. Corporation.

Mr. POWERS. No expenses of any kind which we have in Pfizer International, in any of its companies in the United States, are charged to Charles Pfizer & Co. We absorb those ourselves and they run at the rate of about $4 million a year.

Senator GORE. Then your—how many employees do you have in Panama?

Mr. POWERS. About 200 to 250.

Senator GORE. And how many employees of Pfizer International?

Mr. POWERS. None.

Senator GORE. I thought you said that that was a service——

Mr. POWERS. You mean in New York, I am sorry. I thought you asked how many employees of Pfizer International in Panama. If you mean in New York I would say about, I think it is now about, 265.

Senator GORE. How many employees do you have physically in Panama?

Mr. POWERS. About 250.

Senator GORE. Well, it may be that I am not following you—well, I will strike out "may be." I am not following you. In one case you say—which subsidiary has no employees?

Mr. POWERS. None.

Senator GORE. Well, I asked you a few moments ago how many employees a certain subsidiary had and you said none.

Mr. POWERS. I said none in Panama. That is what I thought your question was directed to, and I guess what you meant was in the United States.

Let us go back over it once more.

Senator GORE. All right. [Laughter.]

It would be profitable to me, I am sure.

Mr. POWERS. I will tell you, Senator, I have not adverted to this subject for 6 or 7 years, and you have taken me quite by surprise.

But the situation is this: We have a group of some 265 people in New York headquarters for our world operations.

Senator GORE. "We." Are you speaking now as chairman of Pfizer of Pfizer International or Panama or Liechtenstein or what?

Mr. POWERS. There is a group of some 265 people who are working in New York as a headquarters for the worldwide operations of the Pfizer companies. These people——

Senator GORE. Now, the Pfizer International Co. is domiciled where?

Mr. POWERS. I made that plural companies.

Senator GORE. Companies?

Mr. POWERS. Yes. These people, because they do work for both Pfizer Overseas and Pfizer Corp. would have had to be given, would have had to be put on the payroll of both companies and be given separate checks with a number of inconveniences having to do with social security and what-not.

As a convenience, in the beginning we formed Pfizer International, a Delaware company. We put all of the New York employees on the payroll of that company.

We then charged to the owners of the company, namely, the Panama organization, Pfizer Corp., and Pfizer Overseas, the Delaware company, the expenses of International, so that in that sense you could say that Pfizer Corp. has no personnel within the United States but depends on Pfizer International, the service company, to carry out these operations.

Now, in Panama, as quite another subject, there happened to be about 200 or 250 employees of Pfizer Corp., the Panama company.

Senator GORE. Are any of the employees of Pfizer International working in the United States paid by the Panama corporation?

Mr. POWERS. No, but charges are made to the Panama corporation.

Senator GORE. The charges of the corporation are made?

Mr. POWERS. Such charges are made for the personnel by the corporation.

Senator GORE. You have quite a complicated setup.

Mr. POWERS. That one point makes it sound as if it is complicated, but it sounds very simple to me.

Senator GORE. To accomplish the purpose which you set out to accomplish, to avoid paying any taxes to the U.S. Government on the profits earned abroad, and build your international empire on those profits untaxed.

Mr. POWERS. But Pfizer International has nothing to do with that. The fact that we organized it does not affect that one way or another.

Senator GORE. I see.

Mr. POWERS. I grant you readily we have done just what you have said and we are now in position to return $40 million a year on that very investment which, it seems to me, has a pretty beneficial effect on this country's balance of payments.

Senator GORE. Well, let us go into that.

In your annual report you show an overall tax rate of a little less than 33 percent. Most other companies seem to have to pay about 52 percent. Will you explain that?

Mr. POWERS. What year are you speaking of, Senator?

Senator GORE. I am speaking of—well, in 1960 it was a little less than 33 percent; in 1959 it was a little less than 30 percent.

Mr. Powers. Yes.

Senator Gore. In 1958 it was 35 percent.

Mr. Powers. I think this is mainly due to two factors. One is our domestic operations were in some difficulties in the years you are talking about, and our foreign operations were prospering greatly, and the tax mix was such that we therefore had more pretax income abroad by far than we had in the United States.

Furthermore, we were in 1959—I do not believe we paid any dividends home.

In 1960 we paid relatively small amounts of dividends; I think it was about $4.5 million.

As a result, the overall U.S. and foreign tax rate tend to be closer to the foreign rate than an average between them, for example.

Senator Gore. So your answer is that while your competitors were paying in the order of 50 percent in taxes, you were paying 30 or 33 percent because of this interconnected link with foreign subsidiaries.

Mr. Powers. If you are referring to competitors, I am not quite sure what you meant by that. Which competitors?

Senator Gore. I am referring to the other drug companies.

Mr. Powers. And are they paying 50 percent or 52?

Senator Gore. I was speaking of a general figure. I have the statistics here.

The average tax payment for seven ethical drug companies combined for 1960 was 48.6. The seven did not include Pfizer.

Abbott Laboratories paid 44.6; Eli Lilly & Co. paid 52.8; Merck & Co., 43.4; Parke, Davis & Co., 48.2; Charles Pfizer & Co., 32.6; Smith Kline & French Laboratories, 53.4.

Is that sufficient?

Mr. Powers. Yes, sir.

Well, the answer to that is partly what I have already told you. I think you will find that we do far more business abroad than any of those companies, and I regret to say that in those years they were probably doing a great deal better domestically than was Pfizer. Whether they were also paying large dividends home which would have raised the tax rate I do not know, but I suggest it would for this reason: At the present time, Senator, our tax rate is now running something in excess of 45 percent, and the two things which have changed most from the years you are talking about are that we are paying large dividends and our domestic operation has improved substantially, so that it has actually been going ahead at a faster rate than is the international operation. That would put us in line with a number of those companies.

Now, why anybody would be at 52 percent—I can only suggest this, that there are two accounting principles involved here. There is one school that feels there should be a reserve for U.S. taxes against all your foreign earnings even though they are not remitted, and there is another school of which we are a part that only shows actual U.S. taxes payable in any given year as a result of remitting dividends, and does not accrue U.S. taxes against unremitted dividends.

Senator Gore. Would you call that honest bookkeeping?

Mr. Powers. I wish you would explain why it is dishonest, if that is your implication, sir.

Senator GORE. You set up no reserve for U.S. taxes on profits earned abroad.

Mr. POWERS. Not when we intend to reinvest them. What would be the purpose?

Senator GORE. That is a very interesting statement, because I would like to read here from your own company's statement filed with SEC:

> The company's equity in the net assets of its foreign and domestic subsidiaries was $98,115,815, and $115,479, respectively, in excess of the costs of its investment in the subsidiaries at December 31, 1960, and these amounts have been included in consolidated earnings retained and employed in the business. Comparable amounts at December 31, 1959, were $78,485,747, and $214,777. The increase during the year represents the earnings of these subsidiaries less dividends paid to the registrant as follows: Foreign, $4,236,107; domestic, $250,000. No provision for foreign income dividend tax in respect to the subsidiary companies' earnings retained at December 31, 1960, is included in the consolidated statements inasmuch as it is considered that such earnings are essential to the continued operation of the subsidiaries' business.

I can but conclude that either you never intend to repatriate these earnings and, therefore, they will never be taxed, or you are indulging in sharp bookeeping practices in your own report.

Mr. POWERS. Well, Senator, this is a practice which is well recognized by the American Institute of Certified Public Accountants. It would be actually an understatement of profits to reserve U.S. taxes on money which is retained abroad for reinvestment purposes.

Now, if money is retained abroad, not for reinvestment purposes it seems to me we are getting close to this subject of accumulation of excess capital which has been discussed in connection with this bill, and which I personally think is wrong.

But that quoted statement, I think, is a sound practice as long as that money is intended for reinvestment, and I think I have made it clear today, sir, that these profits have been intended for reinvestment.

Senator GORE. And, therefore, your books show not even the slightest indication of a contingent U.S. tax liability.

Mr. POWERS. Why would you suggest a contingent tax liability? I don't quite see why you say that.

Senator GORE. Well, either there is some plan to repatriate them or there isn't. Do you ever intend to—let me point out to you that according to this statement your had foreign subsidiary earnings of over $24 million in 1960 with dividends of $4,200,000 remitted to the parent corporation.

Do you or do you not intend to repatriate any part of the $20 million of foreign earnings, over and above that which was repatriated?

Mr. POWERS. Well, $13 million of that we couldn't possibly repatriate because it is already going—it has already gone into bricks and mortar and machinery. About $7 million of it that year went into working capital because of increased business and I suppose theoretically it could be repatriated but it is considered as a necessity of the business at the level at which it now stands.

Therefore——

Senator GORE. You arrive at an interesting point. A concern operating in the United States would not have the privilege of adding $7 million to its working capital without taxation.

It would not have the privilege of adding $13 million to plant and facilities out of its untaxed profits. Yet you tell us quite candidly that you set out with that purpose and that you have accomplished that purpose, and your own books show——

Mr. POWERS. It is a very worthy purpose, I think, under our present laws and if the Congress changes the situation that is another matter.

Senator GORE. That is the point under present laws, but we are going to change those laws.

Mr. POWERS. That is what this hearing is about, I guess.

Senator GORE. Please understand that you are not the only taxpayer, in my opinion, who takes advantage of whatever tax laws exist. All of us, all taxpayers, take whatever deductions to which they are legally entitled. The point I am raising is not that you are morally or otherwise to be indicted on this particular point, but rather that the Congress is remiss in permitting such a provision of law to remain, and that is the subject of your testimony today.

When I ask you whether you intend at any time to repatriate $20 of the $24 million of your foreign earnings, you say that $13 million of it can't be repatriated because you have invested it in additional plant facilities. You say $7 million can't because you have added that to your working capital abroad, which means, I suppose, if you can't do it then you would have no intention of doing it.

Mr. POWERS. That is correct.

If I had the intention of doing it I think I would set up the U.S. reserve that you have been talking about.

Could I mention one subject, Senator? You did mention that these——

Senator GORE. You are a very fruitful witness. I am delighted for you to add whatever you would like.

Mr. POWERS. I don't know whether to be pleased by that or not. [Laughter.]

Senator GORE. Well, at least I mean you provide an example, you provide a reason, by way of example, why the present tax laws should be changed. You have been frank, and so far as I have been able to detect, you have been both frank and full in your response and I don't mean it in any uncomplimentary reference to you.

Mr. POWERS. Thank you, sir, I would just like to make a quick point wherein you talk of untaxed earnings, that isn't quite the case. It is untaxed by the United States, but we are, of course, taxed abroad.

Senator GORE. I was referring to the United States.

Mr. POWERS. Yes.

Senator GORE. Do you have a subsidiary in Liechtenstein?

Mr. POWERS. No, sir.

Senator GORE. Congratulations.

Mr. POWERS. Thank you. [Laughter.]

Senator GORE. Mr. Chairman, I believe I will conclude. This witness, I believe, has helped me make my point so I don't think I will have any further questions.

The CHAIRMAN. Thank you very much, Mr. Powers.

The committee will recess until 2:30.

(Mr. Powers' prepared statement follows:)

STATEMENT OF JOHN J. POWERS, JR.

President and Chairman of the Board,
Pfizer International

Submitted to

SENATE FINANCE COMMITTEE

On provisions relating to foreign business income, in H.R. 10650, the proposed "Revenue Act of 1962"

April 25, 1962

SUMMARY

PART I. THE NATURE OF TREASURY'S PROPOSAL TO TAX UNRECEIVED FOREIGN INCOME (pp. 1-2)

The proposal to tax unreceived foreign business income is not the "elimination of a special privilege of tax deferral," as many have said, but rather a fundamental departure from the traditional tax principle of the United States (and, so far as known, of all other countries) of not taxing unreceived income. It is unnecessary and inappropriate to the objectives set forth by the Administration and is of doubtful constitutionality.

PART II. DIRECT BUSINESS INVESTMENT OVERSEAS -- ITS ROLE IN THE NATION'S ECONOMY (pp. 2-7)

The net inflow of dollars resulting from direct business investment overseas contributes more to the positive side of our balance of payments than does the true or "unaided" trade surplus. A review of direct business investment abroad makes evident its vital contribution to the domestic economy, as well as its essential relationship to Administration policies of increased exports and expanded trade in the North Atlantic trading community. Such investment should, therefore, be increased.

PART III. DIRECT BUSINESS INVESTMENT ABROAD AND THE U. S. BALANCE OF PAYMENTS (pp. 7-14)

Direct business investment abroad has been and continues to be beneficial to the balance of payments, as evidenced by Department of Commerce records from their inception in 1919. The same conclusion is overwhelmingly demonstrated by the individual company statistics which have been introduced into the public record since this debate began. The Treasury's distinction between industrialized and underdeveloped countries as a basis for analysis is not valid but, in any event, does not reverse this positive result. The approach that there is a "short-term" emergency which can and should be partially relieved by tax penalties is basically fallacious. The demonstration in this connection in Treasury's Exhibit III (as per Charts 1 and 2) is based on insufficient data and questionable assumptions. The tax means proposed to relieve the alleged emergency will not work. These measures will result in long-term harm far greater than any supposed short-term benefit.

PART IV. "TAX NEUTRALITY" AND THE EFFICIENT ALLOCATION OF OUR CAPITAL RESOURCES (pp. 15-20)

The new concept of "tax neutrality" introduced by the Administration means tax equality between <u>different</u> tax jurisdictions.

It is not the traditional principle in U. S. law of tax equality within any one tax jurisdiction. The professed objective to divert to the U. S. capital which is now being invested overseas is based upon fallacious assumptions, both because its implication of a shortage of capital at home is not supported by any evidence and because income tax considerations are by no means determinative of investment decisions. The proposal in the name of "tax neutrality" to tax unreceived foreign business income as if it had been earned or received at home is unique in the world and would place American business abroad at a serious competitive disadvantage. The contention that such competitive disadvantage is offset by the fact that Western European countries still have exchange control laws is hardly relevant, particularly because such controls do not result in competitive burdens comparable to those which would be imposed by the proposed tax.

PART V. "EXPORT OF JOBS" (pp. 21-23)

Direct business investment overseas in prospering manufacturing countries has not displaced American jobs because: (a) only an insignificant proportion of goods manufactured in these facilities is sold to the U. S.; (b) it is not true to any significant degree that goods from American plants could have been exported and sold abroad in place of goods manufactured in such overseas facilities. Quite contrary to the implications of the slogan "export of jobs," direct investment overseas has provided additional American jobs by creating new markets for materials, components and machinery manufactured in American plants, as well as finished American goods.

PART VI. THE ISSUE OF TAX ABUSE (pp.24-30)

All reputable American businessmen are in accord with the objective of eliminating tax abuse. However, the proposed legislation goes far beyond tax abuse, levying penalties on the normal business income of American companies operating abroad where there is no question of tax abuse. The "tax haven" issue has been overstated, confounding normal overseas distribution methods with tax evasion by paper companies. It is recommended that:

1. The principle of the proposed amendments to I.R.C. Sec. 482 (contained in Sec. 6 of H.R. 10650) be maintained, primarily because their thrust is mainly against "paper company" operations, and secondarily because there is a need for clarification of the inter-company pricing problem. It is urged, however, that this principle first be

made part of Treasury regulations under Sec. 482 and that Government and industry try over the next few years to arrive at equitable approaches through the regulations to a lasting solution to this problem. Such a solution might well then be enacted into law.

2. The foregoing approach to inter-company sales of goods should not be applied to the transfer of patents, secret processes and other identifiable intangible assets because it is impractical, but the need for action probably exists. However, all such transactions should be reported annually to the Treasury by the U. S. taxpayer in order that Treasury may consider each one in the light of its specific circumstances.

3. Transactions whereby foreign subsidiaries may send profits home to affiliated American companies, ostensibly as loans when they are really intended to have the permanence of dividends, should be curbed. This can be achieved, however, under already existing legislation by assuring that Treasury receives full information on such loans and by requiring that repayment be made within a reasonable period as evidence that the loan was bona fide.

4. The accumulation of liquid assets abroad by a foreign subsidiary of an American company in excess of the needs of the business is opposed to sound business practice, as well as to the national interest. Such an accumulation should probably be considered as amounting to a constructive dividend. It should, therefore, be treated as such in principle, and in practice it is recommended that it be curbed by application of measures such as those in I.R.C. Sections 531-7.

Overall administration of the bill as drawn would impose monumental accounting and reporting burdens upon the taxpayer, as well as extremely complex tasks of enforcement upon the Internal Revenue Service, both because of the nature of various provisions and in consequence of the variety of countries, languages, currencies and differing commercial accounting systems which would be involved.

Finally, it is recommended that the entire subject of taxation of foreign business income in relation to the U. S. balance of payments and the role of direct investment abroad should receive continuing active study, not only to eliminate tax abuse but also to achieve -- under fair principles of law -- results best suited to the national interest. Such study will also help resolve any new intercountry tax problems which we may encounter as we become more closely related economically to the developing North Atlantic trading community.

Part I

THE NATURE OF TREASURY'S PROPOSAL TO TAX UNRECEIVED FOREIGN INCOME

For the past year, since this legislation was first proposed by the Administration, official statements and public pronouncements by Treasury officials and some members of Congress have made extensive use of the phrase "elimination of the privilege of tax deferral" in relation to foreign business income. There could hardly be more misinformation in so few words. In none of the legislative drafts has there been any proposal to repeal an existing provision of the Internal Revenue Code -- simply because there is no such provision. Under the law the Government does not have any right to levy taxes against such income and therefore no taxes have been deferred. For this reason also the colorful reference to the present absence of tax as an "interest free government loan" is grossly misleading and inaccurate.

Whatever the labels, Treasury is in fact proposing (and to a significant extent has been successful in having incorporated into H.R. 10650) a radically new scheme of taxing U. S. shareholders in advance on income which they have not earned, which is not theirs and which they may never receive. Such a measure conflicts with traditional principles of tax jurisdiction and is unnecessary for the accomplishment of any of the stated objectives of the legislation. No other country employs such a tax measure. Finally, if enacted it would create a constitutional issue that could leave American industry's overseas activities and plans in a state of uncertainty for many years to come.

The Constitutional Issue

As stated by the United States Supreme Court in Eisner v. Macomber, 252 U. S. 189 (1920), the Congress has the power to levy a tax measured by the increment in value of shares of stock belonging to a shareholder, due to earnings of the corporation. However, the Court went on to hold that such a tax is not an income tax authorized under the Sixteenth Amendment and hence could be levied only if apportioned among the states as prescribed in the Constitution. There is no such apportionment provision contained in the proposed legislation.

The superficially similar tax under the Foreign Personal Holding Company provisions of the Code is often cited as authority for taxing a shareholder on undistributed income of a corporation, and the decision in Eder v. Commissioner, 138 F.2d 27 (2d Cir.,1943) has been said by some to uphold the constitutionality of such a tax. That is not the fact. The constitutionality of such a tax has never really been tested in

the courts. In Eder, the petitioner specifically and explicitly conceded the constitutionality of the provisions levying this tax. The only question raised was whether the taxpayer's admitted share of the corporation's admitted income could constitutionally be taxed to him in view of the fact that, if distributed to him, he could not convert the Colombian currency so received into U. S. dollars. This issue was decided against him.

There is, then, an unresolved and serious doubt as to the constitutionality of the current proposal to tax U. S. shareholders on the undistributed foreign earnings of a foreign corporation. The bare existence of such a doubt must raise a serious question as to the wisdom of such legislation, particularly when it is neither necessary nor appropriate for the attainment of the Administration's desired objectives.

Part II

DIRECT BUSINESS INVESTMENT OVERSEAS -- ITS ROLE IN THE NATIONS'S ECONOMY

It is only in recent years that direct business investment overseas has assumed the vital place which it now occupies on the American economic scene. It is not surprising therefore that its role in relation to our domestic and foreign economic policy is still the subject of considerable misunderstanding. To make meaningful, therefore, any discussion of proposals to tax earnings from direct overseas investment, it is necessary to restate its role, particularly in relation to the U. S. balance of payments and to the nation's program for expanding foreign trade.

In terms of the effect on the balance of payments, there has been a tendency to understate the contribution of direct investment abroad and to overstate the role of exports. First of all, the direct investment figures appearing in the statements published by the Department of Commerce include not only an outflow of cash but also the value of invested capital equipment, which does not involve an outflow of any money whatsoever. This value of capital equipment is not normally available but in a special study for 1957 the Department of Commerce estimated that it amounted to about $1 billion out of a total direct investment abroad of $2.5 billion for that year.

Secondly, the figures published by the Department of Commerce show, as an inflow from direct investment, only dividends and interest although the Government concedes that if one is attempting to state the effect of direct investment on the balance of payments there

should also be shown the even larger inflow from exports to manufacturin subsidiaries (net of imports), royalties and fees. In the 1957 special study these three items amounted to $2.4 billion, more than the inflow of $2.2 billion from dividends and interest alone.

The Department of Commerce has recently made another interesting analysis in which it deducted from the published export figure those exports which were financed by foreign aid and other Government funds. If, similarly, exports dependent upon direct investment overseas are also deducted from the regular export figure one arrives at an "unaided" or true export figure.

When the necessary reclassifications such as those just described have been made so that our trade position is then, so to speak, shown as standing on its own, we find that in 1961 there was a trade surplus, not of $5.4 billion, as published, but of only half a billion dollars and there was an inflow attributable to U. S. business investment abroad of $4 billion. 1/ Thus, contrary to widespread belief, it is not the trade surplus, but the inflow attributable to U. S. business operations abroad in the form of factories, warehouses and sales offices which contributes most to reduce the amount of our balance of payments deficit.

Nor is this picture true alone of 1961. Applying the same reclassifications to 1959 and 1960 the unaided export surplus for 1960 was even lower and showed a small deficit for 1959.

Exports and Direct Investment

So much for the background. Now the question is: What can be done in terms of trade and direct business investment overseas to help correct the deficit in our balance of payments and to help strengthen our entire economy in the face of increasingly freer competition with Western Europe?

Any attempt on a substantial scale to reduce the outflow of dollars by reducing imports would be such a sharp reversal of the U. S. Government policy in favor of freer trade and a greater economic unity in the West as to be almost unthinkable at this time.

Can the dollar inflow to the United States be increased through increased exports? From a balance of payments standpoint this must of course imply that there would be no corresponding increase in imports to offset the export gain. To what extent is this possible? We now have a small surplus of one-half billion dollars of "true" or unaided exports

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1/ For the computations, see Appendix A.

over imports. The point has already been made that the remainder of what is usually discussed as the export or trade surplus (i.e., $5.4 billion in 1961) is tied to Government financing and direct business investment activities abroad.

What can be done to increase the unsupported export surplus? Not a great deal, probably. The increase of exports of agricultural products, at this moment, holds some promise but seems dependent almost entirely on political negotiation. Aside from increased consumption by U. S. factories abroad, the increase of raw material exports depends almost entirely on prices and demand and no spectacular change seems possible.

When examined realistically, increased exports of manufactured goods present the principal possibility. But this means hard selling in almost every instance. While exhortations, speeches and trade fairs serve to spur the American manufacturer to internationalize his thinking, what he must ultimately do is to go abroad, hire salesmen, fill warehouses and even package, assemble or otherwise finish abroad the processing of American-made products in such a manner as to give him the best possible competitive position in the foreign market. This is precisely what is meant by direct investment. Furthermore, the biggest and most promising markets are in the industrialized countries and therefore while investment in the underdeveloped countries is helpful what is needed most from a balance of payments standpoint is increased direct investment in the industrialized markets of the world.

Direct Investment and Changing Markets at Home and Abroad

It is time that we achieved a full appreciation of the vital function of direct investment abroad, realizing that it represents an unusual opportunity now -- while our mass production and distribution know-how are still relatively unique -- not only to help create a favorable overall balance of payments but to give us new strength through diversification overseas and a solid position in the developing North Atlantic Trading Community.

The United States has gone further in the process of industrialization then any other country in the world. It has reached the stage where mass production and mass distribution can be so efficiently employed as not only to feed, maintain and expand industrial activity and provide for a large military establishment but also to satisfy as never before in history the demands of the consumer. With so much accomplishment already behind us, the degree of opportunity is bound to have become to some extent selective, industry by industry. To continue to keep our capital, our know-how and our people fully employed, to maintain our strength through diversification, to insure continued growth, many American companies have been virtually compelled to build

abroad. This does not mean to belittle the home market, for this is the greatest and most important of all markets. But with our excess energies and monies we have given free rein to the vaunted American know-how by bursting out of our boundaries, very much as we did in the early days as this country's business pushed westward and spread throughout the land.

The Europeans see the need to grow and expand throughout the large markets of the West. The industrialists of Europe are enlarging their plants to mass-production levels, modernizing to take advantage of the most recent discoveries and even beginning to adopt American techniques for mass selling and distribution. They are ready for a great competitive struggle for the markets of the Western world. Hence, this is no time for us to stay at home. To sell means to be on the spot with salesmen, warehouses and often packaging or assembly lines. This goes for Maine or California or France or Italy or anywhere else. That is why direct investment in business operations abroad is not only an opportunity but at the same time an important defensive move in a tough competitive struggle.

In Summary ...

To summarize, direct investment of U. S. business in operations abroad is important to this country because:

1. It results in a substantial and reliable inflow of dollars year after year.

2. It provides American manufacturers with important areas for expansion and diversification.

3. It provides jobs in American factories through the development of exports, including both those which otherwise would be cut off and those which are stimulated by U. S. business activity abroad. Moreover, in times of recession at home, profitable activity abroad encourages maintenance of domestic payrolls.

4. It has proved to be an effective vehicle for spreading throughout the world the American concept of democracy and is one of the best practical methods of establishing ties and relationships with our neighbors of the free world.

5. It is essential if we are to do business freely and advantageously within the North Atlantic trading community.

Secretary of Commerce Hodges expressed his understanding of the intimate relationship between exports and direct business investment overseas in a statement to a business group in Washington in March of this year when he said:

> "U. S. investment abroad is important to our export expansion program. Direct investments in manufacturing facilities abroad stimulate our exports of capital equipment, our exports of parts and raw materials, and our exports of finished products to fill out the lines of subsidiaries producing and selling abroad.
>
> "To the extent that U. S. investment abroad increases the financial strength and the competitive capacity of American companies, it reinforces our domestic economy. And, to the extent that the earnings on these investments are returned to the U. S., they make a direct contribution to improving our balance of payments.
>
> "Our over-all economic objectives require the continued expansion of U. S. investment to help develop (particularly in the underdeveloped countries) the prosperous customers with whom we expect to expand our trade."

But the view of Secretary Hodges is not supported elsewhere in the present Administration, particularly by the Treasury Department. Much of the Administration's thinking appears to be dominated by what The Economist has called the "myths" about American direct investment overseas. In a March 17 article entitled "Why Businessmen Leave Home," The Economist takes the point of view that American firms are investing in Europe because the market is large and growing; that this investment does not hurt the balance of payments; that tax factors are not a primary cause in such investment; and that such investment does not result in the export of jobs to Europe. The first paragraph of the article reads:

> "A series of surprisingly tenacious myths continues to dominate much of the discussion, both inside and outside the United States, of American direct investment in Europe. Like most legends, the four main myths have a tiny element of truth in them, which sustains the myth-makers. But there is some evidence that the facts are gradually beginning to be recognized in the United States, though the Administration -- perhaps to avoid that worst of government embarrassments, admission that it has been wrong -- continues to repeat the old slogans."

Perhaps the full value of American investment in overseas operations is beginning to be seen more clearly as the debate on this subject continues, but so far there is little evidence of this recognition in Washington.

Part III

DIRECT BUSINESS INVESTMENT ABROAD AND THE U. S. BALANCE OF PAYMENTS

The overwhelming weight of the statistical evidence submitted at the May-June 1961 Hearings before the House Committee on Ways and Means by a large number of American companies contradicted the Treasury' assertions that direct U. S. business investment abroad adversely affect our balance of payments. Treasury's own evidence, as originally submitted to the Ways and Means Committee of the House, suffered from the substantial and fundamental error that it showed as inflow from direct investment only dividends and interest and did not take into account the inflow from related exports, royalties and fees. In addition, its figure were based on selected countries and selected years. In testimony submitted to the Senate Finance Committee, Treasury now concedes that its continued study of the matter indicates the validity of showing related exports, royalties and fees, in addition to dividends and interest in determining the inflow attributable to direct business investment abro

Treasury persists, however, in emphasizing a distinction between developed and underdeveloped countries. But there is a substantial interplay between such countries in any one company's international operations which makes such a distinction unrealistic. For example, money reported as earned in an underdeveloped country may have come from sales in a developed country. Dividends reported as received from a foreign based company often are made up of branch profits or sub-subsidiary dividends from all over the world. Money earned in developed countries provides funds for investment in underdeveloped countries. But the point of greatest significance in Treasury's presentation before the Senate Finance Committe is that it abandons reference to the historical record of the inflows and outflows related to direct investment overseas in favor of new theoretical projections which attempt in a difficult and rapidly changing world to make long-range predictions based on the sketchiest of statistical data and a number of dubious assumptions.

Treasury's reason for abandoning the simple approach of looking at the past record is that the inflow from direct business investment, as shown in the record for any one year, is "not related" to the outflow for direct investment shown for the same year, since it takes a while

for money invested abroad to begin to return home. This point is called "crucial" in dismissing the past record as a suitable means of demonstrating the effect of direct investment overseas on the balance of payments. Let it be conceded that the inflow of dollars -- be it in the form of dividends, interest, related exports, royalties or fees -- which is shown in any one year is attributable in large part to direct investment made in previous years. This only proves that it is misleading to take the inflow and outflow of any one year as a demonstration of the effect of direct investment on the balance of payments and only points to the need to cover a sufficient period of time.

If we look at the Department of Commerce records on balance of payments, from the time they were initiated in 1919, we find more dividends and interest returning to the U. S. than new direct investment going out in all but 4 of these 43 years and that the net inflow over all these years was $16.4 billion. This factual record of the contribution of direct overseas investments would be even more overwhelming if figures were available to show the inflow from related exports, royalties and fees and if the outflow had not included the non-cash item of capital equipment.

The table below presents the available figures of the Department of Commerce on direct investment outflow, and on inflow from dividends and interest for the past decade:

DOLLAR INFLOW AND OUTFLOW TO DIRECT INVESTMENT COMPANIES ABROAD
ALL AREAS - ALL ACTIVITIES - BRANCHES & SUBSIDIARIES

(Millions of Dollars)

	1950	1951	1952	1953	1954	1955	1956	1957	1958	1959	1960	1961	Total
Direct Investment-Outflow*	621	528	850	721	664	779	1,859	2,482	1,181	1,372	1,694	1,681	14,432
Dividends and Interest-Inflow*	1,294	1,492	1,419	1,442	1,725	1,912	2,120	2,249	2,140	2,206	2,348	2,637	22,984
Net Investment Inflow	673	964	569	721	1,061	1,133	261	(233)	959	834	654	956	8,552

*Unremitted branch earnings are included both in Direct Investment and Dividends and Interest.

The indication of the substantial benefit of direct investment on the balance of payments during the decade seems clear even though the figures are incomplete.

But the Department of Commerce made a special study for 1957 showing all inflow in that year related to direct investment, with the follo ing effect:

(Millions of Dollars)

	1957
Direct Investment-Outflow*	2,482
Dividends and Interest-Inflow*	2,249
Net Investment Inflow	(233)
Other Inflow from Direct Investments:	
Exports net of Imports	2,073
Royalties	54
Management Fees	187
Total Other Inflow	2,314
NET INFLOW FROM DIRECT INVESTMENTS	2,081

* Unremitted branch earnings are included both in Direct Investment and Dividends and Interest.

The change from a net outflow of $233 million in 1957 to a net inflow of $2.081 billion is dramatic evidence of the full effect of direct business investment on the balance of payments.

Finally, even if one accepts Treasury's assumptions that the most meaningful figures are those relating to industrialized countries and manufacturing operations only, a substantial net inflow on direct investment is still demonstrated by the Department of Commerce figures given below:

DOLLAR INFLOW AND OUTFLOW TO DIRECT INVESTMENT
MANUFACTURING COMPANIES ABROAD
CANADA, WESTERN EUROPE, OCEANIA AND JAPAN - BRANCHES & SUBSIDIARIES

(Millions of Dollars)

	1950	1951	1952	1953	1954	1955	1956	1957	1958	1959	1960	Total
Direct Investment-Outflow*	127	56	133	14	78	103	189	317	188	387	674	2,266
Dividends and Interest-Inflow*	288	240	200	228	271	317	316	345	388	469	459	3,521
Net Investment Inflow	161	184	67	214	193	214	127	28	200	82	(215)	1,255
Other Inflow from Direct Investment												
Exports Net of Imports								341				
Royalties								27				
Management Fees								62				
Total Other Inflow	(Figures not available)							430	(Not available)			
NET INFLOW FROM DIRECT INVESTMENTS								458				

*Unremitted branch earnings are included both in Direct Investment and Dividends and Interest.

The Treasury Department's Approach

Treasury's ultimate position is that while direct investment abroad may, in the long run, have a beneficial effect on the balance of payments, it nevertheless has a short-term deleterious effect. This is simply a recognition of the obvious fact that a dollar invested today will not be returned until some time later. Thus, it follows that if the dollar were not invested, then during the period it would have taken to return it, the balance of payments would be favorably affected. But later, when the return from dividends, interest, exports, royalties, fees, etc., would have exceeded the prior capital outflow, the balance of payments would be permanently hurt, and to a far greater extent than it had been temporarily helped. The farmer who is short of money can cut down on his expenses by not planting seed in the Spring. But where will he stand at harvest time?

The Treasury is taking a short-sighted approach, which should not be taken unless there is no alternative. Are we truly in such desperate circumstances and, if we are, should we rely on the indirect means of a penalty tax to reduce investment? Should we not meet truly desperate needs with clear-cut measures, such as exchange controls? Exchange controls can be directed specifically at the problem -- short-term or long-term. Tax legislation, designed to achieve a control on capital movements, will not achieve its purpose and will be difficult to reverse. But to repeat, are we in such desperate circumstances? Is such an assumption consistent with the Secretary of Treasury's recent statement that he expects that the deficit in the balance of payments will be eliminated by the end if 1963? 1/

1/ Journal of Commerce, February 28, 1962

In any case, one major aspect of the problem is definitely not short-term -- namely, defense needs and foreign aid disbursements. As the President said in reply to a question at his press conference of March 8: "... the balance-of-payments problem of the United States could be settled overnight if we withdraw our security efforts around the world. It is the combination of the $3 billion that we spend keeping our defense forces overseas, combined with assistance we give in other ways, which provides for our dollar drain." 1/ Short-term solutions are hardly adequate or appropriate to cope with a situation created by this "dollar drain" which is certainly long-term in nature.

The labored approach presented by Treasury 2/ -- in which an attempt is made to project the effect of direct investment abroad into the mid-1970s in order to show the significant short-term disadvantage is a valiant but impossible effort. It is already evident from the earlier discussion of the past record, as indicated by the Department of Commerce figures, that only the sketchiest of data is available on which to make such assumptions regarding the future. 3/ Further, in such predictions of the future, there can be no factors for the great imponderables of the years ahead.

Has account been taken of the effect of the formation of a larger Common Market -- of the passage of some form of Trade Expansion Act -- of the probable creation of a North Atlantic trading community? What will be the competitive impact on international trade of the industrial growth of the Soviet Union and Red China -- of the possible defection of any of the Communist satellite countries? Will there not be substantial effect upon international trade from the growing industrialization of the newly developing countries? What will be the impact of the unknown and quite possibly revolutionary inventions and discoveries of the next decade -- of the use of atomic power for peaceful purposes -- of unforeseen changes in political and economic alignments of the old and new nations of the world?

It should be particularly noted that the figures shown in Exhibit III do not answer the simple question: How long will it

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1/ From the report of the press conference in the Wall Street Journal, March 9, 1962.

2/ As indicated particularly by Chart 2, and supporting tables, in Exhibit III of the Secretary of the Treasury's presentation to the Senate Finance Committee.

3/ Note that in Chart 1 of Exhibit III, Treasury applied these assumptions in developing the outflow and inflow figures for 1952-60 (re Canada and Western Europe) to evaluate them by the same approach.

take to get back an investment made today? Using Treasury's bases for computation of its long-range figures (as contained in the various tables of Exhibit III) one would arrive at an answer of -- a little over 4 years in the industrialized countries, with a range of 2 to 4½ years for the various parts of the world used in Treasury's analysis.

The 10 to 15 year period referred to by the Treasury in Exhibit III is the period it would take for the cumulative inflow from direct investment abroad to pass the cumulative outflow, based not on one investment but on continued investment each year accelerating at the rate of 10% per year. While, as has been indicated, Treasury's projections are founded on what is believed to be inadequate data, this assumption of a 10% acceleration is particularly questionable. An assumed 10% annual increase in investment into the long future is highly questionable, not only from the standpoint of the ability of the U.S. to supply it, but also from the standpoint of the ability of the capital-importing countries to absorb it.

Putting aside all these questions as to the bases for Treasury's projection, what about the method of making the projection? What does it purport to show? First, with an investment in the first year of 1,000 and increasing that investment by 10% each year, it attempts to show how many years it will take, from any given point, before:

(1) The outflow during any one year will be exceeded by the inflow during that same year; and

(2) The total outflow on a cumulative basis will be exceeded by the total inflow on a cumulative basis.

Drawing on the data contained in the various tables of Exhibit III and applying the method used in Charts 1 and 2 (and supporting tables thereto) to the various areas of the world used in the tables one would arrive at the following results:

Area	(1) Years on Annual Basis	(2) Years on Cumulative Basis
Canada	6	9
Western Europe	8	13
Canada & Western Europe	7	12
Latin America	3	5
Rest of World	2	4
Latin America and Rest of World	3	5
World	5	9

This approach concentrates entirely on the harm to the balance of payments during the period of years before inflows catch up with outflows but it neglects to show the sharply increasing benefit to the balance that results once these two hurdles have been overcome. If, instead of focusing on the 10 to 15 years of harm, these projections are extended to a total of 20 years, the relatively modest harm in the short-run becomes insignificant in comparison with the huge benefit in the long run. The following figures show the year in which the cumulative net outflow of direct investment reaches its largest amount, the size of that amount, and the cumulative net inflow at the end of 20 years (based on an original investment of 1,000).

Area	Year Cumulative Net Outflow at Maximum	Amount of Maximum Cumulative Net Outflow	Cumulative Net Inflow at End of 20 Years
Canada	5	3,381	73,323
Western Europe	7	5,553	40,225
Canada & Western Europe	6	4,690	51,339
Latin America	2	1,861	215,715
Rest of World	1	1,521	391,604
Latin America and Rest of World	2	1,767	259,610
World	4	3,188	101,914

Thus in a projection of this data for Canada and Western Europe there is a net outflow which reaches a maximum of 4,690 in the sixth year, then starts to reverse itself in the seventh year, becomes a cumulative net inflow by the 12th year, and then climbs sharply for eight years to reach a cumulative net inflow for the 20-year period of 51,339. Accordingly, any portion of the 4,690 maximum cumulative net outflow saved by legislation discouraging direct investment abroad will have the result, over the 20-year period, of a loss of a proportionate amount of the cumulative net inflow of 51,339. It seems clear that the possibility for saving in the short-run is minimal in comparison to the possibility of gain in the long-run; in fact, if the data in Exhibit III proves anything it is that the potential boost to the balance of payments from direct investment abroad is so great that we cannot let the present short-term problem divert us from obtaining that goal.

Summarizing the Treasury approach, it is simply an elaborate way of showing what every businessman is prepared to concede -- that one must wait a reasonable period of time after investing money before it comes back. By concentrating on this waiting period, this approach over-emphasizes and thereby distorts the harm to the investor during

the wait. Simply by extending Treasury's computations for a few more years to include a period when the return on the investment has begun to mount, one is able to put into proper perspective the relatively short period and small amount of short-term harm which the investment causes to the balance of payments, contrasted with the great contribution which it makes longer-range. If the basic ratios are changed in recognition of the effect of the new tax proposals, there would be virtually no change in the short-term waiting period; and although there would be a modest betterment of the short-term damage to the balance of payments, there would also be a substantial loss of inflow to the balance of payments in the long term. Finally, over both the short and long-term there would be a loss of U.S. income tax revenues because of the reduction of income from direct investment abroad as well as the loss of export sales to foreign subsidiaries.

In analyzing Treasury's approach by extending the computations to 20 years there is no intention to indicate that it is feasible to make accurate estimates of this type over a 20-year period. Whatever the fallacies in the Treasury's statistical predictions, they also exist of course in further extensions based on the same assumptions. In fact, the somewhat outsized results for the extended period suggest that it may well be impossible to make forecasts of this type far into the future.

Part IV

"TAX NEUTRALITY" AND THE EFFICIENT ALLOCATION OF OUR CAPITAL RESOURCES

In its recent constant references to "tax neutrality" the Treasury has introduced another new concept which bears examination. Treasury's use of the term seems to stem from the older and, indeed, well established "tax equality" concept in American law, meaning equal application of the tax laws to all within any one tax jurisdiction. For example, a taxpayer states a good cause of action if he can show that his property has been assessed at full value while most other properties in the taxing jurisdiction -- be it city, county or state-- are assessed at, for example, 50% of full value. He would have no right of redress, however, if his claim was that his property is valued higher than properties in another taxing jurisdiction, i.e., another city, county or state. This is the basic meaning of "tax equality" as we have understood it in the United States -- equal application of the tax law within the jurisdiction of the taxing authority.

Treasury has taken this long accepted principle, changed it to mean equal taxes in all tax jurisdictions, given it the new name of "tax neutrality" and then claimed that "Neutrality is a fundamental principle of taxation in the United States." 1/ In the sense described by the Treasury Department, "neutrality" bears a new meaning and is not part of the laws, traditions or fundamental principles of U. S. taxation.

The concept of neutrality, moreover, is a completely impractic one. This would seem to be conceded when Treasury grants that ideally tax neutrality would provide that all "corporate tax rates would be every-where the same, assuming that Government services are comparable." 2/ It is, of course, Government services that one pays for in taxes and it is their variety that makes inevitable varying taxes throughout the thousands of tax jurisdictions which exist within the United States and throughout the world. The suggestion, therefore, that "tax neutrality" per se is desirable has no justification in logic.

1/ Page 1, paragraph 1 of the Summary Statement in Exhibit III of the Secretary of the Treasury's statement before the Senate Finance Committee, April 2, 1962.

2/ Page 1 of Main Statement of Exhibit III.

The attempt to equalize taxes between different tax jurisdictions, in this case, between nations, cannot be achieved, both because Government services are not comparable and because of the complexity of U. S. and, indeed, all income tax laws. To achieve tax equality as between foreign and domestic income it would be necessary not merely to equalize tax rates but all other elements entering into the computation of the tax as well. For example, the same treatment of deductible expenses, loss carry-forward, charitable contributions, capital gains, depletion and numerous other features of U. S. tax law would also have to be applied to the foreign income to equalize the tax burden.

Finally, there must be taken into account the substantially different pattern of taxation abroad, where income taxes tend to be a far smaller source of revenue than in the U. S. Treasury's reply that most other taxes collected abroad are excise taxes, all of which are passed on completely to the customer does not dispose of the issue. In making comparison of total taxes on income earned in the U.S. by a U.S. corporation and earned abroad by a foreign corporation all taxes in the nature of income taxes should be taken into consideration even though, for Federal income tax purposes, they may not be deemed to be "in lieu of" income taxes, such as "turnover taxes", other excise taxes, and excessively high "Social Security taxes".

"Diversion" of Capital

Quite apart from the theoretical approach to tax neutrality, there remains Treasury's contention that because income earned abroad pays less tax than income earned at home, Americans make decisions to invest abroad in lieu of investing at home. Treasury would like to change this presumed circumstance by taxing unremitted foreign earnings, at least in the industrialized countries of the world.

Treasury's proposal assumes, of course, that there is a need for Government action to change investment decisions -- that there is a shortage of capital in the United States which compels a choice to be made between investment at home or abroad. Those in a position to make such investments are confronted by no such shortage of capital and if they were, the important United States home market necessarily would be given priority. Treasury further assumes that, to the extent taxes on foreign earnings are lower than on domestic earnings, the decision will be made in favor of investing abroad. This assumption, too, is wrong. No one can afford to permit differences in the income tax burden on operations in different localities to dictate where investments should be made.

In the business world we have not, in fact, been faced with the need or opportunity to invest both at home and abroad, with only enough capital to do the one or the other. This was testified to repeatedly before the House Ways and Means Committee in the May-June 1961 Hearings and no evidence to contradict that testimony has been put forward

by Treasury. Indeed, all the evidence indicates that adequate capital is available -- interest rates are relatively low, the cost of equity financing is unusually low, prices are firm and there exists substantial over-capacity in many of our industries. We have been building factorie warehouses, sales offices, etc., abroad not in lieu of but in addition to our building at home. We never forget that the United States is stil the largest and the richest market in the world. It is also our home ba and we must be strong at home. We must continue to meet the constant competition of the American marketplace or we disastrously weaken our entire structure. There is no question where we would put our money if we were confronted by the need to make a choice.

Undue emphasis has been placed on income taxes as a reason for investment decisions. Businessmen welcome and often seek reductions in income taxes. For example, the investment credit proposed in HR 1065 may influence the timing of investment decisions. But does anybody conceive that it will actually lead a businessman to build an unnecessary plant? Another example: if the decision has been made, because of marke conditions, to construct a factory in the southeastern part of the U. S. and one town or one county offers special tax inducements, then it is quite possible, all other things being equal, that the businessman will elect to build the factory in that locality. Or, once the decision is made to build a factory, the form of organization or manner of carrying out the decision may well be the method which will give the most favorab' tax result. Thus, secondary decisions of businessmen are influenced by tax considerations but it is difficult to conceive of taxes determining the original decision to build. This would be like getting married to obtain the advantage of a joint tax return.

If there actually existed a capital shortage in the U. S. and a need to change investment decisions, the taxation of unremitted foreign earnings would not accomplish the purpose. Indeed, if there were any need to divert capital from investment abroad to investment at home the simple and certain way to do it is through the requirement of Government approval of transfers of capital abroad. This is not a popular concept for understandable reasons. But if there really exists a true emergency this is the solution and the matter certainly deserves most careful study. Moreover, the reasonable exercise of exchange controls, when and to the extent necessary to handle any emergency, is far more appropriate than to levy a permanent penalty tax which would put Americans abroad at a competitive disadvantage in world markets.

Competition Abroad

No other country taxes business income earned by one taxpayer to anoth taxpayer until it is received by the latter. Thus under the tax proposals the foreign industrialist in countries levying a lower tax than the U.S. have a clear advantage. Even in countries levying about the same tax as

an important advantage will lie with other competing non-nationals who, like the American, are carrying on operations in that country. Such a competitor's overall tax rate may be considerably below that of the American who, under the new proposals, would always be taxed on such income at not less than the U. S. rate, now 52%.

Suppose an American-owned and an Italian-owned company are competing in Germany, where the income tax rate is about 51% (22% if all profits are distributed). The American's home tax is 52% and the Italian's is 31%. The Italian's operations and corresponding profit are divided between Italy and Germany. His overall tax rate falls somewhere between 31% and 51% (or less if all German profits are distributed). The American would be taxed at 52% under the new proposals. Further, it is interesting to note that when the Italian brings his German profit home as a dividend he pays only a 15% company tax since the Italian income tax applies only to profits from domestic sources.

Or take a French subsidiary firm and an American competing in Belgium. The French rate is 50%. The Frenchman's profit would be taxed partially at the 50% rate in France and partially at the 30% rate in Belgium whereas the American would pay 52%. Once more it is interesting to note that when the French concern brings the Belgian part of the profit home as a dividend, France exempts 75% of it from tax (all remitted earnings of branches would be exempt from French tax). It should be noted that neither of these examples involves a foreign subsidiary engaged in a multi-country operation, a "tax haven" in the language of Treasury. But a so-called "tax haven" is often used by foreign industrialists; by and large their governments are not so concerned about taxation of foreign earnings and at times even seem to encourage the use of "tax havens." Moreover, the use of a "tax haven" can also be perfectly proper, even necessary, for the operations of a business. Assume a Swedish company, paying a 40% tax on home income, uses Brussels as a distribution point for goods manufactured in Sweden and sells from Brussels to France, Germany, Austria and Switzerland. Brussels, housing a normal business operation, is entitled to a part of the total profit. This part may not be taxed at all by the Belgian government or a small tax may be levied, depending upon direct negotiations between the taxpayer and the Belgian government. The total profit is divided among all the countries involved and the various parts are taxed as follows: at 40% by Sweden; at, let us say, a negotiated rate of 5% by Belgium; at about 50% by Germany and France; 52% by Austria; something over 20% by Switzerland. The average of all these rates will fall well under the American rate of 52%. Therefore the American, using exactly the same distribution route, will be taxed substantially more than his competitor.

In Exhibit III of the Secretary of Treasury's testimony before the Senate Finance Committee it is said that "Much has been made of the argument that the elimination of tax deferral will put U. S. subsidiaries abroad at a competitive disadvantage vis-a-vis foreign competitors, in

particular in third-country markets." [1] The Treasury then proceeds to rebut this by saying: "But companies in most European countries are subject to direct controls of one kind or another ...". Both in his testimony and in replying to questions afterwards, the Secretary referred to the existence of exchange controls in European countries as if their mere existence were an adequate reply to the business' man's contention that the proposed U. S. tax on unremitted foreign earnings means that Americans will bear a heavier tax burden than most of their competitors abroad.

Why the Secretary considers that this competitive burden will be lightened because some measure of exchange control still exists in Western Europe is not entirely clear. The meaning that may have been intended -- and which seemed to be implied by previous testimony of the Secretary before the House Ways and Means Committee -- is the contention that Western European countries require as a condition of approving overseas investment the repatriation of all profits annually, and tax those profits as if they had been earned in the home country. If, at the same time, the tax burden in the home country approximates the tax burden in the U. S. then truly the reference to exchange controls would be a valid one. But no evidence has been adduced that any country requires repatriation of all profits or, for that matter, of any amount of profits in excess of what would be a normal return to the home country. There was some implication that this might have been a requirement of the French authorities. It is not known if this is so but if it is, the comparison does not stand up; when foreign profits are brought home to France from a branch there is no tax at all and, if from a subsidiary, only 25% of the normal tax is applied. Before the Senate Finance Committee the only specific reference to controls by the Secretary was to the statement of the Chancellor of the Exchequer of the United Kingdom in July 196

> "The test for new investment in the non-sterling area will be that it will produce clear and commensurate benefits to U. K. export earnings and to the balance of payments."

1/ Page 24 of the mimeographed text of Exhibit III.

It is understood that this policy has caused some stiffening in Britain's approval of foreign investment in the non-sterling area but at least through 1961 it is understood that such investment was still at the high level of over 200 million pounds. And while some applications may have been rejected, so far as is known no applications were approved only on condition that all profits be repatriated annually. Indeed, such a condition would be a practical impossibility for a going concern.

Part V

"EXPORT OF JOBS"

The importance of direct business investment abroad to our balance of payments and its value for the economy as a whole and for increased exports have been demonstrated earlier in this statement. Nevertheless the view has been expressed during the past year's debate that such investments, particularly when made in Canada and Western Europe, amount in substance to the "export of American jobs," and this too is offered by the Treasury Department as one of the reasons for the proposed tax legislation -- i.e., to discourage such investment.

The point has already been made that taxing foreign earnings would not in any case be determinative of investment decisions. Therefore, the desired job effect would hardly be achieved, but there is no need to labor this point.

The key point is that those who say that direct business investment abroad results in the export of American jobs are simply wrong. For this to be true it would have to be demonstrated either (a) that such investments have been made for the purpose of producing goods for import into the U. S. in lieu of producing such goods in the U. S., or (b) that U. S. direct investments abroad have produced goods for sale abroad which could otherwise have been exported from the U. S. The facts do not significantly bear out either of these assumptions.

For example, U. S.-owned manufacturing subsidiaries in Canada and Western Europe had total sales in 1960 of $18.2 billion, of which only $259 million was exported to the U. S. 1/ It is preposterous to charge that U. S. business has gone abroad for the specific purpose of reselling a grand total of 1.4% of production back to the U. S., or that $259 million of such imports from foreign subsidiaries could cause any appreciable loss of jobs. Using ratios (jobs to sales) cited by labor officials, $259 million of sales could mean about 30,000 jobs, or less than 1/20 of 1% of the U. S. labor force -- assuming that the goods represented by the $259 million would have been made in the U. S. But this assumption is not justified, for if U. S.-owned subsidiaries in Western Europe and Canada had not sold these goods to the U. S. market, it is more likely that other foreign companies would have supplied the goods, not U. S. factories. Thus it is hardly justifiable to say that the imports cited were responsible for the loss of any significant number of jobs.

1/ U. S. Department of Commerce figures.

While U. S.-owned facilities in Canada and Western Europe were selling $259 million of goods to the U. S. in 1960, these same subsidiaries were importing $1,246 million worth of goods from the U. S. Using the same job-sales ratio, these exports from the U. S. created more than 100,000 jobs.

That is the picture -- imports from U. S.-owned foreign subsidiaries have minimal effect on U. S. employment but exports to those subsidiaries have a very significant effect on the creation of jobs.

The second charge -- namely, that sales abroad by U. S.-owned foreign subsidiaries displace U. S. exports and therefore jobs at home -- is rather more complicated and theoretical. The charge is based on speculation and no evidence exists to support it.

A recent study of U. S. foreign trade made by a special study staff appointed by the Senate Commerce Committee [1/] has the following to say:

> "U. S. foreign investment does not on the whole -- certainly not on balance -- mean the export of American jobs any more than the introduction of labor-saving equipment at home really destroys employment. American companies manufacturing abroad are not, necessarily, making things which displace American exports or which are sent back to the United States to take the place of American goods in the home market. While some displacement does occur, it is a very small part of the sales of such U.S.-owned facilities. Most sales are made in world markets outside the United States in response to quickly changing market situations. Business judgments as to whether a particular product should be made abroad must consider costs and whether a sufficient demand for the product exists in the U. S. market to justify a tooling up of the U. S. plant.
>
> "The international competitive prowess of the United States depends on the huge domestic market, which makes possible a relatively low unit-cost performance for the American producer. To suggest that in the absence of foreign investment the goods involved would be exported from the United States is to ignore differing income levels in the United States and abroad and the fact that products manufactured in the United States may not reflect world market tastes.

1/ "The United States and World Trade -- Challenges and Opportunities," June 26, 1961, Pages 26-27.

> "At least so far as Europe is concerned, it appears that in the great majority of cases foreign plants have been established or expanded to reach a market which could not reasonably be served through normal exportation. In some instances the cost of U. S. manufacture plus transportation charges plus customs duties would have made foreign sales at competitive prices impossible under almost any circumstance. But even where this is not true exports may still have been unfeasible. The reason for this is that with the expansion of European industry and a rising demand for more and more goods, there is inevitably a growing list of products which now can be supplied more economically by on-the-spot manufacture than by importation."

As the report goes on to state: "The question, therefore, is really not whether these products will be manufactured abroad but by whom." (Emphasis theirs.)

Stating the situation another way, the fact is that the U. S. export is lost first -- or was never a real possibility -- and in consequence the U. S. businessman must invest in production facilities abroad or yield the market to a foreign producer. The need to go to a country in order to sell in it -- to invest money there in order to make possible the required selling effort -- has been dwelt on at length in earlier pages. Moreover, a combination of the higher wage rates payable in the U. S., transportation costs to foreign markets, plus tariff and other border costs, not to mention quota restrictions putting an absolute barrier on imports from the U. S., have made it impossible to export a great many items to foreign markets at competitive prices.

Therefore, the setting up of an operation overseas which is competitive within the country or which because of particular trade preferences may be competitive in a third market does not mean that jobs have been exported; rather, it means that we are maintaining American products in these areas, that the stockholder of these companies are receiving benefit, and that the Treasury either immediately or some time in the future will receive revenue. And, let it be repeated, we are maintaining American jobs by exports of materials, components, machinery, etc., to such American-owned operations, as well as a substantial volume of finished goods to fill out the line, which many countries would not allow to come in if there were no investment in a local productive facility.

Reduction of American investments abroad would mean, by and large, foreign competitors would fill the gap. In other words, those jobs do not exist for American workers in any case.

Part VI

THE ISSUE OF TAX ABUSE

It always has been the policy of the United States, as it is of virtually all other countries, not to tax foreign business earnings of a foreign corporation until received by a U. S. taxpayer.

No other country in the world taxes income neither earned nor received by the taxpayer. Many countries apply the principle of territoriality and do not tax their nationals on income earned beyond their borders, even if received as dividends. Others afford special forms of tax relief with respect to income earned abroad.

The British normally tax income earned by overseas activities of a corporation operated and controlled from the U.K., but this is on the theory that income is earned where the operating management and control are located. Hence, it is taxing income which it regarded as being earned within the U.K. Recently, however, Britain passed a new law establishing the British Overseas Trading Corporation, which is taxed only on the profits it brings home.

There is nothing inherently wrong about foreign corporations, whether they be operating in one country or in several countries. Nor is our long-standing method of taxing their income unfair in relation to the tax treatment accorded income earned within the United States. The United States asserts jurisdiction to tax corporations on the basis of two factors, namely, domicile and source of income. Because of its U.S. domicile, an American company is taxed on foreign income which it earns itself or which it receives as a dividend from a foreign subsidiary. In other words, the right to tax is claimed by the U. S. the moment the foreign income is received by the American company. This concept -- that the realization of the income is necessary to create tax liability -- applies, of course, to domestic as well as foreign earnings. Thus, the earnings of a domestic subsidiary of a U.S. company are not taxed to the parent until received by the latter. U. S. income tax is, however, payable by the domestic subsidiary just as foreign income taxes are payable by foreign subsidiaries in the countries in which they operate.

The fact that the U.S. does not tax the U.S. parent company on the foreign earnings of a foreign subsidiary until received as a dividend is, therefore, no special privilege but part of a uniform application of policy with respect to jurisdiction to tax which has been in effect since the inception of the income tax in 1913. Nor is there any impropriety suggested when a company chooses

to engage in foreign trade through a foreign-based company whose earnings will not be taxed until remitted home as long as it is a real and not a paper company.

Why then is the present law respecting the taxation of foreign earnings under attack? The economic reasons have already been discussed earlier in this statement. Speaking now strictly from a tax point of view, it would seem that the reasons must be largely because of the belief of the proponents of this legislation that foreign subsidiaries, be they registered in "tax haven" countries or not, are sometimes used in a manner which constitutes "tax abuse". What then is meant by "tax abuse" in this connection?

"Tax abuses" in the use of foreign corporations are:

1) Diverting to a foreign corporation in another country income earned in this country and therefore taxable here (under existing law): and

2) Changing the form of what is in fact, and really is intended to be, a dividend from a foreign subsidiary to its U.S. parent company (and hence taxable here under existing law), to a non-taxable <u>form</u>, such as an ostensible creation of an indebtedness.

The problem is that Treasury's proposals go far beyond anything reasonably necessary to contain such abuses. This presumably is because its objectives include in addition to the correction of "tax abuse" the economic ends which have been discussed. H.R. 10650, on the other hand, seems to have the correction of possible tax abuses as its major, possibly its only objective.

H.R. 10650

This section will be devoted to a number of areas of possible tax abuse, as well as other subjects raised by H.R. 10650.

Inter-Company Pricing

H.R. 10650 proposed to add to the existing I.R.C. Sec. 482 provisions giving the Treasury authority to adjust income arising from intercompany sales between domestic and foreign organizations where the U.S. taxpayer is unable to prove that sales have been priced on an arm's length basis. Adjustment of intercompany commissions in similar circumstances likewise is authorized. No specific formula for allocating income between those engaged in such sales is prescribed, but the bill suggests certain factors which, in certain circumstances, the Internal Revenue Service is to take into consideration in computing the amount of additional income to be allocated to the domestic taxpayer. It also provides that all the income of a mere "paper" corporation or organization may be treated as domestic (U.S.) income.

Any attempt to settle the difficult question of intercompany pricing is, of course, a worthy effort, for this is certainly an area of uncertainty for many. Moreover, the existence of this fundamental problem at the key point where U. S. goods are transferred by a U. S. taxpayer to a non-U.S. taxpayer has created a great deal of the prejudice against the operations of foreign sales subsidiaries. If it were possible by a pricing formula to make sure that a fair measure of income had been attributed to the U. S. on these intercompany sales, there probably would be less concern about alleged abuses further down the line. But it is doubtful if it ever will be possible to find one formula that would apply equitably to every transaction in every industry. Nevertheless any clarity which can be brought to this area will be helpful, and to make a beginning is worthwhile.

In principle, therefore, the objective of these provisions is approved. It would be preferable, however, not to embody them in the statute at this time, but to make them part of the Regulations until Government and industry have had an opportunity to evolve a satisfactory approach to this difficult problem. Under existing law the Treasury will have, or be able to obtain, all the information needed to make any appropriate adjustments of U. S. income.

Overseas Trading Profits

In the proposals to tax U. S. corporations on undistributed income earned abroad by foreign subsidiaries, trading profits have been singled out for particularly harsh treatment. This is accomplished by classing with passive or "foreign personal holding company income" normal operating income earned from buying a product from a related company outside the country of incorporation of the buyer and reselling it outside that country. This does not necessarily involve tax abuse; it is a typical supply point or depot operation, long used throughout the United States and the rest of the world to minimize distribution costs. To penalize it because it *might* involve "tax abuse" is obviously unfair. It could lead to the organization of a separate subsidiary and the maintenance of a separate inventory in each country in which sales of such goods are to be made, thereby increasing costs and decreasing the ability to compete.

This provision would handicap our overseas business in a field in which America still leads the world -- distribution and merchandising. It is this activity which best promotes the export of U. S. products. The effect of the proposed tax, however, would be to discourage the merchandising abroad of U. S. products purchased from a U. S. parent company, and favor the purchase of goods from other sources.

Investment of So-Called "Passive Income"

Passive income (other than income from insurance of U. S. risks and from patents, exclusive formulas and processes, discussed further below) and income from selling activities would not, under the present proposal, be taxed before receipt by the U. S. taxpayer *if* invested (by the foreign corporation receiving such income) in "qualified property" in "less developed" countries.

The effect of this gesture towards underdeveloped countries is simply too conjectural to have much meaning. But to regard the existence of this type of income, on the one hand, as an abuse of the U. S. taxing system and then to say, on the other hand, that the taxpayer could exculpate itself by investing such income in a less developed country, is a strange new development in our tax laws.

Income from Patents, etc.

Another feature of the bill which will cause great difficulty is the provision to impose an immediate tax on income derived abroad by a foreign subsidiary from the use, license, or sale of any patent, exclusive formula or process if it was acquired from a related U. S. person or, what is more extreme, if such patent, formula or process was developed in the United States, regardless of when or by whom it was developed or how or when it was acquired by the foreign corporation.

This is an extraordinary tax proposal. It is not simply a question of paying an adequate royalty for the use by a foreign subsidiary of its U. S. parent's patents and know-how. The provision would necessitate a complete examination of every aspect of a foreign subsidiary's manufacturing operations to determine whether and how far the broad scope of this provision applied. The taxpayer would be overwhelmed with questions with respect to rights obtained under license agreements. While the royalty may be deemed adequate by the American licensor, will the Treasury agent take a different position? What if, in accordance with the license, the obligation to pay royalties had expired but the rights were still usable? What if a patent purchased at an arm's length price proved later to have great value in new applications of the processes covered by the patent? The taxpayer would be obliged to deal with these and many other difficult problems in computing his taxable income each year, not just in reply to a challenge of a particular transaction. He would have to compute the amount of income which would be attributable to the use of such rights, report that amount as U. S. income and then in all probability be compelled later to negotiate with the Treasury agent as to a final valuation.

This provision regarding assumed royalties clearly goes far beyond the typical example of what the Treasury describes as an abuse in this area -- the transfer to a paper company in, for example, Switzerland of a patent or other asset for inadequate consideration.

All transactions involving transfers of patents, exclusive processes, copyrights, trademarks, trade names and similar identifiable, intangible property to foreign subsidiaries should be reported annually by the U. S. taxpayer so that each transaction is clearly brought to Treasury's attention and each transaction can be considered in the light of its particular circumstances.

Disguised Dividends in the Form of "Loans"

It has been alleged that foreign corporations sometimes make payments to a U. S. parent company (or other shareholders) which payments in fact are, and are intended to be, distributions of its profits, but are given the form and appearance of a loan (or other obligation) and not reported by the recipient as income. Legislation specifically designed to reach any such abuse should be given wholehearted support by all those engaged in international trade. However, a rifle and not a shotgun should be aimed at this abuse; the cure should not do more harm than the ill.

Under existing legislation, sufficient information is now available to the Treasury to enable it to discover the existence of any taxable transactions of that kind. Hence there is no necessity of imposing burdensome provisions on legitimate business activities. Certainly there should be a questioning attitude by the tax agent towards any loan from a foreign subsidiary to an affiliated U. S. company and the furnishing of information concerning such loans should be required by Treasury. But repayment within a reasonably short period should be sufficient evidence that the loan was *bona fide*, with an opportunity afforded to the U. S. taxpayer to establish the *bona fides* of a loan outstanding for a longer period.

Accumulation of Liquid Assets beyond Reasonable Business Needs -- The "Catch-All" Provision

Under this provision whatever portion of a foreign subsidiary's income had not been taxed to its U. S. shareholders under any other provisions of the bill would be taxed to them, except to the extent invested in certain "qualified" assets prescribed by statute. These could be assets used in the subsidiary's regular business (conducted for a prescribed prior period of time) or in a "less developed country." They could not be assets constituting a diversification of the subsidiary's business.

The purpose seems to be to restrict the expansion even of existing U.S.-owned businesses abroad and not solely to correct alleged "abuses." Such a restriction will surely be welcomed with joy by the overseas competitors of U. S. business. It is hoped that the previous discussion of the value of direct business investment overseas will serve as a sufficient reply to this restrictive proposal.

Accumulation of liquid assets beyond the reasonable needs of the business is not believed to be common in the case of U.S.-owned foreign corporations, nor is it entirely clear that it could constitutionally be reached by statute. In the first place, most foreign subsidiaries are owned by widely held U. S. business corporations, which are forced to bring home foreign profits as soon as available, for the prupose of satisfying their stockholders' expectations of dividends. That being the case, they are little inclined to allow their foreign subsidiaries to accumulate liquid assets beyond their reasonable needs. If such accumulations do exist, they certainly should be questioned.

But what can properly be done? To tax the U. S. shareholders on income earned abroad by a foreign corporation, in advance of their receipt of such income, is, as has been previously discussed, a serious departure from present law. On the other hand, the accumulation of unneeded liquid assets is itself so artificial that it might well be considered as constituting a constructive dividend to the U. S. parent company. This is on the basis that such funds are excess to the needs of the subsidiary and their proper disposition therefore is as dividends to the U. S. parent.

If this view stands the test of further study, then it is suggested that consideration be given to applying something like the I.R.C. Sections 531-7 to this situation. Certainly, in principle it is agreed that some steps should be taken to prevent the accumulation abroad by foreign subsidiaries of liquid assets beyond their reasonable needs.

Increase in U. S. Tax on Dividends from
Foreign Subsidiaries by the "Gross-Up" Method

Finally, the proposal to increase U. S. taxes on dividends from a foreign subsidiary by abandoning the existing method of computing the foreign tax credit with respect to dividends received from a foreign subsidiary and substituting the newly devised "gross-up" method, appears to have no real justification. This proposal apparently results from a theoretical and entirely inaccurate observation that both deduction and credit are allowed for the same foreign income taxes. This simply is not so. It is the foreign subsidiary which earns the income and which pays the foreign income tax on it. The income before foreign taxes was never something that could be considered as available to the parent company. Its interest starts with the after-tax or net income of the subsidiary. And when the parent receives a dividend paid out of such net income, the parent gets credit only for that portion of the tax applicable to that portion of the net income which it actually receives as a dividend. It does not get the benefit of any deduction for the foreign tax.

The basic change involved in gross-up is that in determining the foreign tax credit on a dividend from a foreign subsidiary the U. S. parent would be required to include in its U. S. income tax return, not just the dividend received, but the total amount of the subsidiary's income, including the foreign income tax which the parent never received and never could receive. This is the most extreme possible case of taxing unremitted foreign earnings. It is virtually a tax on a tax.

Complexities of Taxpayer Compliance and Treasury Administration

In addition to the foregoing fundamental objections to the way in which many of the provisions affecting the taxation of foreign income are drawn, a serious problem would result from the monumental and practically insurmountable task of assembling, recording, reporting and verifying, for this purpose, accounting information not heretofore required for either business or tax purposes.

The determination of tax liabilities in this bill would make essential the extraction of an enormous quantity of facts from numerous sources, including records kept in foreign languages and currencies and under theories of commercial and industrial accounting fundamentally different from ours. From these facts certain conclusions would then have to be drawn as to geographical sources and amounts of income and expenses, as well as costs and related amounts of depreciation, segregating such items according to nature and source of goods sold, and their destination. All this would involve endless allocations, each being an exercise of judgment as well as of accounting skill and technique.

Once all this work had been done -- and, under the bill, an enormous amount would have to be done, somehow or other, before work could be commenced on the preparation of a U. S. corporation income tax return for any corporation with active overseas subsidiaries -- it then would be necessary to get all of these facts into the prescribed schedules and exhibits making up such returns.

Finally, if the law was to be equitably and uniformly enforced, would come the task of the Internal Revenue Service in verifying the return, involving not merely determination that all the income and expenses of the U. S. corporate taxpayer were properly reported but also that income earned abroad by a large number and variety of foreign subsidiary corporations (not subject to the jurisdiction of the United States) had been properly reported, under this new theory, in the taxpayer's return.

Conclusion

In summary, H.R. 10650 in its present form is not an efficient or even a proper approach to the two broad problems of tax abuse as defined on page 25. It penalizes equally the normal business transaction and the abuse of our tax laws. It is unnecessarily complex and cumbersome. In the case of some areas of potential tax abuse it is difficult, if not impossible, to establish specific restrictive provisions and penalties; the only feasible method is to consider each case in the light of its particular circumstances. What is needed is to be sure that the details on transactions of this type are readily available to Treasury. This alone should sharply curtail existing tendencies to tax abuse. Some of the provisions of H.R. 10650, while acceptable in principle, would be better handled in the flexible area of regulations than in the fixed terms of law. There is still much to be learned in the field of taxation of foreign earnings and the objective now should be to retain as much flexibility as possible. This becomes of greater significance as we draw economically closer to other countries in the Western World, a trend which may soon make it advisable to consider this area of taxation on a multi-country basis.

It is recommended that:

1. Principles along the lines suggested in the bill for application to inter-company pricing should be employed but preferably, indeed almost necessarily, prescribed in regulations which permit greater flexibility than the fixed form of law.

2. Loans from foreign subsidiaries to American-affiliated companies should be considered as dividends unless repaid within a reasonably short period or unless the taxpayer can demonstrate to the satisfaction of the Treasury that they are bona fide loans. Such a provision is not now in the bill and it is probable that, like the first recommendation, it should first appear in regulations.

3. All transactions involving transfers of patents, exclusive processes, copyrights, trademarks, trade names and similar identifiable,intangible property to foreign subsidiaries should be reported annually by the U. S. taxpayer so that each transaction is clearly brought to Treasury's attention and each transaction can be considered in the light of its particular circumstances.

4. All accumulations of liquid assets abroad by foreign subsidiaries in excess of the reasonable needs (including reasonably anticipated needs) of the business might be considered as a reasonable extension of the principle of a constructive dividend to the U. S. parent company. This would require a new provision in the Internal Revenue Code and it is assumed that such a provision would not be inconsistent with the basic premise that U. S. tax jurisdiction should extend only to income received (actually or constructively) as that premise is now understood and recognized in U. S. tax law.

Finally, it is recommended that the Government undertake, with the cooperation of industry and labor, extensive study of all facets of international trade, the balance of payments and direct investment overseas, with particular emphasis upon those aspects on which there has been substantial difference of opinion during the past year's debate.

APPENDIX "A"

Effect of Extraordinary U.S. Government Expenditures Abroad and of U.S. Business Activities Abroad upon U.S. International Balance of Payments Position (for 1961)

	Per Balance of Payments Statement		As Reclassified	
	(in Billions of $'s)			
	Items	Net	Items	Net
1. TRADE SURPLUS (From Exports and Imports)				
a) Exports (Non-Military)	19.9		14.6 (1)	
b) Imports " "	14.5		14.1 (1)	
c) Trade Surplus		5.4		0.5 (1)
2. U.S. BUSINESS INVESTMENTS & ACTIVITIES ABROAD				
a) Dividends and Interest (Inflow)	2.7		2.7	
b) Related Royalties, Fees, etc. (Inflow)			.3 (2)	
c) Exports Attributable to U.S. Business Activities Abroad			3.0 (1)	
d) Total Inflow as above				6.0
e) Less: U.S. Business Outlays Abroad	1.6		1.6	
f) Surplus from U.S. Business Investments Abroad (as usually shown)		1.1		
g) Less: Imports of Goods Manufactured Abroad by U.S. Plants			.4 (1)	
h) Total of Above Deductions (e) and (g)				2.0
i) Surplus from U.S. Business Investments and Activities Abroad				4.0

(SEE NOTES, PAGE 2)

Notes

(1) Trade Surplus -

a) Exports - decreased by

i)	Exports Attributable to U.S. Government Grants and Capital Expenditures, taken from the U.S. Dept. of Commerce Survey of Current Business.	$2.3 billion
ii)	Exports Attributable to U.S. Business Activities Abroad (amount estimated by Dept. of Commerce for 1957).	3.0 "
iii)	Total Decrease in Amount of Exports (to exclude amounts attributable to overseas activities).	5.3 "

b) Imports - decreased by Amount Attributable to U.S. Business Activities Abroad (This estimate is based on Dept. of Commerce studies for 1957). 0.4 "

(2) Related Royalties, Fees, etc. (Inflow). (This estimate is based on Dept. of Commerce studies for 1957). 0.3 "

* * * * *

General Comments

"U.S. exports financed by government grants and capital outlays," U.S. exports and imports attributable to direct business investment and activities abroad, and income on royalties, fees, etc., are not regularly shown in reports published by the Department of Commerce, but are shown in special studies made by that Department. For example, the exports financed by government grants and capital outlays were first shown in the Survey of Current Business for March 1962. These exports include agricultural shipments under P.L. 480, non-military aid shipments and shipments under Export-Import Bank loans.

Export and import figures attributable to direct business investment and activities abroad have been taken from U.S. Business Investments in Foreign Countries which presents figures for 1957. The figure for such exports includes $1.0 billion of U.S. manufactured capital equipment and $2.0 billion of other U.S. products shipped to facilities built by U.S. business investment overseas. The imports into the United States comprise manufactures and semi-manufactures, exclusive of newsprint, pulp and aluminum which are classed, for this purpose, with non-manufactured goods. The 1957 figures have been used for 1961 as no figures are as yet available for subsequent years. These figures are deemed to be conservative estimates for 1961 since direct investment has increased sharply since 1957 and, in any event, all exports attributable to direct investment are not included in the 1957 figure but only those shipped directly to the operations built by the U.S. investors.

Regarding inflow of royalties and management fees, etc., the 1957 Commerce Department survey shows a figure of $241 million. The Department stated that income of this kind has been rising steadily. Consequently, it is felt that $300 million can be considered as a conservative estimate for 1961.

(Whereupon, at 12:40 p.m., the committee stood in recess until 2:30 p.m., the same day.)

AFTERNOON SESSION

The CHAIRMAN. The committee will come to order.

The first witness is Mr. John F. Creed, of Baker, McKenzie & Hightower.

You may proceed.

STATEMENT OF JOHN F. CREED, OF BAKER, McKENZIE & HIGHTOWER, CHICAGO, ILL.

Mr. CREED. Mr. Chairman and members of the Committee on Finance, I am John F. Creed, of Chicago, Ill. I am a partner in the law firm of Baker, McKenzie & Hightower, and am appearing on its behalf.

I propose to confine my remarks principally to a technical examination of those provisions of section 13 of H.R. 10650 (controlled foreign corporations) that deal with the concepts of "foreign base company sales income" and "investment in nonqualified property." By way of preface, however, something need be said of the general character of the section.

To the extent that any proposed legislation in this area is honestly directed at curbing the abuses of the "paper" foreign corporation and the artificial diversion of income from U.S. taxation, such legislation deserves—and will receive—the unremitting support of the American business community, provided this objective is pursued within the bounds of reason and restraint. Sadly, these virtues are rarely to be observed in section 13 of the bill, which would change drastically—in fact, revolutionize—the taxation of income earned by legitimate foreign subsidiaries.

The major thrust of the section is to subject U.S. companies to current taxation with respect to broad categories of income in fact earned by their foreign subsidiaries, irrespective of whether such income is actually distributed in the form of dividends. And in this regard, it cannot be doubted that the bill would raise serious constitutional issues. Finally, the section is fairly susceptible to the criticism that it would introduce an incredible complexity and uncertainty into the taxation of foreign income, with extensive litigation the almost inevitable result.

Turning to an examination of the technical provisions of section 13, it is apparent that a prime ambition of that section is to discourage the use of the foreign trading subsidiary. To accomplish this ambition, the section creates a category of sales income—called "foreign base company sales income"—that would be taxed to the U.S. parent corporation unless invested by the selling subsidiary in less developed countries. The term "foreign base company sales income" refers to income realized by a controlled foreign corporation in connection with the purchase of personal property from a related corporation and its sale to any person, or the purchase of such property from any person and its sale to a related corporation, where—

(1) The property is produced outside the country under the laws of which the controlled foreign corporation is organized; and

(2) The property is sold for use, consumption, or disposition outside such foreign country.

These provisions would generally apply to the profits earned by a foreign trading subsidiary on the resale abroad or merchandise purchased from its U.S. parent. In view of the revisions to section 482 of the Internal Revenue Code proposed by section 6 of the bill, this would seem neither necessary nor proper. But of even greater concern is the fact that those provisions would reach the income earned by such trading subsidiary on the foreign sale of property manufactured abroad by a related foreign corporation. For example, if a controlled Swiss corporation were to purchase property manufactured by a related German company and resell such property to a Dutch customer, the resulting profit for U.S. tax purposes would be classified as "foreign base company sales income."

It is difficult to see how the United States has any legitimate claim to the income generated by such wholly foreign transactions, which involve solely foreign entities. Nonetheless, the bill proposes to tax such income to the U.S. parent company, as if through some alchemy there were an avoidance of U.S. tax.

Section 13 further provides for the current taxation to U.S. companies of post-1962 earnings of controlled foreign corporations invested in "nonqualified property." Investments by such corporations in property ordinary and necessary for the active conduct of a trade or business carried on abroad—whether by the controlled foreign corporation of its 80-percent-owned foreign subsidiary—would normally be construed as a qualified investment, provided the particular trade or business was carried on as of December 31, 1962. If the trade or business is commenced after 1962, however, it will not constitute a qualified trade or business—and hence not be an appropriate receptacle for qualified investment—for a period of 5 years.

In connection with this requirement, the report of the Ways and Means Committee, at page 64, states the following:

> In order to prevent foreign corporations from starting relatively small trades or businesses (incurring relatively small penalties in denial of deferment) and then permitting additions in later years to these investments to qualify as investments in the corporation's "trade or business," the bill provides a 5-year "seasoning" rule.

The problem is that the technical provision goes far beyond this intendment. In effect, the provision would deprive any foreign subsidiary formed after 1962 from utilizing its earnings in its own trade or business, and this would be so even though the initial investment in such subsidiary emanated from the after-tax earnings of the U.S. parent.

Consider, for example, the following situation: A U.S. company in 1963, based on sound business considerations, makes the decision to invest substantial capital in manufacturing facilities in Belgium. To this end, it organizes a wholly owned Belgian subsidiary as the vehicle for this venture, investing $2 million in the form of equity participation. Additionally, the subsidiary borrows $8 million at low interest rates from Belgian financial institutions to construct a plant, intending to repay this debt from future earnings.

In due course, the Belgian company commences manufacturing operations, selling the bulk of its products in the local market. The subsidiary is subject to corporate Belgian taxes of about 30 percent, and in its initial years is eligible for certain tax incentives, such as accelerated depreciation, that the Belgian Government has seen fit to extend to new industrial enterprises. And in these respects the subsidiary is on an identical footing with its Belgian competitors.

But it will not be able to maintain this footing for long. For the fact is that the Belgian subsidiary is a controlled foreign corporation carrying on a trade or business it commenced after 1962. Consequently, it finds that until 1968 it cannot invest its current earnings to finance or expand its business or to repay the $8 million debt without thereby subjecting its U.S. parent to appreciable taxation in this country with respect to the entire earnings of the subsidiary. In fact, the subsidiary is virtually powerless in any manner to prevent the imputation of its income to the U.S. parent. Admittedly, it could avert this result by investing its earnings in less developed countries, but surely this cannot be reasonably expected of a newly established manufacturing company.

I have referred earlier to the profound complexity and uncertainty inherent in section 13 of the bill. Nowhere is this more evident than in those provisions dealing with investment in nonqualified property. We are confronted with a bewildering array of concepts and terminology that are not, and probably cannot be, defined with the requisite preciseness and particularity. Enforcement—or perhaps, more accurately, attempts at enforcement—of these provisions would result in extreme administrative and financial burdens on taxpayers and the Internal Revenue Service alike. And in final result, these provisions would prove almost wholly unworkable, and in any event—and to this we think the Treasury Department would agree—the provisions would not increase the revenue appreciably. For these reasons, we respectfully urge that the committee reject that portion of section 13 relating to investment in nonqualified property.

If the committee feels that some measures must be taken to prevent the recourse by controlled foreign corporations to portfolio-type investments, then it might well consider extending to such corporations the concept embodied in H.R. 5 of the 86th Congress, the Boggs bill, that would generally classify as prohibited property investments representing less than 10 percent of the stock of other foreign corporations.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, Mr. Creed.

Senator Carlson.

Senator CARLSON. Only one comment, Mr. Chairman. I appreciate very much the very good illustration he used of a U.S. company organizing this company in Belgium, I think it is simple enough so that I can understand it, and I think it is a very worthy contribution to this hearing.

Mr. CREED. Thank you, sir.

The CHAIRMAN. Thank you.

The next witness is Mr. Eldridge Haynes, Business International.

STATEMENT OF ELDRIDGE HAYNES, PRESIDENT, BUSINESS INTERNATIONAL CORP., NEW YORK, N.Y.

Mr. HAYNES. Mr. Chairman, in the interest of brevity I will skip a few pages of the statement which I believe that you have before you and summarize a few of the points on the charts that I brought along.

My name is Eldridge Haynes. I am president of Business International Corp. of New York. Our company publishes two weekly services: Business International, in New York; and Business Europe, in Geneva, Switzerland. We also publish research reports including an annual study called "Investing and Licensing Conditions in 40 Countries." Finally, in a research and advisory capacity, we serve some 90 large U.S. corporations.

I am not presuming to represent any of our client companies on this occasion. I am here solely as a U.S. citizen who is deeply concerned about the impact of this bill upon U.S. exports, on U.S. employment, on our balance of payments, and on the effect that this bill can have on the unity and strength of the free world in its struggle against Communist economic aggression. This bill will adversely affect all aspects of the foreign business of the United States, but owing to limited time I shall use the few minutes that I am privileged to spend before you commenting upon the impact of this bill on the foreign sales subsidiaries of U.S. corporations.

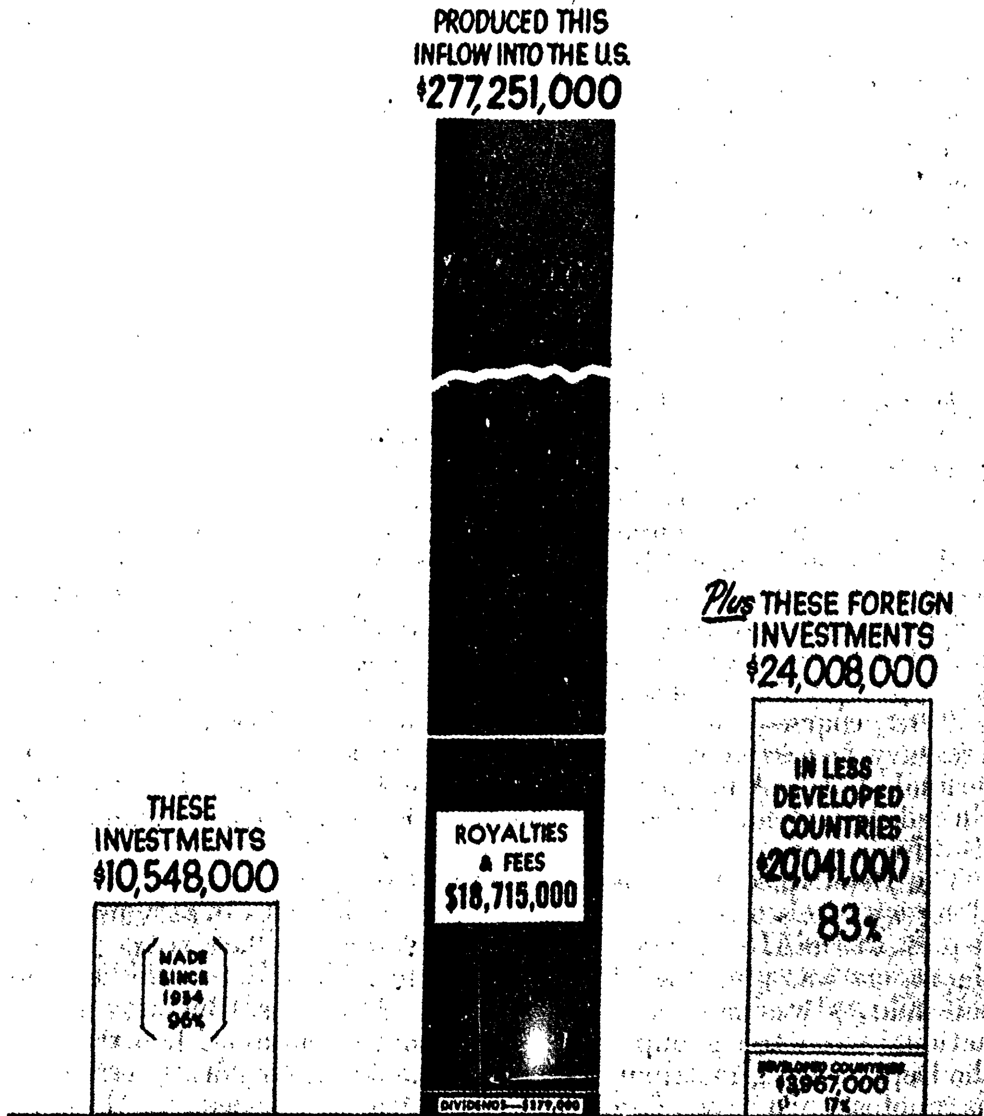
I assume that the committee knows that exports cannot be effectively promoted abroad by writing letters from Chicago to an independent foreign sales agent or distributor. Exports are successfully developed by the setting up of one or more selling companies abroad, staffed with their own managers abroad, their own advertising and sales promotion departments abroad, their own sales training, and—of course—their own salesmen abroad. According to the Treasury Department, there are 293 U.S. sales subsidiaries in Switzerland alone. And there are many more—in Belgium, Holland, the United Kingdom, Canada, Venezuela, Puerto Rico, Panama, and elsewhere.

The Department of Commerce made a study of these subsidiaries along with its study of all kinds of U.S. subsidiaries in response to a request of the House Ways and Means Committee last year. When the report was published by the Department, the data for the sales subsidiaries was not shown separately. However, Business International wrote to a group of companies that we assumed had received the Department's questionnaire and persuaded 21 corporations to send us photostats of the data which they had furnished the Department on 32 trading companies abroad together with certain information we requested. The results are shown on chart I. These 32 subsidiaries, incidentally, all maintain offices abroad and employ 2,384 persons. Not one was in any sense a "sham" foreign corporation—a sign on a door—a letterhead. All were legitimate, hard-working, well-staffed, operating subsidiaries.

I can save a bit of time if I may show you those charts, Mr. Chairman, over here.

The CHAIRMAN. You may proceed.

CHART I



Mr. HAYNES. The first chart shows the performance of those 32 oversea trading companies of 21 U.S. corporations in the years 1959 and 1960. Altogether there was invested in those corporations a total of $10,548,000 from the time that they were incorporated until the time the study was made.

In the years 1959 and 1960 those companies returned to the United States $277,251,000, mostly in exports, some in royalties, fees and dividends.

Now, in addition, and out of the profits by those corporations, they invested $24 million in new facilities, and 83 percent of those investments were made in the underdeveloped areas of the world.

It is a proper question to ask, Why did the 83 percent of the investments go into the underdeveloped areas. That is not like the typical investments made from the United States. We don't put 83 percent of our investments in the underdeveloped areas. But those companies did. And the reason is that the boards of directors of American corporations are more willing to risk their money in high risk areas, which by definition are the underdeveloped areas of the world, that have not been taxed by the United States, than to take 48-cent dollars that have been taxed by the United States and put them into high risk countries.

Now, we can skip to page 5.

(This portion of Mr. Haynes' statement not read before the committee follows:)

Ninety-six percent of the cash invested in these oversea trading companies went abroad since 1954. The dividend inflow into the United States, therefore, has been modest. But it should be remembered that the parent companies profited from the exports, royalties, and service fees which, taken together, amounted to $277 million for 2 years alone.

The capital for the foreign investments made by these oversea trading companies arose from profits earned by these subsidiaries. Even if all the capital transferred from the United States ($10.5 million) had been retransferred to third countries, it would have been less than half the amount that was actually invested ($24 million).

Where investments were made by 32 oversea trading companies in 1959–60

	Amount	Percent
Less developed countries:		
Venezuela	$6,631,000	
Argentina	4,866,438	
Mexico	4,470,000	
Brazil	1,034,100	
Chile	987,748	
Colombia	719,000	
Morocco	400,000	
Lebanon	400,000	
Iran	239,000	
Others	239,356	
Total	20,040,642	83
Developed countries:		
Italy	1,286,000	
United Kingdom	739,700	
France	714,800	
Germany	602,881	
South Africa	422,000	
Others	201,695	
Total	3,967,076	17
Grand total	24,007,718	100

Why did these trading companies put 83 percent of their investments into the less developed areas of the world? There is a very understandable reason. Less developed areas—Latin America, Asia, and Africa—are considered to be high risk areas. Most boards of directors are more willing to gamble money that has been earned abroad and that has not yet been taxed by the United States in high risk areas. If we shut off this means of generating capital we will sharply reduce U.S. private investment in those areas. The Alianza para el Progreso will be hurt, badly hurt.

Mr. HAYNES. Clearly these U.S. oversea trading companies are valuable to the United States. They are developing exports; they are creating jobs in the United States; they are earning foreign exchange needed to balance our international accounts; they are generating capital outside the United States for investment outside the United States, thus preserving the capital of their parent companies to invest within the United States. And they are putting 83 percent of their investments in the less developed areas of the world.

Almost all of them are located in countries which impose little or no tax on foreign income: Would it have been better if these companies had incorporated in Germany than in Switzerland, for example, where the tax rate on income arising from outside Switzerland is only about 20 percent—or less? No one would have called them "tax havens" if they had—but would the United States have benefited in any way? I submit that the United States would have been the loser—in three ways. First, these companies would have had less money and be able to borrow less money to invest or to reinvest in greater selling effort and therefore our exports would have been less. Secondly, they would have been less able to meet competition with lower prices if they did not have the margins to work on which Swiss taxes permitted. Thirdly, the U.S. Treasury would collect practically nothing when the profits came home if they came from Germany. When they come home from Switzerland, the Treasury gets 52 percent less only about 20 percent, including a 5-percent Swiss dividend tax.

How would H.R. 10650 affect the operations of these U.S. oversea trading corporations? Through the act itself, or by action of the Treasury required by this act, these subsidiaries would be so hamstrung as to make their continued sales efforts on behalf of U.S. exports almost useless.

First, the Treasury could fit the price that these selling companies would be required to pay the parent company for the goods they are now selling—or to fix the commission which they would be allowed to collect from the parent (sec. 6, pp. 36–42).

Second, they would be forbidden to make any use of their profits except at a tax penalty—apart from investing in less-developed areas (sec. 13, pp. 111–112). They would not, for example, be permitted to expand their own operations by the creation or acquisition of a foreign distribution company except by paying a U.S. tax for doing so.

Third, they would not know, from one year to the next, what is a less-developed and what is not a less-developed country (sec. 13, pp. 121–122).

Fourth, they could invest only in common stock of a subsidiary in a less-developed country; they could not make loans to such companies (sec. 13, p. 119). It is common practice for local nationals to share the ownership of enterprises in the less-developed nations—and this provision means that the local shareholders would be required to put in additional capital themselves to maintain their equity position.

Fifth, the company in the less-developed areas in which the selling company can invest must be owned by five or fewer U.S. stockholders to the extent of more than 50 percent of the voting shares. Less than 50 percent is permitted if the local law forbids majority foreign ownership. But there are many U.S. affiliates in the less-developed nations

where the U.S. interest is less than 50 percent by choice, or by local government pressure rather than by law. There are to be denied this source of capital, sec. 13, p. 119).

Sixth, in addition, the U.S. oversea trading company must itself own at least 10 percent of the shares of the company in the less-developed area. There are many U.S. affiliates in less-developed areas whose U.S. interests are held entirely by the U.S. parent company. But there is no provision in the bill for the tax-free transfer of the 10-percent interest to the U.S. oversea trading company (sec. 13, p. 119).

Seventh, the temptation to invest in the less-developed areas of the world in partnership with local nationals (as AID urges), is made almost zero by the fact that the Treasury can impose a tax on the parent company for a nonexistent royalty owing to the subsidiary's use of processes, formulas, patents, or copyrights of U.S. origin or furnished to the subsidiary by a related U.S. person (sec. 13, pp. 110–111). This tax would be collected even if the local partners declined to agree upon a royalty, or if the local government refused the necessary dollar exchange, or if the local government refused to allow the royalty as a deduction for local tax purposes.

On the other hand, if the U.S. oversea trading company were engaged in importing into the United States, instead of exporting U.S. products, its profits would doubtless be much greater because the allocation formula (sec. 6, pp. 36–42), gives more weight to capital invested in producing versus selling and therefore favors the country where the goods are produced.

Similarly, if a U.S. oversea trading company were engaged in selling goods made in unrelated foreign factories everywhere in the world instead of U.S. made goods, it would be free altogether of price fixing by the U.S. Treasury (sec. 13, p. 37). Finally, if the U.S. oversea trading company were to sell 50 percent of its shares to the foreigners resulting in the subsidiary being run for the benefit of a foreign country rather than the United States, it would be completely free of dictation by the U.S. Treasury and free to maximize its profits (sec. 13, p. 122).

These provisions clearly suggest that our oversea trading companies will find it very difficult to continue to promote U.S. exports abroad if this bill becomes law. I respectfully submit that these provisions make H.R. 10650 an antiexport bill.

Over and over and over again the Secretary of the Treasury in his appearance before this committee, insisted that U.S. corporations must be competitive in world markets. He said—in response to questions put to him by the distinguished chairman of this committee:

> We do feel, though, we have to give our industry equality before the tax law with their competitors in the rest of the world. We are moving into a world where we are in much closer competition. The competition is becoming much stronger. We are talking about reducing our tariffs which will make the competition even greater. We just cannot live in that world if we do not give our industry the same rules that the rest of the world has.

And again the Secretary said:

All we are asking is to give them (U.S. corporations) the same opportunities that their competitors have abroad, and which would put them on a basis of equality with the rest of the world.

And finally the Secretary said:

I believe entirely in the free competitive enterprise system and it is just because of that that I feel our industry ought to have an equal chance to compete with forign industry which it does not presently have, Mr. Chairman.

Of course, the Secretary, when he uttered these words, was talking not about the foreign income provisions of this bill—but the domestic tax credit. But the words are worth remembering. They are true. Of course, it is vital that our production facilities be competitive. But that is not enough. We shall have invested money in new equipment in vain if we are not also competitive in selling. What good is the finest product if we don't sell it? What good is a modern plant and a crippled selling organization?

When the Secretary insisted that "our industry ought to have an equal chance to compete with foreign industry," he told you all about the tax credits and depreciation rates that other countries give to their home industries. He did not tell you about the tax incentives that other governments give their industries to earn foreign exchange abroad which they need to balance their international accounts. My second chart will give you that information quickly (see chart II).

CHART II

HOW THE MAJOR DEVELOPED COUNTRIES OF THE FREE WORLD TAX FOREIGN INCOME

These countries	Reduce or eliminate taxes on income from outside their borders received by their corporations in the form of:		Levy tax on foreign subsidiaries of their own corporations.
	INCOME OF FOREIGN BRANCHES	DIVIDENDS OF FOREIGN SUBS	
"TAX HAVEN" COUNTRIES			
AUSTRALIA	*YES*	*YES*	*NO* (a)
BELGIUM	*YES*	*YES*	*NO*
CANADA	*YES* (b)	*YES*	*NO* (a)
DENMARK	*YES*	*YES*	*NO* (a)
FRANCE	*YES*	*YES*	*NO*
ITALY	*YES*	*NO*	*NO*
NETHERLANDS	*YES*	*YES*	*NO* (a)
NORWAY	*YES*	*YES*	*NO* (a)
SWITZERLAND	*YES*	*YES*	*NO*
FIVE OTHERS			
GERMANY	*NO*	*NO*	*NO* (a)
JAPAN	*NO*	*NO*	*NO* (a)
SWEDEN	*NO*	*NO*	*NO*
UNITED KINGDOM	(c)	*NO*	*NO* (a)
UNITED STATES	(d)	*NO*	*Proposed*

(a) Use "mind and management" concept--see text.

(b) "Non-resident" Canadian corporation is not taxed in Canada on foreign income generated by its branches or subsidiaries; Section 71 companies in business prior to 1960 not taxed on foreign branch income or subsidiary dividends.

(c) Overseas Trade Corporation (OTC), a UK company, can do business abroad and pay no tax until dividend is paid to parent. A US. corporation can own an OTC and pay no UK tax.

(d) No--except for Western Hemisphere Trade Corporations and corporations qualifying under the China Trade Act.

This chart shows how 14 major developed foreign nations of the free world tax income earned outside their borders. Nine countries reduce or eliminate taxes on income from outside their borders received by their corporations in the form of income from foreign branches or dividends of foreign subsidiaries. You will see here that Australia, Belgium, Canada, Denmark, France, Italy, Netherlands, Norway, and Switzerland all either reduce or eliminate income received from foreign branches. Likewise, all those countries except Italy reduce or eliminate taxes on income received in the form of dividends from foreign subsidiaries. Only three countries, Germany, Japan, and Sweden, tax foreign income the way we do. The United Kingdom has a special provision for a United Kingdom oversea trading corporation whose business is conducted outside of the United Kingdom, and whose profits are not subject to tax until a dividend is declared and paid to the parent.

Now, then, does any country levy a tax on the foreign subsidiaries of their own corporations, any country? The answer is not one. Only in the case of the United States is such a tax proposed. Eight countries shown on on the chart, Australia, Canada, Denmark, Netherlands, Norway, Germany, Japan, and the United Kingdom, deal with the fake foreign corporation, the sham foreign corporation. The paper company, by providing special legislation known as the "mind and management" principal. If the mind and management of the company is in fact at home, then the corporate veil is disregarded and the profits of the alleged foreign subsidiary are taxed as the profits of ordinary domestic companies.

We can now skip to the bottom of page 12.

(This portion of Mr. Haynes' statement not read before the committee follows:)

The 14 countries shown on this chart account for 60 percent of the free world's exports and for 70 percent of the GNP of the free world. And they account for almost all of the free world's private foreign investments. The list includes all of our major competitors in world markets—and increasingly in our home market.

Among other steps to encourage their businessmen to earn foreign exchange, 10 of these countries have created tax incentives to boost exports and foreign investment. Eight of the ten—Australia, Belgium, Canada, Denmark, France, Netherlands, Norway, and Switzerland—reduce or eliminate taxes on income of both foreign branches and foreign subsidiaries. A ninth, Italy, reduces its tax on income earned by its foreign branches. The 10th, the United Kingdom, encourages both exports and foreign investment by providing for United Kingdom oversea trading corporations (OTC) through which United Kingdom corporations may conduct their foreign business. No taxes are imposed upon the profits of an OTC until the OTC remits a dividend to its parent company. Foreign corporations, including U.S. corporations, may own United Kingdom oversea trading corporations and pay no United Kingdom tax whatever on their earnings.

Only three of our major world competitors fail to provide some tax incentive to boost business abroad by both exports and foreign investment. They are Germany, Japan, and Sweden.

The third column shows which countries levy a tax on foreign subsidiaries of their own corporations as the Treasury proposes for the United States. The answer is—not a single one. Eight of our competitors have adopted the "mind and management concept." This means that if a subsidiary of an Australian parent company, for example, is incorporated outside of Australia, carries on its business activities outside of Australia, manages its own operations outside of Australia, and its board of directors hold their meetings outside of Australia—then that subsidiary is not subject to Australian tax. The purpose of the "mind and management" concept is to prevent the use of the "sham corporation."

Mr. HAYNES. In addition to enjoying the tax incentives which their governments provide to boost exports and foreign investments, our European competitors also use subsidiaries in low tax countries. This is especially true of the Germans whose tax treatment, unlike that of most developed countries, is the same as ours. The fact that Europeans use these subsidiaries, even more than U.S. corporations, is shown in a table furnished you by the Secretary of the Treasury which is summarized below together with population and GNP figures to make the comparisons even more meaningful.

	Number of Swiss subsidiaries	Population 1960 (millions)	Total GNP (billions, 1959)
United States	1,025	180.5	$504.4
Total, 5 European countries	1,474	172.3	211.9
United Kingdom	230	52.4	70.6
Western Germany	716	53.4	65.7
France	347	45.5	52.5
Netherlands	112	11.5	11.2
Belgium	69	9.5	11.9

According to the Treasury, there are 1,025 U.S. subsidiaries in Switzerland. But five European countries have 1,604 subsidiaries in Switzerland: the United Kingdom, Germany, France, Netherlands and Belgium. Just those five. Those five countries combined have 50 percent more subsidiaries in Switzerland than we do—but a population less than ours, and a total GNP less than half of ours.

In his statement before the Ways and Means Committee on April 29 of last year, the Secretary of the Treasury stated:

> As long as the tax system 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 the 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.

And that, I think, fairly states the issue.

In summary, I suggest that there should be a distinction made between the sham foreign subsidiary and the legitimate, substantive operating foreign subsidiary. The evidence is overwhelming that we need U.S. foreign-trading companies to maintain and further to build our exports and employment at home, to earn foreign exchange needed to balance our international accounts, to meet foreign competition, and to generate capital outside the United States needed for the economic development of the less developed areas of the world. Clearly, these subsidiaries, no less than our factories at home, should be allowed to compete on equal terms with our foreign competitors.

The CHAIRMAN. Thank you, Mr. Haynes. You have made a very interesting statement.

Now, would you go back to this first chart? Underneath the return of $258,257,000 you have got "exports." What do you mean by "exports"?

Mr. HAYNES. Well, these companies bought back $277,251,000—remember, they are trading companies, they are engaged in selling American goods, and they sold American goods, and sent back as a result of those sales $258,257,000 of exports.

In addition, they sent in about $19 million of royalties, fees, and dividends.

The CHAIRMAN. They were companies operating in this country, I assume?

Mr. HAYNES. Operating abroad; all of these are foreign-trading company subsidiaries, and there are more of them in Switzerland than in any other place.

The CHAIRMAN. I don't exactly understand the exports. Are they exports from this country?

Mr. HAYNES. Yes, all from the United States.

The CHAIRMAN. In other words, they have factories here as well as abroad, is that it?

Mr. HAYNES. All of them had factories here. Some of them had factories abroad and also sold some goods made in factories abroad, but those sales are not included in these figures; these are figures of exports of U.S.-made products only. And the total volume of business done by these companies was greater than is shown here, because some of them also sold some goods made in foreign factories. One of them, for example, was Procter & Gamble. Procter & Gamble sold millions of dollars' worth of goods made in the United States which are shown on this chart—I say they are, I am not sure whether Procter & Gamble was in that list or not—but Procter & Gamble also through its Swiss trading company sells some goods made in their British factory.

But the sales from foreign factories are not included in this figure, Mr. Chairman; the $277 million is only exports of U.S. products, and royalties, fees, and dividends to U.S. parent companies.

The CHAIRMAN. I don't understand fully the significance of the $277 million.

Mr. HAYNES. This was an enormous help in our balance of payments, this inflow of dollars resulting from these exports, which it cost only $10 million to set up.

The CHAIRMAN. Of course, the exports are much greater than that in total for this country; they are about $17.5 billion.

Mr. HAYNES. This figure of $277 million is just for the 21 oversea trading companies.

The CHAIRMAN. How did you select these companies?

Mr. HAYNES. Well, the study was made by the Department of Commerce, Mr. Chairman, in response to a request made by the House Ways and Means Committee. And it is published in the hearings of the House Ways and Means Committee on this bill. But the Department of Commerce did not separate the trading companies from all subsidiaries; they included assembly plants and manufacturing plants and all kinds of subsidiaries. In order to get a picture of what the trading companies are doing for the United States——.

The CHAIRMAN. Explain what a trading company is.

Mr. HAYNES. We wrote to a group of companies that we expected might have received the questionnaire from the Department of Commerce and asked them if they would send us photostats of the returns which they had made to the Department of Commerce. And 21 companies did so, 21 companies that had 32 oversea trading companies. So we received photostats of the same information that had been supplied to the Department of Commerce.

The CHAIRMAN. What, exactly, is a trading company?

Mr. HAYNES. A trading company is a company that is selling goods, either through purchase and resale, or by selling goods on a commission basis.

The CHAIRMAN. It is not a manufacturing company?

Mr. HAYNES. It is not a manufacturing company. Some examples of these—and I would give anything if we could persuade this committee to go to Europe and visit a few of them—I would like you to see Chrysler Co. in Geneva, Switzerland; they have 300 employees in that company in Geneva alone. And since they set up there they have increased their sales from $200 million to $500 million per year in less than 5 years, creating many jobs in Detroit, and foreign exchange for the United States. And all they are doing is selling U.S.-made products.

The CHAIRMAN. Now, have you got any figures that will show the taxes that are paid by these 32 oversea trading companies under the present law? And likewise figures to show the taxes they would pay under the bill as passed by the House?

Mr. HAYNES. I think we could make a calculation of that for you, Mr. Chairman. We haven't done that. But I would be happy to make the calculation and send it to you.

The CHAIRMAN. That would be very interesting to the chairman, if you would show what taxes these trading companies pay now under the present law, and what they would pay in the event the House bill is enacted into law.

Mr. HAYNES. We will make the best estimate that we can, Mr. Chairman, and supply it to you.

(The following was later received for the record:)

BUSINESS INTERNATIONAL,
New York, N.Y., May 3, 1962.

Hon. HARRY FLOOD BYRD,
Chairman, Senate Finance Committee,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: While I was testifying before your committee on April 25, you asked what taxes had been paid by 21 U.S. corporations on the profits generated by their 32 oversea trading companies during 1959 and 1960, and what taxes would be paid by them if H.R. 10650 had been U.S. law. The question was inspired by chart I in my testimony, which provided on indication of the contribution to our balance of payments and U.S. employment by these oversea trading companies.

Only a careful, painstaking, and time-consuming research could yield precise answers. But I promised you the best calculations that I could make in response to your question.

Inquiries made among the companies participating in this study suggest that the taxable income to the United States amounted to approximately 10 percent

on exports and 70 percent on royalties, fees, and dividends. On this basis, the United States collected taxes of $20.3 million, as shown below:

Estimated tax paid in the United States by 21 corporations resulting from income generated by their 32 oversea trading companies

[In millions of dollars]

	Gross income	Taxable income	U.S. tax (52 percent)
Exports	258.3	25.8	13.4
Royalties, fees, and dividends	18.9	13.2	6.9
Total	277.2	39.0	20.3

Under H.R. 10650, all these taxes would continue and in addition the U.S. tax would apply to that part of the undistributed profits of the oversea trading companies not invested in less developed areas. less a foreign tax credit. A check of the 21 companies reveals that there oversea trading companies earned approximately $53.7 million in the years 1959 and 1960 after payment of foreign taxes and dividends paid to the parent companies Chart I shows that these oversea trading companies invested $20 million in less developed countries. The remaining $33.7 million would then become taxable to the United States in addition to the taxes already collected from the parent shown by the table above. This would add an additional tax of $11 million after allowing for the foreign tax credit.

Whether the Treasury would in fact collect much if any of the theoretical $11 million would depend upon several developments including these:

1. Action taken by the foreign governments to levy a withholding tax on dividends, royalties, and fees so as to collect the very tax which the Treasury proposes to collect.

2. Possible decisions by appropriate courts that the taxing of undistributed profits earned by a foreign entity is either unconstitutional in the United States or contravenes U.S. tax treaties, or both.

3. Changes in corporate practice stimulated by this bill. For reasons given in my testimony, U.S. corporations may take any of many steps to avoid being put in a noncompetitive position by this bill. Among them—to sell 50 percent of the shares to foreigners which would put these oversea trading companies beyond reach of this law; or to curtail foreign operations altogether, which would not only reduce or eliminate this added revenue but also reduce the revenue the Treasury is already collecting (table above) and thus worsen our balance of payments owing to reduced exports, and add to our unemployment.

The Treasury, as you know, is opposing the provision in H.R. 10650 that would permit U.S. overseas trading companies in the development areas to invest in the less developed countries without U.S. tax penalty. This change, if adopted, would subject the full $53.7 million to immediate U.S. tax. This surely would be a mortal blow to U.S. exports, our balance of payments, and to the millions of jobs that hinge on exports. And it would seriously reduce, not increase, the revenue of the Treasury, owing to the grim necessity of U.S. corporations retiring from the hot competitive battle for foreign business.

Respectfully submitted.

ELDRIDGE HAYNES, *President.*

The CHAIRMAN. Would you mind putting that other chart back?

As I understand your statement, companies from these countries that you have mentioned that go abroad from those countries and manufacture, they do not pay any taxes until the funds are returned to the parent countries?

Mr. HAYNES. What this chart is intended to show is how France, for example, treats their industries who go abroad from France.

The CHAIRMAN. Now, compare France to the present law in this country.

Mr. HAYNES. Under the present law in this country, when the dividend comes in it is taxed fully at 52 percent less the foreign tax credit. When a dividend comes into France from a French subsidiary, it is not subject to the full 50-percent French tax: they reduce the tax to encourage Frenchmen to go abroad. When a French company sets up a branch abroad——

The CHAIRMAN. Suppose they don't declare a dividend; what happens then?

Mr. HAYNES. There is no tax on it until it comes——

The CHAIRMAN. Is there any tax on those profits that are not returned?

Mr. HAYNES. None. We would be the first country in the free world to reach out and tax the profits of a foreign corporation.

The CHAIRMAN. Explain the United Kingdom taxation as compared to that of the United States under the present law.

Mr. HAYNES. The United Kingdom taxation of foreign income is the same as ours, except that they provide for a special kind of United Kingdom corporation known as an oversea trading corporation, incorporated within the United Kingdom. That company must do all its business outside the United Kingdom, and its earnings are not subject to tax in the United Kingdom until that company pays a dividend to its shareholders.

Incidentally, an American company can own a United Kingdom oversea trading corporation. And there are a few of those.

The CHAIRMAN. Now, under the present law it is not necessary to declare a dividend, but if the money comes back to this country, to the parent company, from the country where the operation is, is that taxable?

Mr. HAYNES. Yes.

The CHAIRMAN. You use the word "dividends," but it isn't necessary to declare a dividend, is it?

Mr. HAYNES. Yes; for the United States to collect to tax under present law from a U.S. subsidiary abroad, a dividend must be declared and paid to the parent.

The CHAIRMAN. In other words, they are different companies in a sense, they have different organizations?

Mr. HAYNES. Yes, sir; entirely separate entities.

The CHAIRMAN. And the only way that money can be returned here is by dividends?

Mr. HAYNES. That is right.

The CHAIRMAN. That is an interesting chart. And you make the statement that there is no country that taxes the profits of a foreign subsidiary unless a dividend is declared.

Mr. HAYNES. None. We would be the first country in the world to do it if we did. I hope we don't. I think it is an invitation to chaos and perhaps even economic warfare. If one nation asserts its right to reach out and tax profits made by a foreign corporation, then obviously the other nations have the right to do the same thing.

The CHAIRMAN. We have been discussing the question of taxation when a dividend is declared and comes back. Now, what other differences would there be in taxation in the House bill as compared to taxation in other countries?

Mr. HAYNES. Well, there are a great many. I listed about seven in my paper. The bill submitted by the House has a special significance to the underdeveloped areas, because it provides for a tax on nonexistent royalties. Now, the underdeveloped areas obviously need technology as much as they need capital. They haven't any local technology. So we bring down our processes, our patents, and our copyrights, and use them, together with our capital, in partnership with local capital. But under this bill the Treasury would have the power to declare that a royalty should have been paid and to impose a tax on the royalty that was not paid.

Even though the partners of the enterprise—Latinos, for example—had never agreed to a royalty, even though the local government may never agree that a royalty is a deduction, and even though the local government may not grant the exchange of dollars to pay the royalty, under this bill the U.S. parent that had the courage to go into the underdeveloped areas would be subject to that tax.

The CHAIRMAN. I think one of the witnesses complained of the lack of a clear definition of what is an underdeveloped area. Can you define that?

Mr. HAYNES. I have no definition, Mr. Chairman. The Treasury has listed some countries which, if this law passes, can under no conditions be declared to be underdeveloped. But they give to the President the power to name from year to year what countries they consider to be developed and what countries they consider to be underdeveloped.

The CHAIRMAN. They have a standard, I assume.

Mr. HAYNES. No standard is provided in the bill.

The CHAIRMAN. Is it done by the Internal Revenue Department, or what?

Mr. HAYNES. I don't know. I had a call from the State Department yesterday; I went over and visited them. And they are very much concerned about West Berlin. And they wanted every bit of help that we could give them to encourage American investment in West Berlin.

Well, under this bill West Berlin is not likely to be listed as an underdeveloped area and is not eligible for any of the guarantees offered under the AID program, and a U.S. corporation will be penalized under this bill for investing in a developed area, which would include West Berlin.

And the State Department was perplexed as to how to encourage more capital to get into West Berlin when they couldn't prove that it is an underdeveloped area.

The CHAIRMAN. Are there any underdeveloped areas as defined in Europe?

Mr. HAYNES. Yes, southern Italy; we have put hundreds of millions of aid dollars in there. This bill rules that Italy, along with all of Western Europe, is developed. We have put hundreds of millions of dollars of AID money into southern Italy, which is surely an underdeveloped part of the world.

Greece and Turkey presumably would be excluded, because they are part of Europe. And there are important underdeveloped areas in Belgium where the abandoned coal mines are, and the Belgians are

offering all kinds of inducement to persuade American investment to come into their undeveloped areas.

There are many underdeveloped areas in Europe, but they would not be regarded by this bill as eligible.

The CHAIRMAN. I suppose Central America is almost undeveloped, is it?

Mr. HAYNES. I don't know how to define an undeveloped country.

The CHAIRMAN. Who determines what countries are undeveloped and, therefore, should get a different tax treatment? Is such a determination made by the State Department?

Mr. HAYNES. I believe the bill—I don't have a copy here—says the President shall name the underdeveloped countries on the first day of the taxable year each year.

The CHAIRMAN. And that lasts for that year, I suppose?

Mr. HAYNES. Yes, just for 1 year.

The CHAIRMAN. And what is the difference in the taxation, then, between the underdeveloped countries and the so-called developed countries?

Mr. HAYNES. What it means is that these trading countries that we are speaking of here under the way the House has provided would continue to take their profits and invest them in the underdeveloped areas. But they would never know from year to year which are developed and which are underdeveloped. And they would not be permitted to take their profits free of U.S. tax and invest them in developed areas.

The CHAIRMAN. In other words, the underdeveloped areas would be governed practically entirely by the existing law, is that it?

Mr. HAYNES. No, under present law we can take profits earned abroad and invest them anywhere we wish.

The CHAIRMAN. That is what I mean. But under the proposed House bill the underdeveloped countries would be treated under existing law, is that right?

Mr. HAYNES. No, unfortunately not, under existing law——

The CHAIRMAN. They would be on the dividend question, would they not?

Mr. HAYNES. Under the existing law, Mr. Chairman, we can invest in the underdeveloped areas by making loans. Under the House bill we cannot, except with a tax penalty, we can only buy stock. Now, the problem in the underdeveloped areas is long-term credit. For instance, it is very difficult to borrow money for 3 years or 5 years or 10 years in Brazil; very difficult. They need medium- and long-term credits. Now, affiliated American corporations are often in a position to make medium-term and long-term loans, or hard-currency loans. It is hard for a Brazilian to borrow hard currency. But American affiliates in Europe have hard currency, it all belongs to the family, and they are prepared to make these loans. But under this bill they couldn't make these loans except by giving the Treasury a tax bite as the money went by. They would be permitted only to buy common stocks.

The CHAIRMAN. Common stocks in these subsidiaries?

Mr. HAYNES. Pages 121 and 122 of this printed version of the bill spells out that.

The CHAIRMAN. But the profits would not be taxed unless they declared a dividend?

Mr. HAYNES. Profits earned in the underdeveloped areas; that is right.

The CHAIRMAN. In other words, what I am trying to get at is that the tax laws applying to the underdeveloped areas are substantially the same as existing law?

Mr. HAYNES. Except for the flow of new capital, this bill would alter present law in the flow of new capital into the underdeveloped areas, it would curb the flow of new capital.

The CHAIRMAN. What is the logic back of that?

Mr. HAYNES. I don't know.

The CHAIRMAN. In other words, you have got to invest in common stocks?

Mr. HAYNES. That is right.

The CHAIRMAN. In a subsidiary of an underdeveloped country?

Mr. HAYNES. That is right. The Secretary has advocated before this committee removing the provision in the House bill which would still allow the trading companies in developed areas to invest in the common stocks in the underdeveloped areas. He wants to eliminate that provision. So they couldn't put a dime in the underdeveloped areas except with a tax penalty.

The CHAIRMAN. Let's take Europe; what parts of Europe are classified for the present taxes as underdeveloped?

Mr. HAYNES. None.

The CHAIRMAN. This bill starts a new classification?

Mr. HAYNES. The Treasury has announced that they consider the whole of Western Europe as developed, and Japan, Canada, and South Africa.

The CHAIRMAN. But you said something about south Italy.

Mr. HAYNES. That is underdeveloped, but not according to the Treasury. According to the rest of our Government, southern Italy is considered underdeveloped and we have put AID money into southern Italy.

The CHAIRMAN. Which areas of the world would be regarded as underdeveloped by this bill?

Mr. HAYNES. The underdeveloped areas would be badly hurt by this bill.

The CHAIRMAN. I say, where are they?

Mr. HAYNES. Everywhere except Western Europe, Japan, South Africa, Australia-New Zealand—all of Latin America, all of Africa, all of Asia except Japan would be classified as underdeveloped areas, and the present freedom to earn money abroad and invest it in the underdeveloped areas would be curbed by this bill.

The CHAIRMAN. Japan is not?

Mr. HAYNES. Japan is considered developed, the same as Europe.

The CHAIRMAN. And what other countries in that area except Japan?

Mr. HAYNES. Australia and New Zealand are considered developed.

The CHAIRMAN. What about Hong Kong?

Mr. HAYNES. Hong Kong is put down as developed. I strongly suspect there is a tax reason for classifying that as developed.

The CHAIRMAN. It is not developed, because I have been there, and they have got about 1½ million people living on floats.

Mr. HAYNES. That is on the list of countries that would be declared developed if this bill passes.

The CHAIRMAN. You have made a very interesting statement.

Senator Williams?

Senator WILLIAMS. Did I understand you to say that in the House bill the President would have the power to name on the first day of the tax year the countries that are underdeveloped?

Mr. HAYNES. Yes, sir.

Senator WILLIAMS. Does that mean that conceivably he could declare all the countries in Europe, Western Europe, as underdeveloped?

Mr. HAYNES. Yes.

Senator WILLIAMS. Then the approval of this bill would in effect confer upon the President the power to raise or lower taxes on foreign subsidiaries at his discretion; is that correct?

Mr. HAYNES. I want to amend my answer of a minute ago. I think under this bill he would be prohibited under any circumstances from naming the following countries as underdeveloped: Australia, Austria, Belgium, Canada, Denmark, France, Germany, Hong Kong, Italy, Japan, Liechtenstein, Luxembourg, Monaco, Netherlands, New Zealand, Norway, Union of South Africa, San Marino, Switzerland, and the United Kingdom. He would never be permitted to name those as underdeveloped.

Senator WILLIAMS. That was my understanding; that is the reason I asked if he could conceivably name any country as underdeveloped at the beginning of the tax year. He could not.

Mr. HAYNES. No. But he could say Brazil has developed.

Senator WILLIAMS. He could say a country was developed 1 year and underdeveloped the next, and raise or lower the tax.

Mr. HAYNES. Yes.

Senator WILLIAMS. Have you or your organization given any consideration to the constitutionality of this legislation?

Mr. HAYNES. We are not lawyers, but the lawyers we know—and I was profoundly impressed by the report of the distinguished chief of staff of the Joint Committee, Mr. Colin Stam—my lawyer friends believe that Mr. Colin Stam was right in the paper that he prepared for the House Ways and Means Committee on this subject.

The CHAIRMAN. Senator Carlson?

Senator CARLSON. Just this: I think Mr. Haynes made a very valuable contribution to this hearing.

The CHAIRMAN. Any further questions?

(No response.)

Thank you very much, Mr. Haynes.

The next witness is Thomas J. Leger.

STATEMENT OF THOMAS J. LEGER, HOUSTON, TEX.

Mr. LEGER. I am Thomas J. Leger, a certified public accountant from Houston, Tex., representing myself. My comments are directed to section 16 of H.R. 10650, "Gain From Certain Sales or Exchanges of Stock in Certain Foreign Corporations."

The capital gains provisions of the Internal Revenue Code have been with us for many years and although minor modifications are continually being made, section 16 is a major departure from the basic capital gains principles. Section 16 will discriminate against particular citizens and taxpayers retroactively to February 28, 1913, and additionally becomes effective upon enactment of the bill. Since other sections of the bill, and in particular section 13, "Controlled Foreign Corporations," will almost entirely eliminate the individual and small groups of investors from the foreign area, section 16 does not give the taxpayers time in which to get their house in order, so that they can live with all the new sections proposed in the bill relating to foreign operations.

In the part of the country where I live, there are many citizens who conduct business activities in Mexico and Central America, principally due to the proximity of these countries to Texas. Their business associations date back many years and as contrasted with the major industrial concerns, many of these investments have been made by the individuals and by small groups. With the profit motive first in mind they have risked their capital in foreign countries; they have had to overcome the problems of being a foreigner; in many instances they face the threat of expropriation and they have many other additional risks and hazards not found in the United States. Many of these people are residents of the foreign countries and their sole livelihood is derived from the business they own and operate, and which is usually operated in the corporate form.

An application of the harsh treatment of this section may be illustrated by the following example involving U.S. citizen X who lives in Mexico and owns 100 percent of the stock of Mexican corporation A. X has a basis of $25,000 in A and a holding period of 15 years. A conducts a metal manufacturing business and has reinvested $210,000 of its earnings and profits in the business during the past 15 years. X is now at retirement age and since A is his principal asset he must sell A to provide retirement income. Since a sale of the capital stock would create a larger tax liability, X arranges with the purchaser whereby A is liquidated and the purchaser buys the assets of A. Since A has paid $90,000 in Mexican income taxes during the past 15 years, X would be required to report as a dividend $300,000 in the year of liquidation. Filing a joint return X's tax liability would be $223,640 less a tax credit of $90,000 for a net tax liability of $133,640. Without section 16 X's tax liability would be 25 percent of $215,000 or $53,750. Section 16 has imposed an additional liability of $79,890 upon X because A is a foreign corporation.

Another injustice in section 16 is that it does not apply to the unsuccessful. Unfortunately not every business venture makes a profit. The investment of venture capital in foreign countries has produed bitter pills as well as sweet ones, but more publicity and conversation is directed only toward those ventures that have made large profits. Placement of venture capital in a foreign country is by no means a guarantee of large profits and no income taxes. If a citizen risked a considerable sum of money in a controlled foreign corporation and had a loss from a sale or liquidation, his loss would still be a capital loss. If he has to pay ordinary rates on the increase in earn-

ings and profits, why not an ordinary loss when a sale or liquidation results in a loss?

The term "tax haven" countries is used very loosely and there exists no more than 10 good "tax haven" countries in the world. H.R. 10650 contains provisions to correct the so-called inequities that have arisen through the use of "tax haven" countries. The Republic of Mexico imposes a corporate tax rate up to 40 percent and although this does not equal the 52 percent U.S. corporate rate, their other types of taxes cause the taxload to be almost as burdensome as the United States.

In the Treasury Department and joint committee estimates of revenue to be produced by H.R. 10650, section 16 is included in the caption "all other items relating to taxation of foreign income, etc." This caption also includes sections 5, 6, 7, 9, 12, and 18 and in 1962 they estimate that it will produce $30 million of tax revenue after taking into account the effect of the economy. For the year 1963, they estimate this caption will produce $5 million of tax revenue. In comparison to the present total tax revenue of the country, this is a very minor amount and yet will inflict more hardship on a particular group than any legislation in recent years.

If this section is enacted, the citizens and residents affected have the following alternative when they find themselves being governed by this section:

(1) They can pay their taxes.

(2) If they are residents of a foreign country, they can become citizens of that country thereby avoiding the tax.

(3) They can evade the tax.

As I mentioned before, it is estimated that this section will produce small revenue, but the hardships on certain taxpayers will be so great that I predict that this particular section will produce little or no revenue when it governs an individual or small group. Put yourself in the place of Mr. X mentioned in the example. He certainly is going to do something to escape the additional $79,890 tax liability, and the most obvious means would be a change of citizenship.

Obviously, this section will stop the investment of capital by individuals and small groups in foreign countries. The Treasury Department is concerned with the flow of capital out of the country because of the adverse effects on the balance of payments. The Treasury Department has taken the position of penalizing its citizens to curtail the flow of capital from the country, whereas the most logical and expedient method would be to reduce the Federal Government's expeditures in foreign areas. Why not reduce foreign aid? Why not reduce the budget to conform with present revenue? Although the House Ways and Means Committee reported this bill out on better terms to the taxpayer, the policies and thinking of the Treasury Department are shown very clearly. These policies are more taxes, for larger Government revenues, for larger Government expenditures.

Last week I received part I of the hearings before this committee on H.R. 10650. It was very gratifying to read the questions and remarks made by your chairman, Senator Byrd, and by Senators Kerr, Williams, and Carlson to Secretary Dillon regarding the budget deficits and the adverse balance of payments.

When speaking or writing about our income tax laws the so-calle loopholes are a favorite subject. These so-called loopholes are usually expressed in the term "loss of revenue to the Government." This term is seen regularly in newspapers and periodicals and is a term that I think is untrue. How does a Government have a loss of revenue when it was never entitled to the revenue? A realistic approach to our Constitution and our republican form of government would not see us here today presenting views against proposed tax increases.

When World War II was concluded, instead of reducing the tax rates to the prewar level, Government expenditures were increased to spend the excess income because war expenditures were no longer necessary. In closing, I implore you to review the history of the past great nations of the world and the causes of their decline and fall. By far the major causes have been excessive taxes and too much government.

Thank you.

The CHAIRMAN. Thank you very much.

Any questions?

Senator CARLSON. Mr. Leger, I notice from your statement that you are a certified public accountant in Houston, Tex. And you mention in your statement some of the problems that these foreign investment companies, and individuals, assume, you state that some of them face the threat of expropriation of their property. As an accountant have you had any experience with any of our corporations or individuals that faced that situation?

Mr. LEGER. Not directly, Senator. Whenever I have been with groups that have made investments or have made a purchase, for example, to go in business in a foreign country, in the consideration of the terms of credit to be extended toward the purchase there has always been a lot of wrangling about expropriation, and in the event that it came about, the payment of the money borrowed against the business to buy it.

Senator CARLSON. Of course, we have had some experience in Mexico, and some in Cuba, and I just wondered if you had had any connection with it yourself directly. It might have been interesting and helpful.

Mr. LEGER. No, sir, not directly.

Senator CARLSON. That is all.

The CHAIRMAN. Thank you very much, Mr. Leger.

The committee has finished the list of witnesses, and we will adjourn until 10 o'clock tomorrow morning.

(By direction of the chairman, the following is made a part of the record:)

STATEMENT OF J. D. STUMP, CONTROLLER, JOS. L. MUSCARELLE, INC., MAYWOOD, N.J., OF OBJECTIONS TO REVENUE BILL 1962 (H.R. 10650)

This memo deals primarily with the provisions of sections 12, 13, and 16, regarding the foreign corporations and must be divided into three sections; the first of which deals with current earnings and profits; the second with a sale or liquidation; and the third covers the earnings of American citizens abroad.

CONTROLLED FOREIGN CORPORATIONS

Under the provision of this bill, there are no distinctions made between a bona fide foreign operating corporation whose earnings and profits accrue from sources without the United States and foreign corporations whose earnings and profits accrue largely from sales within the United States.

The bill is also discriminatory against American capital which is used in the development of foreign countries. The United States, for many years, has spent billions of dollars for the rehabilitation of war destroyed nations as well as the development of the underdeveloped nations of Asia, South America, and the newly emerging nations in Africa; and, at the same time, American capital has probably more than matched any Government grants by making direct investments in these countries which has helped to raise the standard of living of the entire Western World which, in itself creates new markets for American products. Much of this investment is from the earnings of foreign corporations and the source of the income is outside the United States.

Since the arrival at a point of self-sufficiency by the war ravaged nations of Europe, American industries have found themselves in a position where it is almost impossible to compete with the products of these nations due to the higher cost of production in this country. For this reason, many American corporations have formed so-called tax haven companies which are used as selling agents for products overseas. By this device, they have greatly reduced their tax load thereby permitting the companying to maintain a respectable profit margin and still compete with foreign products since they do not require as high a profit margin to return the same net profit. Through this method, the United States has been able to maintain a high level of exports. Much of this profit has been retained by these foreign corporations and reinvested in mortgages, properties, and exploration in underdeveloped and other friendly nations; such as Canada.

As the tax bill is now written, this advantage would completely disappear with the following effects:

1. The retained earnings would have to be returned to the United States each year in order to pay the income tax, thereby drying up the largest single source of mortgage money for foreign investments. It would also have a detrimental effect upon the expansion of American enterprise abroad since most corporations finance expansion out of earnings and profits. It is almost impossible to determine in the year in which the money is earned, how much is going to be earned; therefore, the expansion cannot take place and the money be reinvested in "qualified property" as defined under proposed I.R.C. section 953B. It would appear that this bill would open all foreign corporations which are owned 50 percent by American interests to the provisions of the American Internal Revenue Code as opposed to the provisions of the revenue laws of the country in which it is domiciled. It is, therefore, entirely possible that items which are allowed and recognized under the laws of the country in which the company is domiciled would not be recognized by the U.S. Internal Revenue Code. Therefore, the stockholders who owned 10 percent or more of the stock would be taxed on fictitious earnings and profits. It would also appear that the earnings and profits are taxed year by year with no provision for reserves required by local law, deductions for loss years, or the feelings of resident stockholders or directors with regard to dividends. The cost of enforcing such a law would be enormous and there would be constant squabbles between the U.S. taxing authorities and the taxing authorities of the country in which the corporation is domiciled. This would have a particularly bad effect on the foreign relations with those countries and more so in the cases where there is partial ownership by the foreign nationals.

2. The effects on the economies of the various foreign countries as a result of American owned business closing due to inability to compete would undoubtedly have serious repercussions particularly in countries such as Canada and Panama, which countries have been great beneficiaries of American investment in the last 10 to 15 years. Undoubtedly, some of this gap would be filled by the Germans and Japanese who are waiting in the wings to take over the position of the American investors.

3. Proposed I.R.C. section 951 requires the earnings of a foreign corporation that have not been reinvested in "qualified property" as of the close of a taxable year to be included in the current income of stockholders owning 10 percent or more of the stock. This would place a serious hardship on many of these stockholders to meet their tax obligation in any given year due to their inability to obtain money. With regard to U.S. citizens living abroad, it would probably

result in a mass surrender of their American citizenship. It appears that this provision would apply to any 10 percent stockholder even if the remaining stock was owned 1 percent each by 90 U.S. citizens.

4. The bill would probably result in a far greater distribution of the ownership of foreign corporations thereby removing the incentive which causes many Americans with technical skills and know-how to invest abroad and to contribute their skills to the development and the raising of the standards of living of the peoples of the world.

5. It would probably result in restrictive laws being passed by foreign nations regarding information required under proposed section 6038 thereby forcing the sale of the stock of foreign corporations.

SALE OF STOCK OR LIQUIDATION OF CONTROLLED FOREIGN CORPORATIONS

This bill is especially diabolical when it comes to the disposition of all or a portion of the U.S. citizens interest in a foreign corporation since it removes from stockholders of the foreign corporations the favorable capital gains treatment accorded to stockholders of the U.S. corporations. In other words, a group of people who own a foreign corporation and who may wish to dispose of a portion of their stock would be penalized to the extent that they would have to include as ordinary income in the year in which the sale took place, their proportionate share of the earnings and profits of the corporation that had accumulated from the beginning of the U.S. income tax laws in 1913. This is assuming that they have been able to year by year reinvest the earnings in "qualified property" whether in developed or undeveloped countries.

This retroactive provision is going to cause the immediate liquidation of many foreign corporations with the resulting chaos in some countries that is going to be hard to determine. In addition, it would greatly reduce incentive for Americans to work and expand their skills abroad.

The entire bill is pure discrimination against any American citizen who has capital to invest in a foreign country and wants to maintain control of same to insure the the success of the enterprise. In other words, it would appear that the net effect of this bill would be to destroy the American sphere of influence in the guiding of the economy of any of the undeveloped nations and result in an isolation of American capital within this country. The void will be taken up either by foreign competitors or by greater demands on the U.S. Government for additional funds to keep many foreign governments afloat. It does not appear that in its search for taxes, the Treasury Department has given any thought to the end result of their proposals for it would seem that no matter how much revenue is obtained from these provisions, it will certainly not be sufficient to offset the aid demands of the nations affected. It would further appear that due to the noncompetitive position in which American-owned corporations would find themselves in in countries where the tax rates are much less than the U.S. 52 percent, they would certainly be unable to compete with their foreign competitors. This would probably result in a great drop in American exports particularly in industries where the component parts are manufactured in the United States and assembled in the foreign country due to protective tariffs. There is no doubt that this bill will certainly backfire not only with regard to foreign trade and balance of payments, but also with regard to American control of many vital natural resources, as well as completely upset the economic and tax stability of the Western World.

EARNINGS OF AMERICANS ABROAD

Proposed IRC section 911 places a limitation of $20,000 for an individual living abroad for a period of 3 years and subsequent to that time a limitation of $35,000. These limitations are most unrealistic since the base pay of a highly skilled technician or engineer being sent to the wilds of Brazil or Canada usually starts at a minimum of $25,000 with certain profitsharing benefits. This, in itself, will deter the expansion of American ability and know-how and undoubtedly would result in a greatly increased cost due to inefficiency for many of the larger development projects which are financed by U.S. Government grants.

For many people who have been residents of foreign countries for many years and have established businesses, it will undoubtedly, as stated before, result in the surrendering of their American citizenship. It would seem that neither of these is a desirable end.

CONCLUSION

It is apparent that the Treasury Department is seeking control of all moneys which will subsequently accrue to the benefit of an American citizen regardless of its source, and undoubtedly, the Government wants control of all oversea expenditures that are being made by American capital. Under all of our tax treaties, the U.S. Government has no right to tax the income of foreign corporations except in the case of foreign personal holding companies.

No one disputes the right of the American Government to tax the income of its citizens when it is received. However, this bill would have the effect of placing a constructive receipt approach on all American individuals without any regard to the feelings of foreign stockholders. It would also place a tremendous burden of additional bookkeeping, which would result in additional costs. It would further reduce the competitive position of an American corporation.

At the present time, the U.S. Government has the power under IRC section 482 to allocate income between controlled corporations whether they be domestic or foreign. It would seem that this is sufficient to cover most of the "tax haven" situations from either an import or export angle where earnings are being produced either through sales in the United States or U.S. production facilities.

With regard to "out and out sham corporations," there is plenty of precedent under present court rulings to permit the Government to reach the income of such fictitious corporations. As to other income whose source is primarily in the United States, the matter could be covered by extending the provisions of the Personal Holding Company Act, or through tariff restrictions. This would seem to close the present loopholes affecting income earned primarily in the United States but escaping taxation through a foreign corporate entity. The result of these changes would leave legitimate foreign enterprise to continue its present path of expanding our sphere of influence. It would still permit bona fide foreign residents to maintain their businesses abroad and expand them without the penalty of severe discriminatory U.S. tax laws. It would further permit U.S. residents to expand technological skills and profit from them in foreign lands and still remain competitive.

STATEMENT BY DONALD C. LEVIN, GENERAL COUNSEL, CARGILL, INC., MINNEAPOLIS, MINN.

IMPACT OF CONTROLLED FOREIGN CORPORATION TAX LEGISLATION ON THE U.S. AGRICULTURE ECONOMY

The purpose of this statement is to request that agricultural commodities grown in the United States be exempted from proposed foreign corporation tax legislation.

Approximately $5 billion of U.S. farm products were exported in the past fiscal year, the great majority of which was commercial or "free dollar" sales. It will not be necessary to detail here the importance of those sales to American farm income and to the Nation's balance of payments situation. Of the total export volume in that period, there were 1.18 billion bushels of U.S. grains. Most of the companies handling the largest volumes of grain in world trade are companies of non-U.S. origin or are foreign controlled.

In our opinion it is necessary for U.S.-owned-and-controlled firms, with an American viewpoint, to increase their part in the merchandising of our grain in world markets, particularly in view of the threat posed by policies within our largest customer area, the European Common Market. If foreign owned firms control world trade in farm products, with no primary interest in selling U.S. grain in particular, the United States often will be in a position of a distressed seller. On the contrary, a U.S. owned firm, with investment in facilities to originate U.S. grain, if purely from self interest, will make much more strenuous efforts to promote the sale of U.S. agricultural goods in world markets. The results are larger markets and better prices for U.S. grains, and more important, an improvement in our balance of payments situation.

Cargill's success in this field (by which the company has increased both its U.S. investments and its taxable earnings) began after determination in 1953 that such a business could be conducted only by a substantial and skilled organization based outside the United States. Accordingly, there was organized, separately from Cargill, a foreign corporation called Tradax Internacional,

S.A. (which comes within the defintion of a controlled foreign corporation under the proposed tax bill, H.R. 10650), with principal European operating headquarters in Geneva, Switzerland, and subsidiaries and offices in most of the major customer areas of the world. Cargill has worked closely with Tradax, selling the great majority of its free dollar U.S. exports to it. Cargill's share of the U.S. export business has been earned largely at the expense of the foreign controlled firms and is principally due to the vigorous, competitive, and skillful efforts of the Tradax group.

U.S. grain exports have tripled in 10 years, due in large measure to Department of Agriculture emphasis fostered by Congress. Cargill and Tradax also contributed substantially to this development of increased export volume, particularly in free dollar sales. They have applied American ingenuity, investment, energy, and advanced techniques to increase generally the efficiency of the handling, marketing, and distribution systems, to reduce margins and to make our grains more competitive with those from other countries.

Further, in order to increase volume and efficiency, Cargill has built, purchased or leased export elevators at the following ports: Seattle, Portland, Sacramento, Port Arthur, Baton Rouge, Norfolk, Albany, Baie Comeau (Quebec) (which handles a large volume of U.S. grain shipped via the St. Lawrence Seaway), Toledo, Chicago, Milwaukee, and Duluth-Superior. These facilities are improved continuously and have made it possible to handle the greatly expanded U.S. grain export volume.

As the Tradax companies became seriously competitive in the world grain trade, it became apparent that the nature of the business of world trade in grain, as opposed to the U.S. domestic trade in grain, practically eliminates the possibility of hedging risks in the traditional manner. Therefore, while subsidiary sales and service companies are necessary in its organization, in order to balance total risks it became imperative that one corporate entity as principal in respect to purchase and sale of commodities, foreign exchange dealings, and ocean freight positions was absolutely necessary. Thus, it would be virtually impossible to qualify under the proposed tax legislation by organizing and operating through controlled foreign corporations each organized in a country of destination and thus avoid earning "foreign base company sales income" under the proposed definition.

The experience of Tradax has also made it apparent that, in addition to the need for a substantial organization, trading skill, knowledgeable people in respect to commodities, ocean freight, and foreign exchange, other factors combine to require increasing equity capital or retained earnings. These large amounts of capital are required for taking ownership of the great quantities of the valuable commodities merchandised, for development and improvement of storage, handling, and transportation facilities, and, in order to increase markets for U.S. agricultural commodities, for construction of animal feed and vegetable oil processing plants abroad. These should be located in consuming countries, whether or not classified as "less developed." Without access to earnings or a continuing investment of U.S. equity capital abroad, these needs cannot be met and business cannot endure, let alone increase. Immediate payment of U.S. taxes or other reduction of earnings of an American controlled firm, when its direct competitors suffer no such disadvantage, must force not only retirement from such business but reduction also of earnings of U.S. corporations selling to it.

As to arms-length dealing with such a related foreign firm, there can be no problem of artificial pricing because world trading in grain is noted for the ready determinability of proper prices. Competition in price is so keen and instantaneous, with world prices in fact recognized daily in setting of U.S. export subsidy rates, that profit margins are remarkably small.

Those who take the view that a merchandising organization does not add value to raw materials, as does manufacturing, are mistaken. Value is added consistently and margins are earned for financing, distributing, developing sources of supply, handling facilities and markets for the products, assumption of price and position risks and for supply of services and information.

Finally, the motive for investment (whether U.S. or abroad) is profits for U.S. owners—profits coming either directly from the foreign corporation or through improved earnings for the U.S. corporation doing business with it. Neither will be realized, however, if foreign competitors are given the advantages that would result from the proposed legislation.

We strongly urge, therefore, that if for other reasons it is deemed in the national interest to enact the proposed controlled foreign corporation tax legislation, it is also and equally in the national interest that income from merchandising U.S. origin agricultural products be excepted from the definition of "foreign base company sales income." A special exemption for agricultural products would not represent a congressional change of policy in such matter.

Accordingly, we propose that H.R. 10650, section 13, subsection 952 (subpart F: Income Defined) (e)(2)(A) should be amended to read as follows:

"The property which is purchased is manufactured, produced, grown (excepting agricultural commodities grown in the United States) or extracted outside the country under the laws of which the controlled foreign corporation is created or organized, and".

STATEMENT SUBMITTED BY MR. OTTO L. WALTER, ATTORNEY AT LAW, NEW YORK, N.Y.

The contents of this statement are limited to some of the foreign aspects of H.R. 10650. They are submitted primarily in order to call to the attention of the committee some of the adverse effects and inequities which could result from enactment of the revenue bill of 1962 in its present form.

I do not favor the passage of the legislation in view of its deterrent effect upon the role of U.S. industry in international trade. However, if in the considered judgment of your committee, the bill should be approved, then I hope that some of its particularly unfortunate effects can be corrected before submission to the Senate floor.

ABROGATION OF TREATY PROVISIONS

Section 21 of the bill is intended to give precedence to the new legislation over any treaty provision which it may contravene (see p. 96, H. Rept. No. 1447).

The unilateral abrogation of treaties by act of Congress would be an unfortunate method indeed of canceling obligations which we have undertaken toward other nations. It has been the practice to vary tax treaty terms only through mutual negotiation and agreement with all parties concerned. In this connection, I would refer to the negotiations currently in progress with the Netherlands which are aimed at conforming our income tax treaty with that country to a pending revision of the Netherlands tax law.

The enactment of section 21 could set a very unfortunate precedent for countries which no longer desire to be bound by treaty obligations to follow the simple unilateral route of summary legislation in lieu of the present accepted practice of treaty negotiation. Such a step would considerably reduce the value of the tax treaties as a reliable indicator of the extent to which foreign jurisdictions may tax U.S. citizens.

In addition, section 21 as now drafted would conflict with section 894 which now reads: "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."

In view of the above comments, I strongly recommend that section 21 of H.R. 10650 be deleted.

EQUALITY WITH DOMESTIC CORPORATIONS

In advocating the proposed current taxation of virtually all income of foreign corporations to U.S. shareholders, representatives of the Treasury Department have repeatedly pointed out that they desire only to remove "special preferences" which such foreign corporations presently enjoy (see statement of Hon. Douglas Dillon, Hearings before the Committee on Finance, U.S. Senate on H.R. 10650, pt. 1, p. 102).

It is submitted that, if H.R. 10650 is enacted in its present form, foreign operations will be seriously impeded by considerable tax disadvantages which U.S. shareholders of foreign corporations will experience in relation not only to their foreign competitors, but also as compared to the tax treatment which would be accorded to their subsidiaries if these were incorporated in the United States. Let me hasten to add that local regulations and/or business considerations

brought about by local nationalistic tendencies make it mandatory in many instances, to operate in foreign countries through locally incorporated companies.

Some examples of these potential disadvantages follow:

1. The bill (sec. 13) proposes to tax controlling U.S. shareholders currently on "subpart F income" and "earnings invested in nonqualified property" of their foreign corporations. No provision is made whereunder such income could be offset by losses of foreign sister corporations. Furthermore, the bill does not permit losses of the foreign corporations to offset income of the U.S. shareholders. Neither can such losses be carried back or forward against prior or subsequent years' "subpart F income." Foreign (other than certain Canadian and Mexican) corporations cannot join in consolidated returns (IRC sec. 1504(b)(3)). Moreover the shareholders of a foreign corporation or a domestic corporation which derives more than 80 percent of gross receipts from foreign souces are not eligible to elect under subchapter S to be taxed as a partnership (IRC secs. 1371(b) and 1372(e)(4)).

2. IRC sections 367 and 1491 severely restrict the organization, reorganization, or liquidation of foreign corporations or capital contributions to such corporations, by requiring an advance ruling that the contemplated transaction is "not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes." Requests for such rulings usually delay any contemplated transaction for several months. Often, favorable rulings are denied solely because some possible tax advantage could result from the transaction even though compelling business reasons and/or foreign tax reasons are the major motivating factors. If Congress should remove some of the advantages arising from foreign operations, it would only be reasonable that these disadvantages should also be eliminated.

3. Under section 13 of the bill, a U.S. shareholder could be taxed on current earnings of a foreign corporation even if this corporation is in a cumulative deficit position. (See proposed sec. 952(a)(3).) It would not appear reasonable to tax current earnings of a corporation which cannot be paid out as dividends, in view of the lack of surplus.

4. The provisions of section 13 of the bill which would subject "earnings invested in nonqualified property" to current taxation (proposed sec. 951(a)(1)(B).) bear a close resemblance to the accumulated earnings tax provisions contained in IRC sections 531-537. However, in view of the failure to include in section 953(b) an exempt amount such as the $100,000 accumulated earnings credit under IRC section 535(e)(3), constant disputes would develop between taxpayers and the Commissioner with respect to amounts which are "ordinary and necessary for the active conduct of a qualified trade or business."

On the basis of the foregoing, it is recommended that if it is deemed necessary to enact H.R. 10650, the bill should be amended as follows:

(*a*) To allow foreign corporations to join in consolidated returns with U.S. parent companies.

(*b*) To allow shareholders of foreign corporations and U.S. corporations with a large percentage of foreign income to elect to be taxed as a partnership under subchapter S.

(*c*) To allow losses of foreign corporations to be carried back or forward to be applied against subpart F income.

(*d*) To limit the amount which can be taxed under subpart F to an amount not to exceed accumulated as well as current earnings and profits (as provided in proposed section 952(a)(2)).

(*e*) To allow an exemption of $100,000 prior to subjecting "earnings invested in nonqualified property" to tax under proposed code section 951(a)(1)(B).

(*f*) To repeal IRC section 367 and to amend section 1491 so as to preclude its application to transfers to foreign corporations.

AMERICAN RADIATOR & STANDARD SANITARY CORP.,
New York, N.Y., April 24, 1962.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
Senate Office Building, Washington, D.C.

DEAR SENATOR BYRD: We are a corporation carrying on extensive manufacturing operations both in the United States and in a number of foreign countries. As such, we would be affected by certain provisions of H.R. 10650 now pending before your committee. We would like to comment particularly on the provisions of the bill concerning the investment credit and on certain aspects of it that affect the taxation of foreign source income.

INVESTMENT CREDIT

In order to stimulate investment in capacity expansion and modernization, and thereby provide essential economic growth, section 2 of the bill would allow a tax credit for investments in most tangible personal property and for certain real property, other than buildings and structural components thereof, if the property is used directly in manufacturing, production, transportation, and certain other uses.

This investment credit is independent of the depreciation reform which we feel is long overdue. To the extent that the proposed credit tends to be in lieu of that reform or otherwise contributes to a postponement of the Treasury's announced program for such reform, we oppose it.

Beyond this observation, our principal comment is that the investment incentive is discriminatory because of its limited scope. It should be expanded to apply also to new investments in real property, held for productive use or for investment. This would include not only factory buildings, but also hotels, motels, apartment houses, office buildings, and real estate developments.

Why are those things which house and make production equipment useful excluded from credit. The buildings in which such equipment is installed and the "structural components" of those buildings, which include the plumbing, heating, and air-conditioning products we make, are every bit as necessary as production machinery to a growing economy. Without shelter, and in most cases, without heating or cooling, production machinery has little or no usefulness. So we fail to see any wisdom, let alone justice, in this exclusion.

Not only would the products that we manufacture be ineligible for the credit in the hands of our customers, but there is an additional discrimination in the sense that our own manufacturing facilities, on balance, carry estimated useful lives considerably in excess of the 8 years required for full credit. An investor in assets having lives of 8 to 10 years, for example, will, under the bill as presently drawn, consistently obtain larger investment credits than the investor in facilities of lives substantially more than 8 years. The effect of the provision, therefore, is to favor industries which by their nature utilize shorter-lived assets at the expense of industries whose facilities do not wear out as fast.

FOREIGN SOURCE INCOME

Money earned by American companies in foreign countries is justly subject to equitable taxation by the U.S. Government. Since operations are carried on abroad by American companies in different forms and under varying conditions, however, identical tax treatment is not always equal tax treatment. It is important, therefore, that policies be devised to assure that the end result of taxation is equitable and that it does not impair the ability of American companies to compete with foreign-controlled companies.

With this belief, and with the experience of nearly 60 years of successful foreign operations behind us, we offer the following comments:

Gross-up of foreign dividends

We think the proposal is unwise because, in our opinion, it will not achieve tax neutrality, but will widen the existing tax inequalities between the foreign branch versus the foreign subsidiary form of organization; and because it will create numerous detrimental side effects.

The treatment of a foreign branch of a U.S. corporation under our taxing laws is far different from the treatment of a foreign subsidiary of a U.S. corporation. Three of the principal differences are that, in the case of a branch, (1) losses are immediately recognized, (2) gains or loses resulting from foreign exchange are immediately recognized, and (3) the many elections for treatment of specific items, which the Internal Revenue Code provides, are available to a branch but not to a foreign subsidiary.

In view of these significant differences, it is evident that identical tax treatment cannot be equal tax treatment.

The bill assumes that there is a free choice between the two forms of organization. With the increasing trend toward foreign participation in U.S.-controlled enterprise, the corporate form is, in many instances, the only feasible way to organize the operation. This trend receives current impetus from the desire of foreign countries to participate in new enterprises, coupled with the desire of American management to disperse equity holdings to reduce the risks that are inherent in less-stable political climates.

One of the major side effects would be the reduction in tax revenue in instances where the foreign rate is already in excess of the U.S. rate and where the excess credit can be used to reduce the U.S. tax on royalty or other foreign income. In such instances, the limitation is increased so that the grossing-up proposal will result in higher credits than under present law.

Even where there is no royalty or other income, gross-up could reduce taxes where there are a number of foreign corporations involved, some of which are subject to income taxes at rates lower than the U.S. rate, while others are taxed at rates in excess thereof. Where the foreign tax rate exceeds the U.S. rate, the mechanical effect of gross-up is to increase the amount of taxes that otherwise are creditable, were it not for the limitation. Under the overall limitation, these can be used as offsets to countries where the foreign rate is less than that of the United States.

There are a number of other side effects which may or may not have been considered by Congress. These are largely technical in nature, and in general, arise as a result of the mechanical change proposed by H.R. 10650 which increases gross income by the amount of the foreign tax. Generally speaking, there is an effect in every instance where gross income is employed as a measure, or as a limitation within the Internal Revenue Code. Among the more obvious examples are its effect on earnings and profits, loss carryovers, deduction limitations such as charitable contributions, for examp'e, and definition limitations as in the case of Western Hemisphere trade corporations and personal holding companies.

Taxation of controlled foreign corporations

Section 13 of H.R. 10650 contains a series of highly elaborate and complex provisions which are designed to correct "abuses" with respect to controlled foreign corporations. Our objection to these proposals is that they would impose various restraints upon legitimate private enterprise abroad, since they would apply to all foreign operations, whether "tax haven" or not.

The bill requires a high degree of analysis of income in order to ascertain what portions constitute tax haven income as it is defined in the bill. It also entails a balance sheet analysis designed to trace the disposition of earnings and profits into "qualified" property as distinguished from "nonqualified" property.

Where tax haven income exists, it will be subject to immediate U.S. tax to the extent that it is not invested in less developed countries. Even where tax haven income does not exist, the foreign corporation will still have to account for any increase in earnings and profits realized during the year either by investing them in its trade or business or by investing them in a less developed country. The combination of income statement-balance sheet analysis that is required by these provisions will subject the foreign subsidiary of a U.S. company to restrictions and recordkeeping requirements that its foreign-controlled competitors will not have.

If abuses in this area exist, we believe the Commissioner already has extensive administrative powers to deal adequately with them. Present section 269 of the 1954 code grants him powers to distribute, apportion, or allocate gross income in the case of acquisitions made to evade or avoid income taxes. Section 367 permits him to recognize gains (but still continue to treat losses as nonrecognizable) in transactions involving foreign corporations which, except

for this section, might otherwise fall within the several nonrecognition provisions of the code. Finally, section 482 affords him power to distribute, apportion, or allocate gross income, deductions, credits, or allowances between controlled organizations whether or not incorporated, whether or not organized in the United States, and whether or not affiliated.

These provisions or their counterparts have been part of the income tax law for many years. In addition, section 6038 of the 1954 code, which became effective with respect to annual accounting periods beginning after December 31, 1960, requires detailed information with respect to controlled foreign corporations which should facilitate identification of abuses in particular circumstances.

Modern business is extremely fluid and in any alert company, the management is constantly reviewing investment and marketing opportunities. These may not necessarily be readily identifiable with its particular product line, nor are they always found in a market characterized as being in a less developed country. As a matter of fact, they are most often found in a country that has already reached a degree of economic maturity. If American-owned enterprise is to be hampered in the search for and investment in new opportunities vis-a-vis its foreign-controlled competitors, the readily predictable outcome is that American-owned enterprise will in such circumstances have to yield.

It seems to us that the proposals covering controlled foreign corporations would surely serve as a series of harassments to American-owned foreign enterprise, and could cause us to suffer in our competitive position abroad.

The foreign subsidiaries of American-Standard are staffed completely with nationals of the country in which the subsidiary is located, a policy of long standing with us. Our experience with these foreign associates of ours and with other nationals of countries where we have companies convinces us that these foreign countries would consider some of these provisions as unwarranted meddling by the United States in their own internal affairs—and we find this argument of theirs impossible to refute.

We trust that your committee will give the above presented points the most serious consideration.

Sincerely yours,

JOSEPH A. GRAZIER.

(Whereupon, at 3:45 p.m., the committee recessed, to reconvene at 10 a.m., Thursday, April 26, 1962.)