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 30, MAY 1 AND 2, 1962

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REVENUE ACT OF 1962

MONDAY, APRIL 30, 1962

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

The committee met, pursuant to recess, at 9:30 a.m., in room 2221, New Senate Office Building, Senator Harry Flood Byrd (chairman) presiding.

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

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. Leon H. Keyserling Conference on Economic Progress.

Mr. Keyserling, will you come forward, sir, and sit down?

STATEMENT OF LEON H. KEYSERLING, FORMER CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS, CONSULTING ECONOMIST AND ATTORNEY, PRESIDENT, CONFERENCE ON ECONOMIC PROGRESS

Mr. KEYSERLING. Mr. Chairman and members of the committee, I have a rather lengthy statement here, but I would like to summarize it in about 10 minutes, if that is agreeable.

The CHAIRMAN. Without objection, your complete statement will be put in the record following your oral presentation.

Mr. KEYSERLING. I have a few charts here which will simplify the summary, and enable me to do it easier in a short period of time.

The CHAIRMAN. That is a good idea. We will insert the entire statement in the record after your testimony. You may summarize it.

Mr. KEYSERLING. Yes, sir. I might, in order to make it easier to follow the oral presentation, read the second paragraph of my prepared statement, which relates only to the tax credit proposal, which I regard as the most important from the economic point of view of the provisions in this bill.

It seems to me a provision which business does not seek, labor does not want, the condition of the Federal Budget does not justify, the state of the national economy does not call for, the full consequences of which the public does not appreciate, and which even those economists who favor it have not been able to support with careful or specific empirical analysis. The proposal cannot stand the test of logic; it should not survive the lessons of experience.

The CHAIRMAN. The Chair wants to congratulate you on that statement. We have differed in the past, as you know, but we are in thorough accord in the statement you have just made.

Mr. KEYSERLING. The Senator is very kind, and I know I have not been in accord in the past with the chairman on all matters.

First of all, the reason this tax credit proposal is advanced is to advance the growth of the economy and stabilize that growth.

The members of this committee will recall that in early 1954 I was before the committee, at a time when everyone was very happy about the progress of the recovery from the 1953–54 economic recession, and I, at that time, warned the committee that the American economy was facing a long period of frequent recessions, very low economic growth, and what I called chronically rising unemployment of plant and manpower.

Unfortunately, that has come to pass and, as this first chart indicates, our economy has been afflicted since 1953 by a constant succession of very short-lived booms, stagnation periods, economic downturns, and economic upturns, which have given us an average rate of growth of 2.5 percent.

This average has been so low compared with the historic average and, more importantly, compared with our new technology, that each recovery has found us with more idle plant and idle manpower, and each downturn has found us with more idle plant and manpower, and I do not think that the current recovery is any better than the previous ones or that we have done anything sufficient about the basic and fundamental situation.

Now, second, I want to say that I am friendly to business investment. I am friendly to the expansion of our plant and our technology. I have never been one of those who believed that we should bury it if we could or that we could bury it if we would, and to illustrate this I want to move over quickly to the next chart, which shows my estimates of the trouble that we have been in during the past 9 years, divided into the main components of the economy which are business investment, public outlays, and private consumption.

The first bar bottom section shows that, according to my own estimates, we have had an average annual deficit of $10 billion in the level of business investments, 1953–61.

In other words, it is my belief that we have had $90 billion too little investment over the last 9 years, 1953–61 inclusive.

Moving quickly to the next chart, and this is merely to establish the foundation that I am for business investment, here is another chart of mine which contains my own estimates of the kind of growth that the American economy needs over the next 2 years in order to grow in a healthy and sustainable fashion. As it appears in the second box at the bottom, I project a needed level of business investment for 1963 of $21 billion above 1961.

The real question, therefore, is not whether sensible men agree as to the need for business investment, but how it can be encouraged, how it can be made more healthy, and now I turn to the next chart, on which I will not linger, which shows that business investment, particularly business investment in producer's durable equipment, has been much more unstable than most other parts of the economy, and this is certainly a difficulty we need to deal with.

It has swung upward and downward very erratically, and very irregularly. This has been very bad for the whole economy. It has been more irregular than the processes of the economy as a whole, and it has been one of the factors in the instability and the low rate of growth.

Turning to the next chart—and here we come to the heart of the matter—we have to ask ourselves, what are the reasons for this?

The school of thought which is now recommending the tax concession bases it upon the assumption that one of the main reasons, one of the conditioning reasons, for the poor performance of business investment is an unfavorable tax treatment. This must be an incontestable statement for if one feels that tax concessions are needed to improve the performance of business investment, then one must think that the current tax climate is unfavorable to business investment, at least in that particular respect.

What I have done here, instead of indulging in the theoretical expositions of economists about how the economy works, is to try to look at what has actually happened, and, therefore, I have selected two basic periods.

I have first selected the period 1954–56, before the recession of 1957–58, which is the biggest recession we have had since World War II, and one from which we have never completely recovered, and second, the period 1958–60, before the most recent economic recession from which we have not yet fully recovered.

What this shows here is something that actually has been rather characteristic of the American economy except in wartime, namely, that whenever we are in a period of advancing prosperity, whenever the pressure of demand—and by demand I mean both consumer spending and public outlays for goods and services—whenever the pressure of demand upon our productive facilities is high enough to keep them not in full use but in reasonably full use, there is a tendency, which I do not criticize, I merely describe—I am not here to pillory business—there is a tendency for plant and equipment to outrun the take, and because it outruns the take, we get so-called excess capacity.

When we get excess capacity, business investment is cut back very, very sharply, and this generates or projects or is the catalytic agent for the next economic recession.

Now, the bottom part of this chart—the top part shows, as I have said, that business investment was too low for the 9-year period as a whole—the bottom part shows how investment expansion in 1954–56 was several times as fast as the expansion of demands for the products which the plant made, and this was also true in 1958–60, and then, when it became clear to the business managers that they suffered from great overcapacity, they cut back very sharply.

I do not blame them or indict them for doing that. Business investment turned down extremely sharply as shown by the two following bars, much more sharply than the other parts of the economy.

The conclusion I draw from this, of course, is that in these two basic periods most relevant to our current experience, there was no inhibiting tax factor, there was no inhibiting budgetary factor, there was no absence of funds. When the markets were there, the businessman invested.

Now, coming to the next chart: Here I have compared for the first of these two periods and then for the second of these two periods the trends in prices, profits, and business investment.

This chart deals with the period before the 1957 downturn. Again I say I am not indicting these price changes, and I am not indicting these profit changes. They are all part of the American system.

All I am saying is that the changes which actually occurred before the downturn were sufficient to generate an extremely avid, in fact, and excessive, boom in business investment relative to demand.

For example, we see, in the case of the steel industry, investment advanced 110 percent.

I have given you the facts across the board for many other types of industries. So we had a very hectic, very fervid investment boom which turned downward when we got to overcapacity.

It happened under the present tax structure. I will come to the matter of tax concessions in a moment.

Now, to the next chart, and I am running through these because I want to say a few things orally, and then there may be some questions.

I have done the same thing for the next period of recovery, before the next period of economic downtown. In this case, actually, the price or profit environment was not as favorable as in 1955–57. Prices and profits were moving slightly downward. Some people were talking about a profit squeeze, but despite that, because demand was there, because the economic climate was favorable, business investment again moved upward, and at an extremely rapid rate. In fact, it was a feverish rate, and again it was most conspicuous in the case of iron and steel, but also appeared in many other types of products.

Again, the investment was dampened, the business investment turned down, only when overcapacity became clear.

It had nothing to do with tax stringency, and it had nothing to do with not enough tax concessions.

Moving now to the next chart: This chart deals with funds available to corporations, and shows one of the striking facts of our economy ever since World War II. Some economists think it is good or bad, I am not going to argue here whether it is good or bad. It is there.

This shows that in 1953–61 the total funds used by corporations have increased. The second portion of the chart shows that the possession——

Senator GORE. Total funds, what did you say?

Mr. KEYSERLING. Have increased. Total use of funds, this is sometimes called cash flow, the total use of funds.

Senator GORE. Total availability or total uses?

Mr. KEYSERLING. Total use.

Senator GORE. For plant improvement?

Mr. KEYSERLING. For all corporate purposes.

Then I show what part of them, Senator, are used for plant improvement. Obviously, they could not be used if they were not available in one way or another.

The second sector shows what percentage of this cash flow or available funds was used for investment in plant and equipment, which is the issue here.

That percentage also rose, from 71 to 76 percent.

The third part shows a very important recent phenomenon of the American economy, the increasing tendency to finance from internal sources.

It shows that, taking account of both funds in the form of depreciation and amortization and retained profits and depletion allowances, the total corporate financing out of these sources as distinguished from borrowing has risen from an average of 65.8 percent in 1947–53 to 70.1 percent in 1953–61.

Now, let me just summarize this phase of my testimony, and then I want to bring it entirely up to date by referring to a statement in the April 28, 1962, issue of Business Week.

The chairman and the members of the committee will recall that I was before this committee in early 1957. We were having what was then called a recovery.

We were having what was called an investment boom. The Chairman of the Federal Reserve Board and the Secretary of the Treasury, before this committee in early 1957, shortly before the chairman proposed his extensive investigation of the financial conditions of the United States, said that we needed more plant, we needed more investment, we needed more savings; the level of consumption was too high. We were faced with a great inflationary threat. They used this in justification of the tight money policy. They used this in justification of the amortization schedules and benefits taken out of the Treasury, with which business was then being plied.

Before this committee on the record in early 1957, I said that we were in oversupply on everything; we were moving straight toward an economic recession. We had a deficiency of demand relative to our plant capacity.

The members of this committee asked the proponents of the tax amortization to run around and tell where the shortages were, and this is all on the record, they were able to find only one type of lead type.

Lo and behold, the recession came, and it was the most serious recession since World War II.

Lo and behold, Mr. Martin, Chairman of the Federal Reserve Board, came back to the same committee in 1958 and he said, in substance, that, looking backward, we had an investment boom which was too fervid relative to the demand, and that is why we had a recession.

In other words, this was a complete acceptance of what I had advanced before the committee 1 year earlier.

Let me bring you up to date by referring to this article in Business Week. Let us bring the record entirely up to date by calling your attention to the April 28, 1962, issue of Business Week, which reviews and comments upon the annual McGraw-Hill spring survey of business investment intentions. On page 19, Business Week says:

> When you read the new estimates on industry's capital outlays, be sure to study them in the light of consumer spending. The reason is really too obvious to need stating—

this is Business Week, not LHK—

> industry's need for capital equipment tomorrow is dictated by consumer demand today.

Then Business Week of April 28, 1962, goes on to say, after pointing out that the now-projected level of $38 billion worth of business investment in plant and equipment during 1962 as a whole is even higher than the record spending of 1957, and that planned spending for the same purposes for the 1963–65 stretch runs at a $36 billion annual rate, or more than the actual spending in any 3 years in U.S. history. Business Week also points out that the now estimtaed spending for 1962, capital spending for 1962, falls about $4 billion short of the pace Government economists had hoped would be spent in 1962, and that even the estimated spending for 1963–65 cannot be called a real boom.

With this I agree, but this is the key point Business Week makes, and I would underscore this more than anything else. This is what they say:

Behind this trend—

this trend in capital spending now—

lies the stubborn lag of the spending rate as a percentage of capacity. Most manufacturers today prefer 90 percent. But at the end of 1961 the actual rate was only 83 percent of capacity. In that context—

and I am still quoting—

it is easy to see why industry plans to add nearly 4 percent to capacity this year, with another 10-percent spread over 1963–65. Manufacturers' hopes of getting closer to their preferred rate hinges on an increase in sales.

As the McGraw-Hill survey of business management included the availability of funds, Business Week said this:

Most of them said a startling—

the word is "startling"—

large part of it was coming from their own treasuries.

That is their funds.

Overall, businessmen expect to borrow only 1 percent of their operating requirements this year. Manufacturing companies say that they will do no more borrowing at all. Cash flow among all companies in the survey is expected to be 14 percent above last year—when the expected increase was only 9 percent. Nearly everyone expects profits to be greater this year, so companies plan to retain more earnings, at the same time when funds from depreciation allowances are rising steadily. Steel companies—questioned just before their collision with President Kennedy—expected their cash flow to rise 21 percent this year. The auto industry expects a small increase, a mere 8 percent. The survey indicated that a tax incentive program would do little to increase investment plans this year. Industry as a whole thought there might be a 1-percent increase, but this would add only about $300 million to the present plans.

This, coming from this business magazine, after a survey, reinforces my reason for believing that we are in a situation similar to early 1957, or will be in that situation before this tax proposal could take practical effect, if it were enacted and, therefore, we would, in the enactment of such a proposal, be repeating exactly the errors again which some of us, unavailingly, inveighed in early 1957.

Now I want to say a thing about the recent steel controversy as it bears upon this, which disturbs me very much.

Here we have a situation where the President of the United States used the full powers of the Government to roll back steel prices. Now I have my own views as to whether, from the view of its long-range implications for the American system, this was a wholesome thing to do as it was done. However, I will not discuss that. Every member of the committee will have his own views about that.

All I will say is this: The same administration which rolled back steel prices by marshaling all of the executive powers of the Government in the few hectic hours when it was seeking to justify this, brought forth a wide range of information to the effect that the steel industry had plenty of profits, the steel industry had had no real increases in labor costs since 1958 because of increasing productivity and, therefore, that the steel industry did not need more money.

But as soon as it rolled back the prices to where they had been before, the same administration commenced even more intently to argue for tax incentives in order that the large industrial companies might get out of the Public Treasury the money which they need for investment.

Now I am not arguing in favor of the steel price increase. I think it was not needed. But I do think, if our large American corporations do need money for increased investment, then the price system is the rational, normal American way to allocate our resources, and if we are coming to a situation where every time a Government economist feels that our big, "anemic" corporations like United States Steel and General Motors and Du Pont need more money for investment, then, instead of raising their prices, they should get that money out of the Treasury, in the nature of high and handsome indiscriminate tax handouts, what are we coming to?

What are we coming to if indiscriminate high, wide, and handsome tax subsidies are going to be the way in which, not a weak corporation during wartime, but our strongest corporations during peacetime get the funds with which to carry out our normal investment process?

Now I think we should fish or cut bait. I think, if the Government is going to get into this at all, it should either tell the public that these industries need more money or that they have enough money, either their price structure is high enough to grant them a fair return which American industry is entitled to, or that it is not high enough.

But to say, on the one hand, that it is so high that when they follow the normal business practice of raising their prices because they think they have not got enough income, the Government is going to roll it back, including the use of the FBI, and then the Government is going to turn around and hand them out something in the form of a tax concession, I just cannot understand this.

I am supposed to be a liberal. Some people have called me a radical. I have always really thought I was a conservative, and I think I am. I just do not understand how this squares with any viable concept of the American system over the years ahead.

Let me come to the next main point. The next main point is that we need this tax concession for international reasons. For international reasons we cannot afford higher prices, and for international reasons we have to be more competitive. For international reasons, we have to have a better technology and a better automation and, therefore, industry has to get something more, and since there is not room for them to raise their prices, it is argued that they should get it out of the Public Treasury.

This is quite an aberration in logic and in practical analysis.

To be sure, I am for a higher rate of business investment. I am for our technology growing faster. I am for our productivity growing faster. I have shown on my charts that they grew too slowly during the last 9 years. The question is why?

They grew too slowly because the market processes broke down, not because they were not getting handouts from the Treasury. If we would use a similar amount of public revenue, either to reduce taxes where it would do some good, or to help balance the Federal budget, or to do spending for presumably useful purposes, any one of those avenues would be preferable, at this time, to throwing away over the next 10 years maybe $20 billion in tax revenues or something like that for something business does not want, business does not need, experience has not been called for, equity does not justify, and economic analysis cannot support.

Next, on the foreign thing—excuse me.

Senator GORE. Before you leave that point—excuse me, Mr. Chairman, I do not wish to ask any questions at this point, I wanted some more elaboration of the argument that this investment credit is needed in order to increase our competitiveness in world markets.

Mr. KEYSERLING. I want to elaborate on that right now.

Senator GORE. All right.

Mr. KEYSERLING. My first point is this: We need to be more competitive overseas, we need a more rapidly advancing technology. We need a more rapidly growing productivity, and we need more business investment.

I said at the beginning of my testimony, and I did this deliberately and advisedly, that we should have had $90 billion more of business investment over the last 9 years, and then we would have been more competitive. We would have had more technology, we would have had more productivity. I think we should have a much higher level of business investment, over the next few years, than we are going to get.

But we are not going to get it by repeating the same errors which prevented us from getting it over the last 9 years, because business investment feeds on utilization, and merely to fan once again a fervid investment boom which gets the existing idle plan capacity, how is this in the long run going to provide a healthy climate for business investment? That is the first point.

The second point is that there has been a tremendous exaggeration of this whole international problem, as a scare device for pumping the Congress and the country into approving something that the Treasury has worked out.

Let me illustrate what I mean. I am for the trade program, although I am not prepared to debate it here. I think it will improve our foreign trade position. I think it will improve our balance of payments. I think it is a good step on international political grounds.

But for us to think, for us to think for a second, that even if the trade program were passed immediately, and even if it had optimum results, it would yield more than a $2 or $3 billion annual gain in the performance of the American economy—I do not think there is a single economist who studies this subject in the whole United States who will be found to say that it will add more than $2 or $3 billion a year to our net performance position. I do not think it will add that much.

Now, the Chairman of the Council of Economic Advisers says, and I think it still larger, that we have had recently a $50 billion deficit in our economy. In other words, we are $50 billion short of full production, and we need to grow to take up our labor force and to take up productivity. My own chart indicates that we have to grow another $100 billion to be back to full employment by the end of 1963.

I do not care, Mr. Chairman and members of the committee, that some other economist says $80 billion rather than $100 billion, that is not the point. The only point I am making is that, when you take this $100 billion or $80 billion with respect to the American economic problem, and say that you are going to make a great dent in it with your change in international sales on net balance, whether it be through new technology or in some other way, this is not the tail wagging the dog, this is the flea wagging the elephant.

I am sorry that a great nation, in such trying times, has been so far carried off the road as to be brought into an environment of scare rather than an environment of reason in examining just how much we are going to get from this proposal on the international score.

We are told their machinery is newer than ours. Well, some of it is. But it reminds me sometimes——

Senator GORE. I did not understand that.

Mr. KEYSERLING. We are told our machinery is newer—I mean their machinery is newer than ours and, therefore, that we have to have this tax bonanza.

Well, some of it is. But it reminds me as if I, in my garage, had a Rolls Royce and a Buick, and somebody ran down the street saying that "this little fellow up on the street has acquired a new Ford, his average machinery is younger than yours, you are in an awful fix and you had better go to the Treasury about it."

Of course, steel plants in India are newer than in the United States. India did not dream of a real steel industry until just a few years ago.

Of course, steel plants in Germany and in Japan are newer. They were bombed out a few years ago. On the average they are newer.

If we were bombed out and recovered, ours would be still newer. Of course, some of the plants are newer in Italy, France, and some of the other European countries, because they have lagged so far behind us, because they have really started their industrial development so very much later than we have.

I do not want to have them catch up, but I have been around in those countries. I was in Paris, and I was met by the previous American Ambassador there who wanted to show me some of the French plants, and I certainly am not criticizing the French.

We had to take a long, long drive, and Paris is not a city like Washington. France is a highly centralized country. We had to take a long drive to get to a plant that looked very impressive by American standards.

But in the broad overall, our technology is still ahead. Our plant is still ahead, and I want it to stay ahead, and I want it to get further ahead.

But let us look at the facts as they are, and even granting that we were falling behind, we still have to examine why we have been falling behind, why they have been catching up so fast, and how we can forge ahead of them again, which gets right back again to the central question: What is the right way of stimulating investment in plants and technology?

Do you stimulate it by encouraging another boom moving in the wrong direction, or do you stimulate it the way Business Week wants it stimulated, the way business managers primarily want it stimulated, particularly when they are looking at the facts and not talking from political ideology because businessmen, as well as I and you and everybody, have political ideologies that mix up their economics.

But when the businessman is thinking as a businessman, he says, "I will invest more when my capacity has worked up from 83 to 90 percent."

Now, so much for the foreign thing, if I have answered that at all.

In other words, it has been thrown completely out of joint, and the American people are being led to believe that the poor old United States is being outdone by everybody, and the tax concession will help to get us out of that jam.

Senator GORE. There is one additional point you have not touched. In the name of increasing competitiveness in the international field, vast benefits are proposed across the board, but only a small percentage of production goes into international trade.

Mr. KEYSERLING. This is another example of the flea wagging the elephant.

Senator KERR. Would you just as soon say a gnat wagging the donkey?

Mr. KEYSERLING. I would, Senator. The Senator is correct.

Senator KERR. After all, the elephant is a little passé now.

Mr. KEYSERLING. The Senator has said more in one word than I can say if I had 3 hours rather than 10 minutes, which I have always known, and I thank him for the help. He is absolutely right.

From now on in my lexicon it will be the flea wagging the donkey or the gnat wagging the donkey.

We have a gnat wagging the donkey, and we are asked, in our basic domestic economic policies involving a $550 billion economy, and an investment program of $60 or $70 billion a year, if you take gross private investment, or about half of that if we take plant and equipment, we are asked to neglect the policies which all experience indicates would be helpful and salutary, we are asked to leap over all of the experience that this committee has had before it in 1957 and 1955 and 1953, and we are asked for this tax concession. The donkey has become a little more exuberant, and the gnat has become a little more agitated, but it is still happening.

So we are going to ignore all that experience, on the ground that the tax concession will so speed up our inventiveness and our mechanical genius and our plant and equipment that we will no longer be competed with by the great nations of Western Europe operating through the Common Market, and will no longer be competed with by the upsurging undeveloped countries.

Of course, we will be competed with, and it is just for that very reason that I do not want to shrink from that competition on the peril point of an economic monstrosity. I want to move ahead with handling that competition in an intelligent way by doing the things that will make the American economy stronger, more competitive, more investive, more technological, more productive, grow at a higher rate, and use our resources more fully.

All the other arguments really boil down to the same proposition. It is argued that, if we have a higher level of business investment, we will have a higher ratio of investment to the size of our economy, and if we have a higher ratio of investment relative to the size of the economy, we will grow faster.

Well, point 1, as I have already said, you won't have a higher investment, relative to the size of your economy. You will have a smaller investment, because you will merely repeat what happened during the last 9 years, which turned investment down more than anything else because it is the most volatile sector.

Let us examine the argument itself. It is just like saying, because red blood corpuscles make a man strong, that if he has nothing but red blood corpuscles, he will be as strong as Hercules.

If he has nothing but red blood corpuscles, he will die.

The problem is, What is the ratio of the red blood corpuscles to the white blood corpuscles, to the whole man, which will keep him strong?

So merely to say that investment creates technology, and technology creates productivity, and that, if you will raise the investment ratio, you will be stronger and grow faster—why not raise it to 70 or 100 percent, and have nothing but investment, and then you will be stronger than Hercules? But all the plants will be idle.

The question is, What is the right ratio? How do the proponents of a tax proposal justify the right ratio?

First of all, they look overseas. Everybody likes to look overseas now, and they say, "Why, in Japan the ratio of investment to the total economy was 40 percent."

Sure. But that is not sustainable. It is not going to be 40 percent when Japan is rebuilt. If we were bombed out and rebuilt our ratio would be 40 percent, too, until we got rebuilt.

So it is nonsense to make that kind of comparison.

And then they say, "Look what the ratio is in Western Europe." Well, there are the same defects in the comparison, for various reasons, and what they forget is this: What they forget is that the rate of economic growth which you want and the rate of productive increase which you want has nothing to do with the question of the ratio of investment to the size of the economy, because the ratio of investment to the size of the economy has to be determined by how many units of additional production you get for every unit of investment.

To state it very simply: If you have 10 percent more output, you have to have 10 percent more demand; and if 10 percent more investment creates 12 percent more output or 8 percent more output, which is a technological question having to do with the productivity of capital, then you have to maintain the balance.

When we say that, if we want more growth, we need a higher rate of investment and a higher rate of technology advance, it simply means that, if we want the economy to grow 8 percent a year under forced pressures, rather than 4 or 5 percent a year under normal pressures, then we have to have for an 8 percent growth rate a higher level of investment and demand, but they still have to be in balance.

Even during wartime, when we put on forced pressures to expand investment, investment still had to be in balance with the tremendous take for armaments and other purposes.

So you still have the question of balance. I say, without fear of challenge, that not a single economist in the Government, not a single economist from outside the Government, who has come forward with this argument that if you want a higher rate of growth we need more investment relative to the other parts of the economy, has brought forth any analysis, has brought forth a single factor or figure, has brought forth a single examination of the economy in action, to support this conclusion. They have merely said it must be so because "we say it is so."

Now, the rate of investment relative to the size of the economy may not have been big enough during the past 9 years as a whole. Maybe it has not averaged high enough, because of the downturns.

But there is no respectable analysis supporting the proposition, advanced by the Council of Economic Advisers and others without factual or empirical analysis, that we should go back, they say, to the ratio of investment immediately after World War II.

I think one of the Senators on this committee pointed out the difficulty with that. We were then engaged in a hectic restocking, reinvestment boom because of a long delay in investment during the depression and during World War II.

It was not a sustainable rate. It was the right rate for 1946–48. It has nothing to do with today, and probably it was too high even then, because in 1949 we got into a rather sharp economic downturn because of overcapacity.

Now, it really worries me—it really worries me when on such important issues of national economic policy we hear these arguments.

I think I really have boiled down what I have to say. This is not an issue of whether we believe in investment; this is not an issue of whether we believe in technology or in productivity; this is not an issue of whether we have grown too fast or too slow.

For heaven's sake, nobody has talked more about the fact that we have gone too slow than I have. And if we go faster, investments have to go faster; and if we go faster, productivity and technology have to grow faster. But then we have to get into a reasonable analysis of how the economy works; and if demand were pressing very heavily on supply, if we were suffering from inflationary prospects arising out of that, if we had difficulties arising out of shortage of capacity relative to demand—then we would want by an articulate and costly policy to shift more of our national resources toward production. But that is not the problem.

Let me point out one other thing, if I may, if I am not going too far.

We hear that we have been in trouble during the last 9 years because of the low rate of productivity growth and the low rate of technology growth.

This is incorrect. If productivity and technology during the last 9 years had been growing compatible with the 2½-percent economic growth rate, we would have had a 2½-percent growth rate, but we would not have had chronic idleness increasing at a staggering rate; we would not have had it because the 2.5-percent growth rate, the 2.5-percent rate of economic growth, would have absorbed the productivity rate. The very reason we have the rising idleness of plant and manpower is that the growing productivity and technology have grown faster than utilization.

On top of that, not only have the productivity and technology grown faster than utilization, but the productivity and technology in a technological sense have grown faster than the figures show, and

I will take a very simple illustration. If you have a steel industry operating at 60 percent of capacity and you employ 75 percent of the labor force for humane reasons or because the unions are strong, whatever the reasons may be, I am not criticizing it, and you divide the 75 percent hours of labor input into the 60 percent of production output, you get a low productivity figure. But this has nothing to do with technology; it has nothing to do with plant; it has nothing to do with equipment.

It is slack use, and the low figures on productivity and technology over the last few years have been mostly a matter of low use and not a matter of investment, and, furthermore, if we had maintained demand more in line with capacity there would have been more investment and there would have been more plant and equipment, so both the technological productivity and economic productivity would have grown faster—and the same as to the labor force.

We are now confronted with the amazing fact that the labor force has not grown at all in the past year. Why? Because instead of counting employment, we are changing the unemployed into the people not looking for jobs. In other words, the labor force grows slower when you do not have full utilization, and productivity grows slower when you do not have full utilization, and I have a chart here which shows in the American economy over a period of 50 years that our productivity and our technology have constantly accelerated whenever we were near to full use.

Those bars show, whenever we have been near to reasonably full use, the genius of the American economy has generated an accelerating rate of productivity growth, and the productivity growth has declined only when we got into a period of economic slack because of all the inhibiting factors.

Walter Heller, the chairman of the Council of Economic Advisers, said a few days ago publicly that he was terribly worried because it now appears in this economic boom, productivity and technology are growing much faster than he thought they were going to, and it seems to be permanent.

I will tell him right now this is permanent, and this is our real problem, and the very reason adduced for the tax amortization plan a year ago was an assumption as to the rate of productivity growth, which I challenged then and which has already been refuted by the figures since then.

So I think this disposes of the idea that our problem is basically technology and productivity.

When you get full use—when you get full use your productivity and technology will start to grow faster, and if you are still not satisfied at the rate at which they are growing, then you will say, "We will adopt measures to make them grow still faster," but then you will have to adopt measures to make the other parts of the economy grow still faster, so you are in balance.

But it just does not make sense when every economist inside and outside the Government, when every financial observer, when the administration itself, is saying that we are so far from full utilization, and we do not know whether we will get there, to put the flea before the donkey and say, "We are going to start now to aggravate the very problem which is troubling us." Let us deal with the technological

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problem when it arises again, and it will arise again when American investors show a disinclination to invest as much as they think on the basis of rational analysis, and that is not the problem now. Business Week says it is not the problem now. I do not always quote them, but I do not know any better source of what cash flow is, of what available reserves are, of why businessmen are holding back, than what McGraw-Hill says.

Thank you very much. I have expressed myself a little vigorously on this. I have always done this before this committee.

I think the committee has usually found that I try to be fair, and sometimes found I was not even too wrong as to what was happening in the American economy.

I hope that will be the case again, and I think you can make an enormously courageous contribution to the real economic problems of America, and our real competitive position overseas, if you will reject a proposal which has neither reason nor experience nor judgment to back it up.

Thank you very much.

The CHAIRMAN. Thank you, Mr. Keyserling. You have stated that you have appeared many times before the committee. I have been a member of the committee for 29 years, and I think you have made the most powerful speech this morning against a specific proposal that I have ever heard you make and that is with respect to this investment credit.

You referred to the fact that it would cost $20 billion in 10 years, but you did not include the buildings.

If this is a logical procedure, it will naturally have to be applied to buildings, because some plants cannot be modernized unless you modernize the buildings, too.

The first proposal, as you know, last year, included buildings, and that would vastly increase the cost; am I correct about that?

Mr. KEYSERLING. I agree with the Senator completely. This proposal is so poorly thought through, it does all kinds of things like that. But I did not refer to that, because I think it is so wrong in principle.

When I say we would lose $20 billion over 10 years, this is a guess. I mean it may be $16 billion, it may be $20 billion, it may be $22 billion, but I do not think that is too important because if the thing is wrong in principle, if it has no meritorious features, if it is not going to do us any good, the condition of the Federal budget and the condition of the country cannot stand throwing away these many billions over 10 years.

The CHAIRMAN. Well, the point I want to make is when you start on one of these projects it does not stop. It continues, and if we want to be logical about it, you ought to include the buildings, too.

Mr. KEYSERLING. I think this is entirely true, Mr. Chairman.

The CHAIRMAN. That is what you ought to do.

Mr. KEYSERLING. And this brings up another point relative to this: usually, proposals for tax concessions in the form of rapid amortization have come up during what I call an emergency or nonsustainable situation.

In other words, during wartime you fasten onto these proposals, not because you believe they are of permanent value, but because you believe we are in a temporary situation; not because you believe they will lead to a level of business investment relative to the size of the economy which is sustainable, but because you believe you are in a short-term period when you believe you need to do something different.

There is no short-term emergency of this kind now. This tax credit is advanced as a permanent proposal. It will cost the economy more and more unless Congress repeals it, and it will spread out from one type of fixture to another. As the chairman says, it covers too many fixtures even now.

The CHAIRMAN. Do you agree with the chairman that if this proposal should be adopted, a year from now or 2 years from now an effort will be made to include buildings, because the advocates will claim that it cannot be successful unless you have buildings and equipment, too?

Mr. KEYSERLING. It is one——

The CHAIRMAN. It is perfectly logical, it seems to me, if you want to modernize by Government stimulation, you have got to do it with buildings as well as with equipment.

Mr. KEYSERLING. I agree with the chairman. It is one of the foibles of human nature and, particularly, of people in the Government, and I was in the Government for 20 years, when something they advocate does not work, they always say it does not work because it was not tried hard enough, and they will do that with this.

The CHAIRMAN. I think another point that should be understood is that in all likelihood this $1.4 billion this year, we are certain that is going to be paid by increased debt because we have not balanced the budget, and we are not going to balance the budget this year.

Mr. KEYSERLING. I agree with the chairman 100 percent on this. I have disagreed with him at times as to whether a Federal deficit for some purposes may be desirable. But I certainly am not in favor of a Federal deficit that is large per se. I do not favor it for its own sake.

The CHAIRMAN. You do not favor a deficit for some expenditure that is not going to be helpful.

Mr. KEYSERLING. I do not favor a deficit for some expenditure that is going to be hurtful. This expenditure is positively going to be hurtful.

The CHAIRMAN. And it is going to add $1.4 billion to the debt each year.

Mr. KEYSERLING. There is no question that it will add huge amounts; I cannot guarantee precise estimates.

The CHAIRMAN. We only have balanced the budget 6 times in 31 years.

Mr. KEYSERLING. There is absolutely no question about this.

The CHAIRMAN. I do not see any prospect of balancing it in the future.

Mr. KEYSERLING. I do not think anybody seriously——

The CHAIRMAN. So I do not think we should do anything, and I agree with you that this is something which is not beneficial and adding to the public debt.

Mr. KEYSERLING. We are making a recurring, expanding addition to the public debt, which would be justified only where the economic positive purpose is so clear that the interests of the economy outweigh the interests of public finance.

Here we are making a large and expanding increase of the public debt where the interests of the economy and the interests of public finance coincide in the direction of not doing it, gentlemen.

There is no question about that, in my mind. Furthermore, if the economic situation required stimuli—and I am not here before this committee to argue whether it does, that is a separate question, that issue really is not before this committee—if it did, I could make a quick listing of 10 ways of either reducing taxes which temporarily would add to the national debt, or increasing expenditures which would temporarily add to the national debt which, I venture to say, would be much better than this way.

Public policy is always a matter of marginal choice among alternatives, and to see how hard pressed the proponents of this measure are for a valid argument, some of them have come forward and said, "well, look, there are or were other provisions in this bill which offset the Treasury loss."

Well, since when is plugging a loophole an argument for creating another loophole?

Since when is doing something right in fiscal policy an argument for doing something wrong?

It is not a case of one balancing the other in an economic sense or one neutralizing the other in a fiscal sense. It is a case of saying we did some things before which were wrong, and now we propose something which is a much bigger mistake than what we did before.

I do not understand how this argument can be made. Even if we did not close these loopholes, there would be other loopholes to close, and we would still be facing a deficit situation, and there still would be problems of the right tax policy.

What argument is this? I do not understand this.

The CHAIRMAN. Did you say, did the chairman understand you to say, this was a subsidy?

Mr. KEYSERLING. Of course, it is a subsidy.

The CHAIRMAN. There has been some argument before this committee as to whether or not it is a subsidy. I agree with you it is a subsidy.

Mr. KEYSERLING. I do not know the format of that particular argument, Mr. Chairman, and whether something is or is not a subsidy may be, in part, a matter of semantics.

All I mean is that a public choice is being made to add——

The CHAIRMAN. I may say that nearly every witness who has come before this committee has regarded this as a subsidy of public funds.

Mr. KEYSERLING. I am willing to say it is a subsidy, but I do not know whether I would disagree with the argument that some people have made that it is not a subsidy. Whether or not it is a subsidy, it is the use of public policy to swell the income, to swell the fund receipts of certain recipients beyond what they get in the marketplace. I think that is a fairly good definition of a subsidy.

The CHAIRMAN. Is it not a fact that it is inconsequential what we call it, whether we call it a subsidy or whether we call it a grant or a bonus or whether we call it a gift. The fact is that we are taking $1.4 billion of the taxpayers' money and diverting it for a purpose—as you say, and I agree—is not going to be helpful and will only apply to a small percentage of the business activity in the country.

Mr. KEYSERLING. I think, Senator, your argument is absolutely unanswerable, and that is what I was saying, I do not care what you call it.

The CHAIRMAN. How can you stimulate business by giving a $600 or $700 million windfall, as I understand it, for the last 6 months, when the law was not enacted and, therefore, the investments made during that time were not stimulated by the thought that they would get a rebate.

Mr. KEYSERLING. Senator, I am not sure I can agree with your argument completely on that, but to express my own views perfectly fairly: if you start with assuming that a businessman needs more funds to invest more in the future, it does not matter what excuse you use for giving him those funds.

If I thought that American business really needed the additional funds which this tax concession would give them, it would not really matter too much in an economic sense whether you hooked the excuse to what happened a year ago or 10 years ago.

The CHAIRMAN. I do not think you understood the chairman. I stated that you cannot stimulate, give an incentive to do a certain thing retroactively.

Mr. KEYSERLING. That is correct.

The CHAIRMAN. This subsidy starts the 1st of January, last January.

I do not see how industries which have already spent the money can be influenced by a bill which has not been passed.

The Secretary of the Treasury said they may have been influenced because the administration recommended it.

I hope the time has not come in this country when the administration can make their recommendation and the people accept it on the assumption that Congress is going to approve it.

Mr. KEYSERLING. I agree with you, Senator Byrd.

The CHAIRMAN. Because, after all, the money cannot be appropriated until Congress does so.

Mr. KEYSERLING. I agree with you on that, Mr. Chairman, and I agree the fact that this is made retroactive when it is so dubious on other grounds, enhances and enlarges the enormity of the extent to which this proposal has not really been thought through.

It is not only wrong as to the future, it has been made wrong as to the past.

It is not only wrong in principle, it is wrong because it covers a wide variety of beneficiaries, in terms of investments, so I agree with all you say.

The only point I was making was that, while the fact that the Treasury pays these businessmen money for something that has happened since January 1, cannot induce anything between January 1 and now; it can induce something between now and later on.

The CHAIRMAN. As a general rule, and I have been, as I say, a long time on the committee, the Treasury has been very much opposed to retroactive action on taxes. There may have been a few exceptions.

But, as a rule, if the Congress wants to enact a law to be retroactive with respect to taxes, the Treasury comes in and opposes it; isn't that correct?

Mr. KEYSERLING. That is correct.

Senator, I would say that since I agree so much with you on your general position on this particular measure, I would not cavil about the point that, generally speaking, unless there is a very strong reason for it, retroactive tax concessions are bad.

In this case I certainly would think it is bad because all of it is bad, and this makes it worse.

The CHAIRMAN. This is just a little worse than the other; isn't that right? The retroactive feature is just a little worse than the other because it does not accomplish what the administration is trying to do because you cannot have an incentive to do something on a retroactive basis when you actually have not passed the legislation.

Mr. KEYSERLING. That is correct, and this will not operate as an incentive, even on a forward basis, for the reasons I have given.

If it should operate as an incentive on a forward basis——

The CHAIRMAN. In other words, your general thought is this is so bad it could not be any worse.

Mr. KEYSERLING. I believe it could be worse. [Laughter.]

The CHAIRMAN. All right.

Senator Kerr.

Senator KERR. I have always thought, Mr. Chairman, that the Senator from Oklahoma is more or less in the middle of the road because he is halfway between the philosophy of the Senator from Virginia and the distinguished witness on the stand.

Now, their appearance in the identical position here does not leave him in any state of confusion as to what the issue is, but it is compelling him to reevaluate his cost here with reference to the ideology of the chairman and the witness. [Laughter.]

The CHAIRMAN. If the chairman may be permitted to say so, this is one matter where the chairman agrees with the witness, and there are some other matters, too. But it does not mean that there is a general coalition between the witness and the chairman. I am limited to this one item at the present time. [Laughter.]

Senator KERR. Well, now, if I were the chairman and going to get into the boat with the witness, I would not start in by endangering the coalition by indicating that it was one of expediency and of limited duration, but that is up to the chairman. [Laughter.]

I was only observing that this development does illustrate the fact that a man, in the development of his political philosophy, had better be guided by what he thinks is best for his country and not persuaded to a conclusion because it might be advocated by someone in whom he has great confidence and for whom he has great respect.

The CHAIRMAN. If the chairman may be permitted to say so I have gotten great respect for Mr. Keyserling. I have known him for a long time. I have not agreed with him in all things, but I welcome him in the position he has taken on this very vital matter because it is way beyond, as he has stated very forcibly, it is way beyond $1.4 billion a year.

We are establishing something here we will not see the end of. It is going to grow and grow, and I think it is entirely contrary to the system of competitive enterprise we have in this country, and I am glad that a man who has stood out for many things that were not popular through the years, as you have done, recognizes that situation, and who has made this powerful argument in opposition to this recommendation of the administration.

Mr. KEYSERLING. I can assure you, Mr. Chairman, that I have never done anything less popular with my friends than I am doing now, and I regret it very much.

But I do not believe—and on this I agree with much of what Senator Kerr has said—I do not believe that either considerations of party or politics or of friendship or of ease should interfere with what one says on these vital issues.

The CHAIRMAN. I say further that while I make no commitments, I hope in our future relationships they will be as harmonious. [Laughter.]

Senator GORE. He saved himself now, Senator.

Senator KERR. He added a saving clause there. [Laughter.]

The CHAIRMAN. As to what occurs. I have not made any commitment. Senator Kerr usually takes part in what occurs.

Senator KERR. I gathered from the statement of my good friend from Virginia, Mr. Witness, that any time you agree with his philosophy he will march shoulder to shoulder with you.

A distinguished predecessor of his once said that he would march shoulder to shoulder with anyone who sought the same objectives he did. His name was Jefferson.

The CHAIRMAN. I thank the Senator.

Senator KERR. There was one statement the witness made I wanted to be sure I understood.

Did I understand you to say that the economists, in discussing this said that the result of it, insofar as the balance of payments is concerned, would not increase the net more than $2 or $3 billion per year?

Mr. KEYSERLING. I said, Senator, that I have not been able to find any economist who would take the position that over the next 2 or 3 years the surplus in our trade account would be increased by more than $2 or $3 billion either by virtue of this particular proposal or without this proposal; yes, sir; I did say that.

Senator KERR. I thought you said the net. I think you did use the term "the net."

Mr. KEYSERLING. Yes, sir.

Senator KERR. I would presume that you mean the same thing when you say the surplus.

Mr. KEYSERLING. Well, let me illustrate what I mean. Let us suppose that the surplus on our goods and services account——

Senator KERR. Well, our balance of payments position depends upon the net.

Mr. KEYSERLING. But, Senator, our balance-of-payments position involves many other things beside competition in the relative cost of producing goods and services. I will come to that.

I am not in any way trying to avoid the question, but merely to clarify my position. I am saying that one of the arguments advanced for this proposal is that we are in a competitive position with other parties of the world in the efficiency—cost of producing and selling goods and services.

Now, last year—of course, I think that is being exaggerated. Last year, the surplus or the net, I don't care which term you use——

Senator KERR. Well, you used the term. I was only using the one you used.

Mr. KEYSERLING. All right, sir, I used it.

The net or surplus on our goods and services account, let us say, last year was $4 to $5 billion plus on our side.

What I am saying is that I do not believe that any economist would claim that either by virtue of this proposal or by virtue of the successful operation of the foreign trade program, if immediately enacted, that there was the outside prospect that this net or surplus favorable quantitative position on the goods and services account which was $4 to $5 billion last year, might be more than $6 to $8 billion next year or the year following.

Then I say, if this differential was only going to be $2 or $3 billion, it was the gnat wagging the donkey to regard this as a very important determinant of the problem of what we need to do about an American economy that needs to have a $100 billion advancement in its overall economic productive position over the next 2 years to get back to reasonably full employment. That is all I mean.

Now, when you come over to balance of payments, the balance of payments, of course, is the composite, as the Senator quite correctly says, of the plus and minus on your goods and services account, and the plus and minus on all the other accounts which enter into the balance of payments, including invisible items, investments overseas, and so on and so on.

I also think, if you look at the balance-of-payments position, it would be hard to find an economist who would say that the net change in the overall balance-of-payments position would be affected more than, I will up it here to between $3 and $4 billion or $4 or $5 billion a year—the details are not too important—by this particular congeries of proposals. Even that would not be of great significance, compared to the size of our economic problem, except as you come to the matter of the gold drain, and I think on the matter of the gold drain, we have to take an entirely different approach to it than the conventional approach.

We are going to have to come to some kind of international clearinghouse mechanism, some kind of reconsideration of exchange rates, and so forth.

That involves a lot of questions. All I am saying is that the balance of payments—the administration has caught hold of a balance-of-payments problem, and the gold drain problem, and are using them—not the members of this committee—using them as a rationale for every particular economic program that they happen to bring up at the moment.

Now, the balance-of-payments problem and the gold problem are not really central to the issue of tax policy. It has been made central by a wide variety of distortions, distortions going to how important it is to the American economy, distortions going to how much we have really been challenged by machinery overseas, distortions going to the relative size of our trade picture and our whole economic picture, and so forth and so on.

This misappraisal as to why, if we are in trouble overseas, we are in trouble, which is the most important defect at all, is the only idea I am trying to convey in the use of these qualifications. But I do think the Senator would be hard put, and I did not understand that he was challenging my position, would be hard put to find any economist anywhere who, if he was asked, assuming the enactment of the trade bill, which I must say I favor, its successful application, which I must say I hope for, that it will result over the next few years in a positive gain of more than $2 or $3 or $4 billion a year, and I do not care if somebody says $5 billion, in our net position, and this is so insignificant compared to what is the right kind of American economic policy and American tax policy to pursue in dealing with a $100 billion problem, that I hate to see the gnat wagging the donkey.

This is all I mean by that.

Senator KERR. Now, going back to where I was before I provoked the extended remarks of the witness, if I understood him, he said assuming this bill were enacted, that economists in contemplating its effect indicated their belief that its result on the balance of payments would not be to increase our net in excess of $2 or $3 billion per year.

Mr. KEYSERLING. If I said that, I did not intend to say it. I did not intend to say that other economists had said categorically what I said.

I merely said I think it would be hard to find economists who would challenge or deny what I said, which is a little different.

I did not claim that the proponents of this bill had come before the committee and said what I said, and I do not claim the proponents of this bill have said anywhere that its consequences would be so small. I do not think they would make that confession.

All I say it that, if they were challenged to give their own estimates as to what the consequences would be, their estimates, the estimates of the proponents of the tax credit, would not be much higher than my estimate as an opponent of the tax credit, and this enters into my argument as to whether or not the tax credit is meritorious.

That is all I intended to say.

Senator KERR. The Senator from Oklahoma is of the opinion that if the only result of this provision in the law would be to increase our net a minimum of from $2 to $3 billion a year, it would be most beneficial because it would eliminate the current deficit in our balance of payments, the continuation of which, in the opinion of the Senator from Oklahoma, will create one of the most vexing problems that could confront us. It is one of the most vexing problems which now confronts us, and if this legislation could increase the net or decrease the deficit in the relative prosition of our payments of gold balances, it would be a most wholesome benefit, and very much worth while.

So far as I know, there has been no other proposal brought to the Congress which could accomplish that result with as little dislocation in our foreign relations and disturbance to them as this would.

Senator GORE. Would the Senator from Oklahoma yield?

Senator KERR. Yes; I will yield.

Senator GORE. Was my understanding correct that the Senator understood the witness to refer to improvement of from $2 to $3 billion in net balance of payments?

Senator KERR. That is exactly what the witness said.

Senator GORE. I did not understand it.

Senator KERR. He said he knew of no economist who had claimed that it would increase the net by more than $2 or $3 billion a year. He said his own opinion was that it could not increase more than $4 or $5 billion, and that in relation to the $100 billion problem which confronted our domestic economy, it was like a flea wagging an elephant and, at my suggestion, he changed it to a comparison of a gnat wagging the donkey.

Mr. KEYSERLING. Mr. Chairman, I think I can clarify this in a way which would make me very happy, because it would not bring me into any disagreement either with Senator Kerr or Senator Gore.

Senator KERR. Then you would be a wizard again, which I have often seen you demonstrate before. [Laughter.]

Mr. KEYSERLING. No, sir. I would put it this way: I would distinguish between an argument in the form of a concession and a positive argument.

In other words, my argument was that even if we were to concede, even if I were to assume for the purposes of the argument that this would improve our trade position within the context of our balance-of-payments position, or our balance-of-payments position, by $2 or $3 or $4 billion a year, then I said, by way of a parenthetical remark, that I do not think there was any economist who would claim it would be more than that.

But even if we were to admit this for the sake of the argument, this was not an important enough consideration to justify what I regard as a fundamentally wrong tax position as it impacts upon the American economy.

What I meant by that was this: If I were to concede this were to improve our balance-of-payments position or our trade position by $2 or $3 or $4 billion, I could immediately think of more effective ways of doing this than by a tax proposal which would be so damaging on so many other grounds. This is the first basic half of my argument.

The second basic half of my argument which, in some respects——

Senator GORE. You were talking about the trade bill?

Mr. KEYSERLING. What is that? Senator, I am talking about——

Senator KERR. He is talking about this bill.

Mr. KEYSERLING. I am talking about both bills at this point. I am saying, even if the combination of the trade bill and this tax proposal and all other operative facts were to result in an increase of $2 or $3 or $4 billion annually, either in our trade position or in our overall balance-of-payments position, and then I said parenthetically I did not think anyone could use bigger figures, even then I would argue that this particular tax proposal, if one conceded its marginal benefit in helping to accomplish that purpose, had so many other bad consequences that it would not be worth the cost. This is the basic first half of my argument, Senator.

The basic second half of my argument, which was not implied in the first half, is that I do not believe that if we follow the basic economic philosophy—and here I get to the real point embodied in this tax bill—that we will improve our balance-of-payments position or our trade position, because I think that the main reason for the deterioration in our balance-of-payments position and our trade position is the deteriorating performance of the American economy.

In other words, I think the basic elements in our competition overseas are that we have had a lower rate of growth and a lower rate of investment and a lower rate of improvement in technology than we would have had if we had pursued better economic policies at home.

This was the whole gravamen of my testimony and therefore I think the unfortunate developments in our balance-of-payments position and our gold position and our trade position relatively in recent years have stemmed primarily from the bad performance of the American economy and not primarily from these more technical and classical explanations which the proponents of this tax proposal advance in support of it.

Therefore, I say, if this tax proposal, which seems to me to be an extreme example of the kind of economic errors we have been making over the last 9 years, is enacted, and if in other areas of economic policy we have correlative economic errors which, I believe, are now in process, and if, in consequence, we get the kind of results in our economy that we got before from these kinds of programs, including signally the tax amortization bonanzas, this will continue to hurt our international trade position, our balance-of-trade position, our trade position on our goods and services account, and all other aspects of our international economic situation.

So I hope I have made myself clear, that (*a*) this is a bad economic proposal; (*b*) it will be hurtful to the American economy; (*c*) because it will be hurtful to the American economy, it will be hurtful to our international trade and to our balance-of-payments position; (*d*) even if it helped our balance-of-trade position and our balance-of-payments position at the expense of the national economy, it is again the gnat wagging the donkey for the reasons I have given, and we can find more sensible and rational and enduring ways of improving our balance-of-trade position.

I think this is the nature in which I advance the argument.

Senator KERR. I want to say to the witness that he is aware of the fact that there is no member on this committee who, through the years, has had more respect for him and his opinions than the Senator from Oklahoma.

His arguments here today have been clearly and lucidly presented and effectively presented.

I was only calling attention to the fact, and I reiterate it, that, in the judgment of the Senator from Oklahoma, we have no problem more serious in our national fiscal position than our adverse balance of payments, and it has been one with reference to which the Senator from Oklahoma has been for many years striving to help encourage, help promote, or invoke improvement in, and the Senator from Oklahoma then remarked that if, as a result of this bill, there was a probability that our net position in the balance of payments could be improved from $2 to $3 billion a year, that that would be a very great asset, although the items discussed by the witness as to the bad effects of the bill might be entirely accurate.

Mr. KEYSERLING. May I say one word on the balance of payments, because I have the same high respect for the Senator from Oklahoma, and I want to address myself to the view he urged, not by way of argument but by way of making my view clear.

I think the balance-of-payments problem is one of the most serious problems. I have tried to study it rather carefully over the series of years. The unfavorable balance of payments, of which the gold payments are a part, has not arisen primarily with respect to our trade account.

To some extent, some aspects of the overexaggeration upon the competitive costs of production of goods are overdone, although there is an interrelationship.

If we look at the trade account, and I certainly want America to get as large a share as it can, I think we have been doing about as well as anybody could rationally expect— after all, we came out of World War II as an industrial giant. We had 50 percent of the production of the world, with 6 percent of the population. We had an enormous command over worldwide trade, because the other countries either were decimated or never had been developed.

England had lost an empire. I do not think, frankly, and I hope this won't be misconstrued—I do not think there is any time in the future that we are going to get a much larger share of the trade of the world than we have now. I mean Japan, a little country, a tiny little island, will soon have a population of 100 million, and is much more dependent upon a trade surplus than we are; so is England, so are the Scandinavian countries.

I hope our technology moves ahead very fast, but it cannot move faster than the world average, for they are still far behind. So it is not a trade items problem basically. It is basically a balance-of-payments problem which has arisen outside of the trade element.

How is it outside, and what is it connected with? It arises from the currents, the flow of currents, of those elements in the balance, in the traditional balance-of-payments accounts, other than trade. What are the most important ones for this purpose? Well, first, there is foreign aid, but that is governed by other international economic and political considerations.

Then there are others I want to concentrate attention on. One is the flow of American short-term speculative capital overseas. Second is the flow of American long-term investment capital overseas. Third, there is the withdrawal by foreigners of their capital investments in the United States, both long term and short term.

Now these have been varying a very rapid rate to our disfavor, and this is the central explanation of the unfavorable balance of the payments.

Then I asked myself why has this been happening? I find—I may be wrong—that this has been happening primarily because of the competitive advantage which Western Europe primarily has offered which have caused these flows of capital adverse to the United States.

What are these competitive advantages? Some people say it is the interest rate. I do not think it has been primarily the interest rate. I think it has been primarily that both Americans and Europeans, but especially Europeans, have observed that the European economy is growing steadily at the rate of about 5 or 7 percent a year and offers every prospect of continuing to do so, while we have had four recessions in a short term, and seem on our way to another one.

This seems to me a rather conservative business approach to the problem.

If this is so, and I think it is so, then one sees immediately how my philosophy on this tax credit thing ties in with my philosophy on the balance-of-payments thing; namely, that if this tax credit in its results will repeat the errors which cause the American economy to be so unstable and to have so many recessions and to grow so slowly and to invest so inadequately, and to improve its technology and productivity inadequately, if this tax concession falls in the category of an unwise measure from this point of view, then it will impact unfavorably upon our balance-of-payments position in terms of the analysis that I have made of where our balance-of-payments difficulties have occurred and what the reasons for them are.

In other words, I am saying simply that since America, unlike most countries of the world, is a vast continental economic giant within itself, dependent upon world economic relationships but not to the same extent as England in the past or Japan today, that basically what is good economic policy for the United States domestically is good economic policy for the United States overseas. This is something of a simplification of the proposition, and I am as keenly worried about the balance-of-payments position as the Senator from Oklahoma is.

I think we have got to do something about it. I am afraid we have misappraised, not he or I, but that the proponents of this proposal have misappraised its causes and, therefore, are proposing the wrong remedy.

Senator KERR. I have no further questions.

The CHAIRMAN. Senator Williams?

Senator WILLIAMS. Mr. Keyserling, first, I wish to join the chairman in congratulating you on an excellent statement here this morning. I have heard you appear before this committee many times, and while I have not always been in agreement with you, I have always had respect for your views, but today I think I do find myself in such complete agreement that I am only going to ask you a couple of questions.

First, as I understand your argument, you do not think that the adoption of this investment credit would in any way improve our balance-of-payments situation; is that correct?

Mr. KEYSERLING. I think it would worsen our balance-of-payments position in the sense that being an undesirable American economic policy it would worsen our economic performance, so this, in turn, would worsen our balance-of-payments position.

Senator WILLIAMS. I understand that it is your opinion that the adoption of this investment credit plan would, in effect, be starting an unwarranted subsidy for American industry.

Mr. KEYSERLING. Well, this ties in with your first question. I want to amplify a little my answer to your first question.

The idea that a bad economic policy position would worsen our balance-of-payments position is not new. I, unfortunately, have been in the position, before this committee in 1957 and 1955, of arguing against some of the same things I am arguing against now, and they did worsen our economic position, and the worsening of that economic position did create the very undesirable balance-of-payments position that I am talking about. We were in a wonderful balance-of-payments position until we started hitting a great number of recessions. That is the essence of the problem.

Now as to your second question: Of course, we are not starting something entirely new, because we have had too many of these tax bonanzas already, and that is one of the reasons why I am against it.

But this is new in the sense that this is now the first time that any administration has proposed this kind of thing, so far as I know, as a permanent, rationalized phase of basic American economic and fiscal policy, and not as a temporary improvised response to some peculiar situation.

Therefore, it has much greater implications for the longrun future.

I have not heard the Secretary of the Treasury say, "We are going to try this for a year."

As a matter of fact, one of the things that worries me most is that even while this proposal is being advanced, they are scurrying around in the Treasury to find even worse ways of smearing business with bonanzas that it does not need, with additional amortization proposals at some later time, or do it through the writing of Treasury regulations with or without review by Congress.

Some of these, in detail, may be desirable, I do not know. But the thing, as a whole, the thing as a whole, is costly, wasteful, and hurtful to the economy.

Senator WILLIAMS. Thank you very much, Mr. Keyserling.

I am only going to conclude with just one thought. I appreciate your changing your comparison from the flea wagging the elephant to the gnat wagging the donkey. Thank you. [Laughter.]

Senator KERR. In that regard, if he is going to make a reference he might just as well make reference to something alive as to something which is dead. [Laughter.]

Senator WILLIAMS. The elephant stands as a creature of such strong character and strength that I think it would be alive. [Laughter.]

The CHAIRMAN. Senator Douglas.

Senator DOUGLAS. I regret, Mr. Keyserling, that I was unable to be here to hear your oral presentation. I have read your very able statement, and I am greatly in sympathy with what I take is a major contention, as stated in your memorandum, namely, the main problem of better performance in plant and equipment turns upon successful policies to work down idle plant capacity through the expansion of ultimate demand for the product which the plants produce.

Now, as I say, it ties in very strongly with that argument, and I have advanced it myself on many occasions.

I have produced figures of the type which you produce in the following sentence:

> The percent of plant capacity idle has not in recent years been limited to recessionary periods, although obviously most severe during such periods.

You say—

> the percent of plant capacity idle for the period 1954–61 as a whole was 19.1 percent in the case of iron and steel; 23.1 percent in the cast of nonelectrical machinery, and 16.3 percent in the case of electrical machinery; 13.5 percent in the case of autos, trucks, and parts, and 28.4 percent in the case of other transportation equipment—

and so on, and I have been met with this reply, that the idle capacity is said to be antiquated, inefficient, obsolete, and that to utilize it would mean a very much higher unit production cost and that, therefore, the argument runs, we need new investment not so much to add to the quantity of total capital as to improve the quality and to scrap this relatively inefficient plant and replace it with more efficient plant.

I confess that I have not quite known how to answer this argument. I wonder if you could throw any light on this question.

Mr. KEYSERLING. I think so.

In the first place, this is not the most important phase of my answer, but I think logically it needs to come first.

In the first place, I had never been able to draw as clear a distinction between investment for modernization and investment for expansion as I have heard some economists state.

Of course, both of this is new investment—I will come to this matter of your idle plant capacity—but I just want to say parenthetically that, insofar as the exponents of the tax credit proposal say this is not for expansion of capacity, this is for modernization, there is really not much difference there in the main.

Either one, Senator, enlarges your ability to produce per unit of labor input.

Now, coming to the matter of existing idle capacity, I think there is a lot in the observation, but not too much in the conclusion.

The observation is correct that a lot of the idle capacity is relatively old, although I do think that this is the main explanation of why most of it is idle.

The explanation of why most of it is idle is that the operation of the economy is idling along, far short of reasonably full utilization even of our labor force.

In other words, if there were not much correlation between the amount of plant capacity idle and other measures of an inadequately performing economy, one might say that this excess, this startling proportion of plant capacity idleness, is properly idle because of its relatively higher production costs.

But I, as a matter of fact, get a moderately good correlation—none of those are perfect—a moderately good correlation between the amounts of idle plant capacity and the amount of idle manpower and the amount by which most economists figure that our GNP is falling low when it ought to be high, and so forth, and so I do not find the explanation of it, most of it, in the particular efficiency factor.

Now, to come to the important point: Even assuming a large part of this idle plant capacity were properly to lie idle, we would still come to the question of what should the annual rate of investment be.

There, I will repeat since, as you say, you were not here all the time, I will repeat that I say that during the past 9 years we had too low a level of new investment in plant and equipment, too low by $90 billion; that over the next 5 years, we are likely to have too low an investment in plant and equipment by maybe $50 billion.

So this, to an extent, goes around or avoids the question of whether the idle plant capacity should or should not be idle.

If we had had $90 billion more of new investment over the last 9 years, as I think we should have had, if we get the $50 billion more than I think we ought to get over the next 5 years than I think we are going to get, then I think we would have a much higher ratio of new plant and equipment to older plant and equipment, and I am all for that.

My whole argument on this proposal boils down to the very narrow point, why aren't we getting this high enough rate of investment in new plant and equipment? I am not saying it should be lower, because I want you to look harder at the old; why aren't we getting the new?

I am saying that the default has nothing to do with the argument that the tax system is too repressive. It has nothing to do with the argument that you need tax concessions, which I would call tax bonanzas. It has nothing to do with the level of prices or profits at any point where the demand upon existing plant and equipment is close enough to full use to motivate a higher level of business investment in new plant and equipment than the business managers have themselves projected.

I say this is borne out upon a detailed analysis of 1954–56 compared with what happened thereafter, of 1958–60 compared with what happened thereafter, with the same kind of comparison that might be made of any previous periods of cyclical or secular stagnation of the American economy, whichever you want to call it.

I think this is chronic. I do not think it is cyclical—I think it is a peculiar chronic kind of thing which I have been worried about since 1953.

I say, when you make that observation and when, on top of that, you read this April 28 report of Business Week magazine as to what the business managers are planning to invest, as to what the cash position is, and as to what they say, here you have a very abundant illustration of the fact that this is not a problem to be solved through more liberal amortization treatment, but is a problem where you have to bring to bear the old-fashioned American inducement of knowing what they are going to have to do with what they produce.

So I am not disputing your point about the old plant and equipment.

Senator DOUGLAS. If the problem is the ultimate expansion of demand for the products which the old plants produce, how would you expand ultimate demand?

Mr. KEYSERLING. Well, the techniques for expanding ultimate demands are as well known as the techniques for handing out tax bonanzas to industry.

Let me take two examples. The Senator will recognize that there are many. This gets into the whole question of the complete tableau of American economic policy.

I am not advocating them, but merely, in answer to your question, giving you examples.

Let us suppose this tax proposal would cost—and I am using cost in the fiscal rather than in the economic sense because I think the economic cost would be much worse, because I think it is a bad policy—but in the fiscal sense, let us suppose this proposal costs the American Treasury, the American taxpayer, the American budget, we will take an arbitrary figure, $2 billion a year for 10 years.

My argument is that as an alternative I can quickly think of a dozen ways of using that $2 billion, any one of which would be better than this way.

I think that to grant, what at the current economic levels and in terms of tax rates would look like a $2 billion concession to low and middle income families, with respect to their spendable income, would be much better for the economy and much better for the investor than this particular tax proposal.

I have a chart here, which I did not have time to show, which demonstrates rather conclusively that whereas the deficient $90 billion in business investment over the 9-year period 1953–1961 inclusive was not caused by a fund problem but rather a demand problem, the deficiency in consumer demand was caused very largely not by the propensity factor but by the income factor.

In other words, when you work out the income relationships, and taking account of a lot of maldistribution which also affects the propensity to spend and the propensity to save, on net balance, so to speak, it was an income problem and not just a fund problem.

The whole argument that consumers have plenty of funds, they just do not spend enough of them, I think is entirely meretricious. I do not think it is based on a real analysis of income and income distribution.

So I think that this tax benefit to consumers would do more good than this tax proposal.

Now, I take a second one. I think to spend $2 billion more out of the Federal budget, and again I am not advocating it, to spend $2 billion more out of the Federal budget for education or for housing or for human welfare or for maybe in some ways national defense, although in a sense that is wasteful, or for space exploration or for cancer research——

Senator GORE. Public facilities.

Mr. KEYSERLING. Public facilities; I can think of a hundred ways of spending this additional money that would not only do more good to the immediate recipients but also more good to the investor, if there is anything to my fundamental analysis, than this tax giveaway.

There are two fundamental ways, on the tax reduction side and spending side, which would be more useful than this.

In my view, I can suggest others, but this is the essence of the argument.

On a marginal basis—now, every tax is burdensome per se, and any tax concession lightens a burden. It may be argued that the tax credit has some beneficial short-run effect on the economy.

So, particularly when you are struggling with prospective large budgetary deficits, despite what the President says about the surplus, and particularly when you are struggling, if I may say so, with a political problem, that maybe the American people are more committed to a balanced budget than they ought to be, I am not going to argue that here—be that as it may, why unbalance the budget by $2 billion for nonsense when you have such a hard problem balancing the budget for useful purposes? So it is marginal. This tax credit would be hanging an albatross around your neck deliberately, in my view, and if it has any stimulating effect, they say it will not have, and suppose I am wrong, and if it does, then we are back where we were in early 1957 or in early 1955, where these things had some stimulative effect, but because they were entirely misdirected merely accentuated and abbreviated and exascerbated the time when the overcapacity became so large that you got into another downturn.

Senator DOUGLAS. The present plans of the administration call for a payment on the investment credit of an amount approximately equal to the added revenues obtained by plugging loopholes, so that the present position of the budget is to be maintained at approximately the same level.

Now, of course, I am a strong advocate of plugging the loopholes.

I wondered, however, when we speak of the stimulation to be created by tax cuts, whether in the form of subsidies to investors or reduction in income tax to stimulate consumption, there is not a neglected fact that while demand is being built up in certain quarters, the added revenues collected through plugging the loopholes, would diminish revenues and expenditures there, so that there is no net stimulative effect upon the economy, would not the increased demand for investment, if it comes, be offset by the decreased demand of people who now do not pay taxes on their dividends or interest or other forms of favored income? Similarly, is there any net stimulative effect in a deduction, which you suggest, although you do not necessarily advocate, in the income tax that builds up consumer demand on the part of these people, when it is confined merely to making good the added revenue obtained from plugging loopholes?

Mr. KEYSERLING. I agree with the implications of what the Senator says. I think he is just as right as rain.

Let me develop it a little more. In the first place, as to the general argument that if you plug a loophole which you never should have opened, you should open a loophole which you do not have now, that is so superficial and so ridiculous that I do not see why it is advanced by anybody at all. But let us pass quickly over that.

My point is that this tax, new tax, loophole is bad in substance, and nothing else that can be done as to whether parts of the tax structure, whether they give us revenues or lose us revenues, justify something which in itself has no merit anyway.

Now, coming more to your other point: I do think that, unfortunately, and I do not like to say this, and I hope I won't be misunderstood, we let political tactics, and maybe this administration is doing it a little too much, get in the way of sound national policy.

There is a certain political tactic in withdrawing benefits which have flowed to business. Take expense accounts, which I use merely by way of illustration, I am not at all positive that, if you are looking at the economy in operation, although I am in many ways against the expense account allowances, I am not sure that the economy would be better off if General Motors each year, instead of allowing large expense accounts which flow into ultimate demand, had instead that much more in its coffers to invest in plant and equipment.

I do not think we have made enough analysis of the real economic consequences of these things, how they are really going to impact upon the economy in the context of where we are now.

I think we have to do much more on that. I do want to say that I very strongly believe that the so-called aggregative approach that we need X billion dollars of total demand, or X billion dollars of surplus or deficit in the Federal budget, needs to move on to the further question of the composition of demand from the viewpoint of balance or equilibrium, and the composition of tax cuts or tax additions are also very important, as well as the composition of public spending.

In other words, merely to say you are adding $10 billion to business funds and taking $10 billion away from consumer funds may not be neutral. If, as I believe, the taking of $10 billion from consumer funds is very bad at this time because consumer funds are too low, and the adding of $10 billion to business funds is wasteful because business does not need funds, then the net result is not neutral.

My basic position now is that business needs markets, it does not need funds, and, therefore, to give it, through this tax credit proposal, funds is not only a quantitative factor but also a qualitative factor in the wrong direction. The results would be even worse if the policy were "successful" than if the policy "failed", because if the policy succeeded in giving an unnatural and unsustainable fillup to business investment for the next year or so, we would be repeating the error of 1957–58, and we would be worse off than if they did not use the funds for investment, because it is altogether wrong from the point of view of balance.

Senator DOUGLAS. If an economy does not have adequate ultimate demand sufficient to maintain substantially full employment, are there not only two basic ways in which this disparity can be cured: either, first, a reduction of prices so that the same quantity of voluntary purchasing power can buy a larger total quantity of goods or, second, an increase in total monetary purchasing power so that a larger quantity of goods can be demanded at the same prices or, three, some combination of the two?

Mr. KEYSERLING. I agree with this, Senator, as far as it goes.

I think fiscal policy can also play a part, namely, the tax and spending policies of the Federal Government, and also price-wage policies.

But so far as the statement goes, I agree with it, and branching off into a subject which is not the immediate subject matter of this hearing, but certainly closely related to it, I think that the current monetary policy is another example of the wrong policy at this time.

I agree with what you say about the importance of money policy. I do not believe we have the right money policy now.

Senator DOUGLAS. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Gore?

Senator GORE. Mr. Keyserling, I wish to thank you for a very able appearance.

Mr. Chairman, since the witness is entirely in private life, without public funds to print charts for our edification, I wonder if it would be in order to direct the clerk to obtain a copy of these charts and have them printed in the hearings?

Mr. KEYSERLING. May I say something? I appreciate what the Senator has said. I certainly hope that copies of these charts will be printed in the record. But I am under no pressure as to the means of obtaining these charts. By that I mean that I have copies of these charts. I hope they will be printed in the record.

Senator KERR. Mr. Chairman, I had assumed, since they were part of his testimony, they would be made a part of the record.

The CHAIRMAN. There is no objection to making them a part of the record.

Senator GORE. I did not accuse you of being penurious. But you have gone to a great deal of effort and expense to present this testimony and, therefore, I thought it proper that the charts be printed in the record.

The CHAIRMAN. That will be done, sir. They will follow his prepared statement which refers to them by number.

Senator GORE. Mr. Keyserling, you aroused my interest a good deal in your discussion of the effect of the proposed investment credit on the international balance of payments.

As I understand it, approximately 5 percent of our gross national product goes into commodity exports; is that correct?

Mr. KEYSERLING. That is approximately right.

Senator GORE. And in the composition of this 5 percent there are regular commercial exports, unilateral transfers of commodities, agricultural commodities sold under the Public Law 480 program other soft-currency sales, and transfer of military equipment; is that correct?

Mr. KEYSERLING. Yes, sir.

Senator GORE. Well, my understanding is that we have a comfortable surplus in the balance of payments with respect to commodity transactions.

Mr. KEYSERLING. That is absolutely correct, absolutely correct; a surplus in our goods and services account.

Senator GORE. As I understand, further, our surplus of exports over imports of commodities in commercial transactions is in the order of $3 billion

Mr. KEYSERLING. It fluctuates from time to time. I think that is around the current order.

I think I pointed out last year as a whole it was something like $4 to $5 billion. But this seems to me to be correct; yes.

Senator GORE. Well, now, by what logic or imagination could a subsidy of $1.4 billion to the whole economy, the GNP being more than $500 billion, increase our commercial export surplus, now about $3 billion, by another $2 or $3 billion, when only about 5 percent of the gross national product is involved in commodity exports?

Mr. KEYSERLING. I think the Senator is entirely right. I think he said by what process of logic or imagination. I would say by many processes of imagination, but no process of logic.

More specifically, one of the main difficulties with this proposal, as I tried to indicate, is that there is no analytical quantitative discussion by the proponents, meshing between the magnitudes of the benefits which they say will be accomplished, with how the proposal, actually working on the American economy, would actually translate into these magnitudes of benefits.

What the Senator says is exactly true. If they would put down on paper that here is the size of this tax concession, here is how it would impact upon the investment process, here is how that would translate over the whole price structure of the American economy, here is how this translation over the all price structure would impact upon the volume of our international goods and services accounts, and here are how the changes that might be effected in this international goods and services accounts might impact upon our balance-of-payments position, they would immediately discover what the Senator is now implying, that the pebble would be lost in the ocean and, by the time you got through you would have almost no impact. And meanwhile you would, from the domestic point of view, have been utilizing $2 billion a year or $20 billion over 10 years, or whatever the figure may be, from the budgetary point of view, which is very important in terms of other considerations, for the purpose of accomplishing an international trade-improving position which would start as a ripple and end as nothing. This is one of my basic objections.

This is not simply a case, as is often found, where economists agree on analysis or facts, and disagree on conclusions which involve subjective values as to policy. This is understandable.

My main concern about this thing, I have tried to study it, I have gone through the testimony of the Secretary of the Treasury, I have gone through the other stuff put out on this subject, they have not done their homework, because you cannot find, in terms of their own analysis, factual efforts, observational efforts, to answer the kind of question that the Senator is properly raising.

In other words, if somebody comes forward and says that "we want you to spend $50,000 to build a house," you say, "where is the plan for the house and can it be built in this kind of climate," and so forth, and so on.

I am not appearing here as somebody who differs on economic policy only, or in economic construction of facts which are subject to variable interpretations, depending upon subjective or judgmental factors.

I say again, and I do not say it lightly, that on this whole matter of this tax credit, on the matter of how it relates to the balance of payments, on the matter of how it relates to our whole trade position, the homework has not been done.

I say again, and you may ask your staffs to verify this, you will not find in the lengthy presentations of the proponents any factual quantifications, of how this switch that they are going to push is going to turn on the light.

So this is not simply a matter of my disagreeing with them as to a chain of consequences. They have not done their homework.

When you look at the size of, the magnitude of, the benefits which they imply, as against what happens when you move step by step from a 7 percent tax credit to the effect on investment, to the effect on prices, to the effect on output, to the effect on our competitive trade position all around the world, and then jump to the conclusion that it is going to have the kind of effect that will materially help our balance of payments position, I say we are committing ourselves to spend $20 billion on something which will not happen.

Senator GORE. Let us subject that to a big of analysis. We have agreed that approximately 5 percent of the gross national product is involved in exports, whether commercial, gift, military, foreign aid or both.

If this subsidy of $1.4 billion is to be given to our national productive machinery, with a few exclusions, would it be reasonable to assume that approximately 5 percent of this tax credit would be brought to bear upon that portion of our gross national product which is engaged in export trade?

Mr. KEYSERLING. Well, let us say, you say if the credit initially were $500 million——

Senator GORE. I started with the fact upon which we agreed that approximately 5 percent of the gross national product goes into export trade, and if that be true, as I believe it is, and a tax credit of $1.4 billion is spread across our total economy, would it be reasonable to assume that 5 percent of the tax credit would directly affect those facilities having to do with the production of export commodities?

Mr. KEYSERLING. I think, Senator——

Senator GORE. Or to make it reasonable let us make it 10 percent.

Mr. KEYSERLING. Senator, I get your question. I think that the exercise which you suggest would show clearly that it would do us little good overseas relative to the cost. But——

Senator GORE. I know you have got the point, but let us approach it one step at a time, and maybe I can get it, too.

Just to double the 5 percent, would it be reasonable to assume——

Mr. KEYSERLING. I think your 5 percent figure is more reasonable than 10 percent. So why take 10? Take your 5.

Senator GORE. Let us be overly generous.

Mr. KEYSERLING. All right, let us take 10.

Senator GORE. Ten percent of this credit, $1.4 billion, would be $140 million.

Mr. KEYSERLING. Yes, sir.

Senator GORE. Now again, I ask you, by what logic can we assume that a tax credit of $140 million is going to improve the balance of payments by $2, $3, or $4 billion?

Mr. KEYSERLING. We cannot; we cannot.

Senator GORE. I just do not see it; I agree with you.

Mr. KEYSERLING. Furthermore, Senator, it is worse than that because the method that you have used is in itself an exaggeration because you cannot say that if you have a tax credit of $1.4 billion, and since 5 percent of the economy is engaged in trade, there is going to be a 5 percent ratio. This is not the way it works.

What the proponents of the tax credit are saying is that this tax credit, by more efficiency, will result in reduced prices, and that these reduced prices will enable us to sell more goods overseas.

When you bring that additional step in, you get down to a lot less than 5 percent, because you have to say, first, here is a certain credit to industry. This is going to change their investment pattern so much.

Now according to the judgment of Business Week, they are going to invest 1 percent more than they otherwise would, or about $300 million more in 1962. Now by your method, we apply 5 or even 10 percent to investment in production for foreign trade.

Senator GORE. That is my generosity, not my method.

Mr. KEYSERLING. Yes, sir; but the increase in investment does not in itself sell more goods overseas.

The improved trade position is based on the hypothesis that, with the 5 percent increase in investment, you will get an improved technology and efficiency, and you will get reduced prices, and due to the reduced prices you will sell more overseas.

Senator GORE. By what reason are we to assume that this will bring about reduced prices, when the more likely result is increased dividends?

Mr. KEYSERLING. I agree with you on that, too, and there I have tried to point out—I hate to be so critical, but I find in the position, in the economic position, of the administration on the steel price thing an utter and complete confusion.

I do not believe that steel prices should have been raised, but my reason for believing they should not be raised was, they were high enough to yield to the steel industry an adequate level of profits at a high enough level of operations, and the break-even point is very low—I may be wrong on that—but that is the sound American principle.

But I could not take the position in my own mind that Government should use all its powers to prevent a corporation, acting entirely within the law, from raising its prices, and then say that "because you didn't raise your prices we agree with the very reason for which you wanted to raise your prices, and, therefore, we will give you a tax concession so that you can get, in a different way, the money that you said you wanted to get through raising prices."

If we are going to rely on tax concessions rather than on the price structure to perform this enormous function of the American economy we just do not realize the Pandora's box this proposal is opening up.

Senator GORE. Would such a course indirectly condone or endorse the internal financing to which a great deal of industry has, I think, to too great a degree, resorted?

Mr. KEYSERLING. It more than condones it, because it is saying, in spite of this internal financing which Business Week, even on April 28 says is so huge, they have no cash problem—I read into the record this quotation from Business Week saying that there is not a cash problem, there is not an income problem, there is not a fund problem, there is a capacity problem. And the reason they are only expanding their investment in plant and equipment by $4 billion this year, whereas the Government economists hoped earlier it would be $8 billion, is they are operating at 83 percent capacity, and this shows the facts on cash flow and retained earnings, and says that the manufacturing companies say that they will not borrow anything this year.

The overall companies say that they will borrow only 1 percent. In other words, they are continuing to resort in accelerated fashion to a method of internal financing which, I think, is too large relative to their total use of funds, because it is financing new plant excessively out of what happens before the plant is built instead of financing it out of what happens after the plant is built, or financing it initially through borrowed funds, which really means financing it after the plant is built, in a sense, because you pay off the borrowed funds out of the production created by the plant.

Now with that happening, clearly with this happening, for the Government to hand out to these companies another tax concession which increases the funds which they obtained from sources other than those from which they should be obtaining them, namely, borrowing, or what happens after the plant is built, or I would even say in some cases the operation of the price system, because I do not want to abolish the price system, I agree with you that this is aggrevating the very element of evil which seems to me to be so serious.

Senator GORE. In other words, this would be tantamount to adopting the theory or proposition that business is to expand either by raising prices to their customers, or out of the Public Treasury.

Mr. KEYSERLING. This is the thesis advanced by the administration, that the steel industry needs more funds.

Senator GORE. Let us talk about that. United States Steel Corp. has split its stock six for one since it sold a single share to the public, and the dividends are now calculated on the basis of these six shares instead of the one that the owners originally possessed.

In addition, prices have been increased to the customers, and now we are proposing to give them millions of dollars out of the Public Treasury.

Mr. KEYSERLING. Senator, I agree with you entirely, and again getting back to what the chairman said, I do not agree with Means on everything, but he has written a book on this price and steel question which is most revealing on the subject.

What I say is this: I do not believe that the steel industry needs more cash now. Therefore, I do not believe they should raise their prices. But if I believed they needed more cash now, which I do not, then the normal ordinary way, one way, to get it is by borrowing. Another way to get it——

Senator GORE. You mean equity capital?

Mr. KEYSERLING. That is right.

Another way to get it in the normal process is, if your price structure is really too low geared to what an economy can take, and geared to a fair return measured against your investment needs, then you raise your prices.

Raising prices is not a sin per se. That is the very justification for raising prices in economic theory and practice. So if I believed as strongly as the administration that the steel industry is in need of funds now, I could not be so strongly against their raising their prices, and certainly, if after they had raised their prices, if as a member of an administration, after they had raised their prices, I brought before the public every argument as to why they did not need to raise their prices as a justification for rolling their prices back, with which I agree, then I would not turn around and go across the street to the Treasury and say, "Mr. Secretary of the Treasury, the steel industry is so badly in need of funds, let us hand them out a tax concession," which would do in part what the price rise would have done.

I just cannot follow this. We are merely shifting the method of providing these industries with more funds which they do not need to a method which I think in terms of logic and experience in the American system is a worse method than a price rise.

Senator GORE. I wish to allude to only one other point. There are many points on which I would enjoy an exchange with you, but due to the lateness of the hour and the duration of your testimony, I will ask you about only one other point.

You seem not to indulge in the delusion, under which so many people seem to labor, that our balance-of-payments problem can be solved through increased exports.

Mr. KEYSERLING. It certainly cannot be solved through exports, for the very simple reason that to solve your balance of payments through exports, you not merely have to increase your exports, which I hope will happen in a growing American economy and a growing world economy, in order to solve your balance-of-payments problems through exports you have vastly to increase the ratio of your exports to your imports.

In other words, you have to run a much bigger export surplus than you have run. Unless you virtually strip other programs, such as military investments overseas, and so forth and so on—I think we can do that to some extent. I think we can get some others to bear a larger share.

I hope the time will come when a lower level of foreign gifts overseas happens, and so forth and so on.

But basically, you are right, as I understand what you say, that the proponents of the tax concession are resting their case upon the proposition that the tax concession, by increasing the efficiency of American plant, will reduce our prices and our costs and greatly increase the ratio of our exports to our imports, and thereby help solve the balance-of-trade problem.

They say this again and again and again, and this I utterly and completely challenge. It is impossible, or as nearly impossible as anything can be in economic life, because while our exports may grow as the world economy grows, the United States cannot expect in the next 20 years to have a larger share of world exports and, therefore, a larger export surplus.

How? Where is it coming from? Is it going to be at the expense of Japan? We have been exporting more goods and services to Japan than we have been importing every year, and, as I said before, as they are a little island that is soon going to have 100 million people, if we deprive them of running an export surplus, if you are going to run a bigger export surplus for the United States, other countries have to have smaller export surpluses, Japan, with its explosive population change, being a tiny, little island, is in the position somewhat like England was in, it has to export to live. We have to export to thrive but not to live.

You force them straight into the hands of Red China because China will be their only alternative market for converting raw materials into finished products. This is obvious.

All right, you take England. England has lost an empire. It is obvious that they depend more relatively upon world trade than we do, and this is true even of countries of Western Europe.

Naturally, they have got to be industrializing a little faster than we are because they really started after World War II, and we cannot be entirely hypocritical about this.

We say we want them to thrive and prosper by their own efforts.

We want to keep ahead of them. But we cannot be as far ahead as we were after World War II, and I hope it is not un-American to say this, but how can it be possible to remain as far ahead as immediately after World War II?

This idea that, with a little tax bonanza to industry here and there, we are going to greatly increase our share of worldwide exports and thereby help our balance-of-payments position is, to my mind, entirely impractical.

Senator GORE. Well, I agree with you that it is. I think I would go a little further, I think it is preposterous.

Mr. KEYSERLING. Well, Senator, I do not disagree with you. I am very worried about the presentation of the trade program and many matters, and I agree with the trade program, but the homework has not been done, and wide and gaudy statements are being made as to the enormous benefits that are going to occur that are not based upon taking a paper and pencil and looking at what the operative situation is.

Senator GORE. Well, Mr. Keyserling, I would be inclined to give sympathetic consideration to a proposal that would be specific, if a tax credit could be proposed which would specifically go to an improvement in plant and facilities which would specifically improve our competitiveness in international trade.

As I say, I would be prepared to give sympathetic consideration to that.

Mr. KEYSERLING. So would I.

Senator GORE. But to use the broad shotgun approach and give $1.4 billion to the whole economy, when only 5 percent of GNP goes into international trade, and expect that to solve the balance-of-payments problem, to me is utterly preposterous.

Mr. KEYSERLING. I think, and I am in danger of repetition, that it is going to make the balance-of-payments problem worse because the balance-of-payments economists, being classicists, and thinking of balance of payments as balance of payments were developed by classical economists long before we lived in a modern world, and having the kind of worldwide economic relationships we have now, how is the idea of a nation giving away billions of dollars to other countries—and I am not now arguing whether we should or should not—how does that enter into the balance-of-payments classical position? It does not enter at all because the people were not thinking at that time of that problem. Yet, economists are using outmoded balance-of-payments tableau in trying to solve entirely new and different problems.

Senator GORE. I hope there will be more constructive thinking on the problem of our adverse balance of payments than has so far been in evidence.

Neither the trade bill nor this tax bill will solve that problem. Something considerably more effective, and something, perhaps, even more fundamental in international exchange, capital flow, international monetary agencies, will, in my opinion, be necessary to bring about a solution to that problem in the near future, unless we want to abandon our foreign trade program and our national security commitments around the world.

Mr. KEYSERLING. I think what you say is entirely correct, Senator.

I think, as I said before, that just as the Federal Reserve System was established to provide for a temporary cancellation or offset of long-range and short-term claims, some similar agency among cooperating nations of the West would help us with a balance-of-payments position for the very simple reason that the United States, even during the years that we have had all this clamor, has not been in an unfavorable balance-of-payments position from the long-range view.

It has been in an unfavorable balance-of-payments position only in shortrun items. We are only in a deficit position because the short-term flows are not offset against the long-term flows and, therefore, the short-term flows constitute an immediate claim upon gold.

So, sure, we need better mechanisms. But the one other thing, and I think the most important in some ways of all, is that if you made—I am not obsessed with the American economic growth problem—but if we made a simple correlation as to when our unfavorable balance-of-payments difficulties have occurred most obstinately and most seriously, and if we made a simple correlation of what would have happened to our international balance-of-payments position and our gold position, if the American economy, instead of growing 2.5 percent a year during the last 9 years, which is 30 years below the 40-year average, had grown 3.5 percent to 4 percent or 4.5 percent a year, and if instead of having a recession almost every time we turn around, which this tax credit policy has something to do with, we had a few fewer of them, if we correlated that with the likely trend in our balance of payments, we would have found that we would not have gotten into these balance-of-payments difficulties, because they have come mostly from short-term flows of nontrade capital.

In other words, American businessmen have taken their money to France, foreign businessmen have taken their money out of the United States, speculative short-term capital flow, and most of this has been very responsive to the economic condition of the United States.

So, the most imaginative of all approaches in the balance-of-payments problem is a vigorous approach to the American economic problem.

Senator GORE. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Smathers?

Senator SMATHERS. No, thank you, Mr. Chairman.

The CHAIRMAN. Mr. Keyserling, we thank you very much, sir. You have made a constructive statement, and we appreciate it.

Mr. KEYSERLING. Thank you very much for your courtesy.

The CHAIRMAN. We hope that next time we will have the same unaniminity between the chairman and yourself as we had on this at this session.

Mr. KEYSERLING. Thank you, Mr. Chairman.

(The prepared statement and 18 charts of Mr. Keyserling follow:)

STATEMENT OF LEON H. KEYSERLING [1]

Mr. Chairman and members of the committee, I appreciate this opportunity to state my views on the very important bill now before you. I shall concentrate upon that portion of the bill which seems to me of largest economic significance, and which would provide a 7-percent tax credit for certain types of business investment.

I am opposed to this provision. It seems to me a provision which business does not seek, labor does not want, the condition of the Federal budget does not justify, the state of the national economy does not call for, the full consequences of which the public does not appreciate, and which even those economists who favor it have not been able to support with careful or specific empirical analysis. The proposal cannot stand the test of logic; it should not survive the lessons of experience.

This tax-credit proposal is advanced, first of all, for the purpose of helping to sustain and accelerate the growth rate of the American economy, primarily by encouraging investment in plant and equipment.

A higher and better sustained growth rate for the American economy is indeed a vital objective. Some members of this committee will recall this: Testifying here in early 1955, when the subject of economic growth was sorely neglected, I expressed my deep concern that the American economy faced in the year then lying ahead an extraordinarily low and irregular economic growth rate prospect. I forecast a pattern of short-term ups and downs, which would result in what I called a chronic increase in unemployed manpower and idle plant.

While I was then regarded as unduly pessismistic, because the economy in early 1955 seemed to many to be recovering satisfactorily from the 1953–54 economic recession, the 7 years since then have unfortunately vindicated my deep concern. For the period 1953–61 as a whole, our average annual growth rate was only 2½ percent in real terms. This was about 30 percent below the 40-year so-called historic average, and little better than one-half the rate averaged during recent peacetime years of sufficient length to be significant, under the impact of the new technology. For the 9-year period 1953–61 inclusive, this extraordinary low economic growth rate, according to my estimates, caused us to forfeit more than $340 billion of total national production (measured in 1960 dollars), and to forfeit about 22½ million man-years of employment opportunity. In consequence, millions of American families have suffered the undue hardship of unwarranted unemployment, business has forfeited enormous opportunities for

[1] Former Chairman, Council of Economic Advisers; consulting economist and attorney; president, Conference on Economic Progress.

worthwhile investment and legitimate profits, our worldwide competitive position has been adversely affected, and repeated promises to balance the Federal budget have been followed by repeated deficits in the budget.

The most striking aspect of this extraordinarily low record has been the clearly confirmed trend of idle manpower and plant to be higher at the peak of each short-lived recovery, and higher at the trough of each far-too-frequent recession, than at the previous peak or trough. The current economic recovery, thus far, has clearly been a confirmation rather than a reversal of this chronic difficulty. My first six charts illustrate and amplify what I have thus far said.

I have always recognized the fundamental role of a high and expanding level of private business investment in a dynamic and growing American economy. This investment, particularly in plant and equipment, is one of the three main components in the total demand which must equate in real terms with our total national production in real terms. This private business investment, along with and interrelated with improved working skills and managerial efficiencies, is the mainspring of productivity growth. In turn, productivity growth and growth in the labor force are the two basic elements in national economic growth.

Indeed, my estimates for needed private investment growth have consistently been higher than those of most other economists. My seventh chart estimates an average annual deficiency in gross private domestic investment of about $10 billion for the 9-year period 1953–61, inclusive, or about $90 billion for the period as a whole, measured in 1960 dollars. I estimate this deficiency in gross private domestic investment at almost $21 billion for the past year 1961 alone. As shown by my eighth chart, my estimates for our economic growth needs in future include a level of total gross private domestic investment, measured from the 1961 base, $12 billion higher in 1962, and $21 billion higher in 1963. Investment in plant and equipment averages in the neighborhood of half of gross private domestic investment; its economic significance is incalculably greater than this proportional relationship implies.

I have also been deeply concerned about the extreme fluctuations in business investment, which have been much more severe than the fluctuations in the economy as a whole, as shown by my ninth chart.

But the task of sober economic analysis and policy is not merely to bemoan the unsatisfactory performance of business investment, nor to propose wasteful remedies which ignore the palpable lessons of experience. Careful observation of the economy in action demonstrates clearly why the rate of business investment in plant and equipment was too low in absolute terms, for the annual period 1959–61 as a whole. It was not because the tax treatment of investors, the level of profits and other available funds and incentives, and other factors such as price-wage-cost relationships, militated against a sufficiently high level of investment in producers' goods, at any time when the ultimate demand for products in the form of private consumer expenditures and public outlays for goods and services at all levels of government were high enough to make reasonably full utilization of plant and equipment and technology in being. Entirely to the contrary: Whenever this ultimate demand was adequate or indeed not glaringly deficient, expansion of plant and equipment through the investment process raced so far ahead of ultimate demand that the economy got badly out of balance. Sharp cutbacks in this investment, and general economic recession, consequently followed.

My 10th chart shows how, during the boom periods 1954–56 and 1958–60, total private domestic investment grew several times as fast as private and public demand for ultimate products. (The contrast was very striking, even when one singled out private investment in plant and equipment.) The chart also shows how these investment binges generated very serious downturns in business investment—thus contributing to the general economic recessions—when it became abundantly clear to the business managers that they were confronted by a condition of extremely overexpanded productive facilities, relative to actual and foreseeable levels of demand.

The 11th chart shows how, during the investment boom before the 1957–58 recession, large price advances, and even larger advances in profits after taxes, generated unrestrained and incontinent increases in plant and equipment investment in widely varied sectors of the economy, and above all in iron and steel. My 12th chart, dealing with the investment boom before the 1960–61 recession, shows that, even with some general downward trend in prices and in profits after taxes—which some people called a profit squeeze—investment in plant and equipment again raced upward at a nonsustainable rate, with iron and steel again in the forefront.

My 13th chart illustrates, I think in rather telling fashion, that funds available to corporations for their business purposes have advanced handsomely, and have certainly not been deficient. Measured in current dollars, the total funds used by corporations averaged very much higher during 1953–61 than during 1947–53. The portion of these funds used for plant and equipment grew considerably, comparing the same two periods. And most important of all in its relevancy to the policy issue now under review, the portion of corporate funds drawn from internal sources, including both depreciation and amortization and retained profits and depletion allowances, rose from an average of 65.8 percent during 1947–53 to 70.1 percent during 1953–61.

Let me now bring the record entirely up to date, by calling your attention to the April 28, 1962, issue of Business Week, which reviews and comments upon the annual McGraw-Hill spring survey of business investment intentions. On page 19, Business Week says:

"When you read the new estimates on industries' capital outlays, be sure to study them in the light of consumer spending. The reason is really too obvious to need stating: industry's need for capital equipment tomorrow is dictated by consumer demand today."

After pointing out that the now-projected level of $38 billion worth of business investment in plant and equipment during 1962 as a whole is even higher than the record spending of 1957, and that planned spending for the same purposes for the 1963–65 stretch runs at a $36 billion annual rate, or more than the actual spending in any 3 years in U.S. history. Business Week also validly points out that the now-estimated spending for 1962 falls about $4 billion short of the pace Government economists had hoped would be spent in 1962, and that even the estimated spending for 1963–65 cannot be called a real boom. But then, and this is the key point, Business Week says (p. 26):

"Behind this trend lies the stubborn lag of the spending rate as a percentage of capacity. Most manufacturers today prefer 90 percent. But at the end of 1961 the actual rate was only 83 percent of capacity * * *. In that context, it is easy to see why industry plans to add merely 4 percent to capacity this year, with another 10 percent spread over 1963–65 * * *. Manufacturers' hopes of getting closer to their preferred rate hinges on an increase in sales."

Equally important, the McGraw-Hill survey inquired of the companies surveyed about sources of funds for investment purposes. On this subject, Business Week says (p. 26):

"Most of them said a startling large part of it was coming from their own treasuries. Overall, businessmen expect to borrow only 1 percent of their operating requirements this year. Manufacturing companies say that they will do no borrowing at all. Cash flow among all companies in the survey is expected to be 14 percent above last year—when the expected increase was only 9 percent. Nearly everyone expects profits to be greater this year, so companies plan to retain more earnings, at the same time when funds from depreciation allowances are rising steadily. Steel companies—questioned just before their collision with President Kennedy—expected their cash flow to rise 21 percent this year. The auto industry expects a small increase, a mere 8 percent. The survey indicated that a tax incentive program would do little to increase investment plans this year. Industry as a whole thought there might be a 1-percent increase, but this would add only about $300 million to the present plans."

Thus, I submit that the main problem of a better performance for business investment in plant and equipment turns upon successful policies to work down idle plant capacity, through the expansion of ultimate demand for the products which plants produce. The percent of plant capacity idle has not in recent years been limited to recessionary periods, although obviously most severe during such periods. As shown by my fifth chart, discussed earlier, the percent of plant capacity idle for the period 1954–61 as a whole was 19.1 percent in the case of iron and steel; 23.1 percent in the case of nonelectrical machinery, and 16.3 percent in the case of electrical machinery; 13.5 percent in the case of autos, trucks, and parts; and 28.4 percent in the case of other transportation equipment; 18.3 percent in the case of chemicals; 10.3 percent in the case of petroleum refining; and inordinately high in most important sectors, including even food and beverages, where it was 17.7 percent.

My 14th chart shows that, in contrast with the fact that business investment has not been inhibited by lack of funds, the deficient rate of growth in private consumer spending during the period 1953–61 as a whole, as an ultimate demand factor having so vital a bearing upon the deficient investment performance, finds its main explanation not in too high a ratio of consumer saving to consumer spending, but rather in deficient levels of disposable consumer income after taxes. This illustrates, of course, that if the Congress should decide that the current and prospective condition of the Federal budget permits room for new tax concessions, reductions in tax rates as they bear upon disposable income would be an infinitely more promising way of helping business investment than handing out tax bonanzas which business itself feels it would not use currently, and which, if they were used currently, would merely repeat the error of fomenting a short-lived and nonsustainable business boom, with another severe investment cutback and another general economic recession in consequence.

In this connection, I would like to recall to this committee my testimony before you in early 1957, just prior to the decision by this committee to undertake a thorough investigation of financial conditions in the United States. At that time, in early 1957, the then Secretary of the Treasury, Mr. George Humphrey, and the then chairman of the Federal Reserve Board, Mr. Martin, were urging before this committee that we did not have enough saving to generate an adequate level of business investment, and, consequently, business was plied with accelerated depreciation and other measures to fan investment. They said that this would also help to fight inflation, which they then regarded as the central danger of the moment. They urged that consumption or ultimate demand was then too high, and that a tight-money policy and restraints on housing, among other things, were needed.

It was at this point in early 1957, before this committee, that I challenged these views. I said that idle plant capacity relative to ultimate demand was almost everywhere, that the real problem of policy was to lift the ultimate demand rate relative to the investment rate, and that we were dangerously on our way, not to more inflation, but to another and more serious recession. Unhappily, what I said turned out to be entirely correct, and our economy even today has not yet recovered satisfactorily from the 1957–58 recession, upon which, due to future economic imbalances of the kind which I have been stressing, the 1960–61 recession was superimposed after an abortive recovery movement.

The committee will also recall that, in early 1957, when the proponents of more investment at the expense of ultimate demand were asked where the shortages were, they scurried around in great anxiety, and came up with one particular type of lead pipe. As a final footnote to this whole incident, the Chairman of the Federal Reserve Board came back before this same committee in 1958 and confessed that in 1957, looking backward, we were suffering from an excessive investment boom in plant and equipment relative to deficient consumption.

Mr. Chairman and members of the committee, I submit that we are now in another situation reasonably analogous to early 1957, or will be in such a situation by the time that the tax-credit proposal before this committee could have much practical effect if enacted. Why, then, should we make the same unfortunate mistake again in our national economic policies?

But let us suppose, contrary to what I believe profoundly to be the facts, that those persons are right who still say that business needs special concessions now, in order to obtain the funds needed for adequate investment in plant and equipment. Let us for the moment apply this proposition to the recent steel episode, and see where we come out. When the steel industry raised its prices by $6 a ton, the administration quickly discovered that the steel industry had plenty of funds and profits, that real wage cost per unit of production had not increased for a number of years, due to gains in technology and productivity, etc. And so all of the powerful resources of the executive branch of the Federal Government were quickly marshaled to force back steel prices. I shall not here evaluate whether all of the pressures which the executive branch brought to bear on the steel industry were wholesome in their long-range implications. Various members of the committee will undoubtedly have a variety of views on this important phase of the problem. But even while the administration insists that the steel industry did not need to raise its prices to get more funds for investment, the administration is insisting with increased intensity that the administration's tax-concession proposal is essential in order that the steel industry and other industries may have enough funds for an appropriate level of business investment.

Mr. Chairman and members of the committee, let us stop, look, and think at this point. As I have already stated, the investment problem is not today a business fund problem; it is an ultimate demand problem. But even if it were a business fund problem, even if it were desirable to ration more of our available resources toward investment and away from consumption, where are we heading for in the long pull, if we rely upon indiscriminate tax concessions rather than upon selective price increases to accomplish this result? Where are we going to end up, in terms of sound economic policy, sound financial policy, and sound budget policy, if we have reached the stage where the U.S. Government will be committed, for a long period of years ahead, to grant tax concessions to such "anemic" and "capital starved" corporations as our big steel and auto and chemical companies and others, whenever it is felt that they ought to be investing more in plant and equipment? What happens to the whole American theory of enterprise, under which price policy, properly deployed, is one important regulator of the allocation of resources? Are we similarly, shortly, to abandon wage policy as an allocator of resources, properly deployed, and use instead tax concessions whenever it is thought that some wages should be higher?

I am aware that it will be argued, by the proponents of the investment tax credit, that our international economic position, and our balance of payments and gold problems, require a stable price level in order for us to compete effectively in oversea markets. I heartily embrace the objective of a reasonably stable price level, and, for reasons which I have already given, I can see no justification in general for price increases now, either from the investment standpoint or from any other viewpoint. But then, the proponents of the investment tax credit, having accepted the objective of reasonable price stability, go on to say that business needs more funds for investment in order that our technology and productivity may increase rapidly enough to square with our competitive objectives overseas—hence the tax credits are needed. This is where the proponents of the investment tax credit err.

In the first place, their position begs the whole issue of how we are going to get a higher and more sustainable level of business investment, and thus get more rapid improvements in plant and technology. As already indicated, I recognize the vitality of this need. But as already indicated, the road to achievement of this purpose is to elevate the level of ultimate damand relative to the already declared intentions of business investors. Then they will invest still more. This should certainly be the policy, until we get much closer to reasonable utilization of our existing plant and equipment capacities, and much closer to maximum employment and production, than we are now, or seem now to have any prospect of getting in the near future.

Second, while conceding fully that investment in plant and equipment, and technology and productivity, should have averaged larger advances during the past 9 years than actually occurred, nonetheless the main reason for our low economic growth rate, which is the central cause of our difficulties both at home and overseas, has not been the deficient rate of increase in technology and productivity. This must be apparent at once to any reasoning person. For if our 2½ percent growth rate had been due to a low rate of growth in productivity and technology and in the labor force, then we would have had too low an economic growth rate to meet our national and international needs, but we would not have had the alarmingly serious chronic rise in idle manpower and plant. In other words, we have had this alarming chronic rise in idle manpower and plant because, allowing for the growth in the labor force, the actual increases in technology and productivity have far exceeded their actual utilization.

This is perfectly consistent with another crucial point, namely, that the actual increases in technology and productivity during the past 9 years would have been very much higher, if there had been reasonably full utilization. This is true for two reasons. First, the actual increases in technology and productivity were repressed by the inefficiency costs of very slack utilization of plant and labor force. To put this another way, the technological increases in productivity were in fact much higher than the actual or economic increases which were obtained mathematically by dividing the size of an inefficiently utilized labor input, measured in hours of work, into the size of the actual production output for all hours of labor expended. Second, reasonably full utilization, as I have already demonstrated, would have led to a higher rate of investment for the 9-year period as a whole than actually occurred, by evening out the ups and downs in the general economy accompanied by even more severe ups and downs in business investment in plant and equipment.

It should be added that fuller utilization of existing productive capabilities, including manpower, would also have generated a larger growth in the labor force. Statistical committees are hardly needed, to explain why the size of the civilian labor force has been virtually static for a year when it should have grown by three-fourths million or more, even allowing for the growth in our

Armed Forces. The labor force has stood still because people stop looking for jobs when the jobs are not there. Counted unemployment is thus replaced by concealed unemployment.

My 15th chart shows very clearly, going all the way back to 1910, the strong tendency of productivity not only to advance, but indeed to advance at an accelerated rate, until this advance is repressed by low utilization. I might add, even in the face of the inadequate economic recovery, that the Chairman of the Council of Economic Advisers has recently observed publicly that productivity now seems to be advancing more rapidly and permanently than his group had earlier judged, when they set their targets for economic growth, which in my view were set too low. I submit that this earlier misappraisal was one of the prime factors in reaching the conclusion, or at least has been avowedly one of the factors in supporting the conclusion, that the tax-credit incentive to business investment is needed.

Our first and foremost problem is to expand utilization in line with a rate of technological improvement and automation and productivity now in process. When we show our ability to meet this central and extraordinarily difficult problem, then will be the time to reconsider national economic policies along lines which place relatively more emphasis upon expanding our productive capabilities, and relatively less emphasis upon expanding ultimate demand. My 10th chart provides additional illustration of how technological progress, during the period 1947–60, was so rapid that it resulted in a tremendously reduced employment in manufacturing, relative to industrial production and relative to total national product.

My own view, therefore, is that we should first concentrate our national economic policies upon the central task of restoring and maintaining reasonably full use of our productive resources, both technological and human. When we accomplish this purpose, I submit that investment, technology, and productivity, and the growth in the labor force, will all be fast enough to sustain an economic growth rate of 5 percent or better. Indeed, under these conditions, the tendency of technology and productivity to accelerate their rate of growth would probably lead to an accelerating rate of overall economic growth beyond 5 percent a year.

Thus, I submit that there is nothing whatsoever, either in the record of history or in careful analysis, to support the recorded view of the administration that maximum employment and production on a sustained basis would yield only a 3½ percent annual economic growth rate, and that, to get to a considerably higher annual growth rate, the tax concession, among other measures, is needed. As I have already shown, there has been no time, at least since 1922, when reasonably full utilization of manpower and other productive resources in being has not resulted in an economic growth rate substantially higher than 3½ percent.

Another argument advanced by the proponents of the tax concession to investors is this: It is said that, if we want a higher average rate of economic growth than would result automatically from sustained maximum utilization of manpower and other productive resources, we must increase the ratio of plant and equipment investment to total gross national product far above the levels which would normally result merely from this sustained maximum utilization. Let me now indicate what I believe to be the demonstrable fallacies in this line of reasoning.

It is true that, assuming reasonably full use of resources, and growth in the labor force determined mainly by population growth, the rate at which our economy can grow from year to year will depend on the rate of productivity growth, which in turn depends substantially upon the rate of business investment in producers' facilities. If we want overall economic growth at a 6 or 8 percent annual rate, we need a higher rate of growth in productivity and in such business investment than if we are satisfied with an overall economic growth rate of 4 or 5 percent. This is obvious. But the Council of Economic Advisers and others commit a very serious technical and practical error, when they jump from this truism to the conclusion that a fully employed economy growing at 6 or 8 percent a year requires a higher ratio of business investment in plant and equipment to gross national product than a fully employed economy growing at the rate of 4 or 5 percent a year. Whatever the overall growth target may be, if it is to be sustainable, the ratio of business investment to ultimate demand depends upon the technological question of how much investment produces how much goods to be taken up by ultimate demand. To illustrate, if a 10 percent increase in investment adds more than 10 percent to productive capabilities, as I believe likely in view of the new technology, then a 10 percent increase in investment needs to be matched by a more than 10 percent increase in ultimate demand. Under these circumstances, an increase in the ratio of investment to total gross national product will merely produce a frequent run of general recessions due to relative overbuilding, and the long-term consequence of this—even as during the past 9 years—will be a deficiency in investment growth, productivity growth, technological growth, and overall economic growth. In other words, a 6 or 8 percent economy requires more investment than a 4 or 5 percent economy, but it also requires more ultimate demand, and I have seen no attempt to show why the higher overall growth rate requires a higher ratio of investment in producers' goods to GNP, assuming sustainable ratios at maximum employment under either growth rate.

The reports of the President's advisers appear to have made no attempt to analyze in quantitative terms what would be a sustainable and, therefore, desirable relationship between the growth of investment in producers' facilities and the growth of ultimate demand. Instead, the reports tend to support without due qualification the widely held idea that the higher the ratio of investment to consumption, the higher will be the rate of economic growth. To test this idea, I ask this question: What would happen in the American economy if investment in producers' facilities rose to 30 percent of gross national product?

Notice should also be taken of the use of correlations which do not lead to the conclusions which they are designed to support. The reports, or the Council of Economic Advisers elsewhere, have called attention to the fact that the ratio of investment in plant and equipment to gross national product was higher in the late 1940's than during the past 9 years, and that the rate of economic growth was also higher during this earlier period. But this correlation overlooks the point that, in the immediately postwar years, an entirely different composition of gross national product was needed than the composition needed in the more recent years. A pattern suitable to transition from war to peace is by definition nonsustainable. Further, we have no clear evidence that the 1946–48 investment boom was sustainable; indeed, we got into a sharp recession in 1949, and we do not know definitively what would have happened but for the outbreak of the Korean war in mid-1950. In any event, even if the ratio of investment to gross national product has averaged too low during the past 9 years as a whole, there is no reason to conclude that it might not average higher in the years ahead without the proposed tax concessions, if the economy maintains reasonably full use of its resources.

I want to say a few words more about the use, or rather misuse, in my judgment, of our international balance of payments and gold problem, and the problem of our competitive position in worldwide markets, to justify the tax concession, on the alleged ground that we need a faster rate of growth in productivity and technology, and that consequently we need to induce a higher ratio of investment to our total national product than would result nominally from reasonably full use of our productive resources. I have already pointed out fully that the surest road to improved and more sustainable levels of business investment, and to a more rapid rate of growth in technology and productivity, is to achieve a better balance between the growth of producers' facilities and the growth of ultimate demand, not to distort the relationships further by ill-considered tax giveaways.

But I still need to deal with the argument that those nations overseas which have achieved a higher economic growth rate than we have in recent years, such as Japan and Germany, have had a much higher ratio of investment to gross national product than we have had.

The comparisons are not valid, because if we had been bombed out to the extent that Japan and Germany were, we could have sustained for a few years a phenomenally high ratio of investment in capital goods to gross national product.

I believe that there is need to issue a word of warning against a wide range of international comparisons which are now in vogue, on this whole question of the investment-consumption relationship. Manifestly, an underdeveloped country like India, or a relatively underdeveloped country like Israel, needs to strive for what in our case would be a nonsustainably high ratio of investment to gross national product. In order to achieve this, these countries must vigorously restrain personal consumption. But this does not mean that these countries now have a sustainable pattern of growth; it merely means that they are undergoing a rapid transformation from one kind of economy to another kind. Similarly, the ratio of investment in capital goods to gross national product in the Soviet Union during recent years has little bearing upon the desirable ratio here, although of course the high rate of overall economic growth in the Soviet Union does have some bearing upon how high a rate of overall economic growth we should seek to achieve in the United States. And even the Soviets, in the years ahead, will utilize a larger part of their total national product to lift their consumer living standards.

As to countries like France and Italy, which recently have been growing at a faster overall rate than the United States, these countries have needed a higher ratio of investment to gross national product because they have been and still are so far behind us in the process of general industrialization. But none of the other countries I have referred to have countenanced a ratio of investment to ultimate demand which is nonsustainable, in the sense of yielding recurrent recessions and high idleness of plant and manpower. Our real problem, therefore, is to find for ourselves a ratio between investment and gross national product which offers fair promise of utilizing our own resources fully and steadily. These relationships we must forge out of pragmatic analysis of our own economy, not out of superficial analogies with other economies.

I should add also that many other exaggerations in fact, and errors in logic, have accompanied the effort to build up an emotional support for the proposed tax concession by the erroneous use of international comparisons. Quite aside from the point which I have already developed fully as to how we may best improve the efficiency of our own economic performance and thus compete more effectively overseas, some of the appraisals of the extent to which our own economic situation can be improved, by gains in our international trade position, are vastly exaggerated. Taking into account the current dollar amount by which our total national production or volume of national business is now short of maximum employment and production, and taking account also of the needed increases from year to year to absorb future increases in the labor force and in productivity, I estimate that we need a total level of national production not far from $100 billion higher in 1963 as a whole than it was in 1960. Even if the proposed trade program, which I favor heartily, were promptly enacted and achieved optimum results, it would be hard to find any economist who would think that this could add more than $2 billion or $3 billion a year to the expansion of the American economy. To regard this as a major approach to the whole problem of national economic restoration or national economic policy in the United States, is not the tail wagging the dog; it is the flea wagging the elephant. We are now letting misconceptions, both as to the significance and the potentials of our international economic situation, to turn us absolutely upside down in our national economic policies—policies which, in the long run, will determine not only our economic well-being at home, but also our economic strength all around the globe.

These exaggerations and distortions apply even to the comparisons made between the condition and strength of our industrial plant, compared with that in other countries. The way some figures on this subject have been manipulated is really discouraging. Obviously, the average age of steel plants in India is lower than the average age in the United States, because India not long ago had no real steel industry. Obviously, the average age of some types of machinery is lower in Japan and Germany than in the United States, because they were bombed out not very long ago. If we were bombed out and then rebuilt, the average age of our plants would be still lower. Obviously, even in countries of Western Europe, despite wonderful gains in recent years, they were for the most part grossly unindustrialized per capita, or by any other tests, in contrast with the United States, until a few years ago, and in fact still are. It is only to be expected that these Western European countries will to some degree catch up, and this necessarily involves their being "newer" in a lot of things because they started later. But we should not let this draw us into any irrational panic in our economic thinking. We are still tremendously ahead, by fair measurements, not only in aggregate plant equipment, but also in technology. And more important, the only way to stay ahead is to treat our own economy soundly, and not to repeat the errors which in recent years have caused us relative to lose ground where we should be holding our own.

Finally on this point, from the viewpoint of general economic analysis, I want to stress that I would have no objection whatsoever, through special tax concessions and otherwise, to encourage a rate of investment consistent with what some would regard as a exceedingly high rate of economic growth, let us say even 6 or 8 percent a year, if we deemed this to be essential in view of the worldwide struggle, and if we at the same time took measures to promote an expansion of ultimate private and public demand consistent with a 6 or 8 percent growth in total national product. During the Korean war, I was a very active proponent of special tax measures and other measures to stimulate the building of our productive base through investment in plant and equipment, not on the ground that this was indefinitely sustainable, but rather on the ground that this was the wisest way to prepare for a heavy defense burden of indefinite duration and thus gradually to overcome inflation without permanent starvation of our consumer economy and our peoples living standards. Some others took a different view, but the view which I advocated prevailed, and it turned out to be essentially correct. But the trouble in the current situation is that the proponents of the tax concession are bulls on investments and bears on ultimate demand, in deeds if not in words, and this merely repeats the errors of recent years.

Of course, these additional questions may be raised: Even if this tax credit is not genuinely needed, may it not be of some utility, on the ground that the economy admittedly needs some further stimulation, and that practically any kind of lightening of the tax burden at any point has some stimulative effect? In addition, may it not be argued that this proposed tax credit would not result in direct loss of revenue to the Federal Government, or not in very large losses, because it is accompanied by offsetting proposals to close some specified tax loopholes?

Granted that practically any kind of tax concession has some stimulative effect, we are confronted with a practical situation where the desire to balance the Federal budget, whether right or wrong, is manifestly holding public outlays below the level of some of the most important priorities of our needs. This desire for a balanced budget is also holding the general tax level at rates which many economists, including me, believe too high in that these rates would yield a very large budget surplus long before maximum employment and production are attained. Under these circumstances, it is not enough to say that the tax credit proposal would have some stimulative effect. The point I would stress most emphatically is that the many billions of dollars of direct loss of revenues to the Government which the tax concession would entail, over the years, would be infinitely more valuable to the economy if taken in the form of other types of tax abatement, such as reducing the effective tax take on low-income consumers, or in the form of increased expenditures for very high priorities for national needs. The condition of the Federal budget leaves no room to squander potential tax revenue to the tune of many billion dollars, when there would be so many effective ways of using this potential revenue. In the context of this argument, the proposal to close tax loopholes really has nothing to do with the case. Whether tax loopholes are closed or not, the principle still applies that tax concessions should be directed to where they will do the most good.

Further, even while conceding that the proposed tax concession to investment might have some immediate stimulative effect, I still maintain that it would be highly unwise economic policy, quite apart from immediate considerations of the Federal budget. In the short run, it is certainly undesirable to offer such tax concessions for the expansion of producer facilities, at a time when these facilities are still in large oversupply relative to ultimate demand, and when the main inhibiting factor against business investment expansion is the concern which appears to me legitimate that ultimate demand will not expand sufficiently to justify such additional investment. Thus, the tax concession is untimely in terms of the immediate economic situation. And from the long-range viewpoint, the tax concession would aggravate rather than moderate the established tendency of investment in producer facilities to outrun ultimate demand whenever the economy is operating near maximum employment and production, and thus exerting real pressure upon available productive facilities. In effect, the tax concession would misplace the stimulative effect in the short run, and in the long run would generate economic disequilibrium and therefore be depressive and work against economic growth.

In this broader perspective, the undesirability of the 7-percent tax concession proposal looms very large, because it is symbolic of a more general misplacement of emphasis in dealing with our economic problems in their entirety. Nor are the amounts involved small. The difference between the many billion dollars which would be applied toward these tax concessions, as against the same billions of dollars applied in more wholesome ways, comes to an aggregate net effect which I submit to be of very large and lasting economic significance.

Before closing my discussion of investment and economic growth, I should like to comment upon the monumental study recently completed by the distinguished economist, Simon Kuznets, entitled "Capital in the American Economy." This study has been used, in some quarters, to support the thesis that the U.S. economy has suffered from a long-term deficiency in savings, that this in turn has worked against an adequate long-term level of private investment in the means of production, and that this in turn has worked against an adequate long-term rate of economic growth.

It is impossible in short space to evaluate thoroughly the Kuznets study. In brief, while it is an invaluable gathering of useful data, I do not believe that its description of what happened in the long run is accompanied by comparable analysis of why the economy behaved as it did; that is, by equilibrium analyses. To say that savings and investment were deficient in the long run, even if true, does not reveal the reasons for these deficiencies, nor reveal whether these longrun deficiencies may not have been the result of periodic deficiencies in ultimate demand which caused savings and investment to behave in an erratic fashion, swinging between periods of excess and periods of deficiency. The study, with its long-range focus, does not attempt much analysis of the successive shorter range or cyclical variations in the economy which add up to the long-range performance. These cyclical variations must be examined very carefully, if one seeks to draw policy conclusions from the long-range description.

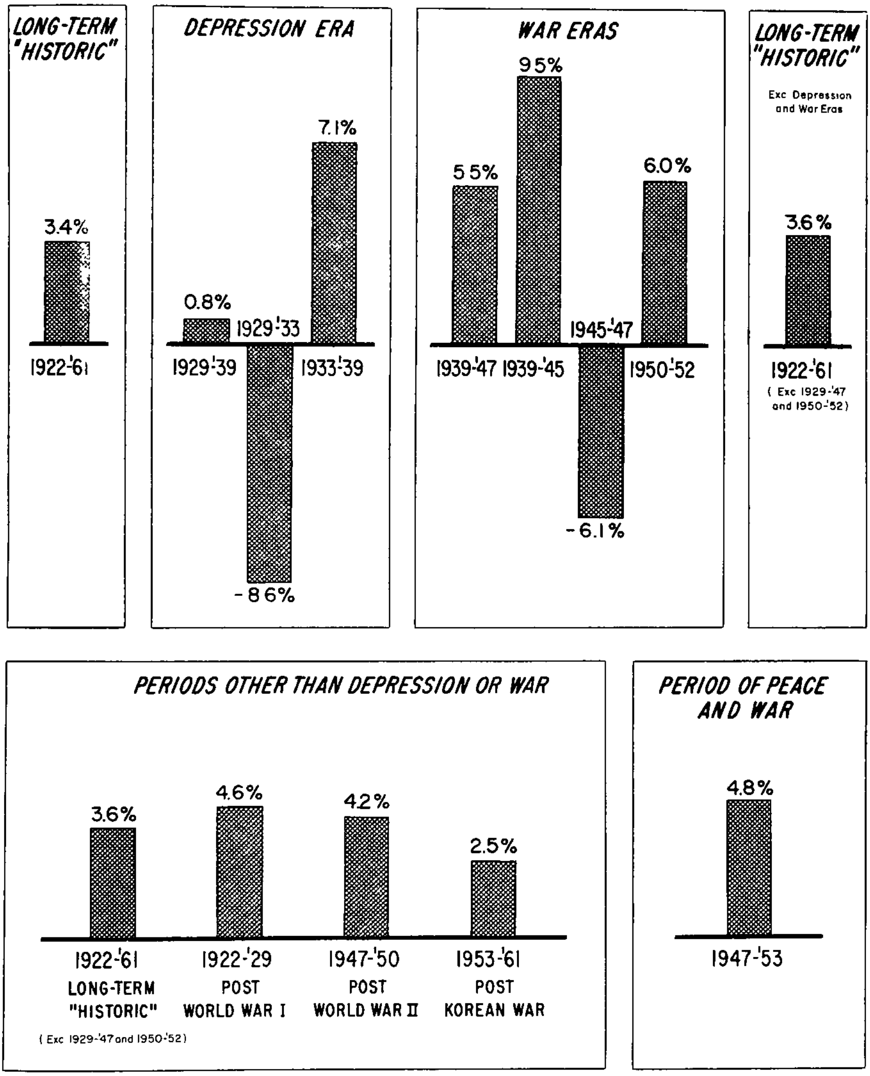
In any event, the Kuznets volume hardly touches upon the record during the most recent years, and not at all upon the current economic situation, and these periods are probably much more relevant to current policy issues than the very long-range trends or the distant past. I would venture the strong guess that Dr. Kuznets, careful scholar that he is, would be the last to argue that his book can provide important guidelines as to whether a 7-percent tax credit now to stimulate investment in producer facilities would be wise or unwise.

I am sorry that I have been so critical, for I am in sympathy with the aims of the administration. I have a high personal regard, and a high professional respect, for the three members of the present Council of Economic Advisers. These comments go double with respect to the President of the United States, whose problems both domestic and international, both substantive and political, would be so close to unbearable if the bearer were not so strong.

Yet I cannot avoid the conviction, especially in the light of the nature and failings of the economic upturn in process since early 1961, that unless we alter our course and profoundly reshape our economic thought and action—and here this committee of the Congress can be of immense help—we shall register an economic growth rate during the next few years not appreciably better than the average since 1953. If this should happen, in view of the new technology and the rapid growth in the labor force which lie ahead, our idleness of plant and manpower in the years to come would average very much higher than in recent years, as shown by my 16th, 17th, and 18th charts. Our domestic defaults would worsen; our international position would become critical indeed. Therefore, I feel that some of us must assume the unpleasant task of being sincerely critical, even if it would be more pleasant to remain silent.

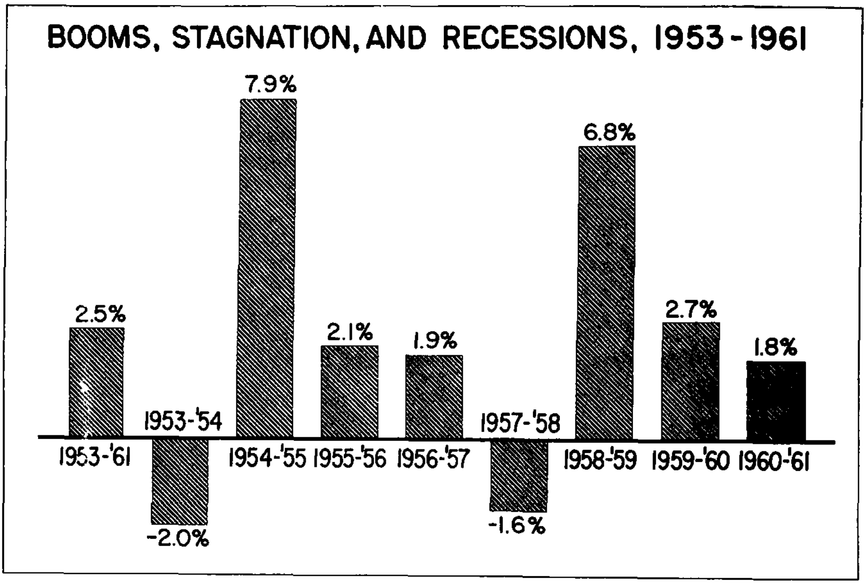
GROWTH RATES, U.S. ECONOMY, 1922-1961

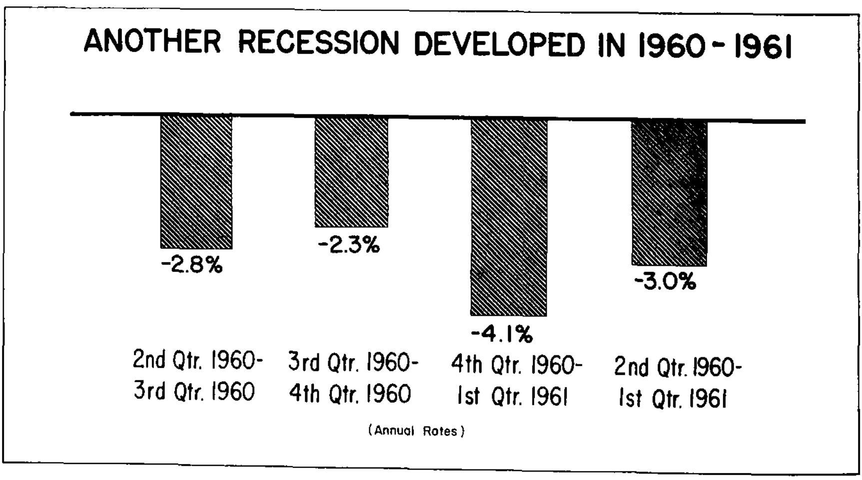
Average Annual Rates of Change in Gross National Product
In Uniform 1960 Dollars



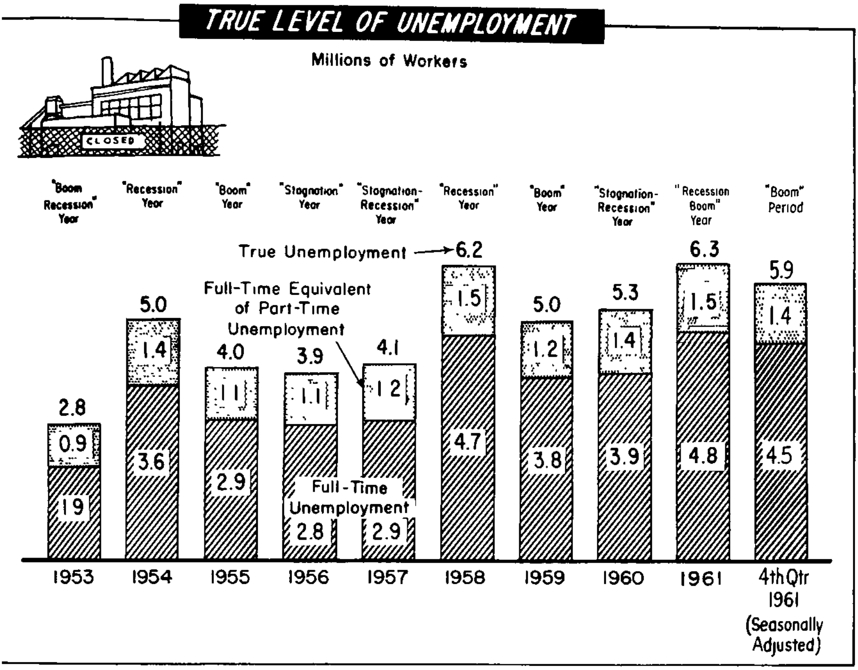
GROWTH RATES, U.S. ECONOMY, 1953-1961

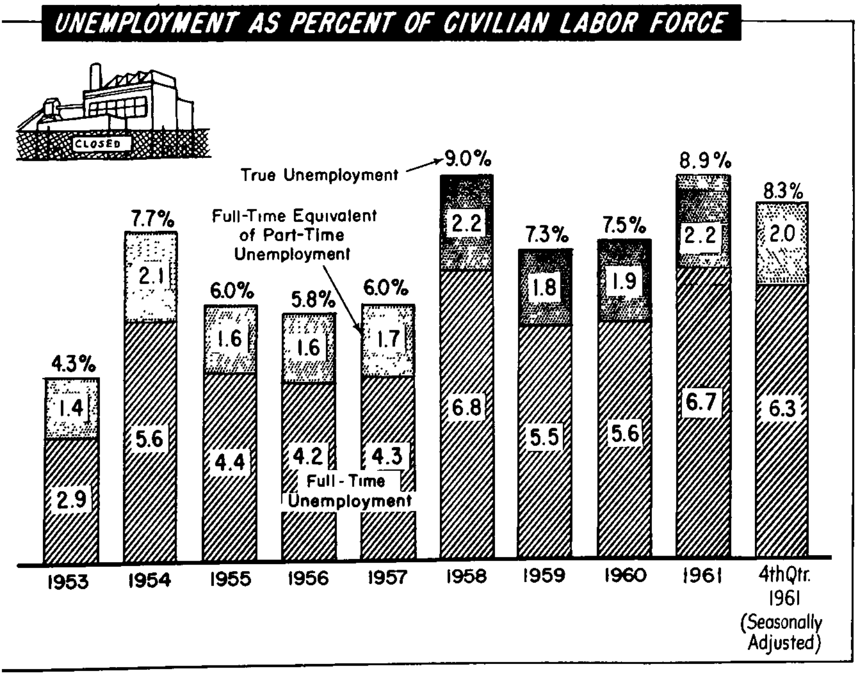
Average Annual Rates of Change in Gross National Product
In Uniform 1960 Dollars





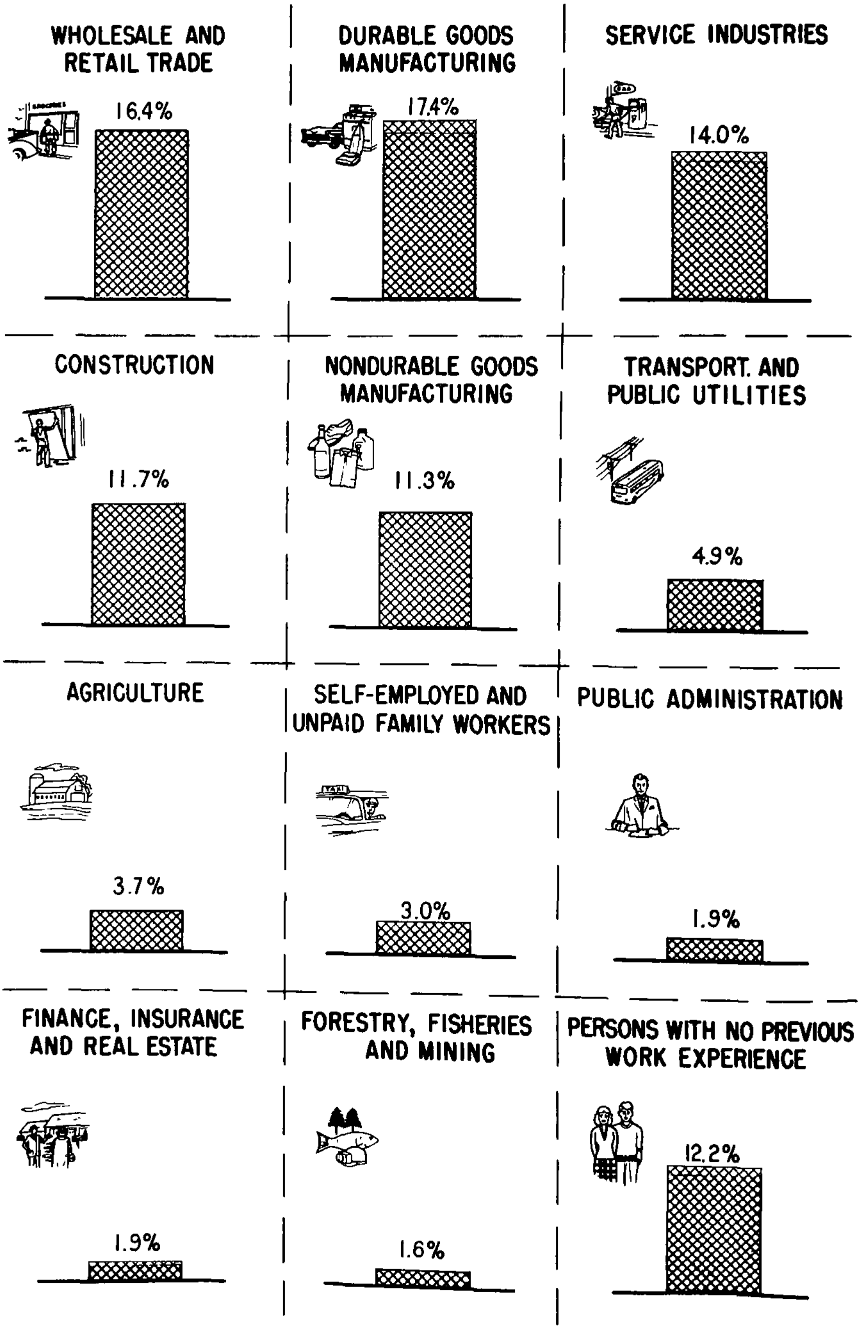
THE CHRONIC RISE OF IDLE MANPOWER



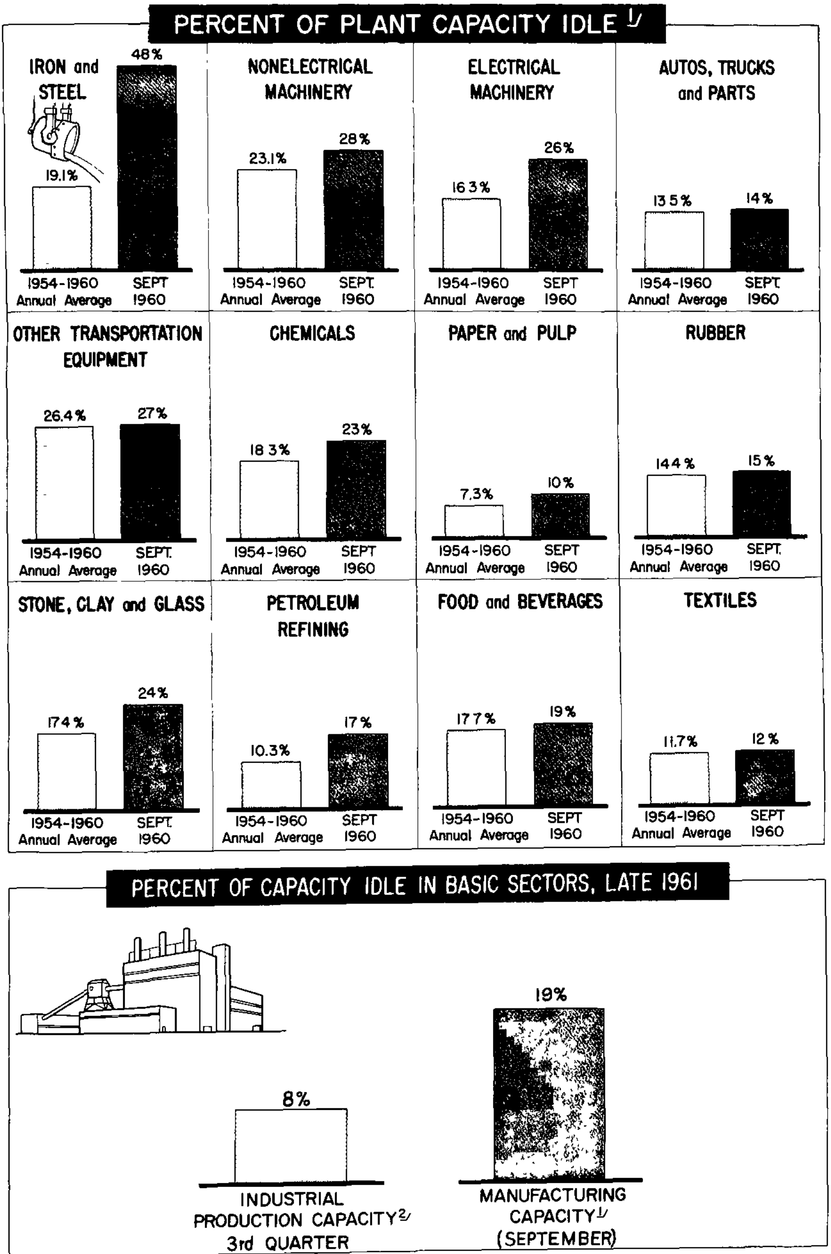


TOTAL OF THOSE UNEMPLOYED SHOWN BY CATEGORY, 1961

(All Categories Add to 100 Percent)



THE GROWING VOLUME OF IDLE PLANT AND MACHINES—1954-1961

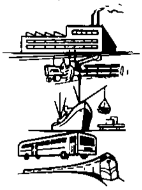


Source of Basic Data 1/ McGraw Hill Annual Surveys, 2/ University of Pennsylvania, Econometric Research Unit

LARGE NATIONAL ECONOMIC DEFICITS DURING 9 -YEAR PERIOD 1953-1961

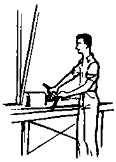
Dollar Items in 1960 Dollars

TOTAL NATIONAL PRODUCTION
(GNP)



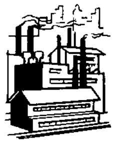
$344 Billion
Too Low

MAN YEARS OF EMPLOYMENT



22.4 Million
Too Low

PRIVATE BUSINESS INVESTMENT
(Incl Net Foreign)



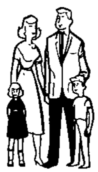
$90 Billion
Too Low

PRIVATE AND PUBLIC CONSUMPTION [1]

$254 Billion
Too Low

. . .THESE HAVE LED TO LARGE LOSSES TO ALL ECONOMIC GROUPS

AVERAGE FAMILY INCOME
(Multiple Person Families)



$5,750
Too Low

FARM OPERATORS' NET INCOME

$55 Billion
Too Low

WAGES AND SALARIES

$228 Billion
Too Low

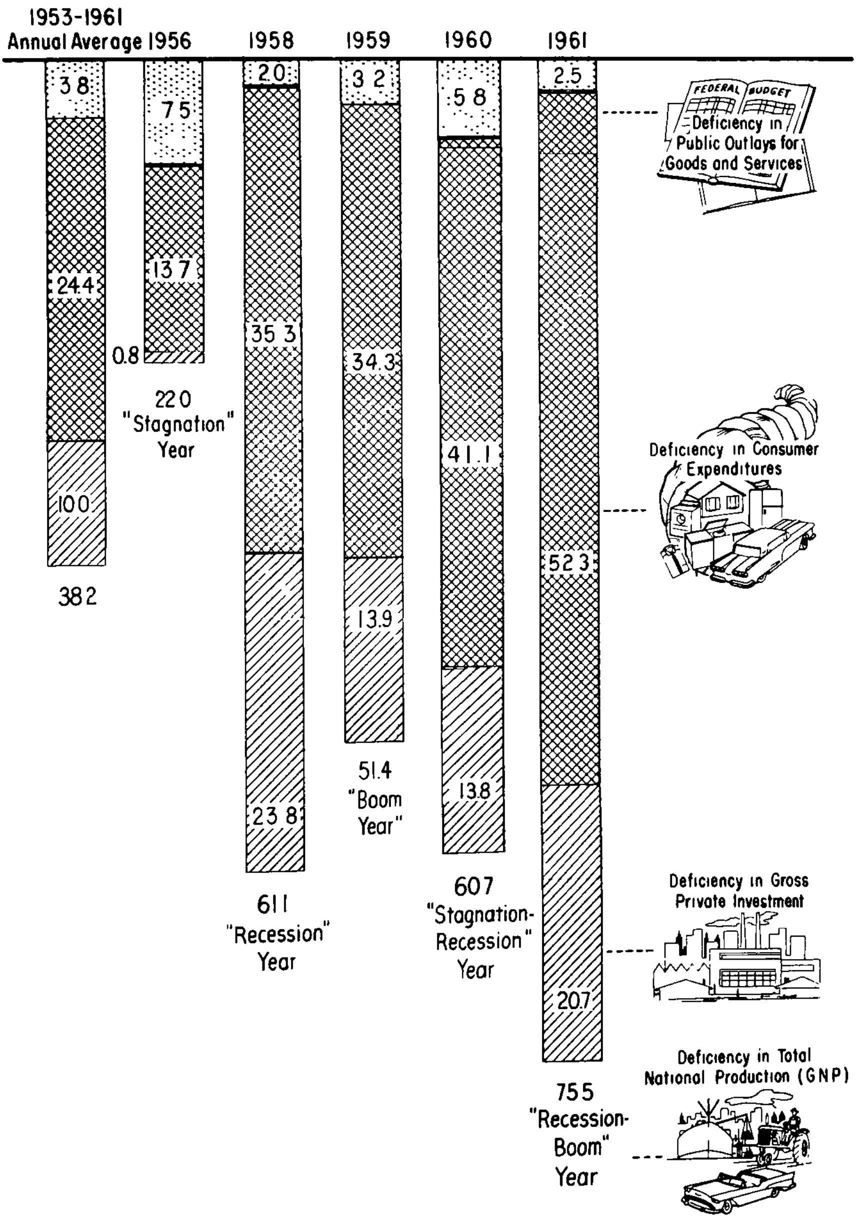
UNINCORPORATED BUSINESS AND PROFESSIONAL INCOME

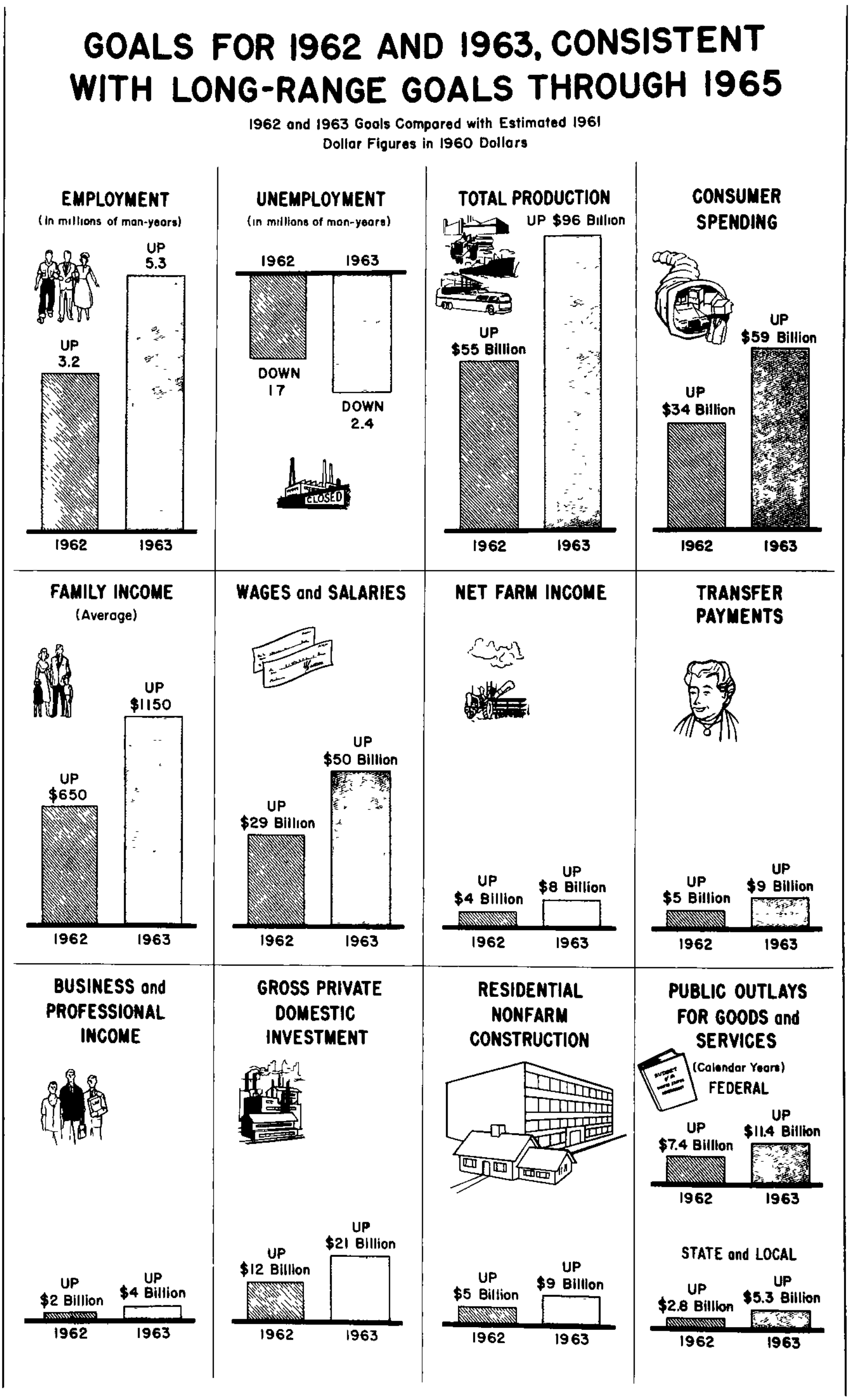
$18 Billion
Too Low

[1] Includes personal consumption expenditures plus government (federal, state, and local) expenditures (220 and 34, respectively)

DEFICIENT "DEMAND" OR SPENDING ACCOUNTS FOR DEFICIENT TOTAL PRODUCTION (GNP)

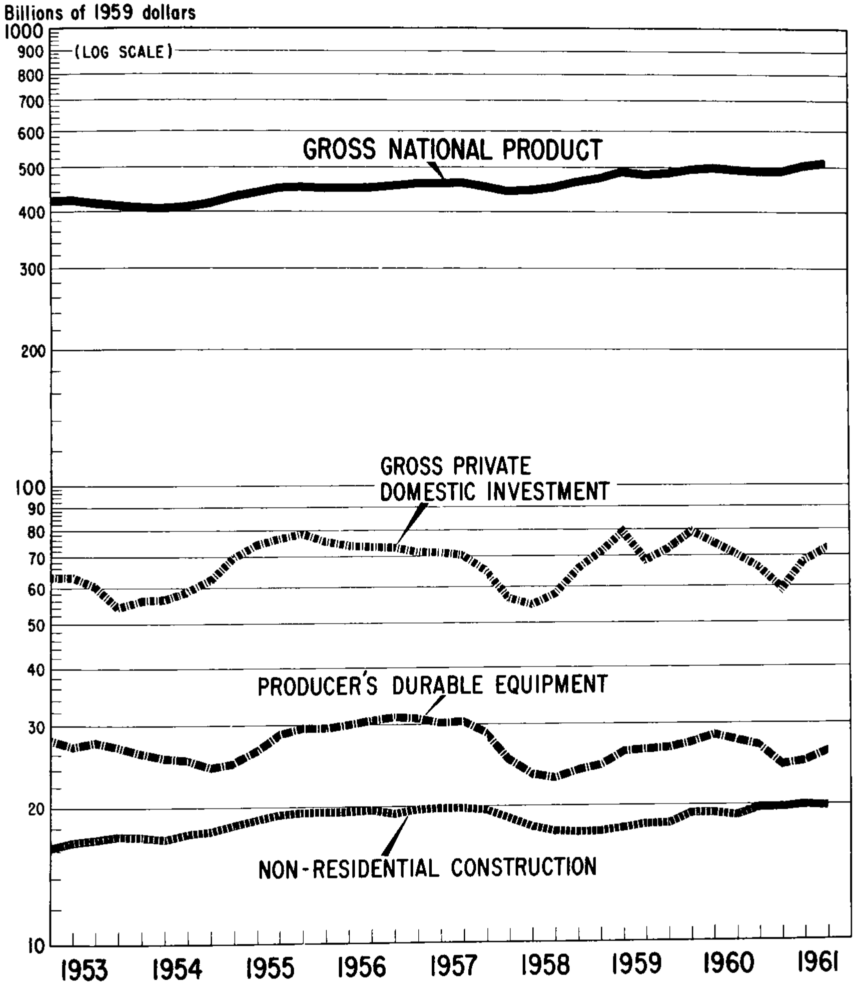
Billions of 1960 Dollars



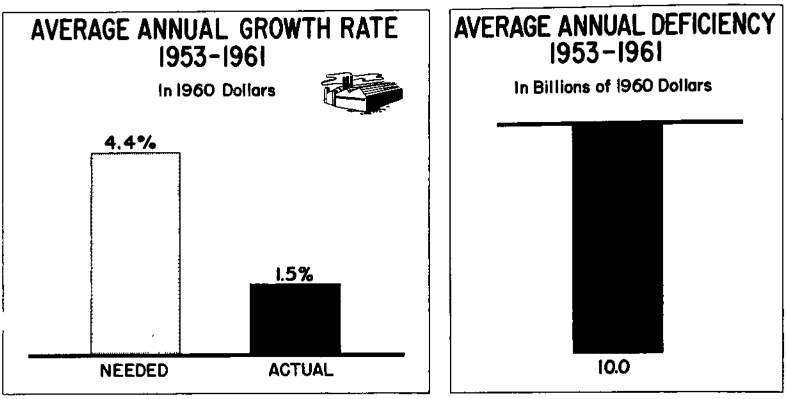

GOALS FOR 1962 AND 1963, CONSISTENT WITH LONG-RANGE GOALS THROUGH 1965
1962 and 1963 Goals Compared with Estimated 1961
Dollar Figures in 1960 Dollars
EMPLOYMENT
(In millions of man-years)
UP 3.2
UP 5.3
1962
1963
UNEMPLOYMENT
(in millions of man-years)
1962
1963
DOWN 1.7
DOWN 2.4
CLOSED
TOTAL PRODUCTION
UP $55 Billion
UP $96 Billion
1962
1963
CONSUMER SPENDING
UP $34 Billion
UP $59 Billion
1962
1963
FAMILY INCOME
(Average)
UP $650
UP $1150
1962
1963
WAGES and SALARIES
UP $29 Billion
UP $50 Billion
1962
1963
NET FARM INCOME
UP $4 Billion
UP $8 Billion
1962
1963
TRANSFER PAYMENTS
UP $5 Billion
UP $9 Billion
1962
1963
BUSINESS and PROFESSIONAL INCOME
UP $2 Billion
UP $4 Billion
1962
1963
GROSS PRIVATE DOMESTIC INVESTMENT
UP $12 Billion
UP $21 Billion
1962
1963
RESIDENTIAL NONFARM CONSTRUCTION
UP $5 Billion
UP $9 Billion
1962
1963
PUBLIC OUTLAYS FOR GOODS and SERVICES
(Calendar Years)
FEDERAL
UP $7.4 Billion
UP $11.4 Billion
1962
1963
STATE and LOCAL
UP $2.8 Billion
UP $5.3 Billion
1962
1963

FLUCTUATIONS IN GNP AND IN TYPES OF INVESTMENT, 1953-1961

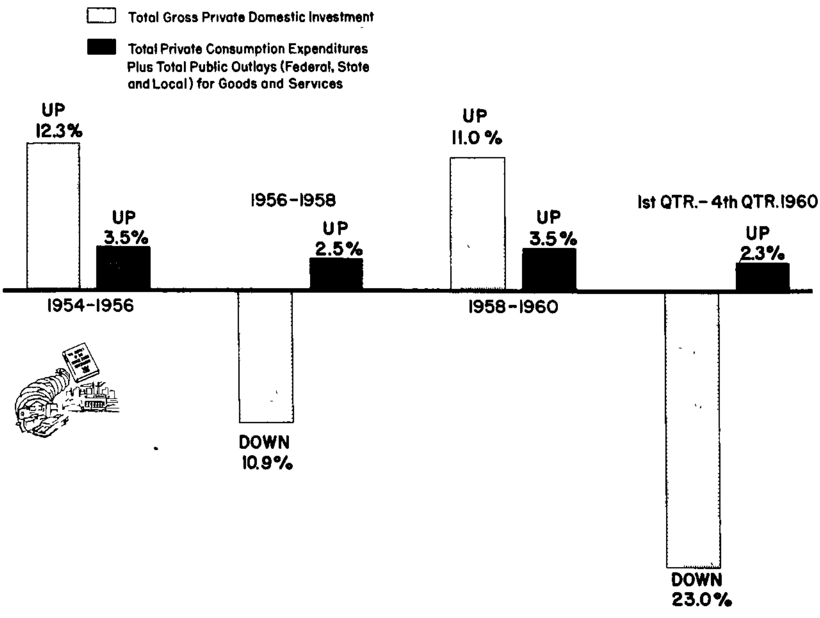
(Quarterly Data, Seasonally Adjusted Annual Rates)



GROSS PRIVATE DOMESTIC INVESTMENT WAS DEFICIENT DURING 1953-'61 AS A WHOLE



BUT AT TIMES INVESTMENT FAR OUTRAN CONSUMPTION; THIS LED TO RECESSIONS AND CORRECTIVE INVESTMENT SHRINKAGE



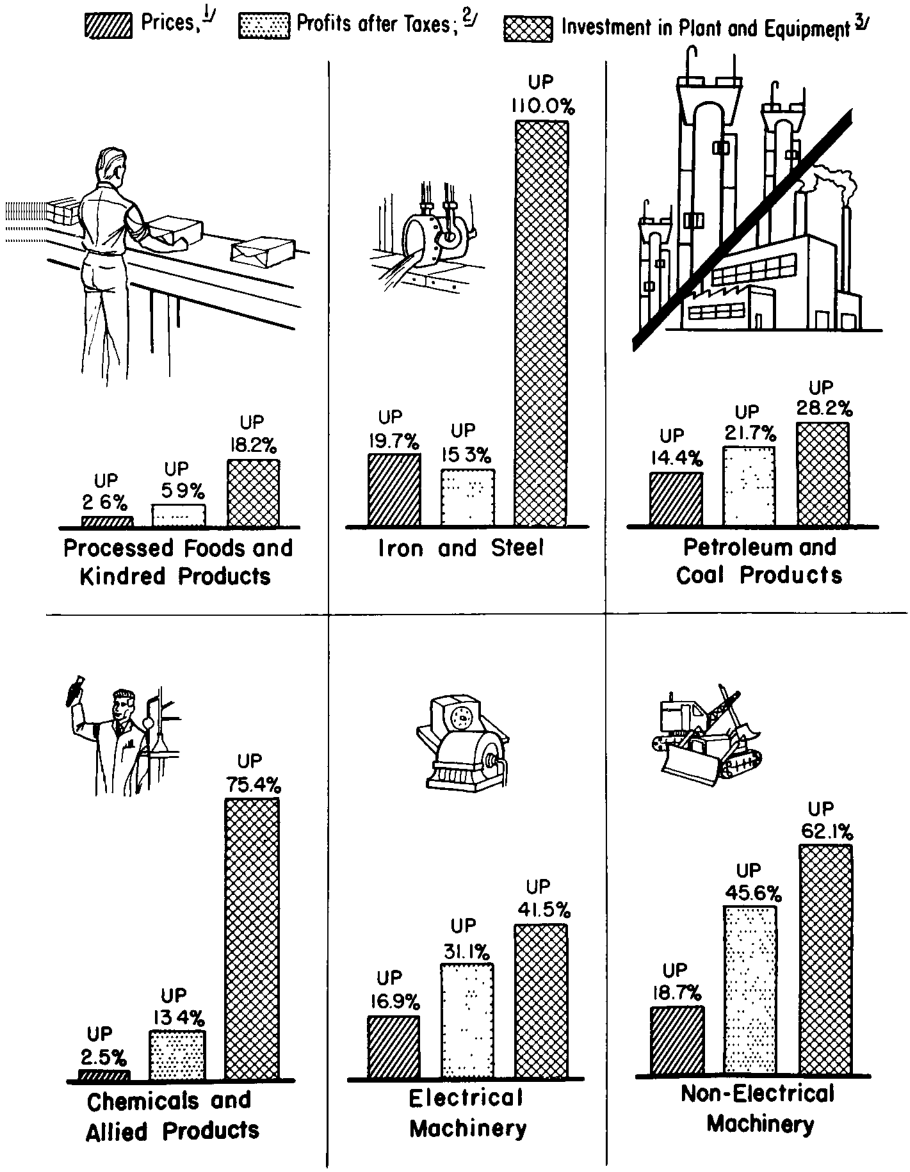
AVERAGE ANNUAL RATES OF CHANGE, 1960 DOLLARS

82190 6116 66%

PRICES AND PROFITS ENCOURAGE VERY HIGH INVESTMENT UNTIL CONSUMPTION DEFICIENCY PUNCTURES THE BOOM

The Investment Boom Before the 1957-1958 Recession

First Three Quarters 1955 First Three Quarters 1957



1/ Bureau of Labor Statistics, (U S Dept of Labor), Commodity Wholesale Price Indexes

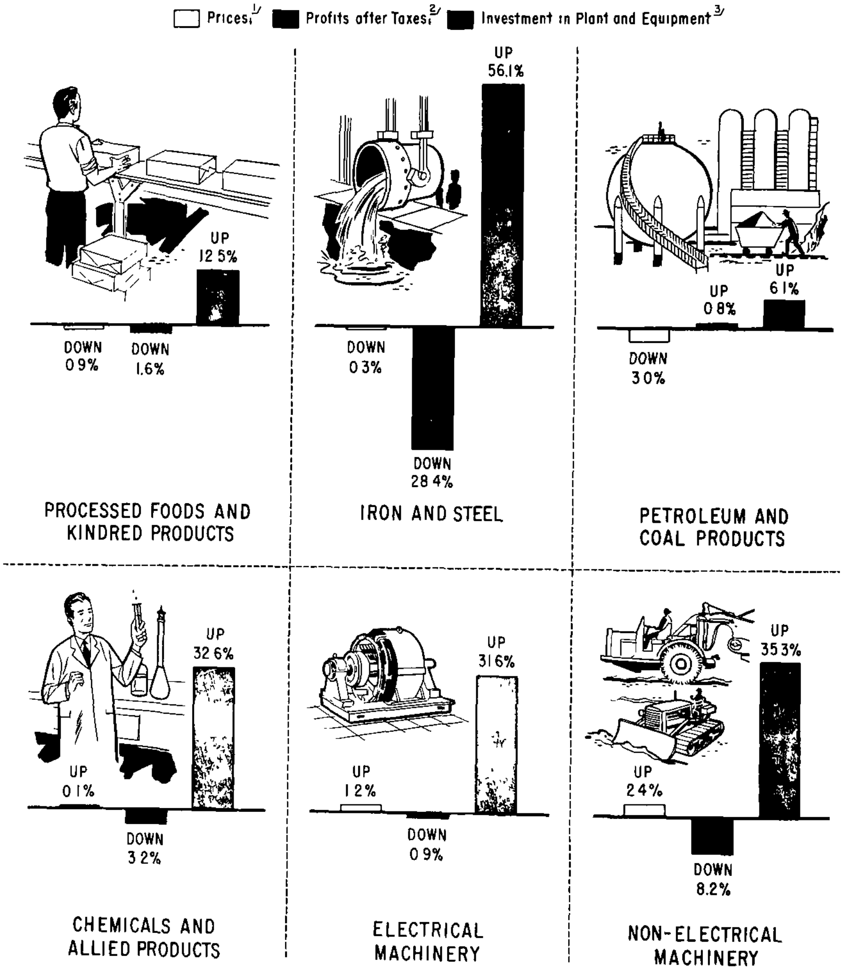
2/ Securities and Exchange Commission, Profit Estimates

3/ Securities and Exchange Commission estimates of expenditures for plant and equipment

HIGH INVESTMENT FEASIBLE AT TIMES DESPITE REDUCED PRICES AND PROFITS

The Investment Boom Before the 1960-1961 Recession

First Half 1959 – First Half 1960



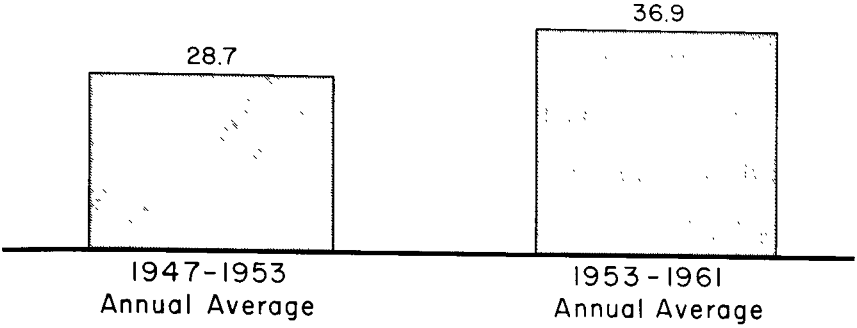
1/ U S Dept of Labor, Bureau of Labor Statistics, commodity wholesale price indexes

2/ Securities and Exchange Commission, profit estimates

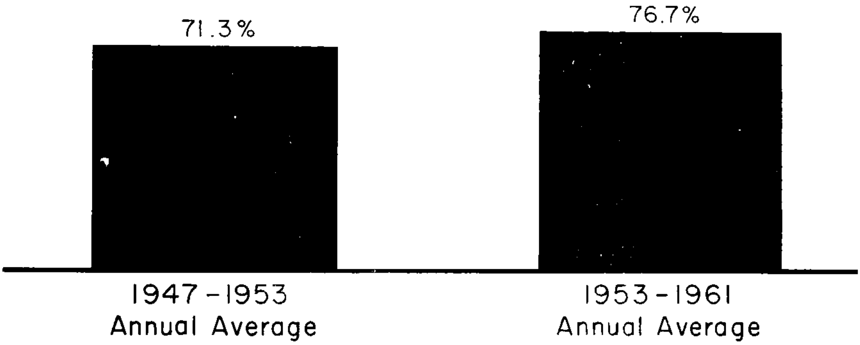
3/ Securities and Exchange Commission, estimates of expenditures for plant and equipment

TOTAL FUNDS USED BY CORPORATIONS HAVE INCREASED

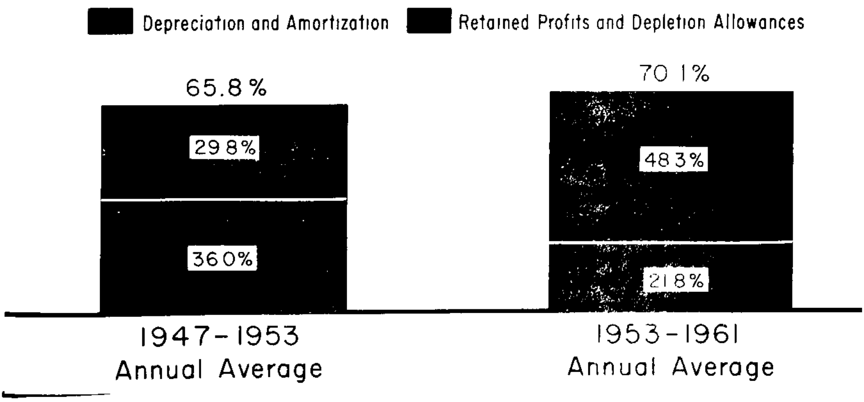
Billions of Current Dollars



PORTION OF THESE FUNDS USED FOR PLANT AND EQUIPMENT HAS GROWN



PORTION OF CORPORATE FUNDS DRAWN FROM INTERNAL SOURCES HAS RISEN



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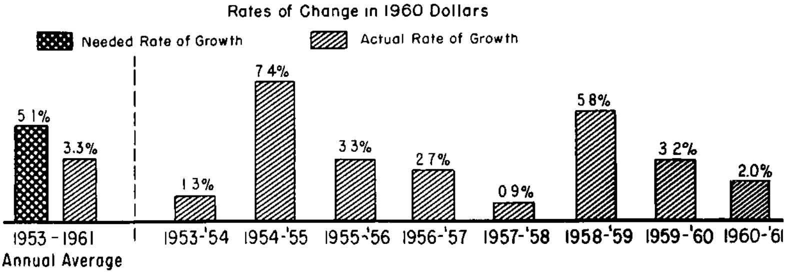
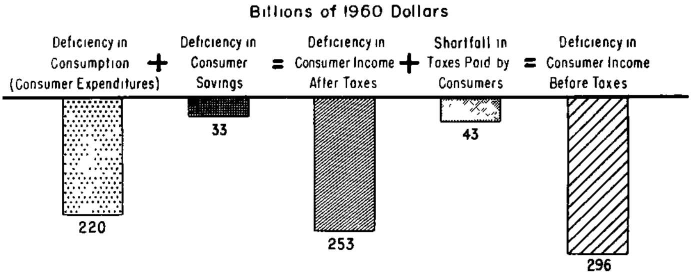
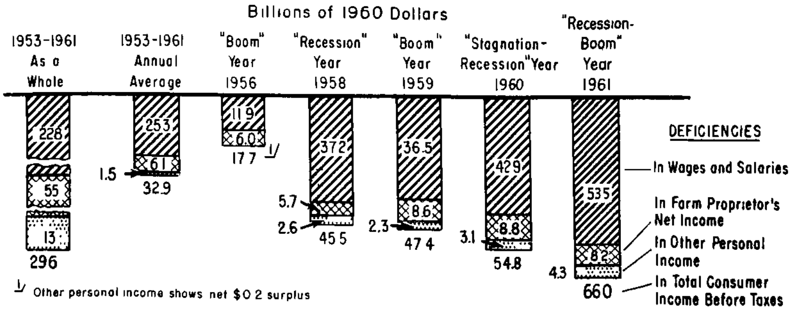
DEFICIENT RATE OF GROWTH IN PRIVATE CONSUMER SPENDING, 1953-1961



$220 BILLION CONSUMPTION DEFICIENCY, 1953-1961 AS A WHOLE, REFLECTED EVEN LARGER CONSUMER INCOME DEFICIENCY

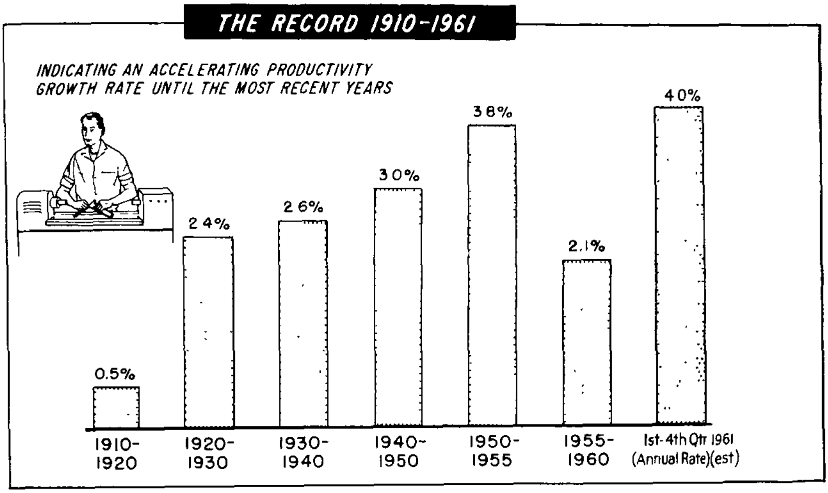


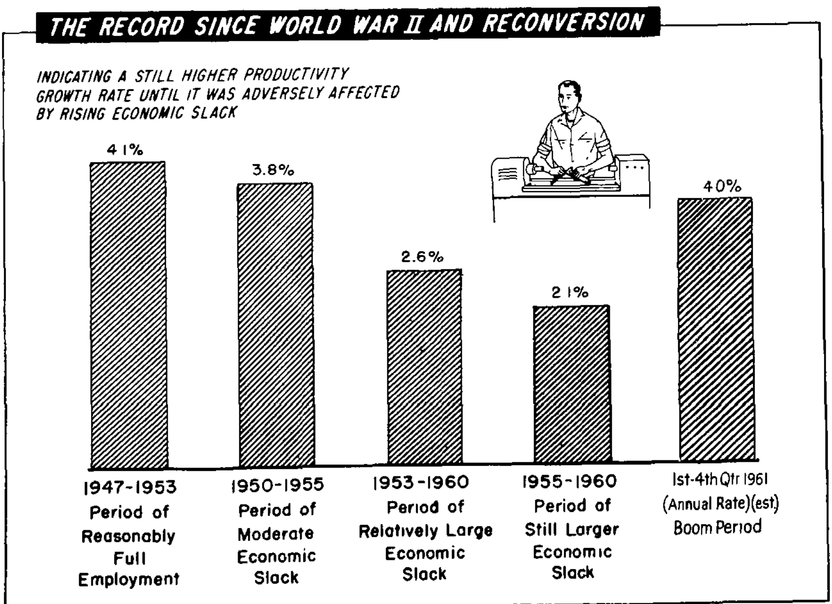
DEFICIENCIES IN WAGES AND SALARIES AND IN FARM INCOME ACCOUNT FOR MOST OF TOTAL CONSUMER INCOME DEFICIENCY



TRENDS IN OUTPUT PER MAN-HOUR -OR PRODUCTIVITY-1910-1961

Average Annual Rate of Productivity Growth
for the Entire Private Economy

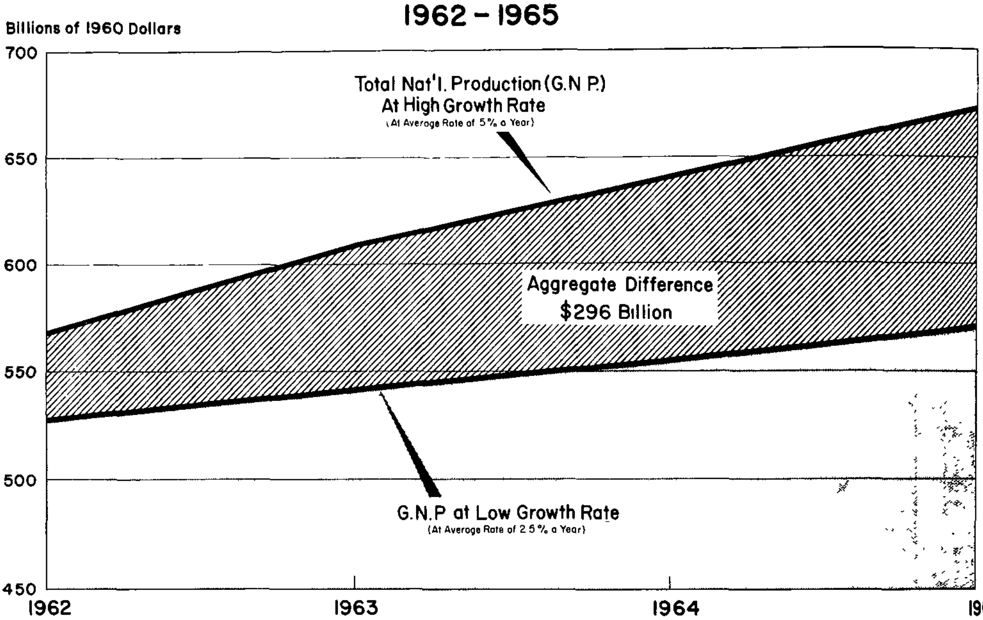




Note. Based on U S Department of Labor estimates, relating to man-hours worked

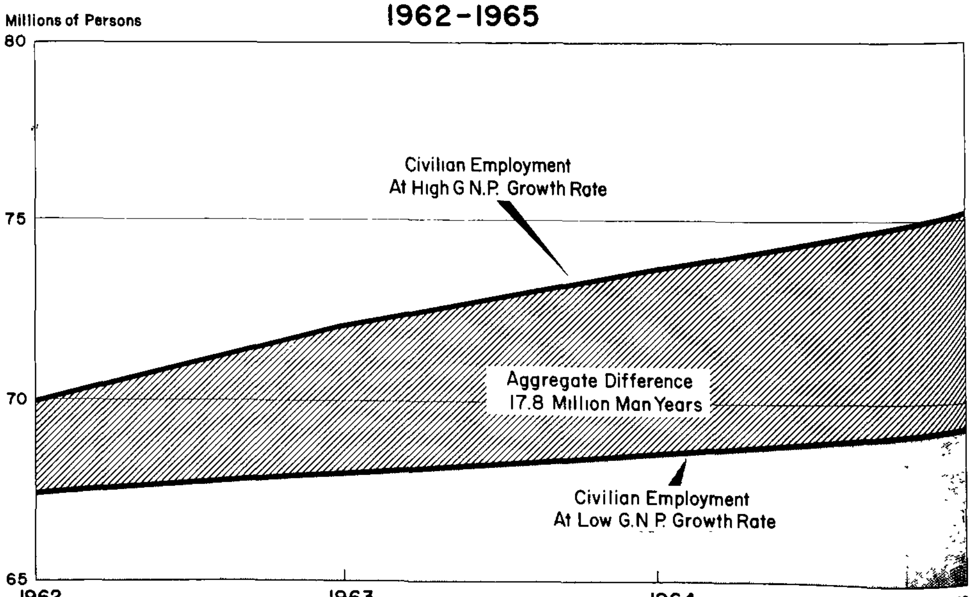
BENEFITS OF HIGH GROWTH RATE IN TERMS OF PRODUCTION

1962 - 1965



BENEFITS OF HIGH GROWTH RATE IN TERMS OF EMPLOYMENT

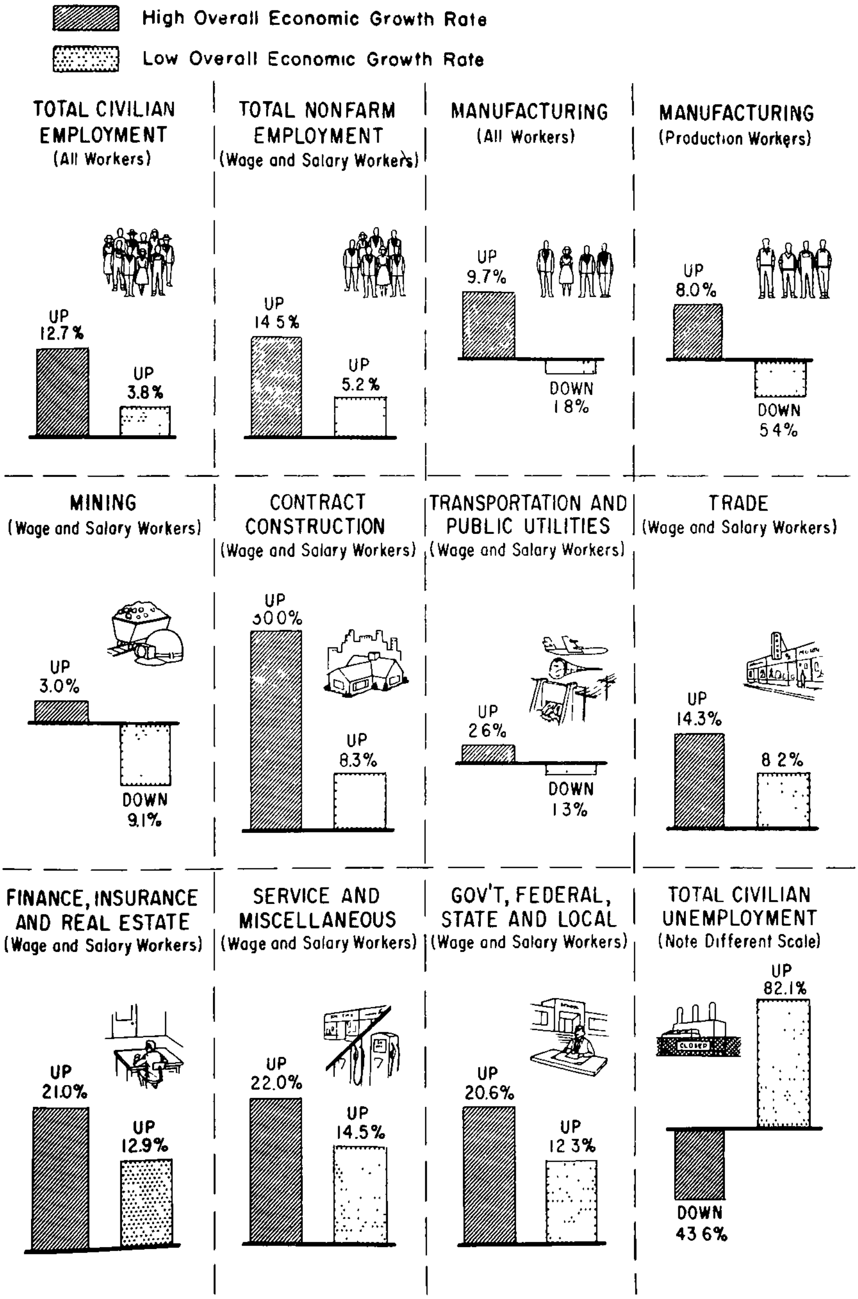
1962-1965



NOTE 1961 is used as the projection base year for this chart

ALTERNATE EMPLOYMENT TRENDS, 1960-'65, AT HIGH & LOW OVERALL GROWTH RATES

Index: 1960 = 100



DIFFERENCES IN RESULTS OF HIGH AND LOW ECONOMIC GROWTH RATES, 1962-1965

Bold Face - Difference in 1965; *Italics - Difference for four year period as a whole*
Dollar figures in 1960 dollars

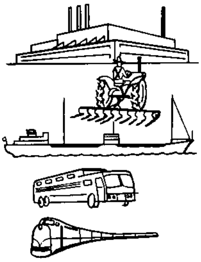
EMPLOYMENT 1/
(In millions of man-years)

6.0
17.8

UNEMPLOYMENT 1/
(In millions of man-years)

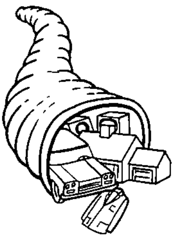
4.9
14.7

TOTAL PRODUCTION



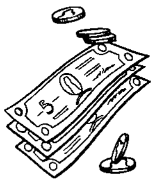
$103 Billion
$296 Billion

CONSUMER SPENDING



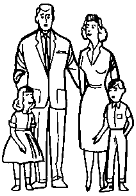
$63 Billion
$186 Billion

PERSONAL INCOME



$79 Billion
$229 Billion

FAMILY INCOME
(Average)



$1,250
$3,700

WAGES and SALARIES

$53 Billion
$157 Billion

NET FARM INCOME

$13.5 Billion
$38 Billion

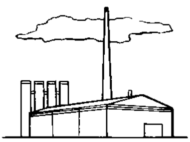
TRANSFER PAYMENTS

$11 Billion
$30 Billion

BUSINESS and PROFESSIONAL INCOME

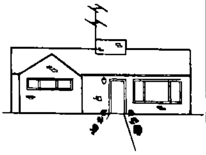
$5.3 Billion
$13 Billion

GROSS PRIVATE DOMESTIC INVESTMENT 2/



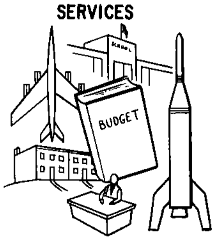
$25 Billion
$68 Billion

RESIDENTIAL NONFARM CONSTRUCTION



$10.5 Billion
$31 Billion

FEDERAL, STATE, AND LOCAL GOV'T OUTLAYS FOR GOODS AND SERVICES



$15 Billion
$42 Billion

1/ High growth rate would draw more persons into the labor market than low growth rate
2/ Including net exports of goods and services

The CHAIRMAN. The next witness is Mr. E. V. Huggins, executive vice president of Westinghouse Electric Corp.

Please proceed, Mr. Huggins.

STATEMENT OF E. V. HUGGINS, EXECUTIVE VICE PRESIDENT, WESTINGHOUSE ELECTRIC CORP.

Mr. HUGGINS. My name is E. V. Huggins and I am executive vice president, associated activities, of Westinghouse Electric Corp. I am responsible for overall direction of Westinghouse foreign operations.

I am here to urge that the tax laws not be changed in a way which would impair the ability of Westinghouse to continue its vital business of exporting American-made goods and services to foreign markets.

Westinghouse has always had as a basic objective the export of the maximum amount of Westinghouse products manufactured by more than 105,000 employees in 100 plants all over the United States. This export program is supported by our extensive efforts in research and development to maintain and improve our competitive position.

In order to strengthen our selling effort abroad, Westinghouse has a foreign sales subsidiary. This subsidiary sells and services U.S.-made Westinghouse products and license agreements in oversea markets from offices in 14 countries of Europe, Africa, the Near East, and Far East. The income of this subsidiary is an important source of capital to provide vital long-term financing for these export sales.

As a matter of basic overall policy, we do not build and operate Westinghouse-owned plants abroad. The wisdom of our policy to export and not manufacture abroad has been demonstrated time and again by the very successful results obtained for Westinghouse, its employees, and the Nation as a whole.

Our foreign operations are being conducted in a manner which promotes important national objectives. President Kennedy stated recently to the Congress that—

> An expanded export program is necessary to give this Nation both the balance-of-payments equilibrium and the economic growth we need to sustain our share of the Western military security and economic advance.

He has stressed the importance of exporting to help combat inflation and unemployment.

According to Secretary Dillon, "Expanding our export trade has become an urgent national need." He advised the Ways and Means Committee that—

> Our outlays abroad for the national defense, aid, and investment are large and continuing. If these payments are to be met the United States must export more.

No one can disagree with these statements. However, unless our tax legislation conforms to this policy, these national objectives cannot be attained.

Westinghouse manufactures in the United States a great variety of electrical products and currently exports about $175 million of those products annually. During the last decade the dollar volume of Westinghouse exports has almost doubled. This rate of growth of exports was many times that experienced by the U.S. electrical manufacturing industry as a whole and substantially greater than the growth in U.S. exports generally.

A large portion of Westinghouse exports is heavy electrical equipment and our company accounts for a substantial percentage of total U.S. exports of these products.

Exports play some part in practically all Westinghouse activities. Exports were directly responsible for the employment of an estimated 10,000 Westinghouse employees in the United States in 1961. These employees, most of whom are heads of families, earned an annual payroll of about $77 million. In manufacturing products for export, Westinghouse in addition incurs costs and expenses, such as the purchase of materials and supplies from U.S. firms and the payment of local taxes, amounting to many millions of dollars annually, which provides additional U.S. employment.

One of the most important reasons for the marked increase in Westinghouse exports has been the ability of Westinghouse to extend long-term credit to its foreign customers providing for payment over 5 to 12 years.

The need of long-term credit in making sales to foreign customers has greatly increased in recent years. The worldwide competitive situation has demanded that Westinghouse extend liberal long-term financing to foreign customers, primarily in the underdeveloped areas, in order to obtain business. It is no longer just price and technical superiority, but also credit terms which bear strongly on competition for foreign business.

This competitive pressure on Westinghouse to extend additional credit to foreign customers comes not only from American producers. Foreign producers and foreign government agencies have been increasingly willing to extend long-term credit. In particular, the major Western European countries have shown themselves quite willing to use credit as the means of obtaining sales. If American electrical producers, such as Westinghouse, are to obtain an increasing volume of foreign orders, they must themselves participate in liberal credit terms.

During the 9-year period 1953–61, the dollar amount of annual foreign orders booked by Westinghouse almost doubled, rising from $91.6 to $176.6 million. At the end of 1961 the total dollar amount of Westinghouse long-term credit outstanding or committed was $100 million almost eightfold the $13.4 million at the end of 1953.

During the period 1953–61, Westinghouse obtained foreign orders of over $240.2 million in which Westinghouse long-term credit was involved. Of the $240.2 million, $141.2 million represented long-term credit. This meant that each $100 of sales obtained through the extension of credit required that Westinghouse supply $59 in long-term credit, or that $100 of long-term credit gave rise to $170 in export sales. Furthermore, it should be noted that over 90 percent of this long-term financing has been for customers in less developed countries. Obviously, the risk of loss is much greater in such countries than in stable countries.

The problem today is to find capital for long-term financing of exports. As indicated, one important source of capital to finance Westinghouse foreign sales has been the income of its foreign sales subsidiary. Since under present law such income is not subject to U.S. taxation until it is returned to the parent as a dividend, and is subjected to moderate foreign taxes, the foreign subsidiary is able to devote its income to financing U.S. exports. At the end of 1961 the retained foreign income of our foreign sales subsidiary was used almost entirely to finance export sales from the United States. If the undistributed foreign source income of the Westinghouse oversea sales subsidiary is subjected to U.S. income tax, the amount of retained earnings available for extension of credit would be seriously decreased. This would adversely affect export sales. It would adversely affect employment and the income of our employees and of the communities in which they live, reduce our purchases in the United States and reduce U.S. and local taxes which flow from these transactions.

Such an unfortunate result can be averted by specifically continuing to exclude from current U.S. taxation any income of foreign subsidiaries which is used to finance export sales from the United States so long as it continues to be so used.

Credit provided by a foreign subsidiary to finance exports from the United States is a positive aid to the U.S. balance of payments. An amount invested in manufacturing plant facilities in a less developed country does not improve the balance-of-payments problem nearly as much as the use of an equivalent amount to finance the export of U.S. goods. Therefore, if the income of a foreign subsidiary invested in such a plant is not to be subjected to current U.S. taxation as provided by H.R. 10650 such income used for financing U.S. exports should not be given less favorable treatment. Indeed, even if the income of a foreign subsidiary invested abroad is subject to current U.S. taxation, income used to finance U.S. exports should not be so taxed.

Secretary Dillon told this committee on April 2, 1962, of two important advantages of the President's recommendations on the tax treatment of foreign income and investment. He stated:

> They will promote domestic capital formation and employment and thus stimulate economic growth in this country. * * * [And] Implementation of these recommendations will also contribute to improved balance-of-payments position for at least the next 10 to 15 years, when we expect we will most need that improvement.

A foreign subsidiary which sells abroad U.S. manufactured products and which uses its earnings to finance such export sales clearly achieves the advantages urged by Secretary Dillon. It improves the balance of payments and increases economic activity and employment in the United States. In the case of heavy equipment, credit is becoming the difference between making the sale or losing it. U.S. taxation of the earnings of such a foreign sales subsidiary would reduce its ability to extend credit to the detriment of U.S. exports.

Therefore, the provisions of H.R. 10650 should be clarified so that section 13 (dealing with controlled foreign corporations) provides that the foreign income of a foreign sales subsidiary (whether it operates on a purchase or resale or a commission basis) used to finance export sales from the United States shall not be subject to current U.S. tax.

This should be accompanied by a clarification of section 6, amending section 482 of the Internal Revenue Code, which gives the Commissioner of Internal Revenue broad power to reallocate income between related businesses, so as to give assurance of a reasonable allocation of income to the foreign sales subsidiary where it performs significant selling activity abroad essential to the making of export sales.

The CHAIRMAN. Thank you very much, Mr. Huggins.

The next witness is Mr. David Flower, Jr., chairman of the Tax Committee of the Electronic Industries Association.

STATEMENT OF DAVID FLOWER, JR., CHAIRMAN, TAX COMMITTEE, ELECTRONIC INDUSTRIES ASSOCIATION

Mr. FLOWER. Mr. Chairman, Senators, my name is David Flower, Jr. I am director of tax affairs of the Raytheon Co. I am appearing today to testify in behalf of the Electronic Industries Association and its tax committee, of which I am chairman.

Electronics is the fifth largest manufacturing industry in the United States, having an annual production in excess of $10 billion. Although the association's membership of 350 members accounts for an estimated 80 percent of the total industry's sales, nearly two-thirds of its members qualify as "small business" under the definition of the Small Business Administration.

As an industry having the largest potential growth of all industries in the United States but at the same time severely handicapped by the heavy impact of imports, we are extremely interested in H.R. 10650.

While most of my testimony will be directed to the foreign income provisions of the bill, I should first like to state the EIA's position on the incentive investment tax credit.

INVESTMENT INCENTIVE CREDIT, SECTION 2

EIA, based on action of its tax committee with the overwhelming approval of its board of directors, went on record before the House Ways and Means Committee and the Joint Economic Committee as strongly supporting the credit. We wish here to reaffirm that support. EIA firmly believes that enactment of the credit, accompanied by announced plans of the Treasury to reform depreciation allowances, will contribute greatly to the Nation's industrial modernization and expansion, stimulate economic growth and enhance the ability of American business to compete with foreign industry which for many years has had the benefit of investment incentive through various allowances in excess of regular depreciation.

FOREIGN ASPECTS OF BILL, SECTIONS 6 AND 13

EIA opposes sections 6 and 13 as being ill advised, unfair, unworkable, and, I might add, unconstitutional.

It is our firm view that section 13 will reduce exports from the United States. Secretary Dillon's stated purpose for the foreign provisions of H.R. 10650 is to discourage the establishment of foreign manufacturing enterprise by American corporations. The theory is that this will result in expansion at home and increase in direct exports instead of foreign manufacture. This theoretical result is based on faulty knowledge of export trade.

INVESTMENT ABROAD STIMULATES BUSINESS IN THE UNITED STATES

It is our experience that electronic companies have established manufacturing subsidiaries abroad to combat a situation of dwindling export sales from the United States. To quote from the report of one member company:

> The primary reason for the steady decline in export of radars has been the increased effectiveness of European (mostly British) competition. At the time the decision was made to attempt manufacture in Europe, imported equipments

from the United States were facing approximately a 35-percent price differential for essentially the same competitive performance. Our share of market had fallen from nearly 80 percent to only about 5 percent. Our Italian manufacturing base is permitting us to compete effectively and is also contributing to substantially increased exports from the United States through the supply of component parts for inclusion in the manufactured product. These amount to about one-third of the cost of parts and materials used.

Our company members have repeatedly found that the establishment of European manufacturing subsidiaries has resulted in extensive export of parts and components manufactured in the United States.

In competition with British, German, Italian, French (high tax country) manufacturers, American companies have manufacturing subsidiaries in those countries and in some cases use Swiss trading companies to market the product thus manufactured abroad, along with those manufactured at home. The European manufacturers use Swiss subsidiaries as do Americans. Until we decide that it is really the foreign trade policy of the United States to become isolationist, except for the underdeveloped countries, this competitive situation should not be disrupted.

Senator GORE. Mr. Chairman, could I ask a question there?

The CHAIRMAN. Senator Gore.

Senator GORE. Mr. Flower, you say that the recommendations of the Treasury would lower exports, then you cite a report from a member of your organization. You use Great Britain as an example. Would you tell us just how sections 6 and 13 are going to affect an American subsidiary manufacturing plant in Great Britain?

Mr. FLOWER. Senator Gore, I think you misunderstood my reference to Great Britain.

I said the competition came from Great Britain. I was alluding to the entire European market.

Senator GORE. All right. I will take it on that basis.

Mr. FLOWER. Yes.

Senator GORE. You named France, Great Britain, the other high tax countries. I see you named Great Britain, Germany, Italy, France.

Will you explain just how, as you have asserted to this committee would be the case, section 6 and section 13 applied to an American manufacturing subsidiary in these countries, would reduce exports from the United States?

Mr. FLOWER. My reference, Senator, is to this: It is to the theory that we should bring, force our American manufacturers out of Europe which, I believe, the Secretary stated in his testimony before this committee, and that this provision would do this.

He stated at the time that he preferred to do it by means of this type of tax rather than by what England has used, direct exchange controls.

Senator GORE. Well, Mr. Flower, several witnesses before this committee have made assertions similar to the ones you have made.

I have been waiting for the proper opportunity to ask someone to demonstrate it.

It seems to me since you have made the flat assertion you would be prepared to demonstrate it.

Now, let us assume, as you have stated here, subsidiaries in Great Britain or any one of the other countries you have mentioned. How would sections 6 and 13 affect these plants? Let us begin with that and then we will see how they affect exports.

What is the tax rate in Great Britain?

Mr. FLOWER. Well, these are all high-tax countries.

Senator GORE. All right.

Mr. FLOWER. Equal or approximately equal to ours.

Senator GORE. And the Secretary has not recommended repeal of the foreign tax credit.

Mr. FLOWER. That is correct.

Senator GORE. What is the tax rate in Great Britain?

Mr. FLOWER. It is 52¾ percent, 53¾ percent.

Senator GORE. Then you would get credit for the taxes you paid in Great Britain on your tax liability in the United States.

So how much more taxes would you pay as a result of sections 6 and 13 on your foreign subsidiary earnings in Great Britain?

Mr. FLOWER. Senator Gore, this is precisely the statement that members of the Secretary of the Treasury's Office have made to me. What it fails——

Senator GORE. Would you answer my question?

Mr. FLOWER. Yes; I am attempting to.

What it fails to take into account is the tremendous burdens, almost insuperable burdens, of accounting, both abroad and here that any effective enforcement of the bill will put onto manufacturers.

Let me give you an example.

Senator GORE. Will you give me a categorical answer, first, and then you can explain it. What additional taxes would this bill levy on the profits of your manufacturing subsidiary in Great Britain? Any?

Mr. FLOWER. Can I jump ahead to examples I would be giving a little later on? I will give them to you now.

Senator GORE. Can you give me the amount?

Mr. FLOWER. Yes. This bill, I think what you are saying, Senator, is if we are going to pay the same taxes that we paid, in other words, what difference does it make?

Senator GORE. I am trying to analyze the assertions you and many others have made.

Mr. FLOWER. All right. We are going to pay more than the English rate or the American rate.

For example, suppose we have losses one year, then profits, and then losses another year. Under this bill we are going to be paying taxes under many circumstances on the profits, with no recognition of the losses as they are recognized under our American tax system.

This could lead to not a 53-percent rate but 150-percent rate.

Senator GORE. Let us assume that you have a profitable operation. Let us assume that next year your manufacturing subsidiary in Great Britain has a net profit of $1 million, and that this bill is passed and your parent company is required to pay taxes on the earnings of its foreign subsidiary. How much additional taxes would this bill levy next year on the profit of $1 million you have realized from the activities of your British subsidiary?

Mr. FLOWER. Under the example you give, Senator, nothing.

Senator GORE. Nothing.

All right. Let us go to the next step. How is that going to discourage exports from the United States?

Mr. FLOWER. Well, Senator, the example that you give is not the only example, and immediately before your giving it I gave an example of a situation where there would be 150 percent or greater tax, effective tax, but that is not the point that I was getting, to really.

I would just as soon hold that a little later. The point I was making is that the thought if you can force American industry to manufacture only in the United States that you will thereby increase your exports does not bear out the experience of the electronics industry.

We have had in this report, for example, a case of dwindling exports, and we have gone to manufacturing in Europe only to combat the loss of market that we have faced.

Senator GORE. I am willing to take any point you like if you would be willing to respond to my questions, and particularly this one. I would appreciate it.

You said the provisions of this bill applied to your parent corporation next year, based on earnings of its foreign subsidiary in Great Britain of $1 million, would result in no additional taxes whatsoever.

But you have proceeded to tell us that in some way this bill is going to reduce the exports of your industry.

Just how, will you tell me, would this bill, in this case which I have stated to you, discourage or harm exports from the United States of parts to your subsidiary in Great Britain?

Mr. FLOWER. Well, I think, Senator, that I did not make that statement at any time. I at no time said that this bill would harm exports to a company from here to our subsidiary. What I said was that where we have a manufacturing company abroad, we find that we sell many component parts to this foreign company, and if you were to draw—if you were to force us home, if you were to force us home, let me repeat, this market would be lost as well; that was the point I was making.

Senator GORE. We are not talking about a law that is going to force you to liquidate your British subsidiary. We are talking about the law that would require you to pay no additional taxes on the $1 million profit made by your British subsidiary.

Mr. FLOWER. Since we are talking England, may I give you another example about England that may answer your question?

Senator GORE. If you will let me proceed for just a moment you may.

Mr. FLOWER. Yes; I'm sorry.

Senator GORE. How, I ask you, is this bill going to discourage the export of component parts to the subsidiary, assuming that it is a profitable undertaking? It made $1 million profit last year. You exported some of your component parts there.

Presumably, your parent corporation made a profit in the export of those component parts. Therefore, it is profitable at home; it is profitable in Great Britain; it levies no additional tax on you.

How, pray tell me, are exports of component parts to your British subsidiary going to be discouraged?

Mr. FLOWER. Well, I think the one place we differ, Senator, is your assumption that it levies no additional or higher taxes upon it.

Senator GORE. You gave me an answer to that. You said——

Mr. FLOWER. I said only in one instance, and I gave you another one the other day.

Now, let me give you another one.

Senator GORE. All right.

Mr. FLOWER. One of our companies purchased an English electronics company this past year.

This electronics company in England is a holding company.

Senator GORE. Had it suffered a loss or a profit?

Mr. FLOWER. At present it is not. I think it is beside the point, but at present it is a loss company, at the present.

Senator GORE. You bought some losses?

Mr. FLOWER. No. I am not talking about that. This holding company has——

Senator GORE. As a matter of fact, whether you are talking about it or not, it is a fact.

Mr. FLOWER. I just want to give you an answer to your original question. This company has operating subsidiaries, a number of them, the English company in England. There is a corporate pattern in England.

Senator GORE. Do any of these subsidiaries have an affiliate relation with, or are they owned by, a tax-haven subsidiary?

Mr. FLOWER. No; none whatsoever.

Senator GORE. Good.

Mr. FLOWER. This company is a holding company in England, and it has a series of English operating subsidiaries making electronics equipment. This is a system that we find in England, holding company in England, subsidiaries in England manufacturing.

Senator GORE. How old is the concern?

Mr. FLOWER. Frankly, I do not know. It is a good many years old. It is not a new company.

Senator GORE. It has been a successful one, then?

Mr. FLOWER. Not too successful. The reason the company, the American company, looking for it, could buy a successful company and pay a very large ratio of earnings or it could buy a fairly unsuccessful company and hope to make it successful, and this is what it did in this particular instance.

Now, the English tax system has what comes to being, close to being, or accomplishes what we have in our consolidated returns. It provides for subvention payments, so called, from the profit subsidiaries to the loss subsidiaries, pursuant to an agreement among the companies.

So that at the end of the year or after it, the loss companies pay—the profit companies pay their profits to the loss companies to the extent of the losses, and there is no English tax, except on the net income.

Now, under section 13——

Senator GORE. What has that got to do with exports?

Mr. FLOWER. I am going to give you an example where section 13 will cause the American tax to be imposed, which is far greater than any imposed in England or America under a comparable situation, and where this tax bill, therefore, forces us to either change the way we are operating in England or force us out of England.

If you have one of these subsidiaries which has $100,000 of subpart F income, and that is all its income——

Senator GORE. Of what?

Mr. FLOWER. Subpart F of section 13, and if it then uses this $100,000 to pay the loss of one of the loss companies, it has no income subject to tax in England, and under this bill the $100,000 will be taxed at 52 percent in the United States.

Senator GORE. That is what you are complaining about rather than——

Mr. FLOWER. No. I spoke about this about a month ago, talking to Assistant Secretary Stanley Surrey before this new bill was out, before the February 27 changes were made by the Ways and Means Committee, when we were then talking about the original Treasury bill, and Mr. Surrey said, "By all means, this is a situation that should not be covered in the bill when there is a system in another country, particularly, let us say, a high tax country, where the parent company, where there is a regular holding company situation, and the subsidiaries are in the same country as the holding company, this should not be taxed in the United States under any circumstances."

Senator GORE. Well, even so, even though that be true, you would only be paying under this bill a tax upon the profits that your subsidiaries earned.

Mr. FLOWER. No, sir; we would be paying a tax on what in the United States would not be taxed if we had used consolidated returns or if in England these various subsidiaries were together instead of being two subsidiaries, although a single one there would be no tax at all, either here, and there is none as it is in England, and this we are now paying or would be paying a 52-percent tax on.

Senator GORE. Will you explain how that is going to discourage exports of component parts from the United States?

Mr. FLOWER. Well, that does not in itself; that does not in itself.

Senator GORE. Then where is this great——

Mr. FLOWER. Except this, if it makes it impossible to do the manufacturing in Europe then you do not have any demand for your component parts from your subsidiary which is not doing any manufacturing in Europe.

Senator GORE. So you do not wish seriously to insist then that this tax bill, if enacted, is going to discourage exports of American component parts to manufacturing subsidiaries in the high-tax countries in Western Europe?

Mr. FLOWER. No; on the contrary, Senator, I have attempted to show that the bill will discourage the manufacturing subsidiary in Europe, and if the manufacturing subsidiary does not exist in Europe there will be no export of component parts to it.

Senator GORE. Well, the only way thus far that you have shown that the manufacturing subsidiary is going to be discouraged is that the parent corporation here might not have the privilege which Great Britain gives to the merging of the profits and losses——

Mr. FLOWER. And our own country gives.

Senator GORE (continuing). Of subsidiaries.

Mr. FLOWER. And which, as you see, is a complete interference by our proposed bill in the method of taxing in England in such a way that it is completely unfair and unequitable.

Here the English are doing no more under their subvention payments than we ourselves do under consolidated returns.

Yet we are not recognizing that, and if there is this type of income, then we, in the case that I have illustrated, will impose a 52-percent tax on this $100,000, which we would not do ourselves here, which the English do not do, and this certainly discourages following the English system of corporate patterns.

I grant you if we operated as a branch in England so that we did away with what the English have as their system of subsidiary and parent, and we liquidated all this and had a branch, then there would not be this income because they would be washed out, one against the other, and I take it that is what the purpose of the bill is to cause.

Senator GORE. Then even though this is the only discouragement to foreign manufacturing subsidiaries in a high-tax Western European country which you cited, you have just shown a way by which this could be mitigated or, perhaps, entirely resolved.

Mr. FLOWER. I have cited two examples, one entirely different, one a loss from the other, and then profits in another year, where only the profits would be taxed, and no loss carryover provision would be applied.

Then I cited this subvention system problem where there are no profits in the year on a net basis, but the profit of the one subsidiary which England does not tax because it becomes a net go-out would be taxed in the United States.

I have cited two situations at least where the tax system, the tax bill, would interfere with the present system, and there is sound reason for the present system in England or we must assume that, and this would discourage doing business in this manner and doing business in England.

Senator GORE. Well, even so, you have cited a way in which this could be taken care of by a reorganization.

Mr. FLOWER. This may be so. In my own company, Senator, entirely apart from taxes, the general counsel of the company, the law department, will not permit us in many instances—I have said, "Let us go in and operate as a branch in Japan, it is a small operation that we are contemplating, it does not mean anything," and he has, and with sound reason, insisted upon there being a Japanese subsidiary.

He does not want—for example, he sees the potentiality of lawsuits against my company in Japan arising out of various contemplated transactions being worked out, and he does not want the company to be subject to suit in Japan under Japanese courts.

He wants, if there has to be a suit against the company itself, he wants it to be brought in the United States where we know the courts and where we know the law and we can defend ourselves, and so he insists on our operating in Japan with a subsidiary.

I, as the director of tax affairs, opposed it. I thought we should not bother with a subsidiary here. He insisted.

Now, this bill would stop that thing, would interfere with it.

Senator GORE. What is your company?

Mr. FLOWER. Raytheon Co. You should know it, Senator, we are one of your, in a small part, constituents. We have a small—we run a Government-owned plant at Bristol, where we have about 2,000 employees.

Senator GORE. Yes; I am acquainted with it. You may be very proud of your installation.

We are not talking about the establishment of an operation in Bristol.

The CHAIRMAN. Are you speaking of Bristol, Va., or Bristol, Tenn.? [Laughter.]

I would like to get in that if it is Bristol, Va.

Mr. FLOWER. The plant is in Bristol, Tenn.

The CHAIRMAN. Where is your plant, which side of Bristol is your plant in?

Mr. FLOWER. It is in Tennessee.

The CHAIRMAN. In Tennessee?

Mr. FLOWER. Before we took over this plant we were at another plant that was in Bristol, Va.

Senator GORE. What official title do you have?

Mr. FLOWER. Director of tax affairs.

Senator GORE. Would you name the foreign subsidiaries that your company has?

Mr. FLOWER. Sure. Do you want the literal names or the Japanese names or where we have them?

Senator GORE. Name the countries.

Mr. FLOWER. We have the example I was giving you in England which is Raytheon's. We have an English company which has I do not know how many operating subsidiaries in England.

We have a Canadian manufacturing subsidiary. We have a minority interest in an Italian manufacturing subsidiary; a very small wholly owned Italian subsidiary.

We have a wholly owned Swiss holding company; we have a Swiss trading company; we have a minority interest—did I hit the Japanese one, Senator?

Senator GORE. No; you did not.

Mr. FLOWER. We have a minority interest in a Japanese manufacturing company.

The company that I talked about as to the dispute between me and the general counsel is a small incorporated office in Japan which either has been or is about to be liquidated and replaced by an American company with a branch in Japan for this incorporated office situation.

In case I have missed any, I might refer to this, I have something here that will give me the whole of them.

We have a small Swiss manufacturing company which we inherited; 51 percent is owned by the holding company, and 49 percent by our own company here.

We have owned by that little company a 100-percent owned, very small French company. We have a 60-percent ownership again in a small manufacturing company in Switzerland.

We have a 51-percent interest in another Italian company—no, I beg your pardon. I gave you the minority interest in one Italian company, 40 percent, and a 30-percent interest in another Italian company.

I think that is about it. We are about to—one of our American subsidiaries has just about formed a manufacturing subsidiary of its own in Canada because it has been dissatisfied with the service it has been getting from our own directly owned Canadian subsidiary.

Senator GORE. Now, are all of these subsidiaries directly owned by the U.S. parent corporation, or are some of these subsidiaries of subsidiaries?

Mr. FLOWER. I believe the record will show that I answered that question already, stating that certain companies, and I gave you them, were owned by the Swiss holding company.

Senator GORE. Then your real——

Mr. FLOWER. I said the Swiss trading company was owned by the Swiss holding company, and I said that 51 percent of another small Swiss manufacturing company is owned by the Swiss holding company.

Senator GORE. Is your British holding company or are any of the subsidiaries in Great Britain owned in whole or in part by your Swiss subsidiary?

Mr. FLOWER. No, sir; there is no connection.

Senator GORE. They are all directly owned?

Mr. FLOWER. The English holding company which we purchased from the British public, by the way, is owned by the parent American company, and it, in turn, has English operating subsidiaries, which was what we were buying, of course, when we bought the company; that stock was owned by the public in England.

Senator GORE. We have defined the area. You have a British holding company wholly owned, directly owned, by the parent corporation; the holding company, in turn, has subsidiaries.

Now, you have pointed out, and I think with some justification, that the pending bill would not permit the carry forward, carry back of losses.

Now, if that were corrected in the bill how would this bill adversely affect or discourage your British operations?

Mr. FLOWER. Let me give you another example of how it will discourage them. This is an infant electronics company in England. By that I mean the normal course of business is one where Raytheon itself is an integrated electronics company which manufactures equipments, as you know, in your State, Senator.

It manufactures missiles for the Government; it manufactures radars; it manufactures commercial surface search radars for commercial vessels, and also for military; and it manufactures magnetrons, and it manufactures all sorts of power tubes and receiving tubes and semiconductors, transistors.

Now, when you start an electronics company manufacturing in any country, you start small. You start manufacturing one or two or more products.

Now, this is still the situation with respect to the English company which we acquired.

It is a small company. I think it cost us $6 million.

Under the bill, Senator, in addition to the troubles that I have pointed out, when this company, even if it were not a holding company and subsidiary, if it were a direct manufacturing corporation in England, when this company expanded in the normal growth pattern of an electronics company, it started to make sonar, underwater sound equipment, whereas it had been only making radar before. For 5 years, Senator, the earnings of that company will be taxed directly to us in the United States and, of course, if there is tax coming back, the purpose of this whole thing is to force the money back, the dividends back, whereas you would expect a young growing company to use these earnings to supply itself with working capital and help its expansion.

Senator GORE. But, Mr. Flower, in your answer to me earlier, you said that this bill would levy no additional tax.

Mr. FLOWER. No; I did not, Senator. I indicated that it would levy additional tax.

Senator GORE. Well, by reason of lack of the privilege of carrying forward or carrying back losses.

Mr. FLOWER. Plus the lack of recognizing profits against losses in any particular year among the various subsidiaries of this system.

Senator GORE. Well, this is a rather small area which ,and if this is corrected, I do not see how your operation there would be either penalized or discouraged.

Mr. FLOWER. I sat, if I might interject, Senator Gore——

Senator GORE. You may.

Mr. FLOWER. I sat through a part of the session on Friday, and I carried home with me and read over the weekend what I thought was a very excellent brief supplied by this group of New York lawyers in which they showed the almost impossibility of complying with the provisions of this law, and if even apart from rate problems—and I did, if you will recall, speak first of accounting problems, these would in and of themselves discourage the operation abroad, and I am not at all sure but what that was not designed.

Senator GORE. You heard the exchange earlier with Mr. Keyserling about the problem of balance of payments or the imbalance of payments.

One of the ways to which I did not refer in my colloquy with him, which creates this problem, is the large outflow of funds each year for direct foreign investment. We are not going to solve the balance-of-payments problem with exports. I know of no economist who seriously suggests that we can do so.

I would not be a party to forcing your business to come home, but I certainly want to take away the tax incentive for you to build more plants in Great Britain or Western Europe, and penalize you taxwise for building another plant in Bristol, Tenn., or Bristol, Va.

Mr. FLOWER. And we would be happy to build there, too, if we saw some use for the product.

Senator GORE. But why, I ask you, should this Government proceed upon the basis of subsidizing the building of industry abroad as compared with the building of industry here at home?

Mr. FLOWER. But, Senator, as far as we are talking—I assume we are talking, both of us, about the foreign provisions. The situations where we have been talking about the foreign provisions, there is no subsidy.

The question is, Are we going to be penalized in connection with even the high-tax countries in such a way that we will be unable to carry on our business there?

Senator GORE. All right. We are talking now about Great Britain. Let us come to your Swiss subsidiaries.

What are the subsidiary ownings or affiliates of your Swiss subsidiary and trading corporation?

Mr. FLOWER. The trading company is different from the holding company. You appreciate that.

Senator GORE. All right. What is your total holding in Switzerland?

Mr. FLOWER. I might explain to you that we originally set up two companies there, a trading company and a holding company. These are both small, and the smaller things I have talked about, the split-ownership one came about as the result of our acquiring an American electronics company which was partly family owned and which had—by Swiss, by the way, and which had Swiss individual citizens, former Swiss, which had this one small operating, manufacturing, company in Switzerland, and this was partly owned by the individuals and partly by the corporation which they had. So that that is the picture, plus——

Senator GORE. Then you have three?

Mr. FLOWER. No; there is another one.

Senator GORE. You have four.

Mr. FLOWER. There is another small one manufacturing transistors, which is 60 percent owned by the holding company.

I might go on to tell you a little about the holding company. In this holding company we have all of the technical people, the technical staff for Europe, accountant, sales director, engineer, and the result is that the holding company has operated—I have pointed this out to Stanley Surrey in our talk—has operated each year at a loss, including this year, a loss of about $100,000 because of the salaries which are not compensated for any other way.

The Swiss trading company does 30 percent of its business of sales from Raytheon U.S.-manufactured goods, and the rest, the other 70 percent, from the Italian minority-owned subsidiary, its products, principally its products; and the trading company will have a small profit this year—I will give you a figure if you ask for it, but I frankly did not check it as to whether it is correct and has operated until this year at a loss.

So this has been—if we are looking at tax savings or tax deferral—it has been tax savings and deferral in reverse.

Had this been a branch operation the U.S. Treasury would have had less revenue than it has through the operation of the Swiss companies.

Senator GORE. Well, Mr. Flower, you are a tax expert and I am not. I am undertaking by your example, the example of your company, about which you know 10,000 times more than I, to show that this bill, if enacted as it passed the House, would not discourage exports of component parts, would not discourage or adversely affect operations in high-tax countries; but now we are talking about a tax haven country where this bill would apply, and additional U.S. taxes would be required as a result of profits earned by subsidiaries domiciled there.

You have said you had four subsidiaries in Switzerland. I asked you to give us the ownership of subsidiaries outside of Switzerland, which traces in whole or in part to these Swiss subsidiaries, and I ask you to do it now.

Mr. FLOWER. The only one, Senator, is the French company which we inherited, very small; I do not even think it has $1,000 of income, which we inherited in acquiring this American company.

We do not have any of our other holdings owned by the Swiss subsidiary, the Swiss holding company.

Senator GORE. Does the Swiss subsidiary still own the American corporation? You said earlier you acquired some——

Mr. FLOWER. No, no. What I meant there was that the individuals who were the largest stockholders of this American manufacturing company which we acquired were originally Swiss. They had become American citizens. That is all I was talking about. I did not mean to confuse you on this.

Senator GORE. Am I correctly to understand then that your company does not have a tax-haven operation?

Mr. FLOWER. That is a loaded question, isn't it, Senator?

Senator GORE. No, I did not intend it so. I understood you to say——

Mr. FLOWER. Are you asking a repeat of what you asked before, we do not have manufacturing subsidiaries outside of Switzerland owned by a Swiss holding company; the answer to that is, yes, except for this very small French company.

Senator GORE. No, I do not mean to ask you any loaded questions. I am trying to learn from your knowledge. It may be that your company does not benefit by tax deferral. You have said that your English company had not benefited by it; I believe that is, at least, a constructive conclusion from your statement. You tell us now that your Swiss subsidiaries have operated at a loss; is that true?

Mr. FLOWER. This year the trading company will have a profit.

Senator GORE. The trading—is this the first year?

Mr. FLOWER. 1961.

Senator GORE. Is that the first year? How old is it?

Mr. FLOWER. I think about 3 or 4 years old.

Senator GORE. What is the order of its profit in 1961?

Mr. FLOWER. This is the figure that I said I would—I have a figure in my mind, Senator. I have not received yet the material that has to be filed, as you know with the tax return, and I am not at all sure whether I am way out in left field. This figure might be a high figure, I am thinking of $50,000 which may be a figure, I am not sure. I will supply it if you like after I can get it.

Senator GORE. Are all of your other operations then in high-tax countries?

Mr. FLOWER. Yes, I think that looks like it.

What do you call Italy, if you call Italy a high-tax country? One of the plans of this—we have a 40-percent owned electronics company, manufacturing company, in Italy, which is the company that we hope to expand.

This, by the way, is—the other owners are a large electric company in Italy, and another electronics company, I believe, either still is partly owned by the Italian Government or was.

Now, this is another particular instance where we supply the management of this company, Raytheon does. The company was put together from a couple of smaller earlier Italian companies.

This, it was our hope and the hope of the Italian interests, the large companies and the Government which are in this as partners with us, and they anticipated that we would become a majority owner within a few years.

Now this, I might point out, that one of the plants of this company is in the Mezzogiorno region, which is southern Italy, which is an area that is very seriously underdeveloped.

It is a depression-type area, and the Italian Government has given tax concessions to any plant which would locate so that the rate of tax is lower there than the standard Italian rate.

Now, of course, not only will we probably lose any benefits of this lower Italian rate given by the Government of Italy to help develop its underdeveloped segment, but also if, as and when we were able to acquire the majority interest, which all of us have anticipated, that is our Italian partners and ourselves, after 1962, the earnings of this company, our share of them, would be taxed immediately in the United States for a period of 5 years.

Thus the lower—although Italy you do not look upon as a low-tax, but rather a high-tax country—the lower taxes paid with respect to that part of the company, the plant in the Mezzogiorno, we would be frustrating the Italian economic policy, the Italian Government's economic policy, by our tax bill because we would be taxing this income directly at 52 percent in the United States, so that by virtue of the credit the U.S. Treasury, through a smaller Italian tax, would be getting the benefit that the Italian Government was hoping to give to taxpayers to get them to come into the Mezzogiorno and establish plants there.

Senator GORE. Let us take the other side of that coin. If we should pursue a policy of giving a tax credit for taxes which a foreign subsidiary did not, in fact, pay, then all the countries of Western Europe need do would be to attract more and more of our own industry, by giving them tax remission, tax concessions or tax exemption for 5 years, as you say is the case in Italy.

It is 10 years in the case of Ghana with the Volta Dam project.

Mr. FLOWER. That is an underdeveloped country, is it not? We will be getting it under the bill.

Senator GORE. We will not if I have my way. But don't you see, Mr. Flower, you have cited the case here that if multiplied would be really disastrous to the flight of American industry and capital.

Mr. FLOWER. If I might say this, Senator Gore, you know I do not really think that the Mezzogiorno, for example, causes American industry to go because of the tax concessions.

Senator GORE. I know there may be other things.

Mr. FLOWER. Let me say this, American industry goes to Italy, we went to Italy, because we were unable to sell radars. This example, the earlier example, came from Raytheon, I know the facts about it.

Raytheon is the one that had 80 percent of the world market in surface search radars on all sorts of ships, and this dwindled to 5 percent.

Now, we went to Italy. We put in a tremendous effort in Italy. By the way, we have a 40 percent interest.

You say to me why? We get directly royalties from this company into Raytheon, United States, no tax deferral, 52 percent. We get royalties from this company. But we are building up and replacing the loss that we have.

What is more, we are literally supplying one-third of what they use in the way of material parts and components.

If this Italian company goes, which is going to build another plant, it can be induced to build it in south Italy rather than north

Italy, perhaps by virtue of tax concessions if everything else is equal—

Senator GORE. Yes, I understand.

Mr. FLOWER (continuing). But this does not draw American capital out of the United States.

Senator GORE. Do you wish here seriously to contend that you should be given tax credit for taxes that you did not pay in Italy?

Mr. FLOWER. No. You have twisted it on me, and I recognize you have a good—you have done a good job on it, but what you have done is twisted it on me.

All I am saying is that the age-old method of taxation of the United States since 1913 should not change, and you are saying, well, if it changes why should you get a bigger credit.

Senator GORE. Well, now, I have not attempted to twist anything. I am using the example that you gave.

Mr. FLOWER. No, you are saying that if we should tax at 52 percent why should we give you a credit for the smaller tax. That is what you are, I believe, saying, and I do not think it is a sound argument.

But I think if you take the premise from which you started that we are going to tax everybody at 52 percent no matter where, then I think you could come to your question.

Senator GORE. Well, let me ask you a hypothetical question:

Would you be interested in moving one of your plants out of Massachusetts down to Tennessee if you were given tax exemption for 5 years?

Mr. FLOWER. I am not so sure, and I will tell you why. I have——

Senator GORE. You would think about it pretty hard, wouldn't you?

Mr. FLOWER. I have done any number of plant location studies involving Massachusetts and various States for Raytheon when it is going to build a new plant.

Senator GORE. I am speaking now of U.S. income tax. If we give you complete exemption—suppose we pass a bill here in Congress that you will not owe any taxes on the income you will earn in Tennessee.

Mr. FLOWER. That is a pretty good bill. [Laughter.]

Senator GORE. That is virtually what you advocate.

Mr. FLOWER. It is probably as unconstitutional as this bill.

Senator GORE. It is virtually what you are advocating, and what you are defending in your operation in Italy.

Mr. FLOWER. No; oh, no. You are saying you in Tennessee are going to have the authority to abrogate the United States 52 percent?

Senator GORE. No. I said if Congress passed it. You have just given us an example——

Mr. FLOWER. Well, I will give you an example, Senator. We did not go to Puerto Rico, and there it was 10 years.

Senator GORE. That is an example to the point.

Mr. FLOWER. Let me say this: All things being equal, other business considerations being equal, if we could go to New Hampshire and pay no U.S. tax, 52 percent for 10 years, and then would only pay the same amount, we probably would go to New Hampshire.

Senator GORE. Well, that is about the same situation in Italy for 5 years.

Well, Mr. Chairman, I shall not persist with this delightful gentleman, but I wanted to explode once and for all this canard that has been brought here that if taxes must be paid on the earnings of foreign subsidiaries, that, somehow, it is going to cut down on our exports.

I think this witness has pretty well demonstrated it.

Mr. FLOWER. But, you know, Senator, that isn't what I said, in the first place, at any time.

Senator GORE. Good. I am glad you did not.

Mr. FLOWER. What I said, I was directing my attention at the time to Secretary Dillon's statement that by forcing—his statement to this committee, that by forcing—manufacturers back to the United States to manufacture here that this would increase exports, and I said that this would not increase exports; that exports had increased where manufacturing had increased abroad in our industry through the use of components needed from this country.

Senator GORE. Well, you know I would like to quote yourself to yourself. You say this:

> Our member companies have repeatedly found that the establishment of European manufacturing subsidiaries has resulted in extensive export of parts and components manufactured in the United States.

Mr. FLOWER. That is precisely what I said.

Senator GORE. That is right.

I am not to infer then that the passage of this bill would in any way discourage the export of parts and components manufactured in the United States?

Mr. FLOWER. No. I argued extensively after you had raised the question, that that would happen, but all I was saying, and the last comment was that I did not get into this as a direct statement in connection with the bill, but in connection with Secretary Dillon's comments.

Senator GORE. I am glad and willing for you and Secretary Dillon to have that out.

(The remaining text of Mr. Flower's statement was read into the record:)

Mr. FLOWER (reading): To the extent that a low tax foreign trading subsidiary, with substantial office and payroll and management abroad, serves the purpose of helping the American parent to sell competitively its products in the foreign market, it creates and maintains manufacturing jobs in the United States in greater number than the sales effort jobs it creates abroad. The committee should realize that a company cannot effectively make sales in Europe by use of salesmen sitting at home in the United States. Destruction of that sales effort, through creation of a taxing system not faced by European competitors, decreases employment in the United States, not the contrary.

LEGISLATIVE SOLUTION

EIA fully supports the efforts of the Treasury Department to correct abuses in the foreign area. We understand that this situation is already being brought under control administratively and that the Internal Revenue Service has intensified and expanded the training of agents in the use of existing Internal Revenue Code tools. The sham corporation should not be permitted to exist as a tax device. If you are convinced that the Treasury needs additional legislation to ease its administrative burden of enforcement of the present law, we suggest that you explore the desirability of legislation (1) taxing the income of foreign subsidiaries if their management is in the United States, and (2) taxing, under equitable limitations, foreign subsidiary income that has not been reinvested in the active conduct of foreign business operations.

We urge that you take this moderate approach before jeopardizing not only the competitive position of American business, but also the favorable economic position of the United States and that of the world.

SPECIFIC EXAMPLES OF HARDSHIPS AND UNINTENDED EFFECT OF SECTION 13

(1) Some years ago one of our companies joined with a Canadian manufacturing company to form a Canadian electronics subsidiary. The American company contributed its entire list of Canadian patents, and the Canadian company contributed cash. A ruling was received from the Treasury that no tax avoidance was involved in this transfer and that the exchange of patents for stock constituted a tax-free exchange.

Under section 13 a fictitious royalty would now be taxed to the United States parent for the use of the patents which it transferred to the Canadian subsidiary for stock. The royalty would also be imputed if the patents had been sold to the Canadian company for cash. In explaining the reasons for the tax on imputed royalties for the use of patents and secret processes in manufacturing abroad, the Ways and Means Committee concluded that—

it was desirable to tax this income to the U.S. shareholders on the grounds that where a patent, copyright, et cetera, was developed or granted in the United States, it is likely that, if it were not for lower taxes abroad, the rights to it would still be held by the domestic company with this company merely licensing its use by the foreign corporation.

This statement presents an objective that has merit. Unfortunately, as with many of its other provisions, the bill here adopts a shotgun approach and hits targets unrelated to the objectives of the provision. The Canadian income tax rate is comparable, of course, with our own rate. This tax on imputed royalties applies even though the Canadian company may have only a minimum of earnings and profits from its business operations and even though it is clearly apparent that this small amount of earnings and profits is necessary to produce working capital for the company. Not only is an unwarranted tax imposed on the imputed royalties but when this Canadian subsidiary actually receives royalties for the license of its patents in Canada, these royalties will be taxed at once in the United States despite the Canadian tax having already been imposed.

(2) One of our member companies recently purchased an English electronics company in order to enter the Commonwealth market. The English electronics company is a holding company which in turn owns several English operating subsidiaries, a corporate pattern common in England. The English tax law permits profits of affiliated companies to be offset by losses of other affiliated companies. This is accomplished by means of a "subvention" payment system whereby the various subsidiaries and parent agree contractually among themselves that the profits of the various companies will be paid over to the loss companies to the extent of the losses. The British tax is then imposed solely on any net profits remaining.

H.R. 10650 would ignore the basic purposes of the British tax law for having such a corporate parent and subsidiary arrangement. It would penalize any American company owning an English holding company by immediately taxing the earnings of the holding company as such income is received by it in the form of dividends. The United Kingdom is a high-tax country; therefore, no U.S. tax deferral is accomplished by utilizing the holding company system. Yet, under the bill the American company and its English subsidiary would be required to maintain elaborate and expensive accounting systems at no gain to the U.S. Treasury. In order to avoid this result, dividends could not be declared to the holding company. This would further interfere with the legitimate English handling of the financing of corporations in that the dividend would become taxable to the U.S. parent irrespective of its subsequent investment in a subsidiary's business.

Further, under certain fortuitous circumstances, extremely harsh results would obtain. For instance, if a subsidiary of the American company's English holding company were to earn $100,000 of subpart F income and make a subvention payment of $100,000 to a loss subsidiary, this $100,000 would not be subject to British tax because the "consolidated group" had no net income. Yet, because the profit subsidiary earned this $100,000, it would be imputed to the American parent as subpart F income with no allowable foreign tax credit. The result obtains despite the fact that were the two subsidiaries operated as one, there would have been no earnings and profits and, therefore, no income would have been imputed to the U.S. parent. It should be again noted that the form of the business structure in no way was for avoidance of U.S. tax. In fact, our member company purchased the stock of the holding company from the British public. No corporate structural changes have been made since the acquisition.

At the present time the acquired company is operating at a net loss. H.R. 10650 makes no provision for recognizing this loss. Dividends to the holding company will be taxed to the U.S. parent without regard to prior or subsequent loss years.

(3) A number of our companies have infant manufacturing subsidiaries in high-tax European countries. The normal course of development of an electronics company is that it would progress into the manufacturing of wider lines of electronic equipment. No one can advise today whether under the terms of the proposed bill these companies will not be considered to be continually investing in new trades or businesses with the result that each time they take a step in the normal growth pattern, an additional 5 years' earnings would be taxed to the U.S. parent. Instead of being able to follow the normal course of any infant company retaining all earnings for its development, there is pressure created by the bill to have dividends declared to pay the U.S. tax.

(4) A member company reports that for many years it has owned a 45-percent interest in a manufacturing company in a high-tax European country. If this company itself or any other Americans acquire 6 percent of the stock, the income of the company will be taxed to our member for a period of 5 years.

(5) One of the plants of an Italian manufacturing subsidiary of one of our member companies is located in southern Italy in what is known as the Mezzogiorno. While most of Italy is highly developed,

the Mezzogiorno is an extremely backward, underdeveloped part of the country, and the Italian Government has provided tax concessions to manufacturers to induce them to establish plants in this part of the country. This policy of the Italian Government to help develop its own underdeveloped area is frustrated by the proposed bill which would tax any new improvement in this area at once to the parent company in the United States at 52 percent. The United States, through a small foreign tax credit, is the beneficiary of the lower incentive tax in the Mezzogiorno. The tax bill thus would tend to nullify the economic policy of the Italian Government despite the avowed purpose of the bill to aid underdeveloped countries.

ALLOCATION OF PROFIT, SECTION 6

One company member which sells multilines of products directly both in the United States and abroad has also engaged in manufacturing and selling operations through foreign subsidiaries. The subsidiaries purchase various parts and components from the parent for use by them in the manufacture of products. These purchases are at prices negotiated with the various decentralized divisions of the parent. There is no other market for these parts and components, which are also used by the parent in the manufacture of its own products.

Under section 6, in the absence of comparative selling prices to outsiders, the Treasury could require the parent to determine the total profit realized by the parent and each of its foreign subsidiaries applicable to the parts or components included in the end products sold by each subsidiary. The parent would also be required to determine the assets (on an adjusted tax basis), compensation, and selling expenses utilized or incurred both in the United States and abroad applicable to the manufacture, production, and sale of such parts or components.

These determinations would be administratively impossible and would provide no meaningful basis for determining arm's-length prices. The statutory allocation formula in many instances would result in attributing far lower sales profits to subsidiaries than would be accepted by outsiders.

APPEARANCES, ET CETERA, WITH RESPECT TO LEGISLATION, SECTION 3

Section 3 of H.R. 10650 would provide a deduction for the costs (including dues to organizations) directly related to appearances before and communications with a legislative body or a committee or individual members thereof, provided such costs are otherwise ordinary and necessary business expenses. As passed by the House, this section takes at best a faltering and inadequate step toward correcting a punitive administrative holding that has been privileged to assume the force of law.

The report of the Committee on Ways and Means accompanying H.R. 10650 recognizes specifically the desirability that taxpayers who have information bearing on the impact of legislation on their trades or business not be discouraged in making this information available to legislators. It also recognizes that the deduction of such expenditures on the part of business is necessary to arrive at a true reflection of their real income for tax purposes. Communications on legislative issues cannot be so narrowly confined or so significantly impeded if we are to have laws responsive to the opinions and the balanced interests of informed citizens. This response will be encouraged materially by revising the scope of section 3 to allow the deduction of all ordinary and necessary expenses lawfully incurred in supporting or opposing or otherwise influencing legislation in the Congress or in a State or local legislative body or in any submission of proposed legislation to the voters.

Such provisions are contained in S. 467, cosponsored by Senators Hartke and Kerr in January 1961. The Electronic Industries Association strongly urges that the language contained in this bill be substituted for section 3 of H.R. 10650.

The CHAIRMAN. Thank you very much.

The committee will recess until 2:30.

(Whereupon, at 1:15 p.m., the committee recessed, to reconvene at 2:30 p.m. this same day.)

AFTERNOON SESSION

The CHAIRMAN. The committee will come to order.

The first witness is Mr. Ward M. Canaday, of the Overland Corp., as presented by Mr. Richard B. Barker.

Will you proceed, Mr. Barker?

STATEMENT OF WARD M. CANADAY, OF THE OVERLAND CORP., AS PRESENTED BY RICHARD B. BARKER

Mr. BARKER. Senator Byrd, members of the Finance Committee, as you know, Senator Byrd, I am appearing here on behalf of Ward Canaday, of Toledo, Ohio, who has been detained in Europe. The statement I am giving was prepared by Mr. Canaday. I merely reviewed it from a technical aspect, so I will give it in his words:

I wish to address my remarks to section 18 of the proposed Revenue Act of 1962 (H.R. 10650). This section amends the estate tax laws so as to include foreign real estate within the gross estate of a U.S. citizen or resident. Under present law, real estate owned by a U.S. citizen or resident is not included within the gross estate of such person.

For some 44 years this present exclusion of foreign real estate from a decedent's gross estate has been recognized under our laws. Originally this exclusion resulted from an interpretation of the law in 1918 by the Attorney General of the United States. In 1934 this exclusion was incorporated into the estate tax statutes and has remained unchanged to this date.

This exclusion of foreign real estate from the U.S. estate tax applies not only to real estate in foreign countries, but also to real estate in possessions of the United States, such as the Virgin Islands. I hope that by appearing before you that I will be able to convince you of the very unfavorable and undesirable effect that section 18 would have on the economy of the Virgin Islands.

The U.S. Virgin Islands were purchased by this country from Denmark in 1917. At that time practically all of the capital that was invested in these islands had been invested by Danish sources, including Danish residents of the islands. After the United States acquired these islands, many Danish residents sold their land on the islands and took their capital back to Denmark. This exodus of Danish capital was a sharp blow to the economy of the islands. The purchasers of the land from the former Danish residents were "land poor." The islands became known as "our Nation's poorhouse." Continuous efforts have been made by the United States to revive and develop the economy of the Virgin Islands. Prominent among these efforts was the formation in 1933 of the U.S.-owned Virgin Islands Corporation. This Virgin Islands Corporation provided work and food for the inhabitants and has stimulated use of land for agricultural purposes, which had largely reverted to bush.

In order to understand the importance of section 18 to the Virgin Islands, it is necessary to understand something about the geography, resources, and economy of these islands. The economy of the three islands which constitute the U.S. Virgin Islands is primarily permanent residences by U.S. citizens from the mainland. The islands have a very low water supply and a small labor force. Because of these two factors and other reasons, there is only a limited possibility of developing the islands by an industrialization program such as the one which has been so successful in Puerto Rico.

All three of the major bulwarks of the economy; that is, agriculture, tourist business, and permanent residences, are particularly tied to real estate. The development of the Virgin Islands is directly related to the investment of new private capital by U.S. citizens in real estate or developments related to real estate. Measures which encourage investment of private U.S. capital in Virgin Islands real estate are by far the most effective means of improving the economy of the islands.

I can use my own experiences in the Virgin Islands to illustrate this point. In 1933, Mr. Harold Ickes, then Secertary of the Interior, asked me to visit the Virgin Islands. At this time I was serving in Washington on appointment by President Roosevelt in helping to organize the Federal Housing Administration. I became interested in the islands and made substantial investments in real estate. In making these investments I relied on the longstanding exemption of Virgin Islands real estate from Federal estate tax.

Since that time, I have invested a great deal of time, energy, and capital in the Virgin Islands. I have a prize herd of 1,200 head of cattle especially adapted to the tropics. I have cleared 3,000 acres of land for grazing and contoured it to increase its moisture content, and I have planted special grasses for grazing on this land. When I orginally acquired this land, I was only able to produce 12 tons of sugarcane per acre. Now production has been raised to 36 tons per acre.

To increase the water table, I built a number of dams on my farm and persuaded the U.S. Government, several years ago, to conduct a conservation development by building dams throughout the islands. I have created new roads and reopened and maintained old ones that had become abandoned and overgrown with bush.

Over the years, I have brought many persons to the islands in hopes of transfusing some of my enthusiasm to these persons. The most prominent of such persons was President Truman who, at my invitation, visited the islands in 1948. One of the things which most impressed President Truman was the very successful way in which warm and harmonious racial relations are maintained among the residents of the islands. He told me he would give the islands a million dollars' worth of publicity, and I am sure that his visit and continuing interest did just that.

Under Presidents Truman, Eisenhower, and Kennedy, I have acted as a Director of the U.S.-owned Virgin Islands Corporation. One year I brought to the islands several doctors from Lederle Laboratories in New York to stamp out filariasis (elephantiasis). I recently contributed land without cost to the Virgin Islands government for the building of a spectacular Skyline Road across the highlands of the island, which road will attract visitors to the islands.

I mention these personal experiences only to illustrate the consequences which have resulted from the investment of U.S. capital in real estate in the Virgin Islands. Many other persons have invested in the Virgin Islands and all have, in varying degrees, made significant contributions to the growth of these islands.

Nevertheless, the Virgin Islands remain as an underdeveloped portion of the world. The standard of living of the average resident of the Virgin Islands is markedly lower than in the continental United States.

There is an unabated need for the investment of additional capital in these islands. Because in part of the estate tax exemption, persons have been attracted to invest in real estate in the Virgin Islands, either for personal residences or in developing tourist facilities. If this trend is permitted to continue the Virgin Islands will have an "operation bootstrap," which may be as effective for these islands as the industrial "Operation Bootstrap" has been for Puerto Rico.

Therefore, I urge this committee and the Congress not to enact any legislation which would abruptly deprive the Virgin Islands of this important, possibly essential, incentive program for the continuing development of these islands. I believe that this purpose can be accomplished by amending section 18 in a manner which will make this section conform with other sections of the bill relating to foreign investments. Section 13 of H.R. 10650, which is the heart of the proposed tax revision with respect to foreign income, permits deferral of U.S. taxation of foreign income when such income is invested in less-developed countries. Under section 13, section 953(b)(5) defines less developed countries to include possessions of the United States. It would be inconsistent and inequitable not to apply this same principle in the estate tax area. The President and the Secretary of the Treasury have consistently indicated that the proposed changes in the Internal Revenue Code should not discourage or adversely affect investments in less-developed countries. There is no reason why this philosophy, which has been incorporated in section 13, should not also be made applicable to section 18. It would indeed be illogical and self-defeating to encourage investments in less-developed countries and possessions under section 13 and, in section 18 of the same bill, force liquidation of real estate investments in these same less-developed countries and possessions. Therefore, I respectfully recommend that section 18 of H.R. 10650 be amended to provide that real estate in less-developed countries, as defined in section 953(b)(5), shall continue to be exempt from Federal estate tax.

If, for any reason, the above recommendation is not adopted, then I believe that the Virgin Islands and those who have invested in good faith in these islands should be given a sufficient time period to make an orderly adjustment to this change in a 44-year-old precedent. If, in accordance with the present version of section 18, the law becomes effective as of July 1, 1964, it will be necessary for many landowners in the Virgin Islands to liquidate their land in a relatively short time period. Equally important to the economy of the islands, it will result in an abrupt stoppage in improvements and investments by existing landowners. An owner is certainly not going to construct a tourist facility, lay out residential lots, or improve the agricultural use of land when all of these investments are subject to estate tax and when the owner must, in the near future, sell all or part of his land in order to provide the necessary liquidity for his estate. The effect of this section as it is presently proposed may be somewhat similar to the retrogressive effect that resulted when Denmark sold these islands to the United States. Again there may be an exodus of private capital. Therefore, for the benefit of the islands economy and the fair treatment of those who have invested in them under a legal provision recognized by this Government for 44 years, I recommend that, at the minimum, section 18 not be applicable to the Virgin Islands for at least 10 years from the date of enactment. This time period will permit normal improvement, development, and orderly sale of Virgin Islands real property by present owners without depressing values through enforced liquidation. It will encourage the growth of values in property which later would be subject to Federal estate tax. It will contribute to the restoration of a self-sustaining economy on these islands.

In closing, I should again like to emphasize that what is primarily needed is a continuation of the present exclusion of foreign real estate when such real estate is located in less-developed countries. The Secretary of the Treasury estimates that section 18 will produce an annual revenue increase of $10 to $15 million. A great percentage of this estimated increase in annual revenue would be realized by taxing real estate which is located in foreign countries which do not qualify as less-developed countries. In fiscal 1961, the U.S. Government paid subsidies of $6,754,980 to the Virgin Islands. If the flow of private capital to the Virgin Islands is halted or reversed by the proposed legislation, it seems clear that it will be necessary to increase the Federal subsidy to the Virgin Islands by more than the small amount of additional estate tax revenue which would be realized from taxing Virgin Islands real estate.

The CHAIRMAN. Thank you very much, Mr. Barker.

Mr. BARKER. Thank you.

Senator WILLIAMS. Mr. Barker, how would this section work in connection with American industry going to the Virgin Islands?

Mr. BARKER. So far, as I understand it, Senator Williams, there has not been too much American industry going to the Virgin Islands, primarily because of the water situation. In Puerto Rico, with which I am also familiar, you have a plentiful water supply to establish industry.

But, as I understand the situation in the Virgin Islands, there is such a shortage of water that large-scale industrial development cannot take place. It is a tourist attraction, a permanent retirement place attraction for American residents, a lovely climate but not too much industry.

Senator WILLIAMS. I am speaking of new industry that comes in, though, from a tax status; how would it work for a new industry?

Mr. BARKER. A new industry? I am not familiar with it, since not too much new industry has gone into it. I have not made a study of that aspect.

Senator WILLIAMS. Harvey Aluminum is putting in a new plant, is it not?

Mr. BARKER. I think they are.

Senator WILLIAMS. Under what terms are they putting in that plant?

Mr. BARKER. That I do not know, sir.

Senator WILLIAMS. Is there anyone testifying from the Virgin Islands here that could tell us?

Mr. BARKER. Not that I know of, Senator Williams. I can find out, if you want me to see what I can find out on that, sir.

Senator WILLIAMS. I heard rumors to the effect that they had been exempted from all Federal income taxes over a period of several years; is that correct?

Mr. BARKER. I thought you took care of that a year or so ago, Senator Williams.

Senator WILLIAMS. I thought so, too, but because I understand the question may be back up again and may need a further clarification I am asking the question.

Mr. BARKER. That I am not sure of. I thought you had taken care of it. I knew you intended to take care of it, sir, but I am not familiar with that company, so it would be impossible for me to answer the question.

Senator WILLIAMS. Is there anyone testifying in connection with Mr. Canaday's position on that point?

Mr. BARKER. Not that I know of, Senator.

Senator WILLIAMS. Would you furnish for the committee a statement outlining the details of the transaction and arrangements that have been made between the Virgin Islands and Harvey Aluminum Co.?

Mr. BARKER. If I can find out. I do not represent them in any way, you see, Senator Williams, so I do not know how. I am representing Mr. Canaday and not the Virgin Islands government.

Senator WILLIAMS. I thought you were speaking on behalf of the Virgin Islands.

Mr. BARKER. No, sir; I apologize.

The CHAIRMAN. You are speaking for the real estate owners?

Mr. BARKER. I am speaking primarily, Senator, for Mr. Canaday, who owns, I think, several thousand acres of land in the Virgin Islands, which he is trying to develop into a permanent real estate development for people to retire to.

The CHAIRMAN. On what island is he?

Mr. BARKER. He is on St. Croix. That is the largest of the three.

The CHAIRMAN. Has there not been a phenomenal increase in the value of the land on all of those three islands? I was there about a month or so ago to St. John's, and little places that seemed to me to be practically without value, that were very difficult to get access to, would be selling for $2,000, $3,000, and $4,000 an acre.

Is that correct or not?

Mr. BARKER. That I would not know. I know that St. Croix is much more agricultural.

The CHAIRMAN. St. what?

Mr. BARKER. St. Croix. You were on St. John's.

The CHAIRMAN. Yes. I was on St. John's and St. Thomas. The real estate values have gone up more there, I am told, than they have in this country.

Mr. BARKER. If I recall correctly, St. John's is where the resort hotel is located; is it not?

The CHAIRMAN. St. John's is where the national park is.

Mr. BARKER. That is right.

The CHAIRMAN. And most of it is in the park. It may be that the land that is not in the park has an unusual value there, but I understand the same situation applies in St. Thomas, land going up for residential purposes.

Mr. BARKER. Mr. Canaday is over on St. Croix and that is where most of the agriculture is. St. Thomas has very little agriculture and St. John's practically none at all, if I recall correctly.

The CHAIRMAN. St. John's what?

Mr. BARKER. The agriculture which exists there, the raising of sugarcane and so forth and the cattle is primarily on St. Croix, the largest of the three islands.

The CHAIRMAN. I saw very little agricultural activity on either St. Thomas or St. John.

Mr. BARKER. That is what I was saying.

The CHAIRMAN. I did not get to St. Croix.

Mr. BARKER. Thank you, sir.

The CHAIRMAN. Thank you very much, Mr. Barker.

I submit for the record the statement of Warren H. Young, representing the Virgin Islands Territorial Board of Realtors.

(The statement referred to follows:)

STATEMENT OF WARREN H. YOUNG, REPRESENTING THE VIRGIN ISLANDS TERRITORIAL BOARD OF REALTORS

The writer of this statement is a partner in the law firm of Young & Isherwood, Christiansted, St. Croix, Virgin Islands of the United States, and he is representing the Virgin Islands Territorial Board of Realtors of St. Thomas, St. John, and St. Croix.

This statement is concerned solely with section 18 of the proposed Revenue Act of 1962. This section would provide that the estate tax base of decedents dying after June 30, 1964, would include foreign real estate. In addition, purchases of foreign real estate made after January 21, 1962, would be included in the estate tax base of decedents even though they die before July 1, 1964.

In more particular, this statement is concerned with the application of this section to real property located in the Virgin Islands of the United States. For the economic welfare of the U.S. Virgin Islands, I urge that this proposed section be modified in such manner that the real property in the Virgin Islands, as one of the underdeveloped possessions of the United States, continue to be excluded from the estate tax base of U.S. citizens. While I am not appearing on behalf of Guam, or other U.S. possessions that are clearly underdeveloped, my request should be equally applicable to such possessions.

Historically, by Federal statute and Treasury regulations since 1934, real property located in any of the U.S. outlying possessions has been treated as "foreign property" for the purposes of being excluded from the computation of the value of the estate of a U.S. citizen for Federal estate tax purposes. This particular tax advantage has been as much a part of the land located in the Virgin Islands as are the tropical sun, the cool tradewinds, the beautiful hills, forests, and beaches. Taxpayer-citizens of the United States, who "found" the Virgin Islands, have acquired that tax advantage in buying Virgin Islands land, along with the other attributes mentioned. They acquired the advantage without having to qualify by doing or causing to be done any great change in their private lives. The U.S. citizen can still maintain his residence in New York, Ohio, Oregon, or elsewhere in the United States without having to become an actual domicilary of the Virgin Islands.

Before the Technical Amendments Act of 1958, the U.S. citizen-taxpayer, who "found" the Virgin Islands, enjoyed an even greater tax advantage. In those days, if he became a domicilary and resident of the Virgin Islands, his entire estate was excluded from the reaches of the Federal estate tax. It is strange that not many U.S. citizens took advantage of this tremendous incentive to reside in the Virgin Islands. One would have thought that many millionaires would have rushed to the U.S. Virgin Islands in the wake of the Tax Court "Fairchild" decision of June 1955, which publicized and confirmed that tax advantage. That was not so, and that comment comes from my own personal experience. I was in active law practice in the Virgin Islands in 1955 and for 5 years prior thereto. Of the many contacts I had with wealthy U.S. taxpayers and their attorneys, who investigated this tax advantage, very few of them were willing to change their whole pattern of living by moving down to the Virgin Islands "lock, stock, and barrel" merely for the purpose of avoiding the Federal estate tax. There were a few prior to 1958, and my office has probated their entire estates free and clear of the Federal estate tax. Although there was much said about the loss of that tax advantage, when Congress took it away in 1958, I do not feel that it materially affected the overall economy of the Virgin Islands.

I mention the recent loss of that tax advantage because I want to contrast it with what is now being considered in section 18 of the proposed Revenue Act of 1962. This tax advantage is much more substantial and essential to the Virgin Islands. In my considered opinion, it is the last real tax advantage left to the U.S. Virgin Islands. It is clear to me, and I hope I can convey the same picture to all of you, that much of the progress that has been made in the Virgin Islands since 1950 has been due principally to the influx of U.S. citizens who have been and are willing to invest their accumulated earnings into dwelling homes in the Virgin Islands to be held by them as rental income units but for eventual retirement. These people, for the most part, occupy their Virgin Islands homes for 1 or 2 months of the year. The rest of the time, the homes are available for vacationers. The real estate brokers and lawyers who brought about these investments in the Virgin Islands stressed the fact that one great advantage of such investment was the exclusion of the real property from one's estate for Federal estate tax purposes, even though the investor remained a resident and citizen of the United States. This is of utmost importance to those investors, who are still in business in the United States and were not ready for retirement.

In the argument above, I discussed the past period from 1950 up to the present time. However, I want to emphasize that currently, and for the future, this tax advantage is still a tremendous selling point for the Virgin Islands. The removal of this tax advantage will be a severe blow to the source of capital that has taken the Virgin Islands out of the doldrums. The Virgin Islands is becoming of jet age, but it still does not have jets. It still is dependent upon Federal subsidies. It is clearly underdeveloped, and it needs the continued tax incentive that has helped it in the past.

I realize that the Virgin Islands is permitted by Congress to keep the income taxes that it collects, and to encourage investment from the States by offering a form of industrial subsidy and tax-exemption program. Without going into statistics, which I am sure are available to you through your own departmental agencies, I wish to go on record as saying that our industrial incentive program has been a miserable failure. While Puerto Rico has enjoyed tremendous success with its "bootstrap" operations and "fomento," what can the Virgin Islands say of its own tax-incentive program?—a few hotels, a couple of button factories, and several watch factories. If it were not for tourism, the rum industry and Virgin Island Corporation, together with the growing influx of the little home and real estate investors, the Virgin Islands would not be where it is today. Of these four named economic influences, the investment in homes and real estate, induced principally by the exclusion of such assets from the Federal estate tax, is not to be underestimated.

I have read statements made and presented to the House Ways and Means Committee on behalf of the Virgin Islands with regard to this same matter. I have also seen a statement to be presented before this Senate committee about the same subject. I am pleased to note that these statements go into greater legal detail and financial statistics. This statement, if not otherwise convincing, has a small virtue of being based upon a personal experience in actual law practice in the Virgin Islands for the past 13 years. It is a law practice very much involved in real estate and closely associated with the many real estate agents and brokers located on all three islands of the Virgin Islands.

It was at the very recent annual meeting of the Virgin Islands Territorial Board of Realtors that this subject was discussed by the members of that association, all of whom stated that a great portion of their sales has been based on the existence of the present estate tax advantage. By unanimous resolution, the members of the association authorized me, as their counsel, to proceed to Washington and present this statement before this Senate Finance Committee. This is not a selfish interest group. They have no large estate tax problems. However, they are closely connected with the economic development of the Virgin Islands, and they know that the continued progress of the Virgin Islands depends upon the continued influx of capital through this one small tax advantage. We urge you to keep it "on the books" for the Virgin Islands and other underdeveloped possessions of the United States.

The CHAIRMAN. The next witness is Mr. Eugene C. Carusi, of the American Committee for Flags of Necessity.

Please proceed, Mr. Carusi.

STATEMENT OF EUGENE C. CARUSI, AMERICAN COMMITTEE FOR FLAGS OF NECESSITY

Mr. CARUSI. The present membership of the American Committee for Flags of Necessity, which was formed in 1958, comprises 17 American independent shipping and integrated industrial companies, listed in appendix A herein. These companies hold stock interests in foreign corporations which own bareboat charter in or are agents for a total of 194 tankers and ore carriers registered under the laws of the Republics of Panama and Liberia. These modern, high-speed vessels, which total 6,740,660 deadweight tons, are engaged in the carriage of bulk cargoes throughout the free world. Without exception the vessels are pledged or committed to augment U.S. sealift defense needs in event of war or national emergency, and in fact represent 62 percent of the total deadweight tonnage in the U.S. effective control fleet.

THE IMPACT UPON AMERICAN-CONTROLLED SHIPPING OF A TAX ON SHAREHOLDERS OF "CONTROLLED FOREIGN CORPORATIONS"

This statement is submitted for the purpose of explaining the direct impact of H.R. 10650 in its present form upon the controlling U.S. shareholders of various foreign corporations which own and operate foreign-flag vessels, the indirect impact upon U.S. business entities doing business with such corporations, and the resultant adverse effects on the defense posture and the balance-of-payments situation of the United States.

In summary, the basic points of this statement are as follows:

(1) Foreign-flag vessels owned and operated by American-controlled foreign corporations are largely bulk cargo carriers (oil and chemical tankers and coal and ore carriers) engaged in the foreign trades in competition with European- and Japanese-owned vessels.

(2) American-flag passenger and general cargo vessels are eligible for U.S. Government operating and construction differential subsidies which, with their attendant tax deferral features, enable them to absorb higher American construction and operating costs. American-flag bulk carriers are not eligible for these subsidies.

(3) Therefore, American-flag vessels cannot compete for the carriage of bulk cargoes in foreign trades except under extraordinary market conditions. Accordingly, no question is raised by this bill as to potential competition between American-flag vessels and foreign-flag vessels. The competition is solely between American-controlled and foreign-controlled vessels—all of foreign registries.

(4) Many of these American-controlled vessels are owned by foreign companies organized and owned by individual American businessmen.

(5) An annual U.S. tax on these individuals stemming from control and based on earings which, under customary ship financing arrangements, are not available to pay such tax would, in most cases, leave these individuals with no choice, economically, other than to transfer control of existing tonnage to foreign interests, and would effectively bar them from acquiring new vessels.

(6) Similarly, imposing a tax at ordinary rates on the gain to be realized by these individuals on liquidation of or sale of the stock in these foreign shipping corporations would make retention of their controlling equity in this area uneconomic in view of the much higher return available from other investments. Here again, only foreign interests would be in a position to take over present investment and consider making new investment in the foreign-flag shipping field.

(7) Any such induced passage of control from these individuals would adversely affect the defense posture of the United States since the resulting foreign control would mean the loss to this country (as acknowledged by the Defense Department and the Maritime Administration) of the effective control which it now has over many of these vessels in the event of war or national emergency (approximately 300 vessels of an aggregate deadweight tonnage in excess of 8 million might be affected).

(8) As the charter market of the last 15 years demonstrates, the cargoes of American and foreign shippers will continue to move in the vessels most economically available. Accordingly, dollars currently inuring to these American individuals and ultimately taxed by the United States would after such transfers go instead into foreign hands.

(9) With this shift of control to foreign interests, employment of American companies and personnel for management, shoreside operations, insurance, and other related activities would be reduced.

(10) Finally, major domestic corporate users of foreign-flag bulk carriers would be forced to supplement their own fleets by chartering in a market where all available independent tonnage was controlled by a small number of aliens.

It is submitted that the foregoing are not the intended objectives of this bill. The Treasury Department has projected an $85 million [1] increase in annual revenue from controlled foreign corporations of all kinds when these proposed changes are fully operative. The portion of such anticipated revenue to be derived from American-controlled foreign-flag shipping will probably be small, and will certainly be

[1] The corresponding estimate of the staff of the Joint Committee on Internal Revenue Taxation is only $50 million.

minimal as compared with the resulting direct and indirect cost to our economy.

BACKGROUND

Under present law, a foreign corporation is taxable only on income from U.S. sources whether or not it is in trade or business in the United States. Further, the earnings of a foreign corporation derived from the operation of ships documented under laws of countries granting equivalent exemptions to U.S. citizens and corporations are excluded from U.S. gross income and exempt from tax. Section 883(1), 1954 code. While this provision was designed primarily to eliminate the double taxation which has historically burdened transportation in foreign commerce, the Federal Government (through such agencies as the Maritime Administration) has in effect encouraged American business interests to avail themselves of its benefits in order to enable them to compete in international trade with foreign shipping which is, by and large, untaxed. Spokesmen for the Navy and Defense Departments have also repeatedly endorsed a policy of encouraging the growth and maintenance of a substantial fleet of American-controlled foreign-flag vessels.[2]

In so doing, the United States has developed a large foreign-flag reserve fleet which would be available to it in time of war or national emergency. A change in the tax law which would induce a transfer of any of these vessels to foreign owners and discourage new construction under American control would result in a loss to the United States. No adequate substitute for these vessels now exists and none can be created without substantial cost in money and time.

GROWTH PROSPECTS FOR AMERICAN SHIPPING IN WORLD TRADE

Competition for the carriage of bulk cargoes is intense, with most owners constantly adding to, or replacing, existing vessel tonnage with faster, more efficient, and generally larger new vessels. Substantial economies are available in conducting shipping operations under foreign flags. Foreign shipowners have in the past utilized these competitive advantages and will certainly continue to do so. American owners have been able, without subsidies, to compete against this foreign-owned shipping for the carriage of bulk cargoes only by availing themselves of the same economies.

Much of the existing American-controlled foreign shipping is owned by groups of individual American businessmen who have not only committed their personal resources to the extent possible, but who have had to borrow a substantial portion of the purchase price of each new vessel. One of the major costs which has to be met by a foreign shipowning corporation is, therefore, the amortization of the debt incurred in the construction of vessels.

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[2] See, e.g., statement of Vice Adm. John Sylvester, Deputy Chief of Naval Operations, reported in the New York Herald Tribune, Mar. 28, 1962, as follows:

"* * * our interest in the matter relates to the impact of this problem on our defense posture.

"Modern war concepts put a high premium on the active operating ship. Flags of convenience shipping, considered to be under effective U.S. control, constitutes an active operating fleet of approximately 420 ships, mostly large tankers and bulk carriers. Over half the tonnage of this fleet was built in the last 5 years."

It is the practice of lending institutions not to extend loans on vessels beyond the period of all charter commitments existing when the loan is made. In most instances, the user of the vessel (because of conditions affecting it) will not bind itself to using the vessel for a period in excess of 10 years. The useful life of new vessels is substantially longer than 10 years, and, as a consequence, the mortgage amortization payments which the foreign shipowning corporation is required to meet may be substantially higher than the depreciation which would be allowable on the vessel for U.S. tax purposes.

The difference between allowable depreciation and the mortgage amortization payments increases the net worth of the foreign corporation and might be treated as attributed dividends to the U.S. shareholders under the proposed bill. Clearly, however, this increase in net worth is not represented by cash available to the U.S. shareholder to satisfy any potential income tax liability.

Furthermore, the U.S. shareholders are usually precluded, by binding contractual obligations, from withdrawing cash from their foreign corporations until the mortgage obligations of those companies are substantially amortized. In many cases competitive charter rates barely cover the vessels' operating and related costs and debt service. In those cases where there are any excess moneys, the lender has almost invariably restricted the payment of dividends in order to provide protection against the risks and uncertainties of the future.

It will thus be seen that many American owners of foreign-flag shipping will be unable to provide for tax burdens not equally applicable to their foreign competition unless the users of their vessels are willing to pay higher rates. Charterers, however, will be unwilling to pay more charter hire for American-controlled vessels than for those under foreign control. Therefore, the effect of this bill will be to encourage the transfer of control of such vessels to interests not subject to the same tax burdens and to discourage new construction commitments.

THE BILL

The operation of a foreign shipping business constitutes the active conduct of a trade or business. Yet language presently in the proposed bill, which is designed to reach possible abuses in different areas, might be interpreted so as to tax currently to the U.S. shareholders the undistributed earnings of the foreign shipping corporation. In addition, the bill would clearly cause individual controlling shareholders to be taxed at ordinary rates on a substantial part of their ultimate gain on termination of their interests in this operating business.

As presently drafted the proposed Revenue Act of 1962 could be construed to include within the definition of foreign base company income some kinds of income received by foreign corporations from the operation of foreign-flag vessels (sec. 952(e)(3)). Further, fulfillment of amortization requirements under vessel financing arrangements could be considered to constitute an investment of earnings in nonqualified property (sec. 953(b)). Either interpretation would result, in many cases, in the taxation of the "United States persons" controlling the foreign corporation even though such foreign corporation does not and, under the binding contractual commitments referred to above, could not make any payments of any kind to these persons (secs. 952 (a) and (e); 951(a)). Further, the bill definitely causes any U.S. person considered to own 10 percent or more of a controlled foreign shipping corporation to be in receipt of ordinary income, taxable at the highest individual or corporate brackets, when such person terminates all or part of his interest therein by stock sale or corporate liquidation (sec. 1248).

EARNINGS FROM THE OPERATION OF FOREIGN-FLAG VESSELS AS FOREIGN BASE COMPANY INCOME

In its report, the Committee on Ways and Means of the House of Representatives has said with respect to the proposed changes:

> Your committee while recognizing the need to maintain active business operations abroad on an equal competitive footing with other operating businesses in the same foreign countries, nevertheless sees 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 (H. Rept. 1447, p. 62, 87th Cong., 2d sess., 1962).

The report then indicates that the reason why passively received investment income should be taxed is that—

> there is no competitive problem justifying postponement of the tax until such income is repatriated.

The report further indicates that passive income includes "rents." U.S. Treasury regulations now include "charter fees" as rents. Despite the fact that the clear legislative intent is to cover only income of a portfolio or investment nature, it is likely that certain types of earnings from the operation of vessels (however different from the traditional low risk portfolio type of rent) might be inadvertently included as foreign base company income.

DEBT AMORTIZATION AS CONSTITUTING INVESTMENT OF EARNINGS IN NONQUALIFIED PROPERTY

The proposed statute would impose a tax on controlling U.S. persons where the corporation invests its earnings in "nonqualified property." To be "qualified," the property must be located outside the United States and be used in a trade or business conducted outside the United States; this rule, which was obviously drafted with a view to businesses whose assets are not intrinsically mobile, appears to make it difficult or impossible for the assets of a shipping business to qualify. If a vessel makes a U.S.-port call, this might be deemed a disqualifying act. The conduct of related U.S.-shoreside operations might be deemed disqualifying. If either of these interpretations prevail, any investment in vessels, including the paydown of mortgage indebtedness, would constitute an investment in "nonqualified property" resulting in a tax on the U.S. shareholders.

Further, all vessels acquired by a foreign corporation organized after December 31, 1962, would be nonqualified assets under the bill until such corporation had been engaged in the active conduct of a trade or business for 5 full years. Since financing and other considerations frequently dictate the use of new foreign corporations in the acquisition of vessels, the threat of immediate taxation under this bill would discourage additional American investment in the foreign-flag reserve fleet.

REASONABLE RETURN ON INVESTMENT IN FOREIGN SHIPPING

Independent American businessmen have in the past been willing to invest their money in the volatile, highly speculative foreign-flag shipping area because they could anticipate a reasonable rate of return considering the risks involved. Even under existing tax law, in the charter market of the recent past, investment in foreign shipping has been economically unattractive. Independents have been generally reluctant to undertake new commitments.

The investment return is already marginal as to many individual operators. Should it be reduced by taxing gain, when the shareholder terminates his interest in the corporation, at ordinary rates instead of the present capital gain rate, even the most enterprising would be inclined to withdraw his capital and reinvest it elsewhere. Since, under the bill, other Americans would be similarly situated, the only apparent alternative would be to sell control to foreign interests.

CONCENTRATION OF CONTROL IN EXISTING FOREIGN GROUPS

If American independents transfer control over their foreign-flag vessels, the major American companies which require additional vessels to supplement their own fleets would lose the reliable and efficient services of American operators. Furthermore, there is a strong likelihood that large, established foreign shipping interests, with their experience in operation and financing, will acquire these vessels, thereby increasing the concentration of tonnage in their hands. In fulfilling their additional tonnage requirements, American charterers would be forced to deal with these foreign-controlled shipping companies.

CONCLUSION

The report of the House Committee on Ways and Means, while expressing the intent that passive, portfolio-type income should be currently taxed to the U.S. shareholder, clearly recognized that active business conducted abroad by American interests should be maintained on a competitive footing. The need to keep American-owned foreign shipping operations in a competitive position is equally clear.

The costs to the United States in applying the proposed tax to shipping would far outweigh the expected increase in annual revenues. Related domestic businesses and activities would be reduced; but more basic are the effects indicated in a letter to Representative Carl Vinson,[3] chairman of the House Committee on Armed Services,

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[3] On Aug. 28, 1961, Representative Vinson stated before the House:

"From a standpoint of national defense these ships can be recovered for our national needs in the event of a national emergency. However, we are facing a situation under which the owners of these tankers and bulk cargo carriers may sell or make an outright transfer of these ships to foreign countries. In that event, the right of recovery of these ships in a national emergency would cease to exist.

"Since we do not have, under American registry, sufficient tonnage of this type of ship to meet the requirements of national emergency, it is both important and urgent that we adopt a national policy which will protect the national interest" (Congressional Record, vol. 107, No. 149, pp. A6713–A6714).

dated August 24, 1961, from Deputy Secretary of Defense Roswell L. Gilpatric, in which he said:

(1) The primary interest of the Department of Defense in flags-of-convenience shipping relates to the impact of our national defense posture and this interest is to insure the availability under U.S. control of as much of this shipping as may be needed in the event of national emergency. The amount of active U.S.-flag shipping now available is inadequate for almost any situation of war or emergency and must be augmented by shipping which can be brought under our direct control as required in the event of an emergency.

(2) It is considered imperative that U.S. effective control of flags-of-convenience shipping be retained. * * *

The foregoing position of the Defense Department was recently reaffirmed by Secretary of Defense Robert S. McNamara. In testifying on April 18, 1962, before the Subcommittee on Merchant Marine of the House Committee on Merchant Marine and Fisheries, he emphasized that—

considerable dependence can be placed upon those ships for use if they be needed in connection with military requirements of this country.

(The appendix to Mr. Carusi's statement follows:)

APPENDIX A

AMERICAN COMMITTEE FOR FLAGS OF NECESSITY

Alcoa Steamship Co., Inc.
American Oil Co.
The Atlantic Refining Co.
Bernuth, Lembcke Co., Inc.
Cities Service Oil Co.
Gotaas-Larsen, Inc.
Gulf Oil Corp.
Marine Transport Lines, Inc.
Naess Shipping Co., Inc.
National Bulk Carriers, Inc.
Paco Tankers, Inc.
Richfield Oil Corp.
Socony Mobil Oil Co., Inc.
Standard Oil Co. (N.J.)
Standard Oil Co. of California
Texaco, Inc.
Tidewater Oil Co.

The CHAIRMAN. Thank you very much, Mr. Carusi.

The next witness is Mr. H. Lee White of the Marine Transport Lines.

Take a seat, Mr. White.

STATEMENT OF H. LEE WHITE, MEMBER OF THE LAW FIRM OF CADWALADER, WICKERSHAM & TAFT, AND CHIEF EXECUTIVE OFFICER OF THE MARINE TRANSPORT LINES GROUP, OSWEGO GROUP, AND TRINITY GROUP

Mr. WHITE. I am a partner in the law firm of Cadwalader, Wickersham & Taft. I am also the chief executive officer of a group of shipping companies, both American shipping and foreign-flag shipping corporations. Our foreign-flag companies are grouped in two groups called Oswego and Trinity; the American corporations in the group are called Marine Transport Lines.

Marine Transport Lines, which is the American group, operates our foreign-flag ships and also operates our American-flag ships and operates ships both foreign and American for other companies that we have no interest in.

We have a total of 9 foreign corporations that own 15 Liberian-flag ships, and they range in size from 12,000 tons to 50,000 tons. Ten of them range in size from 42,000 tons to 50,000 tons, and those 10 have been built since 1959.

In our American-flag fleet we have 19 American-flag vessels, ranging in size from 10,000 tons to 24,000 tons, and our total operating fleet is 74 vessels.

I have a very long and detailed statement which I would like the chairman's permission to submit as part of the record and just give the conclusion from my statement here today.

The CHAIRMAN. Your detailed statement will be inserted in the record following your oral statement.

Mr. WHITE. What I am going to do today is take the conclusions that are in that statement and state them only as conclusions and hope that if anybody questions my conclusions, they will ask me the questions and I will do my best to answer them.

The first thing I would like to say is that American owners such as our group did not form these foreign-flag corporations as tax havens.

We formed them because we were forced to form them by the competition we were facing from the great maritime nations of the world who had low wages, low construction costs, and special tax benefits from other countries of the world supporting their fleet.

The main charter market for these vessels are large American corporations whom we call charterers. They are American oil companies, American steel companies, American aluminum companies. And since the international waters of the world are not a protected market, these large American corporations will only accept a charter from an owner provided they can get it at the lowest price possible.

Therefore, the Americans, in order to compete in that market, had to form these foreign corporations in order to be able to get foreign costs and foreign tax benefits.

The construction cost, for example, in a foreign yard, as against an American yard, is two to three times less than that of an American yard.

The operating costs of an American ship are three to five times that of a foreign-flag ship, and practically all of the maritime nations of the world have given some kind of tax preference or other to their shipping.

As an example, there is a total of American-owned Liberian-flag vessels of about 456, but the total non-American Liberian-flag vessels is about 941. If we did not carry this cargo, this iron ore and this oil and this bauxite to the United States, it would not be carried by American vessels, but it would be carried by non-American vessels, people like Onassis, the big Dutch owners, the big British owners, the big Norwegian owners.

To prove this point, on tanker cargoes that are coming to the United States today, even though we have the right to fly the Liberian flag and use the low operating costs that come from that right, we only carry 35 percent of the oil that is coming to the United States right now.

Sixty-five percent of the oil coming to the United States comes in non-American-owned foreign-flag vessels.

Now, to understand why this particular tax provision is so difficult for American owners of foreign-flag vessels to handle, you have to understand how we finance.

We borrow from 75 to 90 percent of the cost of a vessel from a large insurance company or a combination of large insurance companies and banks. The vessels today cost around $6 to $7 million apiece in the foreign yards; they cost around $12 to $14 million apiece in the American yards for a 46,000-ton ship.

These financing institutions have a customary way; some of it required by the laws of the State in which they are incorporated. They start off by requiring that we put a substantial investment ourselves into the company.

Secondly, they require that for each separate financing transaction we form a separate and distinct corporation.

The reason they do that is they want to make sure that any other transaction that they are not involved in is not going to affect the transaction that they are financing. They have looked at our ship costs; they have looked at our charter; they know what our revenue is going to be; and they do not want that revenue affected by any other transaction we get into.

The CHAIRMAN. Let me ask you at this point:

Why did you select Liberia as the place of incorporating, Mr. White?

Mr. WHITE. There are actually three places that Americans could choose and still have what we call an effective control fleet of the U.S. Government.

You could take Panama; you could take Honduras; or you could take Liberia.

Now, any one of those are about the same, and they are called equally the Pan-Lib-Hon fleet. Now, I just happened to pick Liberia.

The CHAIRMAN. Your statement says that all of them are——

Mr. WHITE. Pardon?

The CHAIRMAN. The first page of your statement says that all of the foreign corporations are Liberian corporations.

Mr. WHITE. I say all of my foreign corporations are Liberian.

The CHAIRMAN. How many people are you speaking for here?

Mr. WHITE. For myself and my own shipping company.

The CHAIRMAN. It is not clear. I think you had better change this statement then. You say:

> These corporations are Liberian corporations and the vessels of these corporations are registered as Liberian-flag vessels.

Mr. WHITE. Senator, if you look at the sentence above, I am speaking about my own two groups, the Trinity group and the Oswego group.

The CHAIRMAN. What are the groups you speak of?

Mr. WHITE. My own shipping companies which are called the Trinity group of companies, the Oswego group of companies and the Marine Transport Line group of companies.

The CHAIRMAN. The Trinity and Oswego group——

Mr. WHITE. They are all mine.

The CHAIRMAN (continuing). Are the ones registered in Liberia?

Mr. WHITE. They are registered in Liberia.

Senator WILLIAMS. When you speak of a series of corporations, you mean a series of corporations, one for each ship?

Mr. WHITE. No.

Actually, it is a series of corporations based on the transaction that is financed by a specific financial institution. For instance, we have 15 foreign-flag vessels. We have them in nine corporations. Those corporations have from one to three ships but each corporation is for a specific transaction.

The CHAIRMAN. Are you beginning at the first of your statement and taking a rough draft and going through it? How are you discussing this statement of yours?

Are you beginning at the beginning of it, or are you making your remarks applicable to what part of it?

Mr. WHITE. I am going through it all. I have taken the conclusions.

The CHAIRMAN. You are starting at the first page?

Mr. WHITE. I am running through, but you will not be able to follow me from this statement.

The CHAIRMAN. What page are you on now?

Mr. WHITE. I would say that I do not know where I am in this statement, sir, because if I followed this statement, we would be here for 5 hours.

What I am doing is giving you the conclusions.

Now, at this point I was talking about the way we borrowed funds, and I said that we had to put in a substantial investment ourselves.

We had to set them up in separate corporations.

And then the financing documents which are very detailed and very long require us to maintain a minimum working capital, and they say that in the event the working capital falls below a fixed amount, the stockholders have to loan money to the company, and they must subordinate that loan to the payout of the lending institution.

That also applies to our original investment.

Whatever we put into one of these transactions, we must leave in the transaction until the bank or insurance company has been paid off.

Now, since most of these charters run from 15 to 20 years, that means that our original investment is locked up for 15 to 20 years, plus we must be prepared to lend other funds into that company and lock them up for 15 to 20 years.

Then the documents prohibit us from paying dividends to ourselves and prohibit us from making loans to ourselves and prohibit us from borrowing money from anyone else except ourselves, and if we lend to the company, we must lend it on a subordinated basis.

Now, further, when anyone discusses the shipping business, they should take into consideration the large risks that are involved in a shipping transaction.

When we build these ships, as I said, we build them in foreign yards. So we take the chance that if a war breaks out abroad, any money we paid the yard during construction will be lost.

The second chance that we take is that the yard itself might go bankrupt, and, in fact, in one of my transactions we had about $6 million in a given ship-construction program in Sweden when the yard went bankrupt, and the only way we got out of it was the fact that the Swedish Government stepped in and financed the yard to keep it going.

We also take the risk that our operating estimates will be wrong, because we have to estimate what our operating costs are going to be over a 15- to 17-year period.

If we tried to put contingencies in for the fact that our crews might sometime down the line be organized by American unions abroad, we would not get the transaction to start with. So we have to knock all those contingencies out, and hope that we will not get into that kind of trouble.

We also have to take the chance that our ship will not go on strike or that it will not have a collision and go off-hire, because most of us, when we estimate a charter rate, estimate on the basis that at most we will have 15 days off-hire a year, and that we will lose income only for 15 days.

Now, I have known of cases where a bad collision occurred. The ship was ripped in two, and although they got insurance for the hull and machinery, they did not get any insurance to pay for the amortization payments to the banker or to keep their operating expenses going, and the ship was laid up for 6 to 9 months.

The other big risk that we took is that if any of the stockholders die during that 15 or 17 years, their estates have a real serious problem because, somehow or other, their estates have to pay an inheritance tax to the U.S. Government on the value of their stock in the foreign corporation even though they cannot get any money out of the corporation at all.

Now, there are three sections that really go to the heart of the problem, so far as the shipping industry is concerned, and which indicate to me that the Treasury Department, when it made this recommendation, did not understand the shipping industry or the foreign-flag ship end of it.

The first is section 952(e) (3).

The CHAIRMAN. Could I ask you a question at that point?

Mr. WHITE. Yes, sir.

The CHAIRMAN. Did you appear before the Ways and Means Committee?

Mr. WHITE. I did not, sir.

The CHAIRMAN. Why did you not?

Mr. WHITE. The original recommendation of the Treasury Department excluded shipping, and their original recommendation—they did not include shipping as one of the industries to be touched. It only came out of the House Ways and Means Committee, with shipping included.

So there was not any reason to testify.

The only reason I am here today, sir, is because H.R. 10650 does now include shipping.

The CHAIRMAN. You are here today to do what?

Mr. WHITE. Is because H.R. 10650 does apply to shipping as it came out of the House. But as it came from the Treasury to the House Ways and Means Committee, it did not include shipping.

The CHAIRMAN. In your statement you say:

> This means that the total tax I would have to pay each year in order to retain my interests in these shipping corporations would be approximately $1 million a year, even though I cannot get 1 cent of income out of the foreign shipping corporations with which to pay this tax.

Mr. WHITE. That is absolutely true.

The CHAIRMAN. Would you explain that?

Mr. WHITE. Yes, sir.

In fact, it could get as much as $5 million that we might have to pay. The way it works is this:

Under——

The CHAIRMAN. Wait a minute. You used the word "I."

Mr. WHITE. Individually.

The CHAIRMAN. Individually?

Mr. WHITE. Individually.

I am not talking about the rest of the stockholders.

The CHAIRMAN. You own the ships yourself?

Mr. WHITE. No.

We have other stockholders, but you multiply—there are five stockholders, so that figure of $1 million, if you apply it to all of us, would be $5 million.

The CHAIRMAN. You do not collect from the company but collect from individuals?

Mr. WHITE. No.

Let me explain how that works, Senator.

Section 952(e)(3) says that any foreign corporation which receives rent, then the income of that corporation is attributed to the stockholders of the corporation and the stockholders of the corporation pay the tax even though the corporation declares no dividends to the stockholders.

Now, there is a longstanding Treasury regulation which says that rent includes charter fees. That means that all of the income of all the foreign-flag corporations is rent so far as the statute is concerned, and since it is all rent, it means that the income of these companies is attributed to each and every one of the stockholders as if they had received it.

And when you own 15 ships, the net effect of it is that they attribute something like $5 to $6 million a year of money that we cannot get our hands on, because there is a prohibition against the payment of dividends.

The CHAIRMAN. Then they are handled somewhat like a partnership so far as taxation is concerned?

Mr. WHITE. That is right.

The CHAIRMAN. Even if you do not get the money, you have to pay.

Mr. WHITE. Pay taxes, and even though we are prohibited from getting the money, because the documents that we have with our financing institutions say we must not take the money out. We must pay it to the financing insitution.

The CHAIRMAN. Go back to it again. Why did you pick Liberia? That is known as a tax haven country as a rule. What reason did you have to pick Liberia to incorporate your companies?

Mr. WHITE. I picked Liberia for the following reasons:

(1) The Liberian Constitution is similar to the U.S. Constitution.

(2) The medium of exchange of Liberia is the American dollar.

(3) There is a very favorable maritime law in Liberia which is similar to the maritime law of the United States.

(4) I am permitted under the laws of Liberia to tender my ships to the U.S. Government, commit them to the U.S. Government in the

event of a war, so I am in a position, owning a Liberian corporation, of being able not to have to do anything which is against the policy of the United States.

Liberia permits me to sign a contract with the Maritime Administration.

The CHAIRMAN. Is that in the form of an agreement?

Mr. WHITE. It is in the form of an agreement with the Maritime Administration.

The CHAIRMAN. That is in writing?

Mr. WHITE. That I have with the Maritime Administration.

The CHAIRMAN. In other words, Liberia could not force you to sell the ships?

Mr. WHITE. No. They have approved each of the agreements, Mr. Chairman.

The CHAIRMAN. And the United States would not be adversely affected in any way?

Mr. WHITE. Pardon?

The CHAIRMAN. The United States would not be adversely affected in the event of the need of the ships because Liberia would make no claim upon the ships?

Mr. WHITE. That is right.

They consent to our signing this agreement with the U.S. Government, and during Korea and during the Lebanon crisis each time these ships were put and turned over to the United States to help the United States, and we signed an agreement which says that any time the U.S. Government wants to, they can requisition for use or requisition for title.

The CHAIRMAN. The only reason that you do not receive any cash from the companies is because of the agreement you make with those who loan the money to you?

Mr. WHITE. That is right.

The agreements with the financing institutions require that most of the money goes to the financing institution to pay back the loan.

Any balance over and above that, which is very small, they require us to lock up into U.S. banks as additional working capital to take care of any future risks in the transaction.

The CHAIRMAN. This would actually make you pay, yourself, personally, $1 million a year?

Mr. WHITE. That is right, and I do not have $1 million.

The CHAIRMAN. What would happen then?

Mr. WHITE. What will happen then is I will sell my fleet.

The CHAIRMAN. You would have to sell your property, would you not, or the Federal Government would?

Mr. WHITE. No; I would sell because at the present time there is sitting in New York a very big group of shipowners from Europe who know about this tax law and know that the American citizens are in trouble, and they are over here trying to buy these ships from us right now. This would be my only alternative to personal bankruptcy.

This is what would happen. This whole fleet would go. I covered 952(e)(3).

Now, the second section that is troublesome——

The CHAIRMAN. One more question.

How long will it be before you get any money out of this?

Mr. WHITE. Before I personally get any money, it will probably be somewhere between 10 to 15 years.

The CHAIRMAN. Why do you want to go into a business deal like that? If you are liable to pay $1 million a year in the event that the tax laws are changed, and then you do not get anything for 20 years——

Mr. WHITE. Let me say this to you, Senator.

The CHAIRMAN (continuing). It does not look to me like a very good business investment.

Mr. WHITE. If I had thought that the administration, any administration, or that the Congress of the United States was going to pass a tax law like this, I would not have entered into this business.

But it did not seem to me that with the reliance that our Government has on this fleet, and the terrible position that the defense of this country is going to be in if this fleet is lost, that such a tax law would be passed since it would tax us differently than American stockholders of American corporations.

The CHAIRMAN. Has any official of the Government taken any part in approving this legislation?

Mr. WHITE. Pardon?

The CHAIRMAN. Has the Secretary of Commerce or the Secretary of Defense approved the legislation as passed by the House?

Mr. WHITE. I do not think they have, Senator. I am a little ahead of myself but I will cover this point for you. If you go back only to August 1961, which is 8 months ago, the Department of Defense had a study made in 1961 to see how important it was to the defense of the United States to keep this fleet of American-owned, foreign-flag vessels.

This is called the effective control fleet, and you have to be careful to distinguish when you talk about these fleets. When they talk about the effective control fleet, they are talking about the fleet of foreign-flag vessels owned by American citizens, committed by them to the U.S. Government's use in the event of an emergency.

Now, the Deputy Secretary of Defense Gilpatric wrote a letter on August 26, 1961, which is only 8 months ago, to the Honorable Carl Vinson, head of the Armed Services Committee, where he stated that the American-flag fleet was totally inadequate for any emergency, and that the country critically relied on this effective control fleet in all of its mobilization plans.

And Congressman Vinson on the floor of the House rose and made a statement that the Armed Services Committee recognized the severe importance to the United States of this effective control fleet.

I would like to read one thing that Gilpatric said.

The CHAIRMAN. On what page in your prepared statement is that?

Mr. WHITE. August 26, 1961.

The CHAIRMAN. What page?

Mr. WHITE. Page 31.

The CHAIRMAN. All right.

Mr. WHITE. Gilpatric said:

> Because of the effect which such a transfer—

and he is talking about ships like those owned by my group and groups similar to us—

of tonnage out of U.S. control would have on defense needs in the event of a national emergency, we asked the Secretary of the Navy to review its requirements for flags-of-convenience vessels in the event of war. The Navy does so and has confirmed its previous position that it is imperative that "U.S. effective control of flags-of-convenience shipping be retained." That position has been adopted as the Defense Department's position in the matter, and the Secretary of State and the Secretary of Labor have been so informed.

Then he went on to say that:

The amount of active U.S.-flag shipping now available is inadequate for almost any situation of war or emergency.

One of the—as I say, I am getting ahead of myself, but since you asked me about this point and since the defense, to me, is of critical importance—one of the admirals in the Navy Department has said that if this fleet was lost, the American mobilization plans would be so much wastepaper.

Now, it seems to me a pretty tragic thing to do, to take by tax legislation and destroy or turn the mobilization plans of the U.S. Government into wastepaper.

And while I am digressing here, you asked me how Defense and Commerce felt about it. It is possible that if they were asked to appear before this committee, they probably would be happy to appear and state their reliance on this fleet.

The second section—before I got off on this defense point, I had talked about 952(e)(3), the rent section. The other section which is as horrible is 953(b). The trouble with 953(b) is, it says, in effect, that if you take the earnings of a company and put them in what they call nonqualified properties, then, again, the stockholders, not the corporation but the stockholders, are taxed as if they had received the money themselves.

Now, the trouble with 952(e) and 953(b) is that when you have 15 ships like we do, the net effect of it is it pushes everybody into the 91 percent bracket. So you are talking about taxing money you do not get; 91 percent of the valuations that are put on those corporate earnings.

What 953(b) does is that it defines a qualified property as a property that is located outside the United States. Because a ship occasionally comes to New York, Philadelphia, Norfolk and the ports up and down the coast, it would not be located out of the United States. So the end result would be that all of the earnings that our company paid to the financing institution on the mortgage, to the extent that the mortgage payments exceeded depreciation, would be taxed to us individually as income.

Now, since most of these financing documents require that you pay the loan back over the life of the charter, which is 15 to 20 years, and since depreciation on a ship is normally 25 years, and since you pay back on a level debt basis, which means that you pay lower on principal in the beginning and higher on principal at the end, and this payment bears no relation to any depreciation schedule, you end up with a tremendous attributed earnings that you would be paying 91 percent tax on.

I figured roughly that about 1969 the tax that I would have to pay, without counting my other four stockholders, would be about $1 million a year on money I could not get my hands on under this section.

The CHAIRMAN. How much tax do you pay under existing law?

Mr. WHITE. We pay none unless dividends are declared or the stock sold or the corporations are liquidated.

The CHAIRMAN. None?

Mr. White, should you pay any taxes? I mean should you escape taxes entirely if you are going to make a large profit at the end of a certain period?

Mr. WHITE. You are making one assumption, Senator, and I would like to answer your question this way. Normally, what we make in one of these shipping transactions on a capital gains basis, the tax that we were set up to pay and the tax that we set our charter rates, the competition with the world—you want to remember that although, as I told you before, Americans own 456 Liberian-flag vessels, non-Americans own 941 and they pay no taxes. The Greeks have special tax laws in Greece. They do not pay any taxes. The net effect of the British and Norwegian laws is that they do not pay any taxes, and they are our competition.

Now, I have checked my companies, and I have been in business since 1956. This is when my shipping business started. We make on a capital gains basis, after paying capital gains taxes, we will make 4.5 percent on our own invested money.

If you talk about what do we make on the capital cost of the ships, it is about one-eighth of 1 percent per year.

Now, if this law passes, we are going to end up making three-quarters of 1 percent on our own invested money.

Now, this is not an American company, so what is the net effect of it? If we make 4.5 percent, that is the same as if somebody was making 8 or 9 percent in the United States before paying 52-percent corporate taxes.

Now, you cannot say that we could make more, because we have to compete with the big owners like Onassis and Niarchos, who are willing to take the charter rates that we are forced to take.

The CHAIRMAN. Is it your position that you should not pay any taxes at any time?

Mr. WHITE. No, sir; I am not saying that. I say we as stockholders should pay the same tax as American stockholders of American corporations which we are now doing.

I am saying we should pay capital gains tax if we sell our stock and ordinary income taxes on dividends received. Here is what I really say, Senator. I say two things:

(1) That so far as the ships that we have built, encouraged by the Defense Department to build them, put our money in them, locked our money up for 17 years, that as to those ships we should only have to pay a capital gains tax when and if the transaction is over unless we can receive dividends before then or we sell our stock or die.

The CHAIRMAN. Wait a minute.

In order to pay a capital gains tax, you have got to sell it, do you not?

Mr. WHITE. Or liquidate when the charter ends.

The CHAIRMAN. What do you mean by "liquidate"?

Mr. WHITE. Close the corporation up at the end of the charter, after the bank has been paid off, when we can do it.

The CHAIRMAN. If you did that, would you not sell the ships then?

Mr. WHITE. We would sell the ships then.

The CHAIRMAN. That is what I mean.

Mr. WHITE. That is right.

The CHAIRMAN. In other words, your idea is you should not be required to pay any income tax, only a capital gains tax in the event that you decide to sell the ships?

I am just trying to get at the situation today.

Mr. WHITE. I would say yes since we cannot receive any income from the corporations.

The CHAIRMAN. As compared to this bill.

Mr. WHITE. We pay no corporate tax today.

The CHAIRMAN. Then you think you should not pay any tax?

Mr. WHITE. That is right since we receive no income as individuals.

The CHAIRMAN. At any time?

Mr. WHITE. Until——

The CHAIRMAN. Except a capital gains tax?

Mr. WHITE. That is right.

The CHAIRMAN. And if you do not sell, you do not pay that?

Mr. WHITE. That is right.

The CHAIRMAN. Is that right?

What becomes of the profits then?

Mr. WHITE. There are no——

The CHAIRMAN. Who gets the profits?

Mr. WHITE. There are no profits, Senator.

The CHAIRMAN. You mean these ships are operated without any profit at all?

Mr. WHITE. No.

Let me give you a typical example. You enter into a charter. You lock your money up. The money sits in a bank in New York, and it stays in that bank in New York until the bank has been paid back its loan, which is 15 to 17 years, so no dividends are paid to the stockholders for that period of time.

So there are no profits that the stockholders can get their hands on and therefore there is no income to the stockholder.

The CHAIRMAN. They are paid back. If they are once paid back, there is going to be a profit then.

Mr. WHITE. Then we will pay the capital gains at that point. That is what I am saying.

The CHAIRMAN. Then you would sell at that point?

Mr. WHITE. That is right.

The CHAIRMAN. That is a peculiar way of doing business. Mr. Stam says the present law is as follows:

> Exclusions from any gross income. Ships under foreign flag, earnings derived from the operation of a ship or ships documented under the laws of a foreign country which grants an equivalent exemption to citizens of the United States, to corporations organized in the United States.

Mr. WHITE. That is the law we are operating under now.

The CHAIRMAN. This corporation was organized in Liberia?

Mr. WHITE. That is right.

The CHAIRMAN. This section of the law says:

Which grants an equivalent exemption to citizens of the United States and to corporations organized in the United States.

Mr. WHITE. Liberia grants that similar exception, so we are covered.

The CHAIRMAN. You are organized in Liberia?

Mr. WHITE. Pardon?

The CHAIRMAN. The corporation was not organized in the United States. It was organized in Liberia?

Mr. WHITE. That is right.

The CHAIRMAN. But the law says, as I read it, an exemption to corporations organized in the United States.

Mr. WHITE. Is that section 883 you are reading, Senator?

The CHAIRMAN. Yes.

Then your contention is that you should not pay any taxes until the debt, or whatever you have created, has been paid off. Then after it is paid off, do the profits then accumulate? I do not imagine you would fix it so you would sell the minute the last dollar was paid.

Mr. WHITE. The profits are accumulating in a U.S. bank, locked up in that bank by the financing documents, so that at the end of the charter the profits then become available to the stockholders, and at that point they would pay the tax.

The CHAIRMAN. But they would only pay a capital gains tax.

Mr. WHITE. That is right because they probably would liquidate the corporation.

Now, further——

The CHAIRMAN. But in order to get a capital gains tax, you have got to sell the ships, do you not?

Mr. WHITE. Or we can liquidate and——

The CHAIRMAN. What do you mean by "liquidate"? Does that mean selling or what?

Mr. WHITE. No, that means closing up——

The CHAIRMAN. It means selling the assets, does it not—"liquidate"?

Mr. WHITE. In the corporation at that time, Senator, there will be two things. There will be money and there will be ships.

The CHAIRMAN. Answer that question.

When you liquidate something, you sell the assets, do you not?

Mr. WHITE. Yes; but the only asset that is not money in the corporation at that time is the ship. You have two things in the corporation, money and the ship, so that the money you can take out and pay your tax on it.

The ship at that time, who knows, it may have practically no value at the end of 16 years.

You take the T–2's that were built 16 years ago. Today they are worth about $250,000.

The CHAIRMAN. And what did you pay for them?

Mr. WHITE. Around Suez they were worth $4.5 million. In 1956 they were worth $4.5 million. They are worth $285,000 today.

The CHAIRMAN. Then you sell them at that price?

Mr. WHITE. I sold two last year for $285,000.

The CHAIRMAN. What you want to do, then, is to continue under the present law whereby you do not pay any taxes unless you liquidate?

Mr. WHITE. That is right; unless we sell our stock or dividends can be and are paid.

The CHAIRMAN. And then you pay a capital gains tax?

Mr. WHITE. And the reason, Senator, is not because I want it. It is because if you do not let us continue, the international trade is going to be carried by non-Americans.

The CHAIRMAN. I know.

I am not talking about that. I want to know whether you pay taxes.

Mr. WHITE. We cannot compete with them otherwise.

The CHAIRMAN. At the very best, you would not pay any taxes for 15 years after you purchase the ships?

Mr. WHITE. That is right; unless we sell or die before then.

The CHAIRMAN. Is that right?

Mr. WHITE. And we would not have any money either.

The CHAIRMAN. You have got to have some money somewhere along the line.

This is a new thing to me, you understand. Excuse my ignorance about it. You buy a ship for $4.5 million, and you contend then—then you borrow the money on the ship?

Mr. WHITE. That is right, and the charter.

The CHAIRMAN. And then the profits go into this so-called trust fund?

Mr. WHITE. That is right, locked up.

The CHAIRMAN. Is that what it is?

Mr. WHITE. And it is locked up.

The CHAIRMAN. And you get no part of it?

Mr. WHITE. We get no part of it.

The CHAIRMAN. And then when you liquidate at the end of a certain time, whatever profit is there you get?

Mr. WHITE. Yes.

The CHAIRMAN. And you pay 25 percent on it?

Mr. WHITE. That is right. It is exactly the same for American stockholders of American corporations.

The CHAIRMAN. Is that the way it goes?

Mr. WHITE. That is the way it works.

The CHAIRMAN. Has anybody made any money by this method?

Mr. WHITE. Yes, and the reason they have made money is——

The CHAIRMAN. You would not be in it if you did not make money?

Mr. WHITE. You always have a hope of making money. Actually in the shipping business, and every time I discuss this question of a return of 4.5 percent, somebody wants to know where the fortunes are that were made in the shipping industry.

They were made in three periods of time, and there is always a hope that one of those periods of time will come.

They were made right after World War II when somebody happened to have a few ships free, not under charter, and could play the spot market.

It happened again during Korea.

And it happened again during Suez.

But today there is not any owner who would not be very unhappy if he had a 46,000-ton ship not paid for and trying to play the spot market for it, because he would lose his shirt.

The CHAIRMAN. How much money have you got invested in this corporation?

Mr. WHITE. In this one particular example, Trinity Navigation, which I am using here, we have got $3.7 million invested.

The CHAIRMAN. That was put in, in cash?

Mr. WHITE. In cash. It was put in $2.2 million in the company itself——

The CHAIRMAN. That went in escrow?

Mr. WHITE. $3.7 million was put in the form of three setups: $1.5 million was put up in the First National Bank of Boston in a collateral account to guarantee the mortgage; $1.5 million, approximately, went into the ship itself; and another $750,000 went into the working capital of the company, so there was a total of $3.7 million.

The CHAIRMAN. You are talking about one ship?

Mr. WHITE. There are three ships in that package.

The CHAIRMAN. You own three ships yourself, is that it?

Mr. WHITE. No, we own 15 ships.

The CHAIRMAN. You?

Mr. WHITE. Yes.

The CHAIRMAN. Yourself?

Mr. WHITE. That is right.

The CHAIRMAN. You have associates?

Mr. WHITE. Four associates.

The CHAIRMAN. Four?

Mr. WHITE. That is right.

The CHAIRMAN. It is "we," then?

Mr. WHITE. That is right.

The CHAIRMAN. They own it as individuals?

Mr. WHITE. We own the stock of the companies as individuals, not the ships.

The CHAIRMAN. And then this present bill, how would it tax you $1 million a year yourself? How does that come about?

Mr. WHITE. The way it works is this:

We make cash flow—when I say "we make," I have to be very careful, because I say the corporation makes about $100,000——

The CHAIRMAN. Wait a minute. Let us get this down. You have got five people. It is more like a partnership than a corporation?

Mr. WHITE. That is right, but we each own one-fifth of the stock of each of these corporations.

The CHAIRMAN. You are going to be taxed $1 million?

Mr. WHITE. I am going to be taxed $1 million myself.

The CHAIRMAN. Every year?

Mr. WHITE. Every year. Not every year because I will sell. It will last about 3 months.

The CHAIRMAN. Can they tax you on something without making a profit?

Mr. WHITE. That is right.

The CHAIRMAN. How?

Mr. WHITE. I will tell you how. This is what surprised me, too, Senator.

The CHAIRMAN. This is something new.

In other words, all five of you would pay $5 million a year tax?

Mr. WHITE. That is right; no income to ourselves at all but a big tax.

The CHAIRMAN. And would not make any profit?

Mr. WHITE. That is right.

The CHAIRMAN. Go ahead and explain that.

Mr. WHITE. OK.

I will take this one company, and this is typical of every one of my corporations, and this has three ships in it. Now, remember, we own 15 ships, so you multiply the result I get here by five, five times three gives me my 15.

In 1963, we had a charter hire income from these three ships of $3.9 million.

We have operating expenses—that is crew, repairs, provisions, stores, everything else—$1,130,000, so that we have an operating profit before debt service and before depreciation of $2.7 million.

Of that $2.7 million, we pay $2,150,000 a year to the bank, $948,000 on this particular year in interest, $948,000 interest, and $1,200,000 in principal to the bank.

Now that leaves me——

The CHAIRMAN. That reduces your debt then?

Mr. WHITE. I am reducing my debt.

The CHAIRMAN. If I borrow money from a bank and have an income, I have got to pay a tax on the income although I may apply that money to the reduction of the debt.

Mr. WHITE. That is right, but the point of the thing is that all of our money goes to the reduction of the debt.

The CHAIRMAN. That is because you have made an agreement with the people that loaned you the money.

Mr. WHITE. Yes, but, Senator, we made it at the time when there was not any such tax on the books. We would never have made this agreement if there was a tax of this kind on the books, because we would have gone bankrupt.

The CHAIRMAN. I do not understand yet how you could pay, five of you pay $1 million apiece when you have earned, you say, $2.5 million.

Mr. WHITE. No. This is only three ships. Maybe I can say this. After I pay the bank off each year, after I pay the operating expenses, I have $450,000 left in this particular corporation.

The CHAIRMAN. Do you take depreciation off of these ships?

Mr. WHITE. I have taken depreciation off as if it equaled the principal payments to the bank. I have got $450,000.

The CHAIRMAN. Does that come off your personal income?

Mr. WHITE. No; it does not.

The CHAIRMAN. Why should it not come off your personal income if you are required to pay for the profits?

You certainly can take the depreciation off; can you not?

Mr. WHITE. Let me say this, sir. The payments geared to the bank are over the life of the charter, which is, say, 15 to 16 years, the depreciation belongs to the corporation not to the stockholders but if the earnings of the corporation are attributed to us as individuals maybe you are right; we should be able to take the corporate losses as personal deductions, also.

The CHAIRMAN. Let me say this to you. A number of businessmen make arrangements with banks to borrow money. I do it.

Mr. WHITE. That is right.

The CHAIRMAN. I had a fire the other day. My cannery burned up, and I am going to borrow money on it.

Mr. WHITE. Yes.

The CHAIRMAN. But I pay taxes on whatever that cannery makes. I pay a tax on it.

Mr. WHITE. That is right.

The CHAIRMAN. Regardless of whether I have got to pay the money to the bank or not.

Mr. WHITE. Yes; but, Senator——

The CHAIRMAN. You voluntarily made an agreement with the bank to put this money in escrow, so to speak, until you paid the total amount off, is that not right?

Mr. WHITE. That is right.

The CHAIRMAN. And then you own the ships. In the meantime, you have taken depreciation off the ships, have you not?

Mr. WHITE. No.

Let me ask you this, Senator. Not considering my shipping industry other than this one company I would be charged with about $200,000 a year.

The CHAIRMAN. You give two or three different sets of figures here.

Mr. WHITE. No.

The CHAIRMAN. You have got your operating expenses and you have got your depreciation.

Mr. WHITE. You know what the depreciation is? The depreciation is $1 million a year on those ships, if you want all the figures. I will read them off to you, and you can put them down. My income is $3.9 million; my operating expenses are $1.1 million.

The CHAIRMAN. You are speaking of 15 ships now?

Mr. WHITE. I am talking about three.

The CHAIRMAN. A little while back you were talking about 15.

Mr. WHITE. But I said you multiply these figures by five.

The CHAIRMAN. Five people own 3 ships or 15 ships? What figures are you going on?

Mr. WHITE. There are 5 people that own 15 ships.

The CHAIRMAN. All right.

Mr. WHITE. The figures I have are on three ships.

The CHAIRMAN. And you figure that you own three. Are they owned by you individually or do you pick out the 3 ships that you own and keep them separate or do you have the 15 all together?

Mr. WHITE. No.

What I have done, Senator, is I have taken—I did not want to bring in here 15 sheets of paper and read 15 statistics.

The CHAIRMAN. I do not care to have you bring in any paper. I would just like to try to understand how you operate now.

Mr. WHITE. OK.

The CHAIRMAN. And you switch around from 3 ships to 15 ships. I want to know how you operate now, how you are taxed now, and what this new bill will tax you.

Mr. WHITE. OK.

The CHAIRMAN. In simple, plain language, try to tell me that, because I cannot understand it.

Mr. WHITE. I will forget these figures.

The CHAIRMAN. Do not give me too many figures.

Mr. WHITE. Today we pay no taxes except capital gains unless we sell because our corporations can't declare dividends.

The CHAIRMAN. What is that?

Mr. WHITE. Today we pay no taxes in the foreign-flag fleet corporations.

The CHAIRMAN. I know that. You have said that a number of times.

Mr. WHITE. Now, No. 2——

The CHAIRMAN. I want to know why you do not pay taxes.

Mr. WHITE. No. 2, the amount of money that we make over and above the depreciation that would be allowed or allowable to us is roughly $200,000 to $400,000 average per ship.

The CHAIRMAN. Per ship?

Mr. WHITE. Which is $3 to $6 million for the 15 ships.

The CHAIRMAN. That is right. That is the first time you have said that. That makes $6 million on 15 ships.

Mr. WHITE. Of that $6 million, we do not get any of it.

The CHAIRMAN. You do not get it because it goes to pay your debts.

Mr. WHITE. It goes to pay our corporate debts and what does not pay our debts the bank takes and puts in the bank and says you cannot have it; you cannot declare any dividends.

The CHAIRMAN. But you made the agreement with the bank?

Mr. WHITE. Yes; but we did it when there was not any such thing on the books. I am sure you would not have made some of the deals that you have made if this bill were facing you.

The CHAIRMAN. If I had to make an agreement like that, I would not go into that particular business.

Mr. WHITE. The reason for it, sir, is that the history——

The CHAIRMAN. You must have thought you were going to make a profit somewhere along the line?

Mr. WHITE. Yes; we thought we would make 4.5 percent.

The CHAIRMAN. $6 million a year, and if the ships last for 15 years, 6 times 15 is $90 million, is it not?

Mr. WHITE. I would be willing—let me say this: There is a certain Greek gentleman sitting in New York today, and if he offered me a total of about $7 million for my 15 ships, with this tax law facing me, I would take it and be happy, and we have got more money in the transaction than that.

The CHAIRMAN. Why did you just tell me a few minutes ago that you made $6 million a year?

Mr. WHITE. I did not. I said bookwise our corporations made $6 million.

The CHAIRMAN. Bookwise?

Mr. WHITE. That is a lot different.

The CHAIRMAN. The only reason you did not make it was that you gave it to the bank to pay off the debt you owe the bank, is it not?

Mr. WHITE. But, you see, one of the things you are assuming, Senator, is that if you pay off a $6 million ship over a 15-year period—and we have got 15 of them and they cost $6 million apiece—at the end of 15 years I have got $90 million worth of assets, and I have not, because I told you only a half hour ago that 15 years ago a man who bought of those T–2's turned around 15 years later and sold it for $200,000.

And I would venture to guess that the odds are that that $90 million worth of ships that were bought, at the end of 15 years one would be lucky if they are worth $7 million to $8 million, not $90 million.

But you are going to tax me, if this bill passes, as though I have got $90 million.

The CHAIRMAN. I just took your figures that you made $6 million a year.

Mr. WHITE. No.

The CHAIRMAN. After paying depreciation and operating expenses. Is that correct or not?

Mr. WHITE. No, I said book profitwise.

The CHAIRMAN. What do you mean by "book profitwise"?

Mr. WHITE. Amortization over depreciation.

The CHAIRMAN. Does not book profit include depreciation?

Mr. WHITE. Does that include depreciation?

The CHAIRMAN. When I make my reports up, I take off depreciation.

Mr. WHITE. I am taking off $1 million a year depreciation, that is right, per ship.

The CHAIRMAN. These are gross profits then?

Mr. WHITE. That is right.

The CHAIRMAN. Why did you not say so? You said book profits. Book profits mean, as I understand it from anything that I have had to do with it, book profits are what a corporation figures after it takes expenses off and depreciation off. Then that is the profit.

Now, what did you do in this case? Did you take the depreciation off and operating expenses?

Mr. WHITE. I have taken the depreciation off when I arrived at the figure. In other words, to put it another way——

The CHAIRMAN. How much did you make on the 5 ships, I mean the 15 ships? How much did you make on them? Leave out this thing about the bank. That is another matter.

Mr. WHITE. When you ask me how much I make, in what way did I make it?

The CHAIRMAN. I do not care how you make it.

Mr. WHITE. After depreciation?

The CHAIRMAN. How much did you make on the ships in 1 year after taking off depreciation and operating expenses?

Mr. WHITE. I would say if I depreciate the ships over a 25-year basis and I am paying the bank over a 15-year basis, I made about $400,000 a ship per year, or about $6 million on the 15 ships.

The CHAIRMAN. There is a conflict there because you claim the ships are worth less at the end of 15 years.

Mr. WHITE. That is right.

The CHAIRMAN. Yet you have taken depreciation off for 25 years.

Mr. WHITE. But the reason is that I do not know of any rule of the Treasury Department today that would allow me to take it off over 15 years and since these are foreign corporations depreciation has no bearing for tax purposes.

The CHAIRMAN. You admit finally that you do make $400,000 a ship, then; is that right?

Mr. WHITE. No.

I say that I will be taxed as if I made $400,000 a ship. I do not think I made anything on the ship.

The CHAIRMAN. Maybe some of these tax experts could explain it. What you are going on is this. The law has been passed here, and I do not know when it was passed, that you are tax exempt; is that right?

Mr. WHITE. Pardon?

The CHAIRMAN. You are tax exempt?

Mr. WHITE. Right now, that is right, we pay the same taxes as individual owners of American corporations pay. Our corporations are tax exempt since they are foreign.

The CHAIRMAN. You do not pay any taxes?

Mr. WHITE. That is right.

The CHAIRMAN. In any way, shape, or form?

Mr. WHITE. That is right, except for the capital gains since we cannot receive dividends.

The CHAIRMAN. Yes.

All right, so you do not pay any tax, and now there has been a law—the House changed that law.

Mr. WHITE. That is right.

The CHAIRMAN. And that is what you are complaining about?

Mr. WHITE. I am complaining because they are now turning to a tax of 91 percent.

The CHAIRMAN. Then you think they should continue to give you tax exemption?

Mr. WHITE. No. I have no tax exemption; only the foreign corporations do.

I do not think, Senator—I am not asking for anything for myself. I think they ought to do it for the national welfare of the country.

The CHAIRMAN. Is it not proper, then, for the officials of the Government—as I understand it, this was recommended by the Secretary of the Treasury—is it not proper, then, for the Government to come in and say:

"Yes, we want these particular parties, the five people here, to be tax exempt as a matter of national security?"

Mr. WHITE. No, they can only testify to the affect on national defense if the vessels move out of American control.

The CHAIRMAN. And have they done that?

Mr. WHITE. I do not know.

The CHAIRMAN. As a matter of fact, the Secretary of the Treasury recommended this, as I understand it.

Mr. WHITE. The Secretary of the Treasury, as I understand it, recommended against including shipping.

The CHAIRMAN. He recommended against it?

Mr. WHITE. Against including shipping in the House bill when it went from the Treasury to the House.

Mr. STAM. They were not included, but the revised bill did include it.

The CHAIRMAN. Did that meet with the approval of the Secretary?

Mr. STAM. It meets with the approval of the Secretary.

Mr. WHITE. He went along with the bill when it came out, but his original recommendation was to exclude.

The CHAIRMAN. You mean in the original recommendation he did not recommend?

Mr. STAM. The original recommendation did not contain the taxing of ships. They were not included. But the revised draft which was worked out did bring in ships, and the Treasury generally approved the bill as it passed the House.

The CHAIRMAN. Did they specifically approve this item?

Mr. STAM. I would not say they specifically approved that item but they approved the bill.

The CHAIRMAN. I understand that. They approved the bill and there were some parts of it that they did not approve.

Mr. STAM. But I understand that since that bill has been reported by the House, they have been more acquainted with the problem than they were before, and they have certain reservations about extending it to ships at the moment.

The CHAIRMAN. I want to be perfectly frank with you. I am just speaking as chairman of the committee:

That what this committee should do is to submit this question to the proper authorities of the Government and let them decide on it, because you are basing your tax exemption entirely on the fact that you think these ships are very vital to us, to the Government of the United States, in case of an emergency. Now, that is for the Government to say and not for you to say.

Mr. WHITE. I agree.

The CHAIRMAN. So what I intend to do as chairman is to submit this question specifically and by itself, without having it in the rest of the bill, to the Secretary of the Treasury, the Secretary of Defense, and the Secretary of the Navy, and ask them to give this committee their opinion as to whether tax exemption should be continued for your company, whatever it is, from the standpoint that it is a vital question to the security of our country in an emergency.

Have I correctly stated it?

Mr. WHITE. I think that the Defense—I cannot say what the Defense Department would say, but, based on everything that I have ever read that the Defense Department has ever issued, I think they will say that this fleet is critically important to the United States.

The CHAIRMAN. What the committee will think, I do not know, but I will certainly be guided by what the officials of the Government tell us, not by what you tell us.

Mr. WHITE. That is right.

The CHAIRMAN. You went into this investment on the supposition that it was going to be tax exempt. Now, the question is, then, whether it should continue to be tax exempt.

Mr. WHITE. That is right since the corporations are foreign corporations subject to the laws of Liberia and the individual stockholders can get no income.

The CHAIRMAN. So what I propose to do—and I hope it will meet with your approval—I am going to submit the matter in writing to the Secretary of the Treasury, to the Secretary of Defense, and the Secretary of the Navy and ask them to comment on it, and, if they desire to do so, to come before the committee. Because I certainly cannot vote to continue a big tax exemption that appears to me to be now, unless it is done with the approval of the top officials of the Government, on the grounds that it is necessary for our national security.

Mr. WHITE. May I say a couple things more, Senator, that you might cover in those letters, if you would like?

The CHAIRMAN. I know it will encourage shipping, but we have got a complete tax exemption here, and I am not willing to vote to continue it unless the proper officials of the Government say it should be done in the interests of the Government.

That is the way I look at it.

Mr. WHITE. May I point out three or four advantages that the U.S. Government is getting and that you might want to cover also with the agencies that are concerned.

We have covered the defense point, I think, completely.

Now, the questions of balance of payments. I have sat here this morning and listened to a lot of discussion about balance of payments, but I do not know of any place where the balance-of-payment problem would get more worsened, if there is such a word, than it would be if, as a result of this tax bill, this fleet were sold.

The total income that all of the American owners of foreign-flag vessels get per year is about $300 million.

Now, these dollars are paid by American corporations to American-owned Liberian corporations, and the money is kept on deposit in the United States.

It stays here.

You let this fleet be sold to non-Americans and the $300 million will get paid by American companies to non-American companies and will get deposited in Europe.

So the net effect of the balance of payments will be that to the extent of $300 million a year we are going to be worse off on the balance of payments.

The CHAIRMAN. You have got off on another question now. You have gone into balance of payments, and you first started out on the question of national defense; that we needed these ships in case of an emergency.

Mr. WHITE. That is right, that is the first point.

The CHAIRMAN. We will include to the Secretary of the Treasury—he deals with balance of payments, and he can express his opinion about that.

The Secretary of Defense then can express his opinion and the Secretary of the Navy can express his, and that is the only way that I would feel justified, as chairman of this committee, in continuing what appears to me to be a complete tax exemption, because when you sell these ships, you claim they are worth practically nothing and there will not be any capital gains tax to pay.

Mr. WHITE. But the profits that come in——

The CHAIRMAN. As a matter of fact, there will be a capital gains loss on them because you are buying them for how many million?

Mr. WHITE. About $6 million apiece.

The CHAIRMAN. Six million dollars. Then you said a few minutes ago they are only worth $285,000 at the end of 15 years.

Mr. WHITE. I said I knew of examples where they sold for $285,000.

The CHAIRMAN. Well, you gave the Chair the impression that that is what they were worth, $285,000, and you paid $6 million for them. How are you going to pay a capital gains tax on that?

Mr. WHITE. I am sorry, Senator, if I gave you the impression that they were only going to be worth $285,000.

The CHAIRMAN. You said that, did you not?

Mr. WHITE. I said that I sold two of the type, which sold for $4.5 million at Suez and we sold them for $289,000.

The CHAIRMAN. Your testimony was they were practically worthless at the end of 15 years.

Mr. WHITE. You do not know what they are going to be worth, Senator.

The CHAIRMAN. Of course. None of us know what anything is going to be worth 15 years from now.

Mr. WHITE. Right.

The CHAIRMAN. I do not know what my apple orchard is going to be worth 15 years from now. But you have made the broad statement that these ships are not worth anything at the end of 15 years.

Mr. WHITE. If I did say that, Senator, I am sorry, because I did not mean that. I said I did not know.

The CHAIRMAN. There is no use quibbling about it, but that is the only way I can see that this matter can be straightened out, is to submit it to the officials of the Government and let them determine whether this tax exemption should be continued.

Mr. WHITE. The only other point, Senator——

The CHAIRMAN. I assume that would be satisfactory to you.

Mr. WHITE. That would be very satisfactory. The only other point I would like to make here is that this is my understanding. If this fleet is lost—and this can also be asked of the Secretary of Defense—that if this fleet is lost, it would cost the U.S. Government between $2 billion and $3 billion to replace it, and this is what they would probably have to do in construction subsidies.

The CHAIRMAN. Mr. White, with all respect to you, I think that is a matter that should be determined by the Government officials.

Mr. WHITE. That is right.

The CHAIRMAN. Now, I want you to know the form of this inquiry, how it is going to be made.

We are going to cite the present law and then cite the House bill, and we will ask these officials of the Government which they think should be adopted, whether we should continue the present tax exempt law or whether we should adopt the House bill.

Mr. WHITE. I do not know whether the Secretary of Defense could answer on the tax question, but——

The CHAIRMAN. The Secretary of Defense could say, could choose to say that this is very vital to our future security.

Mr. WHITE. That is right. That he will probably say.

The CHAIRMAN. I will make it clear that that is what I want him to say. Then if the answer is not clear, I would be willing to have the Secretary of Defense come before the committee because I want to see that full justice is done to you.

But I am not very enthusiastic about continuing a complete tax exemption, as apparently exists under this present law, as I can understand it.

Mr. WHITE. I would like to say one think more to you, Senator, on that, because you seem to believe that somehow or other this tax exemption under the present law is giving a windfall to the American owners of foreign-flag ships, and that it is not true.

I have no objection to paying the same taxes that a stockholder of an American corporation pays with respect to his stock in the American corporation which are as follows:

(*a*) He pays ordinary income taxes; that is, up to 91 percent, on any dividends that he receives from the corporation. He pays no taxes on the earnings of the corporation itself unless those earnings are declared to him in the form of dividends.

(*b*) In the event such a stockholder sells his stock or if he receives the assets of the corporation in liquidation, he pays a capital gains tax at rates up to 25 percent on the gain he realizes over the original cost of his stock.

Under the Internal Revenue Code as it exists today, I am subject to these same taxes to which the American stockholder of an American corporation is subject. My objection to H.R. 10650 is that it subjects the American stockholder of a foreign shipping corporation to a higher individual tax than the stockholder of the American corporation because—

(*a*) The stockholder of the foreign shipping corporation will have to pay taxes at ordinary income tax rates (up to 91 percent) on the earnings of the foreign corporation even though he receives no dividends, which is not true in the case of the American stockholder of an American corporation.

(*b*) If the American stockholder of a foreign shipping corporation sells his stock or if the corporation is liquidated, he will have to pay a tax at ordinary income tax rates (up to 91 percent) on his gain rather than the 25-percent capital gains tax, as in the case of the American stockholder of the American corporation.

When you stop to realize that we make approximately 4.5 percent on our investment, there is no windfall, and under the present tax—under the proposed new tax we would make three-quarters of 1 percent on our investment.

The CHAIRMAN. I am not talking about the present tax rate at the moment. I was talking about the tax exemption. You expect to make money out of this.

Mr. WHITE. About 4.5 percent on our money.

The CHAIRMAN. You would not be in it if you did not expect to make money.

Mr. WHITE. That is right.

The CHAIRMAN. Why would you go into a hazardous business for 4.5 percent when you could invest for tax securities to make that money?

Mr. WHITE. The reason is the speculative run on the ships in 15 years. This is exactly what I would say to you: If this law passes, the Americans will sell their ships because they will be better off putting them in tax-exempt or "blue chip" common stock than we would to end up with three-quarters of 1 percent return.

This is what we are being faced with. This is why I tell you that the fleet will go.

The CHAIRMAN. In other words, this is a matter of patriotism on your part?

Mr. WHITE. No.

The CHAIRMAN. It is not a question of making money?

Mr. WHITE. No.

The CHAIRMAN. Considering that you only get 4.5 percent, you could make that investment very safely in this country and get 4.5 percent on tax-exempt securities.

Mr. WHITE. That is right.

The CHAIRMAN. Without paying any tax at all.

Mr. WHITE. In addition to the 4.5 percent, we have a speculative run for the value of the ships. That is a speculation. You have got 4.5 percent and you have got a speculation of what the thing will be worth 15 years from now.

Now, I do not consider that not worth doing, but I do consider three-quarters of 1 percent too low.

The CHAIRMAN. With all deference to you, Mr. White, this committee cannot go into all these things. If you want to get concessions in taxes, you have got to put it on a basis of something of value to the Government, to the people of this country.

Mr. WHITE. That is what I thought I did.

The CHAIRMAN. And give you freedom from taxes.

Now, what I propose to do is to submit it to the officials who have charge of it, the Secretary of Defense.

If you want to bring in this imbalance of payments, I had not heard that until the end of your presentation, that is involved in it, let the Secretary of the Treasury pass upon it.

Now, if it is necessary for military defense, let the Secretary of Defense pass upon it or the Secretary of the Navy.

Mr. WHITE. That is what I said. I am very happy that you are going to call them.

The CHAIRMAN. We will write them a letter, and if there is anything ambiguous about their reply, we will call them. But I think that is the only way we can do.

I have no question that you have written this in a fashion that you believe to be correct and accurate, but it goes beyond your understanding or your desires in it.

It is a question of, Is it beneficial to this country to give tax relief in order to get these ships?

Thank you very much, sir.

Mr. WHITE. Thank you.

(Mr. White's prepared statement follows:)

STATEMENT OF H. LEE WHITE, MEMBER OF THE LAW FIRM OF CADWALADER, WICKERSHAM & TAFT, AND CHIEF EXECUTIVE OFFICER OF THE MARINE TRANSPORT LINES GROUP, OSWEGO GROUP, AND TRINITY GROUP

I am a partner in the law firm of Cadwalader, Wickersham & Taft, 14 Wall Street, New York City. I am also a substantial stockholder and the chief executive officer of a group of U.S. and foreign shipping corporations. We have a number of foreign corporations and they are collectively spoken of as falling into two groups: (*a*) the Trinity group and (*b*) the Oswego group. These foreign corporations are Liberian corporations, and the vessels owned by these corporations are registered as Liberian-flag vessels. Our American group is composed of a number of U.S. corporations, and they are collectively spoken of as the Marine Transport Lines group. The Marine Transport Lines group owns a number of American-flag vessels and acts as the operator for both the American- and foreign-flag vessels owned by our group as well as the operator for a number of American- and foreign-flag vessels owned by corporations in which we have no interest. Our group owns or controls Liberian corporations which own 15 foreign-flag vessels (already built or building) ranging in size from 12,000 to 50,000 deadweight tons. Ten of these ships range in size from 42,000 to 50,000 deadweight tons and have been built since 1959.

We have by contract committed each of these vessels to the U.S. Government, and, therefore, the Department of Defense and the Maritime Administration recognize that the U.S. Government has effective control of these ships.

Our group, through its American corporations, also owns or controls 19 American-flag vessels, ranging in size from 10,000 to 24,000 tons. In addition to the tonnage set forth above, Marine Transport Lines operates for other owners a total of 12 vessels under American flag and 29 vessels under foreign flag. On the basis of the foregoing, you can see that our group operates a total of 75 vessels.

I am appearing here today because it is my belief that because of the manner in which the foreign-flag shipping business is operated and financed, certain of the provisions of H.R. 10650, if enacted into law, will bring about a situation which is adverse to the interests of the United States, and—

(1) Will result in such a hardship on the U.S. owners of these foreign-flag vessels that such persons' only alternative to personal bankruptcy will be to sell these modern, high-speed vessels to non-American owners and to remove themselves completely from the international bulk carriage business;

(2) Such a result will be disastrous to the defense posture of the United States;

(3) The proposed tax legislation as applied to the foreign-flag shipping business will not result in additional tax revenue but, in fact, will result in overall tax revenue loss;

(4) In fact, the removal of this fleet from American ownership will more probably result in substantially increased expenditures by our Government in the future in an attempt to cure the substantial injury to the defense posture of the United States;

(5) The removal of this fleet from U.S. ownership instead of improving the balance-of-payments position of the United States as was intended by the proponents of the bill will, in fact, worsen the U.S. balance-of-payments position.

There are three provisions of H.R. 10650 that affect the American owners of foreign-flag vessels so materially that they will have no alternative but to dispose of this "effective control" fleet now. These provisions are:

1. Section 952(e)(3)

This section is destructive in its effect if "rent" is construed to include "charter hire." In its report the Committee on Ways and Means of the House of Representatives stated: "* * * the passive income referred to here is the same as foreign personal holding company income except that rental income is included whether or not rents represented more than 50 percent of the gross income involved * * *." While the legislative intent expressed in the report indicates that the House of Representatives was only attempting to reach portfolio types of investments or passively received investment income, there is a longstanding U.S. Treasury regulation under section 543 which expressly includes within the word "rent" "charter fees." It is therefore probable that earnings from the operation of vessels, however different from the traditional low-risk portfolio type of rent, might be included as foreign base company income. The consequences of such an interpretation would be disastrous to the stockholders of American-owned foreign corporations because this income would constitute attributed dividends in the hands of the U.S. shareholder and would force such a shareholder to sell the stock of a shipping corporation to foreign interests since, under customary financing documents which bind the corporations and the stockholders, dividends cannot be declared to him.

American-owned foreign shipping corporations receive income under five different types of standard contracts:

(*a*) *Bareboat charter.*—Under this charter, the owner charters the ship to a charterer (normally a major oil, steel, or aluminum company) on a net basis. The charterer supplies and pays for the crew, fuel, port charges, provisions, stores, insurance, and repairs. Our group has no bareboat charters except that one of our corporations which owns a vessel has bareboat chartered it to a subsidiary which in turn has time chartered it to Socony Mobil Oil Co.

(*b*) *Time charter.*—The owner charters the ship to a charterer (normally a major oil, steel, or aluminum company) for a monthly rate expressed in dollars per deadweight ton of the ship. The owner of the vessel supplies and pays for the crew, provisions, stores, insurance, repairs, and a small portion of the fuel for heating quarters. The charterer pays only for port charges and a major portion of the fuel cost. Practically all our group's Liberian-flag vessels are chartered under time charters.

(*c*) *Consecutive voyage contract.*—The owner of the vessel agrees to carry for the charterer the charterer's cargo to and from a specified port, or ports, as fast as the vessel can go. The charterer is not permitted to carry any other cargo except the cargo of the charterer. The owner supplies and pays for the crew, provisions, stores, insurance, repairs, port charges, and fuel. The charterer pays for this service a fixed dollar amount per ton of cargo carried. Our group has two Liberian-flag vessels under this type of charter.

(*d*) *Contract of affreightment.*—The owner agrees to carry a fixed amount of tonnage for the charterer within a specified period of time. The charterer pays for this service, as in the case of the consecutive voyage contract, a fixed amount per ton of cargo carried. The cargo is to be carried to and from a specified port, or ports. The shipowner may carry tonnage in this ship for other charterers during the contract period so long as he accomplishes the carriage of the tonnage for the charterer within the time specified. The shipowner supplies and pays for the crew, provisions, stores, repairs, insurance, port charges, and fuel. Our group has two vessels under this type of contract.

(*e*) *Single-voyage charter.*—The owner agrees to carry one cargo for the charterer from a specified port, or ports, to a specified port, or ports, and commits himself to commence loading by a specified date. The owner supplies and pays for the crew, provisions, stores, repairs, port charges, and fuel. The charterer pays for the service a fixed dollar amount per ton of cargo carried. Our group has no foreign-flag ships under this type of charter.

When vessels are not under long-term commitment, an owner may operate his vessels within any given year under a combination of two or more of the above types of contracts. In other words, he can charter out his ship during any one year, part time under time charter, part time under consecutive voyage charter and, in addition, take an affreightment contract for a portion of the year.

2. Section 953(b)

This section is destructive in its effect if vessels are not considered to be "qualified property" within the meaning of the section. The problem arises because these vessels which travel all over the world, more or less occasionally come to U.S. ports and, therefore, they might be held to be not "outside the United States." Under section 951(a)(1)(B), a tax is imposed on the U.S. shareholders where the foreign corporation invests its earnings for the taxable year in unqualified property. An additional problem is created because, in order to be qualified property, the property must also be ordinary and necessary for the active conduct of a qualified trade or business. In order to qualify under this provision, a trade or business must be carried on outside the United States. If the foreign shipping corporation has an agent in the United States or its ships touch the United States, business conducted by it would not be qualified under section 953(b)(3). Also, under customary vessel financing agreements, the shipowner is required to place each separate transaction in a separate and distinct corporation in order to assure the financing institution that the borrowing corporation has no liabilities except those created by the transaction financed by the institution. Therefore all ships built after the passage of the act will be in corporations which are not in existence on December 31, 1962, or "during the 5-year period ending with the close of the preceding taxable year," and will not qualify as a "qualified trade or business."

Most new, modern, high-speed bulk carriers are under long-term charter for periods ranging from 10 to 20 years. Lending institutions require mortgages to be amortized over the life of the charter commitments existing at the time the loans are negotiated and normally require repayment on a level-debt basis. The useful life of the vessels for U.S. tax purposes is consequently longer than the life of the charters. Therefore amortization of principal on the mortgage will be considerably larger than the allowable depreciation for the taxable year. To the extent that mortgage principal amortization exceeds depreciation the net worth of the company is increased. If the vessel is not a qualified asset, such increase in net worth would be currently taxed pro rata to the U.S. shareholders of the foreign shipowning corporation. There will, however, be no cash in the corporation which they can reach to satisfy the U.S. tax liability on these imputed dividends. As a practical matter, the U.S. shareholders, faced with a staggering tax liability and no liquid funds with which to meet it, would be forced to sell out.

3. Section 1248

This section requires that on the sale of the stock of a foreign corporation, such as a Liberian corporation, or upon the liquidation of such foreign corporation, U.S. stockholders pay an income tax at ordinary income tax rates rather than at capital gain rates. At first glance it would appear that the American owners of foreign-flag vessels ought to be able to accept this section. The consequences of the section, however, because of (*a*) the risks involved in a shipping venture; (*b*) the high income brackets that all individual owners (the independents) will be in results in a 91-percent tax; (*c*) the substantial investments required from the shipowners; (*d*) the length of time that the investment is locked up under the financing documents; (*e*) the fact that such an individual owner does not (since each shipping transaction is in a separate corporation), like an American corporation, have the benefit of consolidated returns or the right of offsetting losses in one shipping venture against profits in another venture; (*f*) the foreign corporations are already subject to the provisions of the Foreign Personal Holding Company Act, and it may be impossible, because of this act, to unwind these corporations and to reorganize them in order to lessen to some extent the impact of this proposed legislation; and (*g*) the low return the shipowner will receive after the payment of such taxes, will force him out of the foreign-flag shipping business.

I will divide the balance of my statement into two parts:

I. The effect of this legislation on our own Liberian corporations and Liberian-flag ships which have either been constructed or are under contract to be constructed since we have already executed financing documents with American financing institutions committing these corporations prior to the passage by the House of Representatives of H.R. 10650 (for brevity's sake this portion will hereinafter be entitled "Transactions Under Which Shipowners Are of This Date Committed"), and

II. The destructive effect of this legislation on the future of the U.S.-owned foreign-flag fleet (hereinafter entitled "The Effect of This Legislation on the U.S. 'Effective Control' Fleet").

I. TRANSACTIONS UNDER WHICH SHIPOWNERS ARE OF THIS DATE COMMITTED

I recognize that this legislation has the legitimate purpose of attempting to remove certain abuses that have resulted in some cases through the use of foreign corporations by American corporate parents for the purpose of escaping American taxes. The Honorable Douglas Dillon, Secretary of the Treasury, testified on April 2, 1962, before the Committee on Finance, U.S. Senate, on this bill (see p. 98, Hearings Before the Committee on Finance, U.S. Senate, 87th Cong., 2d sess., on H.R. 10650, dated Apr. 2, 1962), as follows:

"The typical activities of such corporations include the handling, as middleman, of many trade transactions—transactions which often are largely paper transactions so far as the tax-haven corporation is concerned. They also include the sale of management services, the collection of licensing and other royalty payments, the insurance and reinsurance of U.S. risks, and the like. In addition, dividends and interest may be paid to these tax-haven companies from foreign subsidiaries in other countries, in a way that involves large savings in taxes."

It is self-evident that the foreign corporations owning and operating foreign-flag shipping do not fall within the scope of the examples that the Secretary of the Treasury indicates as being the type of corporations that the administration is trying to reach. I believe that I can demonstrate that this legislation should not be applied to American controlled foreign shipping. I am sure that the proponents of this legislation have not carefully examined the situation of the shipping business as exemplified by the American controlled Liberian-flag vessels, with particular reference to the manner in which such shipping transactions occur and are financed. The consequences of this legislation to the U.S. stockholders of these Liberian-flag shipping corporations are too horrible to contemplate. It will result in outright confiscation of all the stockholders' property and personal bankruptcy unless he immediately disposes of his interest in such corporations. I believe that if the facts had been brought to the attention of the House of Representatives, relief would have been given by them in H.R. 10650 because I am sure that they would not have given to such owners the alternative of personal bankruptcy or the destruction of a fleet vital to the defense of our country.

As I stated above, at this part of my statement I am directing myself only to the American controlled foreign-flag ships under charter commitments and financing commitments entered into prior to the date that the House Ways and Means Committee reported H.R. 10650. As to these commitments, the shipowner is already firmly bound to perform his agreements in accordance with the signed documents, and the consequence to him of performing these agreements in the light of the provisions of H.R. 10650 are so disastrous that he can only escape them by disposing of all his foreign controlled shipping to non-Americans, such as Liberian corporations owned by non-Americans or corporations organized in Greece, England, Norway, the Netherlands, France, Italy, or Japan and owned by citizens of those countries.

In order to understand the absolute truth of my conclusion, one must understand the customary and normal way in which the independent American shipowner conducts his business with relation to foreign-flag ships. It is the manner in which 14 of our 15 foreign-flag vessels and all 10 of our large, modern, high-speed ships were handled.

A major American oil, steel, or aluminum company (hereinafter called the charterer) decides to go into the shipping market for the purpose of chartering under a long-term contract a new ship to carry cargo for it. The competitive market that it enters is composed of the American controlled PanLibHon (Panama, Liberia, and Honduras) flag shipowners, the non-American controlled PanLibHon flag shipowners, such as Onassis and Niarchos, the ships under the registry of Greece, Great Britain, the Netherlands, Italy, France, Norway, and the other Scandinavian countries. The charterer normally enters into a charter with the shipowner who offers the lowest price. Only in the event that the American controlled PanLibHon flag shipowner's charter rate is equal to that of the non-American controlled foreign-flag shipowner's will the charterer take the American controlled foreign-flag ship. After reaching agreement with the major oil company concerned, in the case of tankers, or the major steel company or aluminum company, in the case of bulk carriers to carry ore or bauxite, the shipowner then enters into a binding agreement with a foreign shipyard to construct the ship and a binding commitment with a financing institution, or institutions, to lend him a portion of the money needed to pay to the shipyard. Whether the shipowner is an American controlled Liberian corporation or a non-American controlled foreign corporation, the primary source of loan funds is U.S. banks or insurance companies. Foreign controlled shipping corporations, however, do have the ability to borrow funds also from banks in their own countries in addition to their ability to borrow from U.S. financing institutions. American controlled foreign shipping corporations do not normally have the ability to borrow funds from foreign financing institutions and are normally restricted to borrowings from U.S. financing institutions.

The financing documents executed by the shipowner with the financing institution are detailed and provide normally for financing during construction as well as for the permanent long-term financing on the delivery of the ships. In addition, we, as well as some other owners, open through U.S. banks confirmed, irrevocable letters of credit to the foreign shipyard guaranteeing those yards the specified payments as called for by the construction contract. The financing documents executed by the foreign corporations owning 14 of our 15 foreign-flag ships are restricted by the following conditions, and, therefore, we, the stockholders of these corporations, face the disastrous result of potential bankruptcy or the sale of our corporations in the event this tax legislation is passed without excluding American controlled foreign-flag shipping from its provisions. A violation of any one of these conditions results in a default under the ship mortgage and foreclosure by the mortgagee since the financing institution is secured by a first mortgage on the vessel and by an assignment to it of the charter. The loan by the financing institution is never made on the basis of the ship alone but only on the ship and charter together. The financing institutions will loan a percentage of the ship cost, roughly 75 to 90 percent, provided the charter revenue derived from the charter over its duration creates sufficient income over operating expenses to assure repayment of the loan, together with interest, over the period of the charter with sufficient margin to cover potential risks, such as an increase in operating costs and the perils of the sea. These conditions are:

(*a*) Each loan is confined to one corporation. Generally the financing institution requires that a new corporation be created which has had no transactions in it prior to the date of the contemplated borrowing and has no debt against it. This requirement is made to assure the financing institution that its security will not be affected by any transaction other than the one which it is financing. Because of this requirement, we are constantly forming new corporations for each transaction and cannot use the funds generated from one transaction to finance another, nor can we use the profits in one transaction to offset losses that occur in another. Our 15 ships are owned by 9 separate corporations ranging from 1 to 3 ships in a corporation, but each corporation covers one specific financial transaction.

(*b*) The loan is generally repaid over the duration of the charter on a level debt basis. Under this provision we are required to pay each month during the loan the same fixed amount of money to the financing institution throughout the life of the charter. In the early years the financing institution applies a very large percentage of this fixed monthly payment to the payment of interest and a very small percentage to the payment of principal. The interest portion gradually decreases, and the principal portion gradually increases as the years pass. This means that the required payments to the financing institution with respect to principal each year bear no relation to allowable depreciation, and, in the latter years, far exceed any depreciation which would be allowed to the corporation under American depreciation schedules. In addition to the fact that in the latter years our depreciation would be less than our required principal payments, the excess of depreciation over principal payments in the early years would be lost since foreign corporations have no loss carry-forward privileges.

(*c*) Each corporation is generally required to maintain a fixed minimum working capital. This requires the stockholders to be prepared to advance to the foreign corporations additional sums of money over those originally contemplated in the event losses occur through the risks inherent in the business. In the event such sums are borrowed, the foreign corporations are prohibited from repaying these funds until the financing institutions have been repaid in full their loan.

(*d*) Each corporation is required to hold in its corporate accounts all sums not needed to pay operating expenses and the level debt payments to the financing institutions, and each corporation is absolutely—

(1) Prohibited from paying dividends to its stockholders;

(2) Prohibited from making loans to anyone, including its stockholders; and

(3) Prohibited from borrowing funds from anyone except on a subordinated basis: any such loans can only be repaid to the lenders at the end of the charter after the financing institution has been paid in full.

(*e*) All charter hire under the assignment is paid to the financing institution rather than to the shipowner. The financing institution deducts the level debt payment due it and any other amounts necessary to establish required reserves and pays the balance over to the corporation. This balance, as stated supra, is locked up in the corporation as additional working capital to meet future unknown requirements and additional security for the financing institution.

(*f*) The corporation is required, if American controlled, to maintain its corporate accounts, including all the cash it possesses or accumulates in a first-class U.S. bank.

(*g*) In many of these cases the financing institutions require additional security from the stockholders either in the form of guarantees or cash.

In order to demonstrate the effect of this proposed legislation on an American controlled foreign corporation owning foreign-flag ships, I would at this time like to use as an example one of our own shipping ventures to demonstrate how our group and those similarly situated will actually be affected:

One of the corporations owned by our group is Trinity Navigation Corp., a Liberian corporation. This company owns three modern 42,000 deadweight ton high-speed tankers. Each vessel is under charter for 16 years from the date of delivery to Gulf Oil Corp. In 1956, when we negotiated these charters with Gulf Oil Corp., the market for this size ship was approximately $2.50 per deadweight ton per month. Our competition for these charters were the Liberian-flag ships owned by non-Americans and foreign-flag ships owned by Norwegian and Dutch owners registered under the flags of their own countries. We secured the charters but only on the conditions that we accept a rate of $2.56 per deadweight ton per month for the first 12 years and $2.20 per deadweight ton per month for the last 4 years, or an average charter rate of $2.47 over the 16-year charters. If my group had not secured these charters, the ships and the charters would have gone to non-Americans, and these three modern, large, high-speed vessels would not now be under the "effective control" of the United States.

We contracted to build the vessels in Sweden at a total cost to us for the three vessels of $26,200,000. We insisted, as part of our contract with the Swedish yard, that the yard purchase the complete powerplant and all the steel for each of the three vessels from U.S. suppliers. The powerplants were purchased from International General Electric Co. at a cost of approximately $4,400,000, and the steel was purchased from Colorado Fuel & Iron Corp. at an approximate cost of $5,800,000. Therefore, out of a total cost of approximately $26,200,000, U.S. business and U.S. labor benefited to the extent of approximately $10,200,000 which would not have been the case if these vessels and charters had gone to non-Americans-controlled foreign corporations.

Our construction contract required that we pay the Swedish yard 80 percent of the total construction cost periodically during construction and the remaining 20 percent on the day the vessels were delivered. In order to guarantee these payments to the yard, we opened confirmed, irrevocable letters of credit through the First National Bank of Boston. The three vessels were delivered between April 29, 1959, and December 30, 1960. Of the total cost of approximately $26,200,000, we borrowed $24 million from American financing institutions; i.e., $6 million from the First National Bank of Boston and $18 million from Metropolitan Life Insurance Co.

These ships are modern, high-speed oil tankers with a speed of approximately 18 knots and are the equal of any vessels in the world. On delivery of the vessels we signed a commitment with the U.S. Maritime Administration making these vessels available to the U.S. Government in the event of a national emergency.

The stockholders placed at risk in Trinity Navigation Corp. approximately $2,200,000 and, in addition, established outside Trinity Navigation Corp. a cash collateral account in the amount of $1,500,000 as additional guarantee to First National Bank of Boston's loan of $6 million. On the basis of these facts, it can be seen that the stockholders put at risk in this transaction $3,700,000.

The financing documents executed with Metropolitan Life Insurance Co. and First National Bank of Boston contain the following provisions, among others—

(*a*) Gave to the financing institutions the mortgage on the vessels and assigned to them the charter hire payable by Gulf Oil Corp.;

(*b*) Required the maintenance of a minimum working capital of $500,000 at all times;

(*c*) Required the repayment of the loan over the life of the three charters; since the last ship was delivered approximately 18 months after delivery of the first ship, the payments were spread over 17½ years;

(*d*) Froze all the profits in the company for the life of the loan; i.e., 17½ years; and

(i) Prohibited the payment of any dividends to the stockholders for the duration of the loan;

(ii) Prohibited the repayment to the stockholders of any part of their investment for the duration of the loan except that the collateral account of $1,500,000 was to be released as soon as the First National Bank of Boston had been repaid their $6 million. This would occur approximately 5 years after the delivery of the last ship;

(iii) Prohibited the lending of money by the corporation to anyone, including the stockholders;

(iv) Prohibited the borrowing of funds from anyone except funds subordinated to the repayment of the bank and insurance company loans;

(v) Prohibited the corporation from acquiring any other vessels or engaging in any business other than the owning and operating of these three vessels under the gulf charter.

The total gross charter hire for the three vessels is approximately $3,900,000 for each of the first 12 years and $3,200,000 for each of the last 4 years. The total gross operating expenses are now running at approximately $1,150,000 per year, resulting in an operating profit of approximately $2,750,000 before paying the financing institutions the principal and interest due them. The payment of principal and interest to the financing institutions each year approximates $2,300,000, leaving a cash amount (not dedicated to the payment of operating expenses, principal and interest) of approximately $450,000 which must be retained in the corporation, deposited in a U.S. bank and is not available for the payment of dividends. This approximate situation will exist each year until 1977. The only change that will occur will be that the operating expenses will increase as the years go by, and charter hire will decrease after the 12th year so that the resulting cash represented by the $450,000 above will decrease to some extent.

Now, let us look at the provisions of the proposed tax legislation as they would apply to this particular corporation:

(*a*) Assuming only that time charter hire is considered as rent under section 952(e)(3), all the income of this corporation would be rent, and we would arrive at the following result:

(1) If we assume, for the sake of argument, that under the proposed tax legislation we would be able to depreciate our vessels in such a way as to coincide with the payments of principal to the financing institutions (this would seem to be impossible to accomplish because (*a*) the loan is repayable over 16 years for each vessel, and normal depreciation for this size vessel under present U.S. regulations is 25 years; and (*b*) the level-debt character of the repayment which results in a payment of principal which does not coincide with any form of straight-line depreciation on a 16-year basis), the corporation would at least have earnings of $450,000. Under the proposed tax legislation, each of the stockholders, since there are five equal stockholders, would be considered as receiving $90,000 of income taxable at ordinary income rates. Each of the stockholders, if they are not already in the 91-percent tax bracket, would be in the 91-percent tax bracket (resulting from the similar impact on each of them from a total of 15 vessels that our group owns in addition to their other income) and would have to pay to the Government $81,900 each year for this corporation only out of their other assets not connected with their foreign-flag shipping business. The present existing U.S. tax laws are so constructed as they affect ordinary income that no man has this kind of ability to pay this kind of tax on money that he does not receive. The stockholder is not able to receive from the corporation the $90,000 because of the prohibition against dividends and, therefore, will not have the funds available to pay the tax of $81,900 when due. The horror of this situation becomes even more self-evident when one realizes that with a total of 15 vessels, this type of income on which our stockholders will be taxed is approximately $2 million a year, resulting in an attribution to each stockholder of earnings of $400,000 which he will not receive and on which he will have to raise the necessary funds to pay $364,000 to the U.S. Government in the form of income tax without regard to the tax on his other income. The other independent owners, other than our group, who have a larger number of vessels will have a correspondingly greater problem.

(2) If, what is more probable because of the present Treasury regulations on depreciation, we will be required to depreciate these ships over a 25-year life, then the consequences to us are even worse. With such a depreciation schedule, the book profit of Trinity Navigation for the year 1963 would be approximately $800,000, increasing steadily until 1969 (although the cash profit decreases through these years), in which year it would be $1,184,000. This would mean that our stockholders would have attributed to them each year this income so that in 1963 they would pay a total tax of $728,000 and in 1969 a tax of $1,077,440 on money they are prohibited from receiving under the terms of the financing documents. As the corporation is owned equally by five stockholders, each of the stockholders would have to pay one-fifth of this tax, and yet the corporation itself is committed in each of these years to pay all this money to the financing institutions or lose its ships except for approximately an average of $450,000 per year, and the stockholders cannot, under the finacing documents, even get their share of this $450,000 from the corporation, let alone the $1,184,000. The personal tax that I alone as an individual would have to pay on the earnings attributed to me from this one corporation would be $200,000, and I would have to pay it out of resources that exist outside the corporation. I do not have this kind of resources. My problem is multiplied five times this figure of $200,000 since the total number of ships that belong to our group is 15 rather than the 3 used in this example. This means that the total tax that I would have to pay each year in order to retain my interest in these shipping corporations would be approximately $1 million a year even though I cannot get 1 cent of income out of the foreign shipping corporations with which to pay this tax.

Although I am sure that the large public corporations, such as the oil, steel, and aluminum corporations which own foreign corporations operating foreign-flag ships, will be badly hurt by this provision, I believe that the independents (individual owners such as our group) who own two-thirds of the effective-control fleet of the United States will suffer the most since (*a*) we are prohibited from paying dividends while these large corporations are not because of their financial stability, (*b*) we do not have large cash resources in corporate treasuries from which we can pay these taxes if the earnings are not declared by the foreign corporation in the form of dividends, and (*c*) because the attribution of income to use as individuals will result in a tax at rates up to 91 percent while the attribution to the large corporations will result in a corporate tax of 52 percent. It therefore seems self-evident to me that the individuals face personal bankruptcy if they attempt to retain their interest in the foreign-flag ships which represent two-thirds of the effective-control fleet of the United States.

(*b*) If vessels are not considered "qualified property" because they are not always "outside the United States" or because the vessel does not meet the definition of "ordinary and necessary for the active conduct of a qualified trade or business" because of the restrictive definition of this phrase in the light of customary financing requirements, the individual stockholders might have attributed to them their pro rata share in earnings resulting from the amounts paid in amortization of their mortgage to the extent that such mortgage principal amortization exceeds the depreciation. Let us take the same Trinity Navigation Corp. for the purpose of exemplifying this statement on the assumption that the allowable depreciation will be a 25-year depreciation. As stated above, the operating profit after the paying of operating expenses approximates $2,750,000 in the year 1963. The interest portion of the level-debt payment for that year is approximately $950,000, leaving a net paper profit before depreciation of approximately $1,800,000. The allowable depreciation for the year 1963 would be approximately $1 million, but the portion of the level-debt payment made to the financing institution as principal that year will be approximately $1,200,000. Therefore, since the amount paid to the financing institution as principal exceeds the depreciation by $200,000, the stockholders would pay up to 91 percent of this $200,000 in taxes to the U.S. Government although none of this money would be capable of being paid to them. The amount paid in taxes on this money not received by them would therefore be $182,000. In 1969, by virtue of the manner in which the level-debt payments are allocable to principal, the payment allocable to principal has increased so that the amount attributed to the stockholders as a nonqualified investment would be $950,000, the difference between the depreciation of $1 million and the principal payment to the financing institution of $1,950,000. The stockholders would therefore be obliged to pay a tax equal to 91 percent of this figure or $864,500 out of funds which they must secure from resources other than their foreign-flag shipping corporations.

Again, this problem is multiplied five times because our stockholders have interests in 15 foreign-flag ships rather than 3. It becomes clear, therefore, that rather than face personal bankruptcy, we will be forced to dispose of our 15 foreign-flag effective-control vessels and that all independent owners like us will also have this as the only solution to their problem.

(*c*) Although it might be argued by those unaware of the facts involved that the independent shipowners should be able to accept the provisions of section 1248; i.e., to pay ordinary income tax rates on the sale of their stock in or the liquidation of these foreign shipping corporations after the repayment to the financing institutions of their loan, I am sure that after an examination of the circumstances surrounding these transactions, it will become self-evident that this is not so. No taxing legislation should be enacted, the direct result of which will destroy a critical part of the defense posture of the United States, nor should such legislation be passed when it works an undue hardship on any group of citizens of the United States or is unfair and, therefore, un-American in its concept. On this basis, it would appear inappropriate to apply the provisions of section 1248 to any stockholder who already owns the stock of a foreign-flag shipping corporation where the corporation is bound to a specific transaction and to specific financing requirements prior to the passage of this tax legislation. At the time such stockholders entered into their transactions and agreed (1) to accept the specified charter hire from the major oil or steel company with the inherent risks involved in the transaction, (2) to the purchase price of the ship, (3) to the requirements of the financing institutions as to the funds the stockholders would put at risk and of other clauses of such financing agreements, (4) estimated their operating expenses and other expenses without regard to U.S. taxes, they would never have entered into the transaction if they had known at that time that on the completion of the charter they would be forced to pay taxes at ordinary income rates rather than at capital gain rates.

To demonstrate that this contention is not a fallacious one, I would again like to use as an example the Trinity Navigation transaction. As I have stated supra, the stockholders of this foreign-flag shipping corporation put at risk a total of $3,700,000—$1,500,000 in the collateral account which would remain there at risk and be untouched for a period of 5 years from the date of the delivery of the last ship and $2,200,000 which was put in Trinity Navigation Corp. itself. This $2,200,000 under the provisions of the financing documents could not be returned to the stockholders until Metropolitan Life Insurance Co. was paid their loan in full approximately 17½ years from the date of delivery of the first ship. Upon the termination of the charters and the payment of all the loans, the total assets of this corporation (excluding two of the vessels which are of uncertain value at that time, the charterer has an option on the third vessel at the expiration of the charter at $50,000) which will be available for distribution to the stockholders is $6,500,000 of which $2,200,000 represents the investment of the stockholders, leaving a profit of $4,300,000. This $4,300,000 will only be available provided the cost of operating the vessel does not increase over what it is today, which is hardly likely, and provided that none of the risks which are inherent in a shipping transaction occurs which is also extremely unlikely in a 17½-year period. Neither the investment of the $2,200,000 nor any of the profits of this corporation will be available to the stockholders until 1977. When the stockholders entered into this transaction and estimated this profit on $3,700,000, a large portion of which must stay at risk for 17 years, and keeping in mind the fact that the investment and the profit itself would only be returned to them in 1977, they counted on a return after capital gains taxes of approximately 4½ percent. In the event the provisions of this tax legislation are applicable, the stockholders will receive as their return on a $3,700,000 investment, $1,500,000 of which is locked up for 6 years, and $2,-200,000 of which is locked up for 17½ years, only $387,000 which amounts to a return of three-fourths of 1 percent on their original investment. I arrive at this result as follows:

The estimated cash flow in excess of operating costs, payment of interest, and amortization of the mortgage debt to the end of the last charter, providing that such operating costs do not increase and providing the charter revenue does not decrease because of damage to the vessel or strikes, amounts to approximately $6,500,000. Out of this $6,500,000, the stockholders would have returned to them in 1977 their original investment in the corporation itself of $2,200,000, leaving an actual cash profit of approximately $4,300,000. Applying the 91-percent ordinary income tax rate to this $4,300,000 leaves a balance of $387,000 which would be their return on $3,700,000 after 17 years. It can hardly be said that any reasonable businessman would have invested this sum of money for this return in view of the risks inherent in a shipping transaction, especially since this $4,300,000 is not a guaranteed profit and probably will be substantially reduced if operating costs over the life of the charter exceed today's costs, or due to accident, other mischance, or labor difficulties, the vessel is off-hire, resulting in no charter income at a time when most of the operating costs will be continuing.

Among the risks that the stockholders were exposed to when they entered into the transaction were the following:

(*a*) The risks that the Swedish shipbuilders might not be able to deliver the vessels because of financial instability or because of war after payments had been made to them during construction. At the time this transaction was entered into, the cold war was at the highest, and no one knew when or if a hot war would develop. The shipyard actually got into financial difficulties prior to the delivery of any of the ships, and our investment was saved only because the Swedish Government and a syndicate of Swedish banks intervened in order to keep the yard in existence.

(*b*) Risks that the operating costs (over a period of 17½ years, such as wages, provisions, stores, repairs, and insurance) would not exceed the estimated costs arrived at when agreeing to the average charter rate over the 17 years at $2.47 per deadweight ton per month.

(*c*) Risks that the vessels might, because of accident, repairs, or strikes, be incapable of performing under the charters for a period of time in excess of 15 days per year which were estimated as the off-hire days when we set the average rate of $2.47 per deadweight per month.

(*d*) The risk that if the estimates were inaccurate, the stockholders, in order to prevent foreclosure and in order to maintain the minimum working capital of $500,000, would have to invest in the corporation sums in excess of the

$3,700,000 under a requirement that any such funds advanced would also have to remain frozen in Trinity Navigation Corp. until the financing institutions were paid; i.e., 17½ years.

(e) The risk that if any stockholder died his estate would have to pay an inheritance tax on his interest in the corporation even though the estate would be unable to get the funds out of the corporation in order to pay the tax. There is no market in which this minority stock interest would be readily salable, and, therefore, the estate would have to, out of liquid funds in its possession, pay the inheritance tax on the valuation established for the holding in the foreign corporation.

I believe you will agree with me that no business group would have gone into this transaction in 1956 if the proposed tax law were in existence at that time. This becomes even more clear when one realizes that, under the present tax legislation, stockholders who own more than one foreign-flag shipping corporation, a situation which always exists because of the customary financing requirements, will be unable to offset their losses in one venture as ordinary losses against their profit in another venture. In other words, as I understand the present legislation, if a foreign shipping corporation makes a profit, an individual stockholder pays an ordinary income tax at rates of up to 91 percent while this same stockholder, having an investment in another foreign shipping corporation which operates at a loss, can only use this loss as a capital loss and against capital gains. In addition, the individual stockholder has none of the benefits which an American corporation would have, such as consolidated returns, loss carry-forwards and carrybacks, etc.

From a purely business standpoint, our group would have been much better off in investing this sum of money in low-yield U.S. Government bonds, since our return would have been about the same, we could withdraw our investment and profit at any time, and we would have had no risk. If we had decided not to invest in this shipping venture or in Government bonds, we could have elected to invest this same amount of money in any of the "blue chip" American corporations' common stocks and, on their sale, after paying only capital gains, would have been far ahead of where we will be with respect to our stock in Trinity Navigation. If we had invested this $3,700,000 in 1956 in General Electric, our stock would now have increased in value by approximately 25 percent; if in General Motors, approximately 30 percent; if in A.T. & T., approximately 138 percent; and if in IBM, approximately 540 percent. This is the increase in value of the shares without regard to dividends that have been paid over the last 6 years. We also at any time could have disposed of the stock, returned our investment to ourselves and kept the profit after payment of capital gains tax, while in our investment in Trinity Navigation Corp. we are locked in until 1977 and will have only a return of three-fourths of 1 percent if the tax legislation is enacted.

On the basis of all these facts and circumstances, it seems improper to me to apply this tax legislation to American citizens who relied in making their investment on the expressed policy of our Government to encourage investments in foreign-flag shipping in order to create an "effective control fleet."

The only solution available to our group and to other independent owners in the face of the consequences of this tax legislation is to sell our Liberian corporations and our Liberian-flag ships to non-American citizens. We will, of course, have to sell our fleets at some sacrifice, because these foreign owners know of the disadvantage in which we are placed by this tax legislation, but at least we will be able to remove the threat of personal bankruptcy and to secure from our corporations most, if not all our original invested funds for other more profitable investments. I cannot, however, see how this proposed tax legislation which brings about this result can in any way be considered as a benefit to the U.S. Government. In fact, it seems self-evident to me that the loss of this "effective control" fleet can only be detrimental to the interests of the United States for the following reasons:

(a) Our 15 foreign-flag ships will pass from effective American control to foreign control. Ten of these vessels are modern, large, high-speed vessels, extremely important to the defense of our country. When one realizes that the independent owners own approximately 300 such foreign-flag vessels and that all these will move to foreign owners with the enactment of this tax legislation, I do not believe that anyone can question the severe blow that will result to the defense and economic posture of the United States. The Truman, the Eisenhower, and the Kennedy administrations have repeatedly emphasized the reliance of our Government on American-controlled PanLibHon ships in the event of an emergency, and all have pointed out the catastrophic effect to our defense effort if these ships should be lost to foreign control. As recently as August 24, 1961, the Secretary of the Navy reviewed the Navy's requirements for these "effective control" vessels in the event of war and confirmed "its previous position that it is imperative that 'U.S. effective control of flags-of-convenience shipping be retained.'" This position of the Defense Department was made very clear in a letter dated August 24, 1961, from the Honorable Roswell Gilpatric, Deputy Secretary of Defense, to Chairman Carl Vinson of the House Committee on Armed Services, excerpts of which are set forth below:

"Because of the effect which such a transfer of tonnage out of U.S. control would have on defense needs in the event of a national emergency, we asked the Secretary of the Navy to review its requirements for flags-of-convenience vessels in the event of war. The Navy has done so and has confirmed its previous position that it is imperative that 'U.S. effective control of flags-of-convenience shipping be retained.' That position has been adopted as the Defense Department's position in the matter, and the Secretary of State and the Secretary of Labor have been so informed. A complete statement of that position is as follows:

"'1. The primary interest of the Department of Defense in flags-of-convenience shipping relates to the impact of our national defense posture and this interest is to insure the availability under U.S. control of as much of this shipping as may be needed in the event of national emergency. *The amount of active U.S.-flag shipping now available is inadequate for almost any situation of war or emergency* and must be augmented by shipping which can be brought under our direct control as required in the event of an emergency.

"'2. It is considered imperative that United States effective control of flags-of-convenience shipping be retained. Further, it is considered that such flags-of-convenience shipping as is covered by agreements or contracts with owners can be brought under our operational control as was done in World War II.

"'3. This dependence on effective control of flags-of-convenience shipping for emergency use is an expedient. It would be much more desirable to have adequate U.S.-flag tonnage available. However, this ideal situation does not exist, and until enough U.S.-flag tonnage is available, we will need to rely on flags-of-convenience ships.

"'4. Until such time as our national emergency needs can be completely met by modern American-flag shipping, *the Department of Defense has no recourse but to support the flags-of-convenience concept. The possible loss of the shipping capability represented by American-owned shipping of Panlibhon registry to uncontrolled registries is of great concern to the Department of Defense.*'" [Italic added.]

On August 28, 1961, Chairman Carl Vinson of the House Committee on Armed Services formally stated to the House of Representatives his firm belief that the foreign-flag fleets owned by American citizens be retained in their hands so that they would be under the effective control of the U.S. Government. His statement is as follows:

"From a standpoint of national defense these ships can be recovered for our national needs in the event of a national emergency. However, we are facing a situation under which the owners of these tankers and bulk cargo carriers may sell or make an outright transfer of these ships to foreign countries. In that event, the right of recovery of these ships in a national emergency would cease to exist.

"Since we do not have, under American registry, sufficient tonnage of this type of ship to meet the requirements of national defense in times of national emergency, it is both important and urgent that we adopt a national policy which will protect the national interest."

I would like to call your attention to the fact that these statements made by these two men, who are directly concerned with the defense of our country and who are fully aware of the dangers that exist today to that defense, were made only 8 months ago. If "the amount of active U.S.-flag shipping" then "available" was "inadequate for almost any situation of war or emergency" on that date, it would appear that they would also be inadequate today and that the U.S. Government must retain "effective control" of the American foreign-flag shipping. I would also like to point out at this time a statement on the same subject by the Honorable C. Douglas Dillon, now the Secretary of the Treasury, which was made by him when he was Under Secretary of State for Economic Affairs on June 8, 1959, when he spoke publicly as follows:

"Our Government, our shipping industry and our maritime unions are all in agreement that if it were practicable we would prefer to have a much larger merchant marine operating under the United States flag. We recognize however, that, for many years, this has not been practicable from a competitive viewpoint owing to the lower costs of operation possible under foreign flags. Until such time as American-owned ships, now sailing under foreign flags, might be operated competitively under the American flag, we see no alternative but to continue on the present course.

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"The fact that Panlibhon ships which are carrying American exports and imports are beneficially owned and controlled by United States citizens is of great importance from the standpoint of our *mobilization requirements*." [Italic added.]

Vice Adm. John Sylvester, USN, Deputy Chief of Naval Operations (Logistics), in a report to Senator John Marshall Butler, on February 20, 1961, made the following statements on this subject:

"The strategic importance of ocean transportation in wartime dictates that the United States must have under its control sufficient active merchant type shipping to promptly meet our initial emergency sealift requirements.

"Our present capability to handle this task is marginal at best. The slow rate or progress made in the replacement of aging vessels has left us facing the 1960's with a largely obsolescent merchant marine.

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"Our industrial economy is now dependent on sea transportation for the importation of vast amounts of petroleum, metal ores and other raw materials, and for the exportation of finished products. No other type of transportation can meet these tremendous requirements. *It is imperative that the world's foremost trader control sufficient merchant shipping to transport what we need, when and where we need it. This is true from the standpoint of our emergency requirements, and it is also valid when we consider the outflow of dollars in payment for forcing controlled shipping services.*

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"The degree of promptness with which sealift responds in an emergency will have an important impact on the eventual outcome.

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"The vast proportion of our U.S.-flag merchant tonnage was constructed under the World War II building programs: Seventy-nine percent of our dry cargo and 54 percent of our tanker tonnage are in the 15–19-year-old age bracket. Nearly all of these ships were mass produced for specific wartime purposes. Many of their design features were matters of expediency rather than choice. They have long been outmoded from the standpoint of modern design.

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"Only 1.7 percent of the U.S.-flag tonnage of dry cargo ships are under 5 years of age. Only 5.9 percent are from 5–9 years old." [Italic added.]

Because of the need to clarify the situation with respect to this "effective control" fleet, a study was conducted by the National Academy of Sciences, National Research Council, Washington, D.C. Adm. Arthur W. Radford, U.S. Navy, retired, former Chairman of the Joint Chiefs of Staff, served as chairman of the advisory panel on wartime use of the U.S. Merchant Marine, and this report, made in 1959 (known as the Walrus report), was submitted as their findings. I would like to quote excerpts from this report as follows:

"Despite international criticism of U.S. practices, many foreign shipowners have also registered ships under 'flags of convenience.' These include British, Danish, Greek, Italian, Norwegian, and Swedish shipowners. British shipowners can also use Bermudan registry under British flag as a tool of convenience (lower taxation).

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"At the same time, U.S. flag merchant tonnage is not adequate to meet our total wartime needs. This is particularly true with tankers, as about half of the U.S.-owned tanker tonnage is registered under foreign flags.

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"1. Should continued opposition on the part of foreign shipping interests, foreign governments and U.S. and international maritime labor organizations render the registry and operation of U.S.-owned ships under 'flags of convenience' untenable, we would be faced with the problem of determining what steps to take to insure the continued availability of these ships for national defense. It is probable that we would have to adopt one, or a combination of two alternatives—

"(a) To allow the U.S.-owned 'flag of convenience' fleet to migrate to the traditional maritime flags of Western Europe. This would be detrimental to the U.S. national defense posture, as we would have to depend upon uncontrolled foreign merchant shipping to meet a significant portion of our emergency sea transportation needs. * * *

"(b) To expand governmental subsidy programs to support the operation under U.S. flag of all U.S.-owned and controlled merchant shipping that is engaged in competitive foreign trade. This would embrace 'flag of convenience' shipping, the existing subsidized segment of the U.S. flag merchant fleet, the numerous U.S. flag ships whose applications for a subsidy are pending, and probably others. Such course of action would prove to be a most costly undertaking and there is no likely prospect that the Government will adopt such a program."

(b) The non-American foreign controlled shipping has been used to carry cargo to and from Cuba, Communist China and other Iron Curtain countries. None of our foreign flag vessels has so been used. If the American independent owners are forced to sell their foreign-flag vessels to non-Americans, then, at the expiration of the charters under which they are now operating, these vessels would be available to carry cargoes to and from all our enemies. This would be a tragic situation since American citizens would have brought into being these modern vessels, and tax legislation of the U.S. Government would have turned them over to be used by our enemies.

(c) The U.S. present deficit balance of payments position will be adversely affected. Our 15 vessels produce a gross charter revenue of approximately $18 million per year, all of which dollars pass through U.S. financing institutions. Those dollars not needed to repay the financing institutions are left on deposit in U.S. banks. Once these vessels are owned by non-Americans, these U.S. dollars will pass into the hands of foreign banks. When one realizes that there are approximately 300 of such independent American owned foreign-flag vessels, this impact on the "balance of payments" position of the U.S. is increased 20 times. It must be remembered that the charterers of these vessels are primarily U.S. oil, steel, and aluminum corporations which are obliged under their charters to pay charter hire in American dollars, and these American dollars now go to U.S. controlled PanLibHon corporations, the dollars, however, remaining in U.S. banks. If the vessels are sold to non-Americans, U.S. charterers will continue to pay charter hire in American dollars, but those American dollars, in that event, will be paid to non-American owners who will deposit their dollars in foreign banks. In the future these same American major oil and steel corporations will only have a non-American foreign-flag market in which to charter vessels, thereby increasing the outflow of American dollars to foreign hands.

The American controlled foreign-flag shipowners spend a substantial part of their charter revenue in purchasing supplies and services from American corporations. For example, the foreign-flag fleet operated by our group during 1961 spent a total of approximately $5,500,000 in the United States for various supplies for these ships. If these ships move to foreign control, the expenditures for these items will be made in foreign countries. If you multiply this by all the ships owned by Americans, you can see that a substantial amount of American dollars and a substantial amount of sales of American products and services will be lost to foreign countries. One of the express purposes stated by the administration for their recommendation to tax foreign corporations was to help the United States in its present balance of payment problems. Applying this tax legislation to the American controlled Liberian-flag shipping corporations, instead of serving to help our balance of payments, can only result in having an additional adverse affect on the U.S. balance of payments position.

(d) Because American corporations will lose the sale of their products and services to American controlled Liberian vessels if these vessels are sold to non-Americans, there will also be an actual reduction in the amount of taxes collected. This result obtains because American controlled foreign-flag owners use operating agents in the United States, procure our marine insurance on their fleet to the fullest extent possible from American insurance brokers, and buy as much of their stores, provisions and fuel as they can in the United States.

As I have pointed out in paragraph (*c*) above, our own group spent for supplies and services in the year 1961 $5,500,000, and this represents only a small portion of the amount of money spent by all the independent owners. The American corporations from whom we procure these services and supplies hire American labor and pay American taxes on the business they secure from us. If these vessels become non-American owned, this business will belong to non-American sources who do not hire American labor and do not pay American taxes.

(*e*) The Government will actually receive very little income, if any, by applying this tax legislation to American controlled foreign-flag shipping, because if these vessels are sold to non-Americans, as a consequence of the passage of this act, taxes will not be collected on the income from these vessels.

(*f*) In a very short time the officials of the U.S. Government charged with our defense will be importuning Congress to appropriate large dollar funds to replace the "effective control" fleet which has been lost to the U.S. Government as a result of this tax legislation. Almost immediately after the loss of the fleet, it will be imperative to construct new tonnage to replace this lost tonnage in order to meet defense requirements. This will result in tremendous expenditures of money by the U.S. Government, far in excess of the sums that are expected to be produced by the so-called "tax haven" legislation. It is my understanding that the Honorable C. Douglas Dillon, Secretary of the Treasury, has estimated that the total tax to be collected from all the so-called "tax haven" corporations, not just the foreign-flag shipping corporations, would be $85 million. It has been estimated by officials of the Defense Department and Maritime Administration that in order to replace the present fleet of American controlled foreign-flag ships it would cost the U.S. Government in operating subsidies alone $600 million a year. In addition to this, construction subsidies (which are not now available) would be necessary in order to bring this new fleet into being. If we assume that American yards' construction costs are only two times (most estimates are higher than that) that of the foreign yards' costs, the construction subsidies alone would represent $1 billion. Even with such an expenditure in the form of operating subsidies and construction subsidies, this fleet would not be replaced in the light of present world shipping conditions.

The subsidy figures are based on the assumption that American owners, once they have disposed of their foreign-flag ships, would be willing to construct and operate American-flag vessels if they receive an operating differential which made their operating costs equal to foreign operating costs and if they received a construction subsidy making their construction costs equal to foreign construction costs. This the American owners could only do provided there were enough charters in existence to cover the new 300 ships which were to be built. This does not seem probable because the present fleet of 300 vessels, when sold, would take with them the charters under which they are now operating, and there is not available in this shipping market today, or in the foreseeable future, anywhere near the number of charters to assure business for such a new fleet, and, therefore, the shipowners would be unable to borrow from the financing institutions in the United States the funds necessary to build the ships, nor would they be willing to invest the money required to keep these ships operating without charters. It is, therefore, likely that the U.S. Government, instead of being called upon for an operating subsidy of $600 billion and a construction subsidy of $1 billion, might be forced to build a fleet itself at a cost of between $2 billion and $3 billion and absorb the operating costs which will exceed the $600 million a year operating subsidy.

(*g*) There are corollary benefits to the U.S. economy and to our balance-of-payments position that arise because of the American ownership of these Liberian-flag ships. These benefits (not publicized) occur because of the ingenuity of American businessmen in promoting transactions which result in the building and chartering of these foreign-flag ships. I will cite only a few of these types of transactions in which our group was involved in order to point out the type of transactions which will be lost in the event the American-flag shipowners are removed from the foreign-flag shipping market. Since our group has no corner on ingenuity, I am sure these examples can be multiplied many times over by other American foreign-flag shipowners:

(1) As part of our transaction to build the three Trinity Navigation ships referred to above, we arranged for the sale by General Electric to the Swedish shipyard of three complete powerplants. We understand that as a result of our including these powerplants in the Swedish ships, about 30 such units were sold by U.S. companies manufacturing this type of powerplant, and we know of 8

which were sold as a direct result of our transaction. In addition, we arranged for the Swedish yard to purchase the steel for our ships from Colorado Fuel & Iron. We know of at least three other ships which were built from Colorado Fuel & Iron steel as a direct result of our transaction. Without regard to the amount of money expended by the owners of these other vessels, the General Electric equipment and the Colorado Fuel & Iron steel bought for our three ships totaled approximately $10,200,000. If you include all that were sold as a result of this transaction, the total dollars received by U.S. manufacturers exceeded $30 million.

(2) In 1959 and 1960 we contracted to purchase two 47,000-deadweight-ton high-speed supertankers from Japan at a cost of approximately $12 million under agreements whereby the Japanese agreed (in return for our purchasing the ships) to purchase from sources we designated approximately 14 million barrels of oil at a price of approximately $16 million. We chartered these two ships to a major American oil company under a 20-year time charter, and this same American oil company supplied the oil to Japan at a sales price of $16 million. This transaction took place at a time when Russia was attempting to sell its oil at a cutrate price in the Japanese market and resulted in a sale for $16 million of oil that the American oil company would not otherwise have been able to sell to Japan.

(3) In 1960 and 1961 we agreed to purchase two high-speed 50,000-deadweight-ton combination ore and coal carriers from the Japanese at a cost of approximately $12 million on the conditions—

(*a*) That Fuji Iron & Steel, a large Japanese steel company, would buy approximately 500,000 tons of coal a year from American coal companies during the next 15 years. This resulted in a sale of 7,500,000 tons of coal at an approximate sales price of $100 million by American coal companies to Japan.

(*b*) That they charter these two vessels from us to carry the coal for the 15-year period and to pay us charter hire in American dollars.

These shipping transactions, therefore, directly resulted in jobs for American labor, profits for American industry and taxes to the U.S. Government which would not have been secured except for the fact that Americans were engaged in the foreign-flag shipping business. This type of ability to promote this kind of transaction will end when the American-controlled foreign-flag corporations and ships are transferred to non-Americans. These corollary benefits will then accrue to the countries of which the non-Americans are citizens; that is, primarily the developed countries of Western Europe.

In the light of the consequences that will result if the Americans are forced to dispose of their interests in foreign-flag shipping, it would seem that the U.S. Government gets little benefit, if any, from the small portion of the $85 million which is estimated to accrue in taxes from the so-called tax-haven legislation. This is the first time that I can recall that tax legislation which would be enacted by the Congress of the United States works a greater hardship on relatively small, independent owners than it does on large major corporations. This result comes about because the large corporations, with great dollar assets (*a*) do not borrow their funds for vessels in the same manner that the independent owners do and, therefore, do not have the prohibitions in the financing documents against paying dividends to the parent corporation; (*b*) the income attributed to these corporations will be taxed only at the corporate rate of 52 percent, (*c*) if, for policy reasons, they do not desire to declare the dividends from their foreign subsidiaries to the American parent, they have large reserves in their corporate treasuries with which to pay the tax; and (*d*) if policy dictates, it does not work an undue hardship on them to keep their investment in shipping tied up for a long period of time without return. It is also the first time that I know of when any tax legislation would so clearly result in the destruction of an essential American industry with a resulting gain to non-Americans and bring about a worsening of our defense position in such critical times.

II. THE EFFECT OF THE PROPOSED LEGISLATION ON THE FUTURE OF AMERICAN-CONTROLLED FOREIGN-FLAG SHIPPING

My statement up to this point has been confined to the effect of H.R. 10650 on the existing American-controlled foreign-flag fleet of ships. From this point on, I would like to discuss the advisability of applying the provisions of H.R. 10650 to foreign-flag vessels which would normally in the future be built by American citizens but which have not as yet been acquired and therefore are not at this date subject to the restrictive provisions of financing documents, construction contracts, and charters. The only distinction that could be argued as existing between the two situations is that in the case of the ships already acquired which are subject to presently executed long-term, binding commitments, the stockholder has already made his investment, entered into the transaction, and bound himself to the financing restrictions on the basis of the tax legislation in existence at the time he entered into the transaction. No such individual could reasonably be expected to believe that a tax of the type contemplated which is so confiscatory in effect would ever be enacted. To pass such legislation as against such individuals would be unduly harsh and would create an unfair hardship on such a stockholder. The only difference between such a stockholder and an individual who in the future after the enactment of this proposed legislation contemplates entering into such a similar transaction is that such an individual has freedom of choice in the light of the tax situation then in existence to decide not to enter into such a transaction and therefore not to acquire the vessel but rather to permit a non-American to accept the charter and acquire the ship.

There is no question that if this tax legislation is passed in its present form without exempting American-controlled foreign-flag shipping from all its provisions, no Americans will build or acquire in any manner, after the date of its passage, vessels under foreign flag since the financial institutions will be unable on the basis of the legislation, regulations, and policies under which they operate to relax their present restrictive requirements, and the American investor will not be prepared to accept the risks involved and commit his funds to such long-term investments for a return under 1 percent per year. As Secretary Dillon has aptly put it in the hearings before this committee (p. 87 of the April 2 hearings): "There is often a thin line between a 'Yes' and 'No' decision in the investment area." It seems to me that this tax legislation crosses that thin line and will bring about a "No." This tax legislation, therefore, will result in the complete loss of the present effective control fleet of the United States and the certainty that no new, modern ships will be built for that fleet after the date of its passage.

It is my understanding that the so-called tax-haven legislation is expected to produce $85 million. This estimate is based on the taxes that it is expected all American-controlled foreign corporations will pay and not just the American-controlled foreign corporations engaged in shipping. In fact, I would expect from the House Ways and Means Committee report that the greatest portion of this revenue is expected to come from the foreign subsidaries of large American corporations engaged in sales, licensing of patents, and other truly passive investments. In fact very little revenue, if any, will arise from the tax on American-controlled foreign shipping since, if this shipping is transferred to non-Americans, no taxes will be collected.

Let us now see whether our Government through tax legislation which will produce very little tax revenue, if any, should force the destruction of the effective-control fleet. I would like first to point out that the term "effective-controlled U.S. fleet" is not synonymous with "flags of necessity," "flags of convenience," or "runaway ships." These latter "terms are all-embracing since they refer to vessels owned not only by U.S. citizens but citizens of other countries registered under Panamanian, Liberian, Honduran, and other economically advantageous flags." The term "effective-controlled U.S. ships" is selective and specific "because it means only U.S. controlled Liberian, Panamanian, and Honduran flag vessels which have been committed to the U.S. Government in the event of an emergency. It is primarily under Liberian or Panamanian flag." (See U.S. Department of Commerce, Maritime Administration report, "An Analysis of the Ships under 'Effective U.S. Control' and Their Employment in U.S. Foreign Trade During 1960," dated February 1962. See also Adm. Arthur W. Radford's, "Walrus Report.")

I would like at this point in this statement to trace the history of American ownership of PanLib vessels and to set forth the facts which have lead our highest Government officials (particularly those concerned with the defense of our country) to encourage the creation of the effective-controlled fleet and its continued expansion.

The development of shipping under the Panamanian and Liberian flags can roughly be divided into two periods of time. The first period was that of the mid-1930's throughout World War II. Prior to World War II, American companies, particularly those in the oil industry, operated sizable fleets of ships under European flags. Even at that date, this method of operation provided the only possible approach to meeting the strong competition of European shipping operators in the tramp trades since Americans did not receive Government support for their operations. The basic reason for the inability of American-flag shipping to compete in the world markets was then, as it is today, the disparity of wages of American and European seamen, the difference in construction costs of American and European yards, and the tax benefits given to foreign shipping by their nations as against the tax benefits given to our shipping by the U.S. Government.

As Hitler's power in Europe grew, it became crystal clear that the American ownership of European-flag vessels would soon be in danger. As an example, to illustrate the chain of events that brought about the Panamanian fleet, one only has to look at the steps taken by one major American oil company in order to meet the problem. This company had a substantial fleet of tankers registered under the flag of Danzig, and, as Hitler's aims became apparent, this company recognized that the status of its interest in Danzig might be seriously jeopardized. The company looked elsewhere for a home for its fleet and discovered that Panama's maritime laws were favorable to shipowners. The company, in 1935, transferred its ships from Danzig to Panamanian registry. The fleet consisted of approximately 25 vessels, and, because of its size, did much to encourage the growth of Panama's shipping industry. Immediately after the transfer the German crews were replaced by American crews, but this lasted for only a short time when the American crews were replaced by British crews. This change was originally made so as to satisfy the terms of the U.S.-declared neutrality in 1938, for these ships were then being employed in providing essential cargoes for the war effort of Britain. This fleet was so effective under the rules and regulations that existed at that time that this same oil company was requested by the U.S. Government to add 15 more vessels to its Panamanian fleet. The oil company responded to the request of our Government, and, by this method, the U.S. Government found a very effective means of aiding our Allies without violating our declared neutrality.

Liberia developed as a maritime country in the latter half of the 1940's. This small country, with strong American ties and with little, if anything, of a maritime law, attracted the American shipowners as well as non-American shipowners to register their ships under its flag. A fair and just maritime law was developed by American and Liberian law experts.

As a result of the Second World War and the industrial expansion which occurred thereafter, the drain on American natural resources became tremendous. This made it necessary for America to import enormous quantities of raw materials, particularly oil and ores, in large bulk ships. The rebuilding of industry in the many countries ravaged by the war also created further demands for raw materials and for the most efficient manner of transporting these materials over the oceans. As a result of this, the need for a new and different kind of vessel developed since the war, and it is this need which expanded the growth of the Panamanian and Liberian fleets.

The American shipowner who desires to compete in these expanding trades where he receives no support from his Government, has little choice of alternative courses to follow. One must remember that unlike the foreign subsidiary of an American corporation located in Germany which competes with other German industry or the one located in Great Britain which competes with other British industry, the American stockholders who own foreign-flag ships compete against the shipping of the world. The area of competition is not limited to a specific country, but extends to all the maritime nations of the world. To register ships under the American flag, which would require the employment of American crews, the building of the ship in American yards and the payment of U.S. taxes, from the standpoint of ordinary, simple economics, is completely out of the question. The advantages of Panamanian and Liberian registry were sufficiently attractive to also lure shipowners of other nations, particularly Greeks and Italians, into their fleets. The British also created a flag of necessity in Bermuda and in the Bahamas. As a result of this combination of factors, Panama and Liberia emerged as major shipping nations.

The growth of the American-owned PanLib fleet was not un-American—it was a development that was encouraged by our Government as a means to assist our Allies and ourselves, and PanLib ships of the late 1930's and early 1940's played a major role in advancing the Allied cause just as the PanLib ships in the Korean conflict were of great assistance in handling our transportation problems.

The total American-owned "effective control" PanLib ships on January 1, 1961, was 456 ships of approximately 11 million deadweight tons and approximately 300 of these are owned by independent owners, such as our group. On the other hand, the total non-American-controlled PanLib fleet on that same date was 941 ships with a deadweight tonnage of approximately 13 million tons, all of which pay no taxes to anyone now and will continue to pay no taxes even after the passage of the proposed legislation. It was to compete on even terms with these non-American-controlled PanLib vessels with low operating costs and no taxes, as well as the vessels of other foreign maritime nations, such as Greece, Italy, Norway, and Great Britain, with their lower operating costs, special aids from their governments in the form of subsidies for the building and operation of vessels and special tax benefits that the American owners chose to register their vessels under PanLib flags in order to compete in the foreign trades of the world.

The special tax treatment given by some of these governments to vessels registered under their flags are as follows:

(*A*) *Liberian and Panamanian flags*

There will be no taxes on Liberian- and Panamanian-flag vessels owned by non-Americans, and there is no requirement in the country in which the owners are citizens to force them to return their profits to their mother nation and to pay a tax thereon. Their funds are available to continue to build new ships, and, when they calculate a charter, their estimate of return is the same before taxes as it is after taxes. This fleet is composed of 941 vessels with a deadweight tonnage of 13 million tons. It is larger that the American-controlled PanLib fleet.

(*B*) *British flag*

(1) *Bahamas and Bermuda.*—British citizens, as well as non-British citizens, may organize corporations under the laws of the Bahamas and Bermuda, and if such corporations own and operate ships, they are permitted to fly the British flag but pay no taxes to the British, Bahamas, or Bermudian Government.

(2) *Corporations organized under the laws of Great Britain.*—Under Great Britain's tax legislation, tankers may be depreciated over 16 years, and all other vessels, regardless of size, over 20 years. In addition, the owners of these vessels are allowed an additional 40 percent of original cost as depreciation, called initial depreciation, in the year the vessel is acquired. This initial depreciation is entirely exclusive of the normal depreciation allowances granted with respect to ships.

(*C*) *Greece*

Corporations organized under the laws of Greece.—All earnings from Greek-flag vessels are exempt from taxes for the first 7 years after they have been constructed. Any vessel less than 20 years old, refitted at a cost higher than twice the value of the vessel on the day the refitting work commences, is exempt from two-thirds of the normal taxes for 7 years from the date on which work starts. In other words, when an owner builds a vessel and registers it under the Greek flag, he pays no taxes for 7 years, and then at the end of 19 years, when his ship is of very low value, he can reconvert his ship and for the next 7 years pays taxes at only two-thirds of the normal rate. The normal tax for all businesses in Greece is 35 percent, but shipowners are exempt from the normal corporate tax and instead pay a much lower rate after the 7-year period; i.e., 2.5 percent of charter hire in the case of voyage charters or 4 percent in the case of time charters.

(*D*) *Norway*

The tax laws confer considerable benefit on shipowners as against other types of business by means of increased depreciation allowances and by permitting reserves for periodic repairs and maintenance. There is deducted from profits before any tax is assessed the following: (*a*) Profits resulting from the sale of ships, from the sale of contracts for the purchase or construction of a ship, or from insurance received on the loss of a ship provided these profits are used to purchase another vessel within 8 years from the date the profit occurred: (*b*) depreciation is calculated on the basis of 6 to 8 percent of original cost depending on the type of vessel; in addition shipowners may claim either "initial" or "additional" depreciation. The former permits an additional deduction, in excess of that allowed for normal depreciation, of 25 percent of the cost of the ship to be taken over the first 5 years of its life. The latter, which is an alternative to "initial" depreciation permits an approximately 2 percent extra depreciation over a 5-year period; (*c*) reserves for special survey or classification repairs; this type of repair work is the most expensive that a shipowner has to face throughout the life of his charter; (*d*) losses can be carried forward and deducted from taxable income for a 10-year period.

The examples listed above show the tax disadvantages the American owner competing against vessels of foreigners has to face for American and other cargoes of the world. Proof of the favored treatment given by these foreign nations to their shipowners is demonstrated by the fact that between January 1, 1960, and July 1, 1961, non-American owners transferred 76 ships totaling 2 million tons from the so-called tax havens of Panama and Liberia to the flags of other nations. As further proof of the favorable treatment given by these maritime nations, one needs only to examine the facts in connection with the selection by non-American owners of flags of registry for their newly built ships. In 1958 36 percent of all tankers delivered from non-U.S. yards that year were registered under PanLib flags, but in 1960 only 29 percent of the tankers built outside the United States that year were registered under PanLib flags. In the first 7 months of 1961 only 12 percent of the tankers delivered from foreign yards were registered under PanLib flags.

The American international shipping industry must be able to compete with the foreign shipping industry as it is always in direct and open competition not only for cargoes going to and from the United States but also for cargoes moving to and from all countries of the world. It is true that a relatively small percentage of American international trade is carried on American-flag ships. However, the fleet of foreign-flag ships in which Americans hold interests is not a cause of that situation. It is rather the effect on the situation of low foreign wage costs and foreign preferential tax treatment which has made American shipping noncompetitive and has forced the unsubsidized bulk carrier fleet engaged in foreign trade to operate under a foreign flag or not at all. If foreign-flag ships in which Americans hold interests carried a lesser percentage of American foreign trade, the difference would be made up by foreign owned ships and not by American-flag ships. Foreign vessels having much lower operating costs and preferential economic benefits from their government can offer much lower charter and freight rates, and American and foreign industrial corporations which must be able to meet competitive prices in both the export and import markets cannot do so without taking advantage of these rates.

One of the primary reasons that Americans were forced to register their vessels under PanLib flags was to escape the high construction and operating costs of American-flag vessels in order to remain competitive in the world charter markets. Construction costs in foreign shipyards are less than one-half those in U.S. yards. American seamen's wage scales are three to five times higher than prevailing foreign wages; for example, if you compare a 45-man American crew on a 46,000 d.w.t. tanker against a 48-man foreign crew on the same tanker, the following difference in wage and fringe benefit costs results:

	Per month
U.S. crew	$48, 705. 43
Italian crew	15, 614. 74
Norwegian crew	13, 946. 38
British crew	12, 595. 61
Greek crew	12, 051. 65

The difference in operating costs without regard to the difference in capital costs is even greater than appears from the above figures when other differences in costs, such as repairs, are taken into consideration. The disadvantage of the American-flag ship as against the foreign-flag ship is sharply exemplified if one, without considering the difference by including the disproportionate excess of the American ship capital cost over the foreign, examines the operating differential during 1 year in which a 46,000 d.w.t. tanker would run round trip between the Persian Gulf and New York:

U.S.-flag ship	$1, 742, 986
Italian-flag ship	1, 204, 124
British-flag ship	1, 267, 324
Japanese-flag ship	1, 167, 534
PanLib-flag ship	1, 237, 163

You can see that on this voyage the U.S.-flag vessel's costs were approximately $500,000 per year more than that of vessels of other flags and that the PanLib vessel's costs are approximately the same as those of other maritime nations. If one adds to these costs the amortization of the capital cost differential between the American-flag ship built in American yards and the foreign-flag vessel built in foreign yards (using 25 years and 5½-percent interest rate), the operating disadvantage of the American vessel is approximately $1 million per year.

The dollar handicap under which an American-flag vessel must operate is so substantial as to be virtually conclusive against the participation of such a vessel in the competitive world market. Without the PanLibHon flags, with competitive wage costs and tax preference, the U.S. owners would not be able to build and own a modern fleet, and the U.S. Government would be faced with completely inadequate ocean transportation in the event of a war or with the need to spend a substantial amount of money to build and maintain such a fleet.

If American capital is to be denied participation in world trade on terms that prevail in that trade, then no further American capital will be invested in that trade, and the American capital that is there now will be withdrawn. As a result, the foreign trade of the United States in the import and export of bulk cargoes by water will then be carried in foreign-owned foreign-flag vessels. There will be no lack of foreign capital to take over the share of this trade in which American capital is now invested.

If this should happen as a result of this tax legislation, the consequences to the defense of the United States and to its economic well-being would be catastrophic. The Department of Defense and others charged with the responsibility of meeting and evaluating defense needs consider that the bulk carriage capabilities of the American-flag merchant fleet are completely inadequate to meet the defense requirements of the United States and that, therefore, the availability of vessels owned by U.S. citizens under PanLib flags is of critical importance to national security (see the letter dated Aug. 26, 1961, of Hon. Roswell Gilpatric, Deputy Secretary of Defense, quoted at page 31 hereinbefore). This fleet has been committed by its American owners to the U.S. Government, and there is no question in view of this commitment and the U.S. citizenship of those owners that this fleet is under the "effective control" of the U.S .Government. It is of importance to note at this point that 65.2 percent of this PanLib fleet is owned by the independent American owners, such as our group, who without question will be forced to dispose of their fleets if this tax legislation is enacted. Only 34.8 percent of this fleet is owned by the major American oil, steel, aluminum and fruit corporations. (See Department of Commerce report dated February 1962 quoted at p. 46 hereinbefore.)

The importance of this PanLib fleet to the defense of the United States and to its economic well-being can be seen from the following facts: On January 1, 1961, there were 456 vessels owned by American citizens and registered under PanLib flags, approximately two-thirds of which were owned by independent shipping owners. Of these vessels 282 were tankers and 71 were bulk-cargo ships, such as ore, coal, and bauxite carriers. The total deadweight tonnage of these vessels approximated 11 million deadweight tons. About 50 percent of these ships were built in the last 5 years and are fast, large, modern, and efficient ships.

On the other hand, the total U.S.-flag fleet in existence on January 1, 1961 (disregarding passenger vessels and reefer ships), was approximately 980, with a total deadweight tonnage of 13,500,000 deadweight tons or an average of 13,877 deadweight tons each as against 450 American-owned PanLib vessels, with a deadweight tonnage of 11 million deadweight tons, or an average of 24,311 deadweight tons each. Of the American-flag 13,500,000 tons 10 million were built prior to 1947 and only 1,900,000 tons were built after 1956. Of the PanLib 11 million deadweight tons, 5 million tons were built after 1956. This 5 million tons is represented by 115 ships, or an average ship deadweight tonnage of 43,400 tons each. The American-flag fleet's tonnage built after 1947 is only 3,500,000 deadweight tons, while the American-owned PanLib fleet built after 1947 is 7 million deadweight tons. In other words, the fleet of vessels owned by U.S. citizens and registered under PanLib flags constitutes more than half of all the tankers available to the United States, substantially all the oceangoing ore carriers, and approximately 72 percent of the modern, high-speed vessels: i.e., those built after 1956. The United States has become dependent upon oversea sources for about 20 percent of its petroleum requirements, about 40 percent of its iron ore usage, and about 80 percent of its bauxite needs for aluminum production. At the present time over 90 percent of the vital bulk imports into the United States is carried in foreign-flag shipping, only partly in American-owned foreign-flag vessels which are under "effective control" of the United States, the greatest portion is carried by foreign-flag vessels owned by non-Americans and, therefore, not subject to the proposed legislation. If you examine into petroleum imports alone for the year 1959, you will find that 65 percent of this petroleum was carried to the United States in non-American-owned foreign-flag vessels. In other words, even with the advantages to U.S. citizens of PanLib registry, approximately two-thirds of our petroleum imports went to non-American-owned vessels because of their competitive position. If this tax legislation is approved, 100 percent of these vital imports will be carried in the non-American-owned foreign-flag vessels.

As I have stated above, officials of our Government have repeatedly stressed the fact that the U.S.-flag fleet is inadequate in the light of our defense needs and that we are completely dependent in this area on the American-owned vessels of PanLib registry. It is true that many of the non-American-owned foreign-flag vessels belong to NATO countries, and it might be contended that the United States could rely on these vessels in the event of an emergency. Such a reliance, however, would not protect the United States because (*a*) the U.S. obligations are global in scope, and emergencies may arise wherein our interests are not identical with those of our European allies; (*b*) a war could develop that does not involve NATO; (*c*) our approach to trade with Cuba, Communist China, and other Iron Curtain countries is different from our allies; (*d*) in the event of an emergency our mobilization would be delayed while we waited until they allocated vessels to us.

Rear Adm. Daniel V. Gallery, U.S. Navy, retired, in a speech before the Navy League in May 1961 very concisely and clearly set forth what would happen if the United States lost its "effective control" fleet, when he said: "If we lose them, our mobilization plans are so much waste paper."

It would, therefore, appear on the basis of the facts developed above that—

(1) American citizens did not create these foreign shipping corporations as "tax havens" but created them rather to meet the competition they faced resulting from low wages and preferential tax treatment available to their competitors. This need to operate under foreign flag, free from taxes and high American operating costs, is even more necessary today than it was when the fleet was created. The non-American owners who will pay no taxes during the period of their charters, no ordinary income taxes, and probably no capital gains taxes on liquidation of their corporations or sale of their stock will be able to invest their funds in new vessels and accept a lower charter rate than the Americans, thereby forcing the Americans out of the foreign-flag business.

(2) If the provisions of the proposed tax legislation are made applicable to the independent owners of foreign-flag vessels, the "effective control" fleet of the United States will be lost because—

(A) The independent owners (who own two-thirds of this fleet), being subject to ordinary income tax at rates up to 91 percent through the attribution of corporate profits under sections 952 and 953 will be forced to sell their vessels and withdraw from the foreign-flag shipping business or face personal bankruptcy. This results from the fact that loans on vessels are usually repaid on the level debt payment method over the period of the charter, and all financing documents contain restrictive covenants prohibiting the stockholders from receiving dividends or loans and require the profits of the corporation to remain in the corporation until the loan is repaid. This section is particularly harsh on individuals who made their investments and executed their charters and financing documents in the light of the tax law then existing.

(B) The independent owners will dispose of their present fleet and will not construct any new vessels if section 1248, which taxes them on liquidation of their corporations or the sale of their stock in foreign corporations or the sale of their stock in foreign corporations at ordinary income tax rates, is enacted. In each case, because of the number of vessels owned by each owner and because of their other income not associated with the shipping business, it results in a tax up to 91 percent. None of these men would have invested the required money in the vessels that they have, nor will they so invest funds in the future, if their profits are taxed to that extent. This conclusion results because shipping is a real risk venture, financing documents require that part or all of the investments made remain in the corporation until the loan is repaid, and such new loans on new large, modern vessels are usually amortized over a period of from 15 to 20 years. The return on such a long-term investment with such risks is so minimal that Americans will cease to invest in foreign shipping. For example, the Trinity Navigation Corp. matter cited above, if you only consider the $3,700,000 invested by the stockholders and no not take into consideration the fact that the ships cost approximately $26,200,000, the return to the investors would be three-quarters of 1 percent per year.

(C) It cannot be argued that the tax legislation puts such individual owners in the same position that they would have been if they were American corporations so far as taxes are concerned. American corporations doing business in the United States compete with other corporations who pay the same tax, while the American individual owner of foreign-flag ships competes with non-Americans who pay little or no tax. American corporations have the benefit of consolidated returns, the right to offset losses in one venture against profits in another, to establish their books in the best manner allowable in order to minimize taxes and have the right to establish a corporate structure which results in the least impact of taxes. The independent owners of foreign-flag vessels will have none of these benefits and, in fact, may have been held to be bound to elections made in their foreign corporations at a time when, since there was no tax applicable to such corporations, no consideration was given to the election.

(3) The loss of the present effective control fleet and the failure to add new ships to this fleet will result in a severe blow to the interests of the United States because—

(A) The present American flag fleet is totally inadequate to meet our defense needs in almost any emergency. Therefore, the U.S. Government in its mobilization plans is completely dependent on the U.S. effective-control fleet because of their number, size, speed, and age. The mobilization plans of the Defense Department will be so much waste paper if this fleet is lost.

(B) The balance-of-payments position of the United States, about which this Government is so disturbed, will be severely worsened:

(i) The charter hire income earned by this fleet is paid by major American corporations to these American-owned PanLibHon corporations, this charter hire does not leave the United States, but rather is deposited in major U.S. financial institutions. In the example given, the charter hire paid approximated $1,200,000 per ship per year. If we average the charter hire receivable through each vessel of the independent owned effective-control fleet at only $1 million per year, the total independent owned fleet receives approximately $300 million per year in charter hire. If this fleet is sold to non-American owners, American corporations will pay this $300 million to non-Americans who will not keep it in the United States.

(ii) The American-controlled foreign corporations buy many services and supplies in the United States. For example, our group spent in the United States, for services and supplies for the foreign-flag vessels which we operate, during 1961 about $5,500,000. When one realizes that we are only one of the groups owning such vessels, it can be seen that the total figure of dollars spent in the United States by the effective-control fleet is many times this figure. If this fleet goes to foreign owners, these dollars will not be spent to acquire U.S. services and supplies.

(iii) The fact that U.S. citizens have owned these foreign-flag vessels has resulted in many corollary sales of American products that would not have occurred if non-Americans had owned this fleet. The examples given by me as to such transactions in which our group was concerned total $126 million. If you consider all the American groups involved, I am confident that the benefit to the United States is an even more substantial figure.

Secretary Dillon, in analyzing the effect of the proposed legislation on the so-called tax-haven foreign corporations (see hearings before the Committee on Finance, U.S. Senate, Apr. 2, 1962, at p. 183), set forth five reasons why, in his opinion, this legislation would not affect the balance of payments adversely in the type of corporations the administration was attempting to reach. None of these reasons are applicable to foreign corporations which own foreign-flag vessels because—

(i) These corporations maintain their bank accounts in the United States;

(ii) The dollars being paid under the charters are American dollars which remain in the United States and will only leave the United States provided these vessels are owned by non-Americans;

(iii) The flow of the dollars from the American charter to the American owner is easily ascertainable by reference to the charter;

(iv) These corporations compete on a worldwide basis with non-American corporations; and

(v) These corporations sell only to the United States the services under the charter, and these charters could not be attached to American-flag ships. They do not replace tonnage that could be under American flag but only tonnage that could be under foreign flag.

(C) Instead of an increase of revenue through this proposed tax legislation, there will be a decrease in tax revenue and an increase in Government expenditures which will probably result in heavier taxation on all American citizens and corporations in the future or a major deficit in U.S. Government's balances.

(i) If my belief that the U.S. citizens owning this foreign-flag fleet will sell to foreigners proves correct, there will be no additional tax revenue from foreign-flag shipping under this proposed legislation because the non-Americans are not subject to the tax.

(ii) Mr. Dillon, Secretary of the Treasury, estimated that the tax-haven proposals would produce $85 million a year. I do not have any knowledge what portion of this figure is expected to be derived from foreign shipping corporations. I believe, however, that most of this $85 million is expected to come from foreign corporations which have real passive income, not charter hire, and in corporations engaged in sales of their parent corporation's products. When one realizes that the purchases by our group total $5,500,000 per year on which the sellers to us pay a tax and that the sale of the $126 million in products mentioned above results also in a tax imposed on those sellers, and one further realizes that we are only one group, it would appear that the loss in taxing revenue resulting from the corollary profits of having this fleet owned by American citizens is very much greater than the portion of the $85 million which it is expected to produce under the present tax legislation.

(iii) Once this effective-control fleet is lost, it will not be long before there is a great outcry to replace this fleet because of our critical defense needs. I think it is clear to all that it is essential that if our Government does not have this fleet, it must bring into being a comparable fleet. It will cost in the form of construction subsidies alone $1 billion to replace the fleet and at least $600 million a year in operating subsidies to keep the fleet competitive with the world fleets. It probably will take at least 10 years to build this replacement fleet, leaving us virtually helpless facing a determined enemy such as Russia. This is the best picture that can be presented since, in fact, it will probably cost more than $1 billion to replace the fleet. The $1 billion figure is a figure based on the assumption that only a construction subsidy would be paid and is calculated on the differential in costs between American and foreign yards. It assumes that private American capital will be willing to invest at least the other $1 billion which represents the foreign construction cost. This is not so today because no American would invest in new shipping unless there are available long-term charters nor will any American financing institution finance such purchases. Since there are very few, if any, such charters available now except those already attached to the present existing PanLibHon fleet, and very few considered possible in the near future, the probable result is that somehow the whole $2 billion will have to be supplied by the U.S. Government. The portion of the $85 million which it is expected that the American-owned foreign-flag vessels will produce under this tax is a paltry sum compared with these consequences.

It is my understanding that the President, because of the national interest in this "effective control" fleet, has established a Cabinet-level Committee composed, among others, of the Secretary of Defense, Secretary of Commerce, and Secretary of Labor to investigate all the facts and circumstances surrounding this fleet and to recommend a national policy to be applied to this fleet. I also understand that the administration plans to recommend in 1963 a general overhaul of the Internal Revenue Code. In view of the consequences of applying this proposed legislation to the American-owned "effective control" fleet, it is respectfully requested that this fleet be exempt from the provisions of H.R. 10650.

The CHAIRMAN. Mr. Erling D. Naess, president of Naess Shipping Co., who was scheduled to testify today, has submitted the following statement in lieu of appearing:

STATEMENT BY MR. ERLING D. NAESS, PRESIDENT, NAESS SHIPPING CO., INC.

1. GENERAL

I am Erling D. Naess, U.S. citizen, born in Norway, president of Naess Shipping Co., Inc., a New York corporation, and a stockholder and director of Norness Shipping Co., Inc., a Panamanian corporation which, with its subsidiaries, owns a fleet of tankers and dry cargo bulk carriers under flags of foreign countries.

Many vessels of this fleet fly the flag of the Republic of Liberia. All of the vessels, except one which was built in 1952, were built within the past 6 years. Including new buildings on order, the total cost of the fleet is in excess of $250 million.

It has been the policy of the U.S. Government to make construction and operating differential subsidies available to a limited number of approved types of passenger and general cargo vessels operating on specific liner routes under U.S. flag. The vessels owned by the companies in which I am interested do not compete with U.S.-flag vessels, they are in no way subsidized, and they do not enjoy any of the privileges bestowed on certain U.S.-flag vessels under the so-called 50–50 legislation.

The international shipping operations conducted by my group are exposed to the most intense competition from shipowners all over the world and, particularly, from the merchant fleets of European maritime nations such as Great Britain, Norway, Greece, and others. Our participation in this industry does not constitute a flight from the United States or an escape from taxes, but an attempt to compete in international shipping under the only circumstances available to us. Considerable economies are available in conducting shipping operations under foreign flags. My group could not compete for the carriage of bulk cargoes in foreign trade unless it took advantage of these economies.

A section of our fleet is engaged in the transportation of American coal from Hampton Roads to Japan and northern Europe. It can safely be said that the American coal mines would not have been able to sell the coal to Japan, in competition with coal from other countries, unless my group had been able to quote the extremely low freight rates which govern the long-term transportation contracts entered into with prominent American coal exporters. Thus, the services rendered by my group will stimulate the American economy in a depressed area by making more jobs available for coal miners and it will help to ease the balance-of-payments problem by bringing Japanese dollars to the United States.

Another section is engaged in the transportation of American-controlled foreign crude oil to foreign markets. Also in this section, the freight rates are established in the face of the keenest possible competition from the shipowners in the European maritime countries. By joining in this competition to provide extremely efficient and low cost ocean transportation, I believe American independent operators render an important service to the American-controlled international oil industry, who, otherwise, would have to rely entirely on foreign shipowners for their tonnage requirements.

2. THE STRATEGIC AND ECONOMIC IMPORTANCE OF THE AMERICAN-CONTROLLED "FLAGS OF NECESSITY" FLEET

Under agreement with the U.S. Government, my group's Liberian-flag vessels are available to the United States in the event of a national emergency and form part of the "effective U.S.-control fleet."

Spokesmen for the U.S. Government have repeatedly reaffirmed that the "effective U.S. control fleet" is essential to the defense posture of the United States. As recently as April 18 last, the Secretary of Defense, Mr. McNamara, told the House Merchant Marine and Fisheries Committee that the Department of Defense relies on American-owned tankers and ore carriers registered under the flags of Panama and Liberia as being under the Nation's "effective control" for use in an emergency. He also confirmed that, in spite of the growing importance of airlifts, commercial cargo ships still have a vital role to play, namely, that of supporting a sustained flow of heavy equipment and mass material which cannot be moved economically by aircraft.

The February 1962 issue of the Naval Institute Proceedings contained an article by Capt. Ira Dye, who is attached to the Joint Chiefs of Staff, in which he points to another basic fact, which is often overlooked; namely, that "the need for these flags-of-convenience ships is a national as well as military need. The continued U.S. control of these new supertankers and ore carriers is highly important to the operation of the national economy, particularly during periods of emergency when the industrial tempo tends to quicken. The continued flow of vast quantities of bulk imports of oil and ores is necessary to the efficient operation of our industrial machine in peace or war."

3. THE REVENUE ACT OF 1962

American business has, during the past 15 years, been encouraged by various U.S. Government agencies, such as the Maritime Administration and the Defense Department, to build up the effective control fleet. H.R. 10650, as presently drafted, and apparently through inadvertence, threatens to destroy the "effective control fleet" upon which the Defense Department relies and which Captain Dye describes as "highly important to the operation of the national economy." There are three principal reasons for this:

First, some or all of the income earned by shipowning companies could arguably be treated as rents and might therefore be included within the definition of "foreign base company income." The House report, in describing the purpose of section 13 of the bill, states:

"Your committee, while recognizing the need to maintain active American business operations abroad on an equal competitive footing with other operating businesses in the same foreign countries, nevertheless sees 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."

Although the operation of a foreign shipping business constitutes active conduct of a trade or business, the proposed Revenue Act of 1962 appears to place it in the category of "passive" or "portfolio" type of activities which it is one of the aims of the bill to reach.

Second, the bill taxes to the U.S. shareholder earnings of a foreign corporation invested in nonqualified property. The bill defines qualified property as property located outside the United States. Since many of these vessels occasionally come into U.S. ports, they would probably not be qualified.

The effect of the two foregoing provisions would be to treat as attributed dividends in the hands of the U.S. shareholders the earnings of a foreign shipping company. Under long-term mortgage loan agreements, as well as for other reasons, the foreign shipping company is restricted from paying dividends. In most instances, as in mine, the shareholders do not have funds available from other sources to pay the taxes Therefore, the effect of this bill would be to force the owner of the stock to sell it to foreign interests.

Third, it is unrealistic to assume that the American shareholders' problem can be solved by the shipping company's repatriating its full earnings by way of dividends. Not only the restrictions imposed by the finance institutions preclude this. The foreign shipping company's prime source of capital for replacement of tonnage, as well as for expansion, is undistributed earnings. In order to remain competitive and to obtain new charters, the foreign shipping company must replace obsolescent equipment and it must expand. In this respect it is no different from the majority of American industrial undertakings.

I have been informed, and have every reason to believe, that important foreign, particularly European, shipping and financial groups are already now placing themselves in financial readiness to participate in the "kill" when, as a result of H.R. 10650, American owners of substantial holdings in foreign shipping companies will, faced with a staggering tax liability and no liquid funds with which to meet it, be forced to sell out.

In addition to the problems created by section 13 of the bill, there is another section, No. 1248, which, as presently drafted, will impose hardships which would place an American stockholder in an untenable position. Under section 1248, gain on the sale, exchange, liquidation or redemption of stock in an American-controlled foreign corporation would be taxed at ordinary income rates to the extent of the American stockholder's ratable share of the corporation's accumulated earnings and profits. This provision would reduce the rate of return on a shareholder's investment in foreign-flag shipping companies to such a low point that it would tend to force the sale of the stock of existing companies and effectively stop investment in new tonnage.

Since the U.S. Government relies upon the "effective U.S. control fleet" for its national defense, it is respectfully submitted that the bill should be amended in such a way as to permit these owners and operators not only to retain control over existing fleets but to expand these fleets.

4. STUDY COMMITTEE

The entire subject of foreign-flag shipping is presently being examined by a high level study group consisting of various members of the Cabinet. Congress may wish to defer any legislative action affecting the taxation of the foreign-flag shipping industry until the conclusions of this committee are made public.

5. CONCLUSION

I would like to express my appreciation to this committe for being afforded an opportunity to express my views. I have devoted my life to international shipping operations and am deeply concerned that Congress, in its desire to eliminate abuses and unwarranted tax preferences, shall fail to take into consideration the special features of international shipping and, in so doing, may jeopardize the continued availability to the United States of those foreign-flag vessels which are now under effective U.S. control and which have repeatedly, in the recent past, been described as a vital resource of the United States, both in the event of a national emergency and in time of peace.

I am not asking for any special tax privilege, but merely to be able to meet long-term financial obligations, keep our fleet up to date and continue to meet foreign competition on equal terms. I believe such treatment will also be in the national interest of the United States.

The CHAIRMAN. Mr. N. R. Danielian of the International Economic Policy Association has submitted the following statement for the record in lieu of his personal appearance.

(The statement referred to follows:)

STATEMENT OF THE INTERNATIONAL ECONOMIC POLICY ASSOCIATION

PART I. LEGAL ANALYSIS

CONTENTS

INTRODUCTION

The various proposals to tax U.S. shareholders on their pro rata share of the undistributed earnings of foreign corporations.
(1) The Treasury Department's April 20, 1961, proposals.
(2) The February 1, 1962, tentative decisions of the House Ways and Means Committee.
(3) Section 13 of H.R. 10650, as passed by the House of Representatives on March 29, 1962.
(4) The Treasury Department's April 2, 1962, position before the Senate Finance Committee.
Memorandum of law and tax analysis relating to proposals to tax U.S. shareholders of foreign corporations, prepared for the Committee on Finance, U.S. Senate.

SECTION A

The proposed tax treatment of foreign income of foreign subsidiaries involves invalid tax legislation because it is either (i) an extraterritorial reach for power, lacking traditional grounds of jurisdiction, or (ii) an unconstitutional attempt to tax capital, not income, despite *Eisner* v. *Macomber*.

The proposed tax will be either extraterritorial tax legislation or an unconstitutional levy on capital.

(1) By consistent reference to a harmless-sounding phrase ("The privilege of tax deferral"), the Treasury invites the charge of trying to prejudge, by a label, a crucial jurisdictional issue if, in truth, there is no "power to tax," there can be no "privilege to defer tax."

(2) Two, and only two, traditional principles of territorial jurisdiction to tax have been recognized by our Supreme Court over the years: Extraterritorial taxation is void.

(i) Three landmark Supreme Court cases on basic income tax jurisdiction.

(ii) Recent excess profits tax exemptions: They were grounded not on shifting sands of "Policy" but on the enduring rock of "No jurisdiction to tax."

(3) Both proposals appear to ignore fundamentals of jurisdiction to tax.

(4) In form the tax proposed is merely a tax on U.S. shareholders and residents with respect to their current share of undistributed profits. In reality and substance the tax is aimed at the earnings of foreign subsidiaries using American capital.

(5) The concept of a "Controlled Foreign Corporation" will not carry the jurisdictional burden assigned to it.

(i) In fact, the formula itself can give no assurance of true or effective control. Thus there may be no genuine, constructive receipt of income by established judicial standards even if the rule of more than 50 percent ownership in U.S. shareholders is met.

(ii) Not even a bare pretense of control or constructive receipt is required under the 10 percent stock ownership rule.

(6) Realistically viewed, the proposed tax, although represented as a tax on U.S. shareholders and not on foreign corporations, violates *Eisner* v. *Macomber*, 252 U.S. 189 (1920). Even Congress cannot create income or tax mere increment in value.

(i) General.

(ii) Memorandum of General Counsel of Treasury Department.

(iii) In Eisner, the basis of the decision was that the undistributed earnings of a corporation are not income of the shareholders.

(7) Foreign personal holding companies.

(8) Validity of the tax proposals under the commerce clause.

(9) Congress faced this type of problem once before in the earliest U.S. statutes taxing unreasonable accumulations of earnings.

(10) A costly and unreasonable dilemma for the taxpayer is posed by the proposed tax on foreign income, which is self-defeating.

(11) The enactment of legislation taxing shareholders on their undistributed share of the income of a foreign corporation prior to its distribution as a dividend would create a precedent for taxing shareholders of domestic corporations in a similar fashion.

SECTION B

The bill violates the spirit and purpose of our well-established tax treaty policy, inviting retaliation from more than 20 nations.

Introduction.

(1) Regardless of its form, the tax is in substance on the foreign corporation and hence is in substance "on the income of the foreign corporation."

(2) The Secretary's statement appears to assume that there is jurisdiction to impose a U.S. tax "directly" on the foreign income of foreign corporations.

(3) The likely effect of the new tax legislation on treaty countries.

(4) A severe blow at our tax treaty structure and at the "sensible accommodation" which has served well to reconcile conflicting jurisdictional claims: country of domicile versus country of source.

SECTION C

The proposals will subject foreign earnings of U.S.-owned foreign corporations to higher effective U.S. tax rates than domestic earnings, and thereby fail to achieve tax neutrality and equity.

(1) The proposals are not confined to combating tax abuses.

(2) The proposals will not assure greater equity in taxation. Each would subject undistributed foreign earnings to greater U.S. taxation than domestic earnings.

SECTION D

Section 482 of existing law provides the framework for the prevention of abuses of the U.S. taxing jurisdiction.

(1) Section 482.

(2) The bill would amend section 482.

(3) Section 6038 requires information about transactions between related persons.

(4) The bill would amend section 6038, also.

(5) More information is desired by Revenue Service to apply section 482.

(6) New legislation ought to require whatever additional information is necessary to enforce section 482, rather than embark on a new and untried road.

(7) Comments on the proposed amendment to section 482.

(8) In lieu of enacting a single fixed statutory formula of apportionment the committee should seriously consider granting the Secretary the power to prescribe regulations under section 482 which are similar to the regulations under section 863, setting forth processes or formulas of general apportionment.

SECTION E

Discussion of section 13.

(1) The same trade or business test.

(i) General.

(ii) Effect on competition with foreign competitors.

(iii) Effect on competition with American-owned foreign corpotions.

(iv) Difficulties in determining whether a trade or business is the same as that previously carried on.

(v) Effect on relations with foreign minority shareholders of controlled foreign corporations.

(2) Foreign base company sales income.

(i) When is property purchased?

(ii) When is property sold for use, consumption, or disposition outside the country?

(iii) Determination of amount of sales income will create additional administrative problems.

(3) Income from patents, copyrights, exclusive formulas, and processes substantially developed in the United States or acquired from related U.S. persons.

(4) The bill requires the U.S. shareholder to include in his income undistributed profits attributable to transactions occurring before he became a shareholder.

Conclusions.

Part I. Legal Analysis

INTRODUCTION

The Various Proposals To Tax U.S. Shareholders on Their Pro Rata Share of the Undistributed Earnings of Foreign Corporations

(1) THE TREASURY DEPARTMENT'S APRIL 20, 1961, PROPOSALS

On April 20, 1961, the President sent to the Congress of the United States a tax message containing his recommendations for Federal tax revision. This message outlined fundamental proposals relating to the taxation of foreign profits of foreign corporations in which U.S. persons have a stock interest. Later in the year the Secretary of the Treasury officially presented these proposals before the Ways and Means Committee and outlined in more detail the proposed revision to be made in the application of the U.S. tax to foreign profits of foreign corporations. The original Treasury proposals would have required each U.S. shareholder of a foreign corporation to include in gross income as a dividend, a proportionate share of his undistributed earnings. As to existing foreign corporations, the proposed measure would have taxed all U.S. shareholders of a foreign corporation in which more than 50 percent of the shares were owned by 10 or fewer U.S. shareholders. As to foreign corporations created in the future, the tax would have applied to each U.S. shareholder owning 10 percent or more of the shares, whether or not more than 50 percent of the shares were owned by U.S. shareholders. However, the Secretary recommended that the present deferment treatment be continued with respect to a foreign corporation operating in a less-developed country or countries, unless the foreign corporation could be classified as a tax-haven corporation.

(2) THE FEBRUARY 1, 1962, TENTATIVE DECISIONS OF THE HOUSE WAYS AND MEANS COMMITTEE

After holding hearings on the April 20, 1961, proposals of the Treasury, and after consideration of the subject in executive session, the Committee on Ways and Means announced, under date of February 1, 1962, that it had tentatively made the following decisions with respect to the taxation of the U.S. shareholders of controlled foreign corporations:

(*a*) Unreasonable accumulations of income by a foreign subsidiary controlled by a U.S. corporation would be considered for tax purposes as distributions by the foreign subsidiary to the U.S. corporation. Income used for "reasonable needs of the business" would not be subject to the tax. This provision would not apply in the case of investments in tangible or intangible property used in carrying on a trade or business of the taxpayer where 90 percent or more of the income is from foreign sources, in securities of a subsidiary of the foreign corporation in which it alone or with no more than four other U.S. taxpayers has an interest of 50 percent or more, or in cash and other liquid assets needed currently or reasonably expected to be needed in the business in the near future. The tax would be imposed on the shareholders and not on the corporation itself. The provision would apply in the case of foreign income reinvested in passive investments (such as stocks, bonds, royalties, interest, etc.). This provision was described by the committee as similar to the "unreasonable accumulation" tax now applying in the domestic area.

(*b*) The foreign personal holding company tax would be applied, in effect, to certain foreign base companies where five or fewer corporations or other persons hold more than 50 percent of the stock. In such cases, if less than 20 percent of the company's income is passive, there would be no application of the provision. If between 20 and 80 percent of the income is passive income, the passive income itself would be taxed. If over 80 percent of the income is passive income, all of the income would be taxed. The tax would be on the shareholders and not on the company itself. There would be an exception for reinvestments in an operating company in which the corporation, together with no more than four other U.S. taxpayers, has at least a 50-percent interest.

(*c*) Loans made by a foreign subsidiary (or a subsidiary of it) controlled by a U.S. corporation to the parent corporation (or to a subsidiary of the U.S. corporation) would be treated as dividend distributions to the extent of earnings and profits of the foreign subsidiary.

(*d*) In the case of insurance or reinsurance of U.S. risks abroad where 50 percent or more of the stock of the company doing the insuring abroad is held by U.S. corporations, citizens, or residents, the income attributable to the writing of the insurance would be taxed to the U.S. shareholders.

The tentative decisions announced by the committee under date of February 1, 1962, were modified by it on February 27, 1962.

(3) SECTION 13 OF H.R. 10650, AS PASSED BY THE HOUSE OF REPRESENTATIVES ON MARCH 29, 1962

Under date of March 12, 1962, the House Ways and Means Committee reflected its decisions on this subject in section 13 of H.R. 10650. The bill was passed by the House of Representatives on March 29, 1962.

In general, under section 13 of the bill, each U.S. person who "owns" 10 percent or more of the voting power or value of the stock of a foreign corporation, more than 50 percent of the voting power of which is owned, directly or indirectly, by any number of U.S. persons, is required to take into account for years after 1962 his pro rata share of the following types of income of the controlled foreign corporation:

(*a*) Income from insurance of U.S. risks.

(*b*) Income, actual or imputed, from patents, copyrights, exclusive formulas, and processes, which were substantially developed in the United States or acquired from any related U.S. person.

(*c*) Personal holding company type income (rents, dividends, interest, other types of royalties not included in (*b*) above, etc.) and income derived from certain sales of personal property to a related person and from sales to any person of personal property purchased from a related person, reduced by the increase in investment in a trade or business in less-developed countries. (The provisions in (*c*) apply only in the case of a controlled foreign corporation in which five or fewer U.S. persons own, actually or constructively, not more than 50 percent of the voting stock.)

(*d*) The current year's earnings of the corporation from all other sources to the extent not invested during the year or shortly thereafter in the trade or business carried on by the corporation for the preceding 5 years (or carried on continuously since December 31, 1962) or in any trade or business carried on in a less-developed country.

The proposals for current taxation of U.S. shareholders contained in section 13 of this bill are the subject of analysis and examination in this document.

(4) THE TREASURY DEPARTMENT'S APRIL 2, 1962, POSITION BEFORE THE SENATE FINANCE COMMITTEE

On April 2, 1962, Secretary of the Treasury presented his position on H.R. 10650. In his prepared statement to the Senate Finance Committee he advised as follows:

"The privilege of deferring U.S. taxes until income is repatriated as dividends should simply be eliminated for our subsidiaries in advanced industrial countries, as the President has requested. The deferral privilege should be retained, for income earned in less-developed countries, in line with our general foreign policy objectives" (p. 43).

In his prepared statement to the Senate Finance Committee, the Secretary did not indicate to what extent he was recommending the various stock ownership rules previously submitted to the House Ways and Means Committee and described under (1) above. It is clear, however, that he is recommending the same general approach previously advocated by the Treasury before the House Ways and Means Committee. As a result, the original proposals of the Treasury are also the subject of analysis and examination in this document.

Memorandum of law and tax analysis relating to proposals to tax U.S. shareholders of foreign corporations, prepared for the Committee on Finance, U.S. Senate

On behalf of the International Economic Policy Association (IEPA), this memorandum is respectfully submitted as IEPA's statement on the central legal and tax issued of the proposals now pending before the Senate Finance Committee under which U.S. shareholders would be taxed on the undistributed income of foreign corporations. One proposal is contained in section 13 of H.R. 10650 which, in general, would tax U.S. shareholders on such income unless the income is reinvested in the same trade or business, or in a trade or business carried on in a less-developed country. The other proposal, submitted by the Secretary of the Treasury to the Senate Finance Committee on April 2, 1961, would tax U.S. shareholders on all of such income unless the income was earned in a less-developed country.

Under the bill, the income of a controlled foreign corporation reinvested in a trade or business carried on by such corporation would be taxed currently to the U.S. shareholders unless the trade or business is the same or substantially the same trade or business as that carried on for the preceding 5 years, or since December 1962, or is a trade or business carried on in a less-developed country. The fact that such profits so reinvested in another trade or business are ordinary and necessary for the conduct of such business, and are not unreasonably accumulated, is immaterial under the bill.[1]

Under the proposals submitted by the Secretary to the House Ways and Means Committee in April 1961, each U.S. shareholder owning stock in a foreign corporation in a developed country in which more than 50 percent of the corporation's stock is owned by 10 or fewer U.S. persons would be subject to U.S. tax on the undistributed income of that corporation, whether or not that shareholder had more than 10 percent of the stock of the corporation. However, with respect to foreign corporations organized after the effective date of the legislation, the tax would be imposed on each U.S. shareholder owning 10 percent or more of the stock of the foreign corporation and he would be subject to tax whether or not 50 percent of the stock of the foreign corporation was owned by U.S. persons. Under the Treasury proposal, the undistributed income of such foreign corporation would be taxed to such U.S. shareholders whether or not it was reinvested in the same trade or business and was ordinary and necessary for the conduct of such business. As indicated previously, the Secretary did not advise the Senate Finance Committee to what extent these particular recommendations relating to stock ownership are still being advocated by the Treasury.

This memorandum is directed primarily to the taxation of U.S. shareholders of a foreign corporation on their pro rata share of the latter's earnings which have been reinvested by it in a trade or business and are ordinary and necessary in the conduct of such trade or business. Part I deals solely with legal and tax analysis, part II solely with economic factors.

Section A of part I emphasizes that, wholly apart from the business desirability or undesirability of the innovations of the proposals, they create massive doubts concerning the constitutional power of Congress to impose the taxes in question. Admittedly the United States lacks jurisdiction to tax the foreign income of foreign corporations as such without more. Labeling the tax as one on U.S. shareholders on their current share of the foreign undistributed profits does not change the nature of this tax—whatever it truly is. Our first task is to pierce the uncertainty which veils the exact meaning and nature of the tax as proposed.

Section B of part I emphasizes how dangerous this proposed tax may be, and how vulnerable, from the standpoint of our many tax treaties. Even if all jurisdictional and constitutional doubts could be dispelled, still the proposals to tax currently the foreign income of foreign subsidiaries—on whatever ground (including stock ownership by U.S. citizens or corporations, to the extent of the percentage of earnings attributable to such ownership)—would violate the spirit, if not the letter, of treaty obligations. Such proposals would also encourage and arguably justify charges of bad faith against this country and might finally invite damaging retaliation in kind from other countries.

Section C of part I demonstrates that the tax proposals are not limited in their application to occasions of abuse of the U.S. taxing jurisdiction but are applicable with equal force to undistributed earnings of a foreign corporation which are retained for substantial bona fide business purposes. It demonstrates that the proposals will fail to achieve their professed objectives of tax neutrality and greater equity in the U.S. taxation of foreign earnings of foreign corporations owned by U.S. shareholders, as compared to U.S. taxation of domestic earnings of U.S. corporations. Section C shows that the proposals will result in subjecting such foreign earnings to higher effective U.S. tax rates than such domestic earnings because of the many differences of which the so-called deferral is only one, in the U.S. tax treatment of such foreign earnings and such domestic earnings.

[1] Sec. 13 of the bill.

Section D of part I demonstrates that sections 482 and 6038 of existing law provide the framework for the prevention of abuses of the U.S. taxing jurisdiction and can be made more effective if Congress requires from controlling U.S. shareholders whatever information is necessary for effective enforcement of the law.

Section E to this memorandum discusses the "same trade or business" test imposed by section 13 of the bill, its effect on the ability of U.S.-owned foreign subsidiaries to compete with foreign competitors and other U.S.-owned foreign corporations, and the difficulties in determining whether a trade or business is the same as that previously carried on. Further, it discusses the effect of such a test on the relations with foreign minority shareholders of U.S.-owned foreign corporations. Section E also discusses the difficulties in determining when provisions of the bill relating to "foreign base companies sales income" may be applicable and if so, to what extent. In addition, section E discusses the inappropriateness of the rule relating to income from patents developed in the United States in the case of patents transferred to a foreign corporation pursuant to a ruling previously received from the Internal Revenue Service after the latter satisfied itself that the transaction pursuant to which the transfer was made did not have the avoidance of Federal income taxes as a principal purpose.

Section A. The Proposed Tax Treatment of Foreign Income of Foreign Subsidiaries Involves Invalid Tax Legislation Because It Is Either (i) an Extraterritorial Reach for Power, Lacking Traditional Grounds of Jurisdiction, or (ii) an Unconstitutional Attempt To Tax Capital, Not Income, Despite Eisner *v.* Macomber

THE PROPOSED TAX WILL BE EITHER EXTRATERRITORIAL TAX LEGISLATION OR AN UNCONSTITUTIONAL LEVY ON CAPITAL

Even if the tax treatment proposed were unanimously endorsed as wise from the business and trade standpoints (and we believe that the opposite is more nearly true—see part II of this memorandum), this committee, in keeping with its sound traditions, would not wish to endorse a tax program which is subject to grave jurisdictional and constitutional doubts. Section B of this part I will show that, in addition, the proposals repudiate (at least in spirit and purpose) our solemn treaty commitments with other countries.

The proposals for taxing foreign income suffer from both these vices at once.

(*1*) *By consistent reference to a harmless-sounding phrase "The privilege of tax deferral," the Treasury invites the charge of trying to prejudge, by a label, a crucial jurisdictional issue. If, in truth, there is no "power to tax," there can be no "privilege to defer tax"*

Repeatedly the Secretary speaks of unwarranted discrimination in our granting to foreign income earned abroad "the privilege" of escaping the full burden of 52-percent U.S. tax rates imposed on domestic dollars earned here.

Yet this is a privilege only if the United States has legal power, in the jurisdictional tax sense, to impose, or not to impose, its own tax rates on the foreign subsidiaries earning this foreign income. The IEPA believes, for the reasons set forth below, that the United States does not have such legal power, and that consequently it is a misnomer to refer to the failure to exercise a nonexistent legal power as a privilege accorded such foreign corporations.

(*2*) *Two, and only two, traditional principles of territorial jurisdiction to tax have been recognized by our Supreme Court over the years; extraterritorial taxation is void*

Over the past 40 years the Supreme Court has developed a coherent, workable basis for jurisdiction to tax income. This basis relates not to statutory methods of taxation, but rather to legal powers within the framework of due process: jurisdiction in the true sense.

Mostly these doctrines have been developed with reference to State statutes and the 14th amendment. To some degree they have been develope in relation to the validity of congressional taxes under the 5th and 16th amendments. Fortunately the criteria for "jurisdiction to tax" have been found by our highest court to be essentially the same.

Two basic principles have emerged: (*a*) the United States possesses and asserts jurisdiction to tax worldwide income of all its "nationals"—including therein U.S. corporations, citizens, and residents; (*b*) on the basis of "fairplay" and protection of earnings and property, the United States likewise possesses and asserts jurisdiction to tax all income "from sources within the United States"—regardless of its ownership.

(*i*) *Three landmark Supreme Court cases on basic income tax jurisdiction.*— These are *Shaffer* v. *Carter*, 252 U.S. 37 (1920); *Travis* v. *Yale & Towne Manufacturing Co.*, 252 U.S. 60 (1920); and *National Paper Co.* v. *Bowers*, 266 U.S. 373 (1924).

These historic, carefully reasoned decisions all uphold jurisdiction to tax nonresidents of the taxing State on income arising within its borders. By clear, necessary inference they deny jurisdiction to impose an income tax on nonresidents who earn no income and own no property within the State. These State and Federal rules are consistent with each and proceed together.

In *Shaffer* v. *Carter*, Justice Pitney took especial pains to observe that the limitation upon a State's jurisdiction to tax income of nonresidents was like the limitation in one of our earliest Federal income tax laws (1861) and this determination has been observed down to the present. The Court saw little, if any, difference in the meaning of "due process" for this purpose under the 14th amendment and under the 5th amendment. (Accord, the *Yale & Towne* case, supra.)

In *National Paper Co.* v. *Bowers*, the Court upheld, against a domestic corporation buying goods in this country and selling them abroad, a State income tax which was challenged for lack of due process because no such tax (allegedly discriminatory) was imposed on foreign corporations engaged in the same business. One clear, powerful sentence of the opinion has direct relevance:

"The Government * * * rightly contends that domestic corporations are required to pay a tax on their incomes from all sources, while foreign corporations are taxed only on their income from sources within the United States, because, to repeat, only that income is earned under the protection of American law."

(ii) *Recent excess profits tax exemptions: They were grounded not on shifting sands of "policy," but on the enduring rock of "no jurisdiction to tax."*— Both the excess profits tax of 1940 and the excess profits tax of 1950, in specific terms, exempted from the U.S. tax foreign corporations not having income from sources within the United States. Both grounds, in short, for validly levying on the foreign corporation, were lacking.

The Ways and Means Committee report and the Senate Finance Committee report did not suggest that they were applying "a zero tax rate" in excluding such foreign corporations from excess profits tax, but rather stated that the reason for the exemption was that the United States lacked jurisdiction utterly.

"The 30-percent gross income tax on nonresident foreign corporations is imposed rather than the ordinary corporate income tax since the jurisdiction of the United States over such corporations is limited to the sources of their income which are within the United States. *The lack of jurisdiction over the corporation itself not only precludes the imposition of a tax upon the net income of nonresident foreign corporations, but also the imposition of an excess profits tax.* Therefore, the bill follows the precedent of the World War II statute and specifically exempts such corporations." [Emphasis supplied.] (H. Rept. 3142, 81st Cong., 2d sess. (Dec. 2, 1950). See also, S. Rept. 2679, 81st Cong., 2d sess. (Dec. 18, 1950).)

There was no suggestion that the United States should here attempt to do indirectly what it could not do directly and thus try to tax foreign corporations via their US. shareholders' stock ownership to the extent of the "excessive earnings" allocable to their respective interests.

The last general attempt by Congress to tax corporations engaged in active trade or business by taxing their shareholders was the tax, under the 1918 Revenue Act, on unreasonable accumulations of earnings. (See further discussion of this point under sec. A(6) below.) Congress, because of the constitutional doctrines of *Eisner* v. *Macomber*, which was handed down in 1920, has not sought since then to tax an active trade or business corporation by taxing its shareholders.[2] It has taxed the corporation directly, as in both section 102 of the 1939 code and section 531 of the 1954 code.

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[2] There are and have been provisions which tax shareholders on undistributed income of a corporation if an appropriate election is made (Subch. S, secs. 1371–1377 is an example.) Since such provisions are elective, they are not relevant to this discussion

Nor do we know of any authority for such third type of alleged jurisdiction, i.e., to impose an income tax on a corporation engaged in the active conduct of a trade or business, even though the tax in form is imposed on the U.S. shareholders, based on their percentage ownership of undistributed earnings.

(3) Both proposals appear to ignore fundamentals of jurisdiction to tax

By seeming to ignore historic and basic tenets of income tax jurisdiction, both proposals assume that wise tax choices can be made (and later freely changed if changing times so indicate) without great concern about fundamental, historic restraints on jurisdiction to tax, as declared by our Supreme Court.

If these fundamental restraints on the taxing power can be easily abandoned and ignored, then greater freedom to tax may, indeed, be asserted, but only at the cost of sacrificing important equities, fairness, and a jurisdictional rule of "sensible accommodation" (as Assistant Secretary Surrey once called it[3]) between competing sovereign states.

Repeatedly, the President's April 20, 1961, tax message to the Congress, and the Secretary's May 3, 1961, statement to the House Ways and Means Committee, urge that their main concern is the preferential treatment of foreign investment income. The Secretary's April 2, 1962, statement to the Senate Finance Committee, continues to refer to the "privilege" of deferring U.S. taxes until income is repatriated as dividends. They oppose what they call "the privilege of deferring U.S. income tax on earnings derived through foreign subsidiaries" until such earnings are distributed as dividends. They repeat their view (stated merely as a conclusion) that this is a deferral and that it results from granting what this country could withhold: a privilege. Such a gratuitous favor to foreign investments (resulting in what they call an interest-free loan) makes possible, in their eyes, prejudicial discrimination against U.S. investment and earnings at home and hurts our balance of payments.

Sometimes this privilege of deferral is stated in terms of equalizing incentives—to invest either abroad or at home—by a neutral tax policy. Sometimes, presumably in order to bolster a sagging argument for the legal or tax foundations of deferral in general, resort is had to examples of sinister tax havens. By this means the entire privilege-of-deferral argument is lifted up and portrayed as the answer to certain tax abuses which otherwise cannot (so the Treasury argument implies) be cured.

But in the process of effecting a cure by this remedy, it is inevitable that a great loss must, in our judgment, be suffered: the loss which follows from scrapping time-tested tax concepts and abolishing what Assistant Secretary Surrey himself once described as a "sensible accommodation" of worldwide income jurisdiction over a Nation's citizens and corporations to the equally valid claims and needs of the country of source.[4]

Nor should the truth be forgotten that (*a*) the foreign subsidiary's earnings in a foreign country currently and annually bear the same tax burden (of all kinds—income tax plus turnover taxes, sales taxes, and any others) which competing companies in that country bear; and (*b*) all dividends paid to any U.S. shareholder from such earnings are, in fact, taxed in his hands at the 52-percent rate, subject to applicable tax credits.

It must be clear that regardless of economic considerations (see pt. II hereof), the United States cannot validly tax foreign corporations currently on their foreign earnings. The classic and only grounds of jurisdiction under U.S. tax law are lacking; and we know of no warrant for improvising a new, unproved tax which is ostensibly on the U.S. shareholder, but actually is on his proportionate share of the earnings, being measured by this formula. When the objective of the tax is considered (i.e., forcing current and allegedly equal U.S. income tax burdens on foreign subsidiaries) the use of stock ownership (United States) is seen to be merely a necessary jurisdictional device. It is an error, in our judgment, to claim that failure to do so is somehow a deferral of tax through granting a gratuitous privilege.

From all this it must be evident that the United States has not surrendered any jurisdiction. The United States is meanwhile asserting all the jurisdiction which our Supreme Court has said exists. When foreign earnings come home, they are fully taxed.

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[3] 56 Columbia Law Review 815 at 827 (1956).
[4] Ibid

(*4*) *In form the tax proposed is merely a tax on U.S. shareholders and residents with respect to their current share of undistributed profits. In reality and substance the tax is aimed at the earnings of foreign subsidiaries using American capital*

In form, the tax is imposed on U.S. shareholders (corporate or individual). And the tax must take this form and must be cast in this somewhat artificial way, in order to have its best chance of being judicially upheld as based on proper jurisdiction. For even the most extreme proponent of extending our tax powers would presumably not contend that the United States can properly or effectively tax the foreign income of a foreign corporation whose shareholders are not Americans and are not resident here.

But, as we have seen in (3) above, the fact of U.S. stock ownership is seized on as a means of bridging an otherwise unbridgeable gulf. The proposals, consequently, invoke the formula of a controlled foreign corporation.

(*5*) *The concept of a controlled foreign corporation will not carry the jurisdictional burden assigned to it*

Under the bill, a controlled foreign corporation is one in which any number of U.S. persons own, directly or indirectly, more than 50 percent of the voting power of its stock. Where such control exists (whether actual or not if the U.S. persons do not agree), each U.S. person owning, actually or constructively, 10 percent or more of the voting power or value of the stock, is taxed upon his pro rata share of the foreign corporation's undistributed earnings which have not been reinvested in the same trade or business or in a less developed country. Under the Treasury's April 1961 proposal, in the case of a foreign corporation created before the effective date of the legislation, a controlled foreign corporation is one in which more than 50 percent of the stock is owned by 10 or fewer U.S. shareholders. Where such control exists, each U.S. shareholder, whether or not such shareholder owns 10 percent or more of the stock, would be taxed on his pro rata share of the foreign corporations' undistributed earnings. The tax result under both proposals is exactly as if the controlled corporation had distributed such earnings as a dividend. Such a drastic, far-reaching, tax experiment, burdening all foreign subsidiaries, suggests the following comments:

(i) *In fact, the formula itself can give no assurance of true or effective control. Thus there may be no genuine, constructive receipt of income by established judicial standards even if the rule of more than 50 percent ownership in U.S. shareholders is met.*—"Control" is significant only as a means of establishing "constructive receipt" of the undistributed earnings of the corporation in the U.S. shareholders.

Apart from the widely known tax truth that constructive receipt is a doctrine "sparingly applied" and hardly to be invoked on so grand a world scale as here proposed, one proposition is nearly self-evident: No one can reasonably claim that time-tested, court-proved essentials of "constructive receipt of income" are here present. Treas. Reg. § 1.451–3, backed by solid case law, requires that a taxpayer's control of income alleged to be "constructively received" shall not be subject to "substantial limitations or restrictions" and, in the case of dividends, that such dividends must be "available for the shareholders' free and unrestricted use * * *."

Even if bare legal power to declare out all earnings as dividends may sometimes exist in the U.S. holders of 51 percent of the stock of the foreign subsidiary, such power may, on the other hand, not exist despite the percentage. Debt restrictions, article restrictions, foreign exchange limitations, laws concerning capital deficits, minority shareholder objections—all these and many other substantial roadblocks, in addition to ordinary business prudence, may preclude even the semblance of true "constructive receipt" of undistributed earnings.

(ii) *Not even a bare pretense of control or constructive receipt is required under the 10-percent stock ownership rule.*—Although a mere 10-percent shareholder could not, as such, normally have the remotest reasonable expectation of claiming control in any practical or meaningful way, under the bill he would be taxed on his pro rata share of the earnings of the foreign corporation in which he owns 10 percent of the stock if U.S. persons own more than 50 percent of the voting power of the corporation, whether or not a small cohesive group owns more than 50 percent of such voting power, and whether or not he is a member of any such cohesive group.

Under the bill, the inability of a 10-percent shareholder to actually participate in the "control" of such foreign corporation is irrelevant. Such participation by a 10-percent shareholder in "control," as the rationale of jurisdiction, is unnecessary under the bill.

Under the Treasury's April 1961 proposal, a mere 10-percent U.S. shareholder of a foreign corporation created after the effective date of the legislation would be taxed on his pro rata share of the earnings of the foreign corporation, whether or not more than 50 percent of the voting power of the corporatin was owned by U.S. shareholders and whether or not he was a member of the group which did control the corporation. In such a case, it is obvious that "control," as the rationale of jurisdiction, was thus abandoned as unnecessary. And this blunt transition was made unequivocally without even a bow to any intriguing, though untenable, hypotheses such as ignoring the corporate entity, in order to make the transition seem more plausible.

It is respectfully urged that whatever the weaknesses of the more than 50-percent rule (and they are critical), the startling weakness of the 10-percent rule are even more disturbing.

(6) *Realistically viewed, the proposed tax, although represented as a tax on U.S. shareholders and not on foreign corporations, violates* Eisner *v.* Macomber, *252 U.S. 189 (1920). Even Congress cannot create income or tax mere increment in value*

(i) *General.*—Since "constructive receipt" by any U.S. shareholder and the power in a 10-percent U.S. shareholder to participate in "control" are unnecessary under the proposals, and since the proposals cannot validly assert authority to tax the foreign income at its source ,it follows that what the proopsals seek to tax can only be the allegedly increased value of the U.S. shareholders' interest in the foreign corporations; i.e., the value which may be created by earnings left after the foreign tax (or taxes) are paid. We have seen that the only hold which this Government can assert upon the foreign corporations (prior to distribution of their earnings as dividends to American owners) is furnished by the nationality (or residence) of the owners.

But in what respect is a U.S. shareholder richer after the foreign corporation has earned its income and paid its foreign tax, so long as the earnings are not distributed as dividends? Answer: Only in the respect that the shareholder's ownership interest may have increased in value. But there has been "no realization of income" to the shareholder himself—regardless how such realization may be defined. There has been, as to the shareholder, no taxable event.

It is neither profitable nor necessary to plunge here into fruitless debate over alleged refinements and limitations of *Eisner* v. *Macomber*. Most students of taxation will readily agree with Roswell Magill that *Eisner* v. *Macomber* reminds sound law insofar as it stands for the irreducible, basic proposition that "taxable income" has an intelligible meaning; that the term "realized" also has intelligible meaning; and that "taxable income" must be "realized" in order to be subject to income tax.

On all this Justice Pitney, at the close of his famous opinion, remarked that despite the 16th amendment, Congress had no power "to levy a tax on the stockholder's share in the accumulated profits of the corporation even before division by the declaration of a dividend of any kind. * * * What is called the stockholder's share in the accumulated profits of the company is capital, not income" (p. 219 of 252 U.S.).

Eisner v. *Macomber*, viewed against the backdrop of the proposals, affords an almost spectacular demonstration of the truth of the conclusion in (6), arising from the virtual identity in principle between the proposed tax and one of the Government's main arguments in *Eisner*.

In *Eisner*, the Attorney General argued that "Stockholders have such an interest in the earnings and profits of a corporation that the same are within the power of Congress to tax as income even before they are divided. * * * Congress having the right to tax undivided profits," the issuance of certificates representing such earnings did not destroy the right.

In short, the very principle provided for in the proposals was relied on by the Government 40 years ago; but the majority of the Court said "No."

(ii) *Memorandum of General Counsel of Treasury Department.*—In a memorandum [5] dated June 12, 1961, the General Counsel of the Treasury Department

[5] Vol. 1, Hearings Before the Committee on Ways and Means on the President's 1961 Tax Recommendations, p. 313.

discussed the constitutionality of the April 1961 proposal of the Treasury Department and concluded that the legislation then proposed would be held a valid exercise by the Congress of the taxing power under the Constitution.

The General Counsel concluded that the Supreme Court would uphold the validity of the measure under the 16th amendment on either of two grounds:

"First, the Court would find that within existing precedents the taxes under the proposed bill would be imposed upon income constructively received. Secondly, if the Court follows the trend of its past decisions and the pronouncements of leading scholars in the field, it would also hold, if squarely faced with the question, that a congressional finding that an accession to wealth constitutes income, is conclusive under the 16th amendment" (p. 314).

He believes the question is whether the undistributed earnings may be held to have been constructively received and, as support for his view that the undistributed earnings may be taxed as income to the shareholders, he cites *Eder* v. *Commissioner*, 138 F. 2d 27 (2d Cir. 1943), involving the application of the foreign personal holding company provisions. He does not believe that the landmark decision in *Eisner* v. *Macomber*, 252 U.S. 189 (1920), would require a holding to the contrary and argues that that decision did not involve the question of the constructive receipt of income, but whether or not a common stock dividend constituted income even though it did not increase the value or the proportion of the common stock holdings of the taxpayer in the corporation. The Court there decided it did not. He cites the dissenting opinion in that case for support and advises that since 1920, the Court has tended to limit the *Macomber* doctrine to its particular facts. He also advises that there is a substantial body of opinion that, if faced with the same facts again, the Court would overrule its 1920 decisions.

(iii) *In Eisner, the basis of the decision was that the undistributed earnings of a corporation are not income of the shareholders.*—The IEPA does not believe the *Eisner* case can be so conveniently limited, as the General Counsel of the Treasury has attempted to do, to the single question of whether receipt of a stock dividend amounts to the receipt of income. True, the very issue of that case was whether or not a stock dividend declared out of earnings subsequent to March 1, 1913, constituted income, but the basis of the decision holding that it was not income was that the undistributed income of the corporation was not income of the shareholders. That the Court considered the latter issue is evident in the last paragraphs of its opinion where it made the following statement:

"* * * the Government nevertheless insists that the 16th amendment removed this obstacle, so that now the *Hubbard case* is *authority for the power of Congress to levy a tax on the stockholder's share in the accumulated profits of the corporation even before division* by the declaration of a dividend of any kind. Manifestly this *argument must be rejected, since the amendment applies to income only, and what is called the stockholder's share in the accumulated profits of the company is capital, not income.* As we have pointed out, a stockholder has no individual share in acumulated profits, nor in any particular part of the assets of the corporation, prior to dividend declared.

"Thus, from every point of view, we are brought irresistibly to the conclusion that neither under the 16th amendment nor otherwise has Congress power to tax without apportionment a true stock dividend made lawfully and in good faith, *or the accumulated profits behind it, as income of the stockholder.*" [Emphasis supplied.] (P. 219.)

This reasoning of the Court was in response to arguments made by the Attorney General in that case who unsuccessfully argued that the Congress had the right to tax the undistributed profits to the shareholders, that this right could not be defeated by the issue of a stock certificate to represent them, and that, since the stock certificate represented earnings of the corporation accruing subsequent to March 1, 1913, they were taxable as income. He also argued, again unsuccessfully, that the shareholder's "share of undivided profits which has, by undergoing a mere change of form become 198 shares of stock, was itself income within the power of Congress to tax" (p. 192).

Thus, the Court in the *Eisner* case considered the very issue under consideration here and decided it adversely to the Treasury Department.

In summary it appears that although the U.S. Supreme Court, in the *Eisner* case, decided the very issue adversely to the Treasury Department, the latter is suggesting that this committee nevertheless recommend such legislation to the Senate, notwithstanding the *Eisner* decision, on the theory that the Court would decide it differently the next time. The IEPA respectfully suggests that the committee should not lend itself to such an experiment in the testing of constitutional principles, especially when, as part II demonstrates, the necessity for doing so has not been established.

(7) *Foreign personal holding companies*

As authority for the Treasury's April 1961 innovations(apart from the experience of other countries) the Secretary referred to a single, isolated, and exceptional "precedent": taxation of U.S. shareholders of foreign personal holding companies on their undistributed foreign profits.

In his memorandum, the General Counsel of the Treasury asserted, in support of his conclusion that Congress has the power to tax U.S. shareholders on their share of undistributed income of a corporation, that the tax measure suggested by the Treasury Department in April 1961 is "substantially similar" to the foreign personal holding company provisions, enacted by the Congress in 1937.

Although the bill does not adopt in toto the Treasury's April 1961 proposal under which, in general, each U.S. shareholder owning 10 percent or more of the stock would have been currently taxed on his pro rata share of all the earnings of a controlled foreign corporation, whether or not reinvested in the same trade or business, the principle in issue is the same under the bill as it is under the Treasury's April 1961 proposal. (Under the bill the undistributed earnings of the corporation will be taxed to such a shareholder unless reinvested in the same trade or business or in an underdeveloped country. Thus, earnings reinvested in a different trade or business will be taxed to each such U.S. shareholder, even though such earnings so reinvested are ordinary and necessary in the conduct of such trade or business and are not unreasonably accumulated.)

The imposition of a tax under the personal holding company legislation was upheld by the Second Circuit Court in *Eder* v. *Commissioner*, 138 F. 2d 27 (2d Cir. 1943). But the *Eder* case is almost wholly irrelevant and immaterial in our present inquiry:

(*a*) Nowhere in the *Eder* decision, which involved complete control by four U.S. members of one family of a Colombian personal holding company, is there any significant discussion of "realization of income" in the *Eisner* v. *Macomber* sense, or any true coming to grips with the nature of taxable income. This is readily understandable because the Government's case was based on 100-percent control in the four family members, and an aggravated scheme for escape of taxable income from U.S. tax.[6]

(*b*) In the *Eder* case, typical passive investments were involved: interest, dividends, royalties, etc. The tax law has always looked with suspicion on incorporated pocketbooks whether at home or abroad; but for this very reason the relevance of the *Eder* case to world commerce and the carrying on of active trade or business is far from evident. It is perhaps significant that the Secretary does little except to cite the foreign personal holding company law as an alleged precedent and then leaves it.

(*c*) There is a superficial resemblance between the foreign personal holding company tax on the one hand, and the tax proposed by the Treasury and the tax provided for by the bill, but even this superficial resemblance is not complete.

This personal holding company tax is applicable only to a corporation which is a personal holding company. A personal holding company under existing law is defined to mean a company which has a minimum of 60 percent, and in some cases 50 percent, of its gross income for the year which is passive in nature, i.e., dividends, interest, and the like. (Sec. 7 of the bill, however, would reduce the percentage in the personal holding company provisions to a straight 20 percent.)

Under the Treasury Department's proposal, the undistributed income of every controlled foreign corporation in a developed country would be taxed to the U.S. shareholder, regardless of the operating character of its income, and the proportion of such income to its total gross income. Under the bill, undistributed income of every controlled foreign corporation would be taxed to the U.S. shareholder, regardless of the operating character of its income and the proportion of such income to the total gross income, unless such income is reinvested in a less-developed country or in the same trade or business.

[6] IEPA recognizes, of course, that certain flagrant tax abuses have included utilization of foreign personal holding companies.

The resemblance consists only of structure or form. The differences, however, are fundamental. They are differences in scope, content, and purpose. The existing personal holding company law (whether foreign or domestic) hits at the rich man's "incorporated pocketbook" and rests basically on a tightly knit family or individual group voting together and owning mere passive investments, and not a business. The proposals would require U.S. shareholders of every foreign corporation in a developed country, including foreign operating companies, to take into income their share of the undistributed earnings of such operating companies, unless, in the case of the bill, such earnings were reinvested in a less-developed country or in the same trade or business. The impact of the personal holding company provisions and the suggested legislation is vastly different, not "substantially similar."

It is difficult to believe that even the Treasury Department relies heavily on this supposed analogy or precedent.

To the best of our knowledge (excluding consent dividends of personal holding companies), a tax has never been imposed by the Congress on shareholders covering the undistributed profits of a corporation where such profits are reasonably needed for reinvestment in the business and where the corporation was not formed or availed of for the purpose of preventing the imposition of tax on the shareholders.[7] Hence there is no real precedent by the Congress for the legislation now requested—legislation which would extend the taxing jurisdiction of the United States to the undistributed profits of a foreign subsidiary of American corporations even though such profits are retained by the subsidiary for substantial bona fide business purposes.

(8) Validity of the tax proposals under the commerce clause

The Secretary of the Treasury, in his testimony before the Ways and Means Committee, suggested only the taxing power of Congress, and an analogy to the personal holding company provisions of the code, as the basis for the legislation originally proposed.[8] The General Counsel of the Treasury in his memorandum[9] filed with the committee, found it necessary to rely also upon the Commerce Clause of the Constitution.

The Treasury's belated discovery of an additional basis to support the constitutionality of the legislation it proposed in April 1961, and presumably the legislation in the bill also suggests either uncertainty or inconsistency or both. It suggests uncertainty if the Treasury does not really know whether it is proposing a tax law or a regulation of foreign commerce. It suggests inconsistency if in fact it believes it is proposing a tax law, but is willing to have it treated as a regulation of foreign commerce. Reduced to its simplest terms, the Treasury Department's position appears to be a proposal of an overall tax program, but a recognition of doubts about the constitutionality under the taxing power of one portion of it. Therefore, the Treasury Department seems to feel that it would be convenient to have this portion called a regulation of foreign commerce so that it will not be held unconstitutional. Such a shifting of position by a change of labels to avoid constitutional objections should not be condoned.

To support his conclusion that the proposed legislation would be upheld as a valid exercise of the power of the Congress under the Commerce Clause of the Constitution, the General Counsel advises that a major purpose of the legislation then proposed is to adjust the balance of international payments. Although this may be one of the purposes, there is substantial evidence that the primary purpose is to deal with "tax heavens," and that any regulatory effect is an incidental purpose.

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[7] In *Collector* v. *Hubbard,* 12 Wall. 1 (1870), the Court upheld an act of 1864 requiring the inclusion in an individual's income of the gains and profits of all companies in which he was a stockholder. This case was overruled by *Pollock* v. *Farmers' Loan and Trust Co.,* 158 U.S. 601, *et seq.* The overruling of Hubbard by Pollock has special force because Eisner specifically says this was the effect of Pollock.

Personal service corporation taxes of prior law also require mention as taxes on the shareholder; but in these cases capital. generally speaking, was not a major income-producing factor.

Under the prior excess profits tax acts, certain undistributed profits of a corporation were taxed to the shareholders if the corporation made the appropriate election Under the provisions of subchapter S (secs 1371–1377) of existing law, undistributed profits of a corporation are taxed to the shareholders of such corporation if the appropriate election is made by the corporation and consented to by the shareholders. Also, under the provisions (sec. 852(b)(3)(D)) of existing law, undistributed capital gains of a regulated investment company are taxed to the shareholders thereof, if the company makes the appropriate election. Since in such cases, such treatment depends upon election of at least the corporation, such provisions provide no precedent for the proposals under consideration.

[8] Vol. 1, hearings, pp. 309–310.

[9] Vol. 4, hearings, p. 313 at p. 318 *et seq.*

The Secretary of the Treasury conceded as much in his testimony before the Ways and Means Committee. This is evident from his reply to comments made by Congressman Hale Boggs.[10]

Further, the General Counsel himself concludes that the Supreme Court would uphold the validity of the proposed legislation under the *due process* clause of the Constitution "since the proposed legislation *is designed to prevent tax avoidance* by the use of the foreign corporations 'controlled' within the meaning of the proposed legislation."[11] [Emphasis supplied.]

The report of the Ways and Means Committee in respect to section 13 of the bill does not express that committee's views on whether the committee was recommending the legislation under the taxing power of Congress or under the foreign commerce power of Congress, or both. However, it did make it clear that, in its judgment, the President's primary emphasis in his message to the Congress was on removing tax deferral in the case of what have been called tax havens (p. 57). One thing seems clear. There is no express statement by the Ways and Means Committee in its report that the purpose of section 13 of the bill is even in part to alleviate the balance-of-payments situation. The committee simply indicated that it had concluded that the U.S. tax should be imposed currently on American shareholders on income which is held abroad and not used in the taxpayer's trade or business unless, in accordance with the policy annunciated by the President, it is reinvested in less developed countries.

The IEPA's analysis in part II hereof, demonstrating the minor effect of the proposed legislation on the balance of international payments, and the existence of reasonable and more effective alternatives which would more directly and effectively adjust the balance of international payments suggests that such a purpose is not the primary consideration.

The General Counsel asserts that a valid regulation of interstate or foreign commerce may be accomplished by the imposition of a tax. The only authority cited for this proposition (*Sunshine Anthracite Coal Co.* v. *Adkins*)[12] involved a revenue measure which was an incidental part of an otherwise valid regulatory scheme. It was not an attempt to regulate by imposing a tax unrelated to a comprehensive regulatory scheme. To uphold a measure as a regulation that is in form, operation and effect a "tax," it would seem only reasonable to require either that the measure be part of a regulatory scheme or that its purpose and effect be primarily regulatory in nature.

The General Counsel further assets that if a primary purpose of congressional legislation is to regulate interstate or foreign commerce, the statute is subject only to limitations on the commerce power and is not limited by restrictions on the taxing power. If this statement simply means that when Congress exercises its power under the commerce clause such exercise will be subject only to the limitations applicable to such power, it may be accurate. At least, this may be so where the primary purpose is regulatory and the revenue aspects of the statute are incidental. However, if the statement means that a statute which is a tax in form and operation will be upheld as a regulatory measure even though the primary purpose is related to the revenue aspects, the statement is not supported by the cases cited in the Treasury Department's memorandum. If the proposition means that a statute which is in form a tax measure will be upheld as a regulatory measure where it has both revenue and regulation as major purposes, it is not clear whether the statement is accurate, or not; but

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[10] The relevant colloquy is quoted below:

"Mr. BOGGS. In your statement on yesterday, you said that most Western European countries have tax rates which are at substantially the same levels as ours, and, as a matter of fact, I asked you to give some of those rates. I understand that your main interest was not so much in the corporation doing business in Western Germany, or in France, or in Great Britain, but your present interest was in the so-called tax-haven countries, and you singled out for particular reference the Swiss operations.

"If this is the case, why do you not just limit your proposal to these countries about which you are concerned?

"Secretary DILLON. One of the basic reasons for that, Mr. Boggs, is that in this particular field in Europe, the laws have been proved highly complex and it seemed to us almost impossible to write a law that would apply to every possible use of a Swiss tax haven and would not generally impinge on these other countries. That is the reason we thought it would be far simpler from the administrative point of view just to remove deferral overall, *which would have the effect of completely stopping the Swiss problem that we are primarily interested in, the tax haven problem*, and which would at the same time not have a substantial effect, as I said before, on companies operating in the majority of the larger European countries which did not make use of tax-haven things themselves." [Emphasis supplied.] (P. 322.)

[11] Vol. 1, hearings, p. 313 at p. 318.

[12] 310 U.S. 381, 60 S. Ct. 907, 84 L. Ed. 1263 (1940).

a court would probably attempt to determine which of the "major purposes" was primary.

The General Counsel asserts that the proposed legislation will be considered a regulation of commerce as long as Congress indicates its intent in this regard. The primary authority for this proposition is not conclusive since the court in the *Board of Trustees* case,[13] cited in the Treasury Department's memorandum, considered not merely the recitals of Congress but the "entire congressional plan" and was able to characterize the revenue aspects as incidental. What is more, the General Counsel's argument would appear to be self-defeating in that it proves too much. Surely, the Treasury Department cannot believe a court would feel bound by an assertion of congressional intent regardless of the form, operation, effect and other circumstances in respect of the statute in question. A more reasonable test of characterization enunciated by the very authorities cited in the Treasury memorandum is that legislative purpose must be determined by analyzing congressional declarations of intent and all other relevant circumstances. Under any such test, the proposal for the taxation of the undistributed income of American owners of foreign enterprises would probably be characterized as a revenue measure. Finally, the artificiality of the General Counsel's argument in this respect is demonstrated by his final suggestion that the regulatory purpose of the bill is expressed both in legislative findings and in an "appropriate title for the bill." It is hard not to infer that the Treasury Department is here making an eleventh-hour attempt to bolster an unconstitutional tax measure by semantics.

(9) *Congress faced this type of problem once before in the earliest U.S. statutes taxing unreasonable accumulations of earnings*

The acts of 1913, 1916, and 1918 all imposed a tax not upon the corporation, but rather upon the shareholder seeking to avoid surtax—as if the corporation were a partnership. Following *Eisner* v. *Macomber*, *supra*, in 1920, the comparable act of 1921 recognized, as shown in the committee reports, that, by reason of that decision:

"Considerable doubt exists as to the constitutionality of the existing law * * *" (Ways and Means Committee, 67th Cong., 1st sess., H. Rept. 350).

All subsequent versions of this law, seeking to penalize "unreasonable accumulations" and "shareholder intent to avoid surtax," have followed the approved pattern of the 1921 act.

In one sense, it is true that every tax upon a corporation measured by its net income is ultimately borne by its shareholders. But this economic truth does not cancel the tax truth that under our Constitution no income tax may validly be imposed on the shareholders simply because their corporation makes money, even though their stock may appreciate in value. As to the shareholder there has been no "taxable event"; he has had, at most, only unrealized gains or mere appreciation in value.

A similar determination was made by the Supreme Court in *Hoeper* v. *Tax Commission of Washington*, 284 U.S. 206. A Wisconsin statute required in part that the income of the members of a family should be added together and that the tax levied on this amount should be payable by the husband. As to a husband forced to pay tax on the combined incomes of himself and his wife, the Court held that the attempt to tax him on another's income was a denial of due process. Although a husband's relationship to his wife differs from a stockholder's relationship to his corporation, nevertheless Justice Roberts' words have relevance and significance for the issue here presented:

"We have no doubt that, because of the fundamental conceptions which underlie our system, any attempt by a State to measure the tax on one person's property or income by reference to the property or income of another is contrary to due process of law as guaranteed by the 14th amendment. That which is not in fact the taxpayer's income cannot be made such by calling it income."

(10) *A costly and unreasonable dilemma for the taxpayer is posed by the proposed tax on foreign income, which is self-defeating*

Although this indictment of the program may logically belong under part II as being primarily economic in nature, it belongs also in this part I because it bears on the legality and feasibility of the proposed legislation. Assuming that the bill were to pass, the taxpayer's dilemma would be this: If the controlled foreign corporation reinvests its earnings in a different trade or business be-

[13] *Board of Trustees* v. *United States*, 289 U.S. 48, 53 S. Ct. 509, 77 L. Ed. 1025 (1933).

cause business circumstances deem diversification a prudent course of action, rather than distribute such earnings or reinvest such earnings in an underdeveloped country or in the same trade or business, the U.S. shareholder must independently find the means to pay such tax without receiving any distribution from which to pay it. (Taxpayers would face a similar but more aggravated dilemma if the Treasury's proposals were enacted into law.)[14] This alternative is one from which all taxpayers and lawmakers, alike, recoil. It even induced Justice Pitney to say, in *Eisner* v. *Macomber*, that, "where the shareholder, unless possessed of other resources, has not the wherewithal to pay" the tax, this clearly shows that the tax is on "a capital increase and not income."

On the other hand, if, to avoid these difficulties, the majority can somehow compel the necessary distribution of such earnings (or, in the case of the bill, the reinvestment of such earnings in an underdeveloped country or in the same trade or business rather than the reinvestment in a different trade or business) then grave questions of imprudent management may force themselves to the front.

(11) The enactment of legislation taxing shareholders on their undistributed share of the income of a foreign corporation prior to its distribution as a dividend would create a precedent for taxing shareholders of domestic corporations in a similar fashion

The full tax impact of treating foreign corporations like partnerships (which is roughly the effect of the new proposals as to U.S. shareholders) cannot, of course, be forecast accurately for domestic enterprises. Such influence might, however, be great. The IEPA does not suggest that Congress would necessarily apply to shareholders of domestic corporations the same technique as that now proposed for shareholders of foreign corporations. It does suggest the obvious parallel as a relevant consideration. If so, the question at once arises whether the useful and necessary form of doing business, known as a domestic corporation, could survive so heavy a direct tax onslaught hitting all its shareholders, big and little.

The following colloquy[15] between the Secretary of the Treasury and Congressman Hale Boggs in connection with the former's testimony to the Committee on Ways and Means is of particular interest on this issue:

"Mr. BOGGS. * * * If you are able to pierce the corporate veil, or call it what you will, in the case of foreign corporations, do you have any doubt about your ability to do it in the case of domestic corporations?

"Secretary DILLON. As far as tax law is concerned, *I do not think there is anything in this proposal that we cannot do equally with domestic corporations.* Not being a lawyer on all matter of law, I do not think that I can go beyond that." [Emphasis supplied.]

There is no decision of which the IEPA is aware (outside the special field of personal holding companies) which requires that majority shareholders be treated as having declared a dividend annually of the company's earnings simply because they may have the power to do so.

If this doctrine should ever become law in the case of the average American business corporation—so that its earnings are automatically taxed to the shareholders as if they were partners—the tax cost would be so great that individuals could not in many cases afford to own the stock, and the penalty of abolishing the corporate vehicle, as a most useful business device, would fall on millions of small shareholders as well as on the larger shareholders.

SECTION B. THE BILL VIOLATES THE SPIRIT AND PURPOSE OF OUR WELL-ESTABLISHED TAX TREATY POLICY, INVITING RETALIATION FROM MORE THAN 20 NATIONS

INTRODUCTION

Before entering upon a detailed analysis below concerning the probable damaging effect of the proposed new tax legislation on our tax treaties, it is useful to summarize the basis and philosophy of such treaties. Prof. Dan Throop Smith, former deputy to the Secretary of the Treasury for tax policy, summarizes well, in two condensed paragraphs of his new book "Federal Tax Reform," the purpose and effect of tax treaties:

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[14] In exhibit III to his Apr. 2 statement to the Senate Finance Committee the Secretary recognized that in some cases the parent firm "may choose" to pay any additional taxes due, "in which case there will be no effect on the foreign subsidiary's competitive position at all" (exhibit III, p. 25).

[15] Vol. 1, hearings, p. 322.

"The provisions of tax treaties are an important part of our total law on the taxation of foreign income. The treaties establish common rules on the allocation of income. Through treaties the concept of a permanent establishment has been developed with provisions that each country will tax a foreign company only if it maintains a permanent establishment in the country. This permits casual and exploratory commercial contacts in another country without being subject to its tax jurisdiction. Under treaties each country usually agrees to allow the income taxes paid in the other country as a credit against its own taxes, a right which we give by statute as well.

"Treaties also contain reciprocal provisions by which the countries concerned agree to waive their rights to tax income which they would tax under their statutes. Interest, royalties, and the income of trade apprentices, students, professors, and professional people who are in a country for limited periods may all be made exempt by treaty from taxation in the country of its source, that is, where it is earned. If the two countries have about the same tax rates, this does not necessarily give any net tax reduction to the recipient of the income. The country in which the income is received or of which the recipient is a citizen will usually tax it anyway. Since it is not taxed in the source country, there will be no offsetting foreign tax to apply the domestic tax in the country of destination. Taxation is shifted from the source country to the country of destination. Where income flows are substantially the same in both directions, total revenues in each country are substantially unchanged. The principal effect is to relieve taxpayers of the annoyance of having to pay taxes in two countries. International transactions and movement of people are encouraged by removing tax annoyances even though tax burdens are not reduced" (pp. 273–274).

In the Secretary's "Detailed Explanation of the President's Recommendation" (p. 52) (submitted to the Ways and Means Committee) under the heading "Method of Taxation" appears a brief reference to the probable relationship between the President's proposed tax program and our existing tax treaty obligations. The Secretary says:

"This method of taxation would eliminate possible conflicts with U.S. treaty obligations which might occur if tax were imposed directly on the income of foreign corporations." [16]

Implicit in this statement are, we respectfully submit, three major misconceptions which require frank description and exposure.

(1) Regardless of its form, the tax is in substance on the foreign corporation and hence is in substance "on the income of the foreign corporation"

We will not repeat here those reasons set out in part I, section A, which, in our judgment, establish that the President's proposal, in seeking to equalize tax incentives for foreign and domestic investments, intends to tax, and in economic reality does tax, foreign corporations and so strikes directly at their foreign income.[17]

We venture to suggest that it is the substance, not the form, of the proposed tax that is significant from the standpoint of its effect on other countries, on our trade and tax relations with those countries, and on our treaty obligations.

What will the bill and the Treasury's proposals do? What is the economic impact of each? Will each force companies to pay out "commercial and industrial profits" which otherwise would in whole or in part be reinvested abroad? Will the effective U.S. tax rate (adjusted for all necessary differences in defining "taxable income") exceed the effective tax rate of the country of origin? If so, will not the country of origin, relying upon the "permanent establishment" test of jurisdiction to tax earnings attributable thereto, raise its own taxes so that it and not the United States will derive he maximum benefits? And may it not also impose new taxes on U.S. subsidiaries owned or controlled by its own corporations or citizens, following our own pattern and example?

These are the questions of basic import. They are not answered, nor are "possible conflicts" avoided, by form. We recognize that the United States, by entering into tax treaties (mainly to eliminate double taxation) does not thereby automatically surrender any jurisdiction over its own citizens or corporations. But, in consenting not to tax certain kinds of income earned by,

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[16] In his Apr. 2, 1962, statement to the Senate Finance Committee, the Secretary adhered to this position. He there said, "None of our income tax treaties are affected by any section of the bill" (p. 54).

[17] We have seen that the only conceivable alternative is a prohibited levy on capital appreciation without any realization of gain by the shareholder or any taxable event to him. The Treasury has admittedly seized the only plausible form by phrasing the levy in terms of an assessment on our citizens or corporations.

and attributable to, enterprises of the other contracting country—in consideration of similar and mutual forbearance by such other country—the United States has, in fact, agreed, not to levy taxes on such enterprises by unilateral action and except in accordance with treaty obligations.

The income tax treaties generally provide that an enterprise of the other contracting state shall not be subject to U.S. tax on its industrial and commercial profits unless it has a permanent establishment within the United States. Each of the conventions was negotiated with knowledge by each of the contracting states of the other's method of taxation. Hence each of the other contracting states knew that the United States did not tax U.S. shareholders on the undistributed profits of a foreign corporation. Although, generally speaking conventions, in one way or another, reserve to the United States the power to tax its citizens, residents, and corporations as if there were no convention, it is difficult to believe that the other contracting states contemplated that, in spite of the exemption granted to an enterprise with respect to its industrial and commercial profits, the United States was completely free to impose its tax on those same industrial and commercial profits prior to their distribution by the enterprise if it did so by imposing the tax on the U.S. shareholders of the enterprise of the other contracting state. Consequently in these conventions the IEPA believes that the proposed legislation would violate the spirit, if not the letter, of the convention.

There is no doubt that each of the parties to the various conventions was fully aware that in some cases an enterprise of one of the contracting states might be a subsidiary of an enterprise of the other contracting state. Each of the conventions contains a provision providing, in general, that where an enterprise of one of the contracting states, by reason of its participation in the management or financial structure of an enterprise of the other contracting state, 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, any profits which would normally have accrued to one of the enterprises but by reason of those conditions have not so accrued may be included in the profits of such enterprise and taxed accordingly. Under these circumstances it cannot be said that the provisions granting exemption to an enterprise of one of the contracting states on its industrial and commercial profits were not intended to be applicable to an enterprise when it was a subsidiary of an enterprise of the other contracting state.

Although the income tax treaties generally provide that an enterprise of the other contracting state shall not be subject to U.S. tax on its industrial and commercial profits unless it has a permanent establishment within the United States, article III of the income tax treaty with New Zealand provides that:

"The *industrial or commercial* profits of a New Zealand enterprise shall not be subject to a U.S. tax unless the enterprise is engaged in trade or business in the United States through a permanent establishment situated therein. * * *" [Emphasis supplied.]

In this case, the convention literally prohibits the imposition of a U.S. tax on the "industrial and commercial profits of a New Zealand enterprise" which has no permanent establishment in the United States. In this convention, there is no express provision reserving to the United States the power to impose its taxes on its citizens, residents, or corporations as if there were no convention. Consequently, it appears that under this convention the industrial and commercial profits of a New Zealand enterprise are granted exemption from U.S. taxation so long as the enterprise has no permanent establishment within the United States, and such profits are unrepatriated to the U.S. shareholders, i.e., still remain as profits of the enterprise. In this case, it appears that the proposed legislation violates not merely the spirit, but also the letter of the convention. Hence, the Secretary's categorical assertion that none of the income tax treaties are affected by the bill seems unduly optimistic.

In recognizing that certain of the provisions of the bill may contravene provisions of existing income tax treaties the House Ways and Means Committee was much more realistic than the Secretary. In the interest of forestalling any possible litigation, the House Ways and Means Committee desired to make it clear that section 7852(d) is not to apply to any provision contained in the bill. The latter section provides that no provision of the Internal Revenue Code is to apply where its application would be contrary to any treaty obligation of the United States in effect on the date of enactment of the Internal Revenue Code. The committee said that "if any provision of this bill should contravene any existing tax treaty then the new statutory law is intended to have precedence over the prior treaty obligation"[18] (p. 96).

(2) The Secretary's statement appears to assume that there is jurisdiction to impose a U.S. tax "directly" on the foreign income of foreign corporations[19]

Here too, there is little point in repeating the precedents, the history, and the sum total of legal considerations which in part I, section A summarize the aggregate of forceful reason which indicate the error of this assumed jurisdiction. No doubt few really important propositions in constitutional law are clear and certain in the same sense that 2 plus 2 equals 4, and it is true that distinguished tax scholars have differed in this very area.

Nevertheless, stating the matter in its most conservative aspect and granting to the administration all the freedom one can in good conscience summon, we believe that a grave doubt, a substantial, persistent, unanswerable doubt, exists concerning the legal power of America to impose a tax "directly on the income of foreign corporations" or, to state the issue in slightly more approved style, "directly on the foreign corporation" in respect of its income. Our conviction rests upon the cumulative force of the several major constitutional and extraterritorial sanctions analyzed in part I, section A.

We believe, finally, that this committee, with its traditional respect for the Constitution and for clearly valid tax legislation, should not recommend tax legislation so poorly supported from the standpoint of probable legality.

(3) The likely effect of the new tax legislation on treaty countries

Although this area involves a slight repetition from a different vantage point of certain aspects covered in (1) section B above, it could well be that foreign country opposition to the President's proposal could be decisive. For this reason, we turn again to the U.S. treaty structure and to the probable consequences of any unilateral increase of our tax rates on foreign enterprises now enjoying supposed protection.

In general, the existing 21 treaties contain a provision under which each of the contracting states grants exemption to an enterprise of the other contracting state with respect to the "industrial and commercial profits" (business income) of the enterprise unless it has a permanent establishment within the former contracting state. Under these treaties the United States has in effect agreed not to impose its income taxes on the enterprise of the other contracting state with respect to industrial and commercial profits unless such enterprise has a permanent establishment in the United States.

The additional income subject to tax by reason of the proposed legislation is, as we have seen, the undistributed profits of the foreign subsidiary. And this is true even though technically the undistributed profits of the foreign subsidiary may serve only as the yardstick for measuring additional income to be taxed to the American parent.

Nevertheless, the legislation is designed to encourage the distribution of the current year's profits of the foreign subsidiary to the American parent, upon penalty of having the American parent pay a tax on profits it has not received if the distribution is not made. (Unless the subsidiary's profits are, in fact, distributed, the legislation could hardly alleviate any adverse balance of payments.) To the extent, then, that the legislation is successful, and distributions of profits necessary for use in the subsidiary's business are made, the burden may and, indeed, must be viewed as a burden upon the foreign subsidiary which has parted with these profits.[20]

If the foreign subsidiary is thus encouraged (really required) to distribute its current year's profits without regard to business necessities or wise planning and if, as a result, the ultimate burden is fairly viewed as being on the foreign

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[18] In his Apr. 2, 1962, statement to the Senate Finance Committee, the Secretary said the House Ways and Means Committee inserted sec. 21 in the bill "to forestall useless litigation," but advised that the Treasury had "no doubts" about the outcome of such litigation, and since sec. 21 "may give the impression that we are overriding our treaty obligations" recommended that it would be desirable to dispel that impression by eliminating sec. 21 "to make it clear that we are honoring our treaty obligations" (p. 54).

[19] Of course, there can be no question of U.S. power to tax foreign corporations on their income arising from sources in this country. For this reason, the statement in (2) above is made slightly more explicit than Secretary Dillon's own words which, however, relate to foreign income of foreign corporations.

[20] Any burden on a subsidiary is naturally also a burden on its parent. But we are not here playing law school games: we are asking deadly earnest questions. And the answer to this question is that the new tax will probably be viewed as a breach (in spirit if not in letter) of our treaty obligations.

subsidiary (which may have derived its profits entirely from foreign sources), other treaty nations may be quick to say that the United States is unfairly seeking to tax by unilateral action the foreign subsidiary on its foreign profits. If events are so viewed by foreign governments with whom we have tax treaties, serious repercussions are possible.

(*4*) *A severe blow at our tax treaty structure and at the "sensible accommodation" which has served well to reconcile conflicting jurisdictional claims: Country of domicile versus country of source*

(i) It is generally agreed that, although our first tax convention was not finally executed until 1932, and became effective in 1935, still the accomplishments in negotiating treaties since that date, principally, but not entirely, with countries of Western Europe, have marked a vital stride forward in our trade relations with those other countries.

The U.S. statutory foreign tax credit and the provisions of mutually agreeable tax treaties are the two indispensable pillars of our tax structure from the standpoint of avoiding, or reducing, double taxation (see e.g., Magill, *13 Tax Law Review*, p. 127, supra, on the vital importance of tax treaties "as completely complementary to the foreign tax credit.")

(ii) As Assistant Secretary Surry and many others have pointed out, an inevitable clash exists between (1) assertion of unlimited jurisdiction to tax worldwide income based on domicile or citizenship or state of incorporation and (2) assertion of equally unlimited territorial jurisdiction based on protection of the business and earnings by the country of source or origin to the extent of such protection. This clash, unless resolved by agreement, can produce crippling and almost confiscatory doub'e taxation, aggravated by the multiplicity of different kinds of taxes (largely excise taxes) in other countries which do not qualify as a credit against our own income tax and often constituting a higher percentage of the total tax burden in that country than in the United States.

We believe that Assistant Secretary Surrey was right in endorsing our tax laws (including tax treaties) as a "sensible accommodation" of the two kinds of jurisdiction, supplementing the highly important tax credit. We deprecate the assault which, in our view, the Treasury Department now seems to be making on this wise arrangement.

SECTION C. THE PROPOSALS WILL SUBJECT FOREIGN EARNINGS OF U.S.-OWNED FOREIGN CORPORATIONS TO HIGHER EFFECTIVE U.S. TAX RATES THAN DOMESTIC EARNINGS, AND THEREBY FAIL TO ACHIEVE NEUTRALITY AND EQUITY

(*1*) *The proposals are not confined to combating tax abuses*

The IEPA does not condone any abuse under the present jurisdictional rules where profits of a foreign corporation controlled by American stockholders have been accumulated and retained abroad for no substantial bona fide business purpose, but rather are retained principally to avoid U.S. tax on dividends received from those profits by American shareholders. Nor does it condone any artificial arrangements between an American parent and its foreign subsidiary resulting in any arbitrary diversion of profits from the America parent to its foreign subsidiary.

However, neither the Treasury proposals nor section 13 of the bill is limited to occasions of abuse. Neither is limited to U.S. shareholders of foreign subsidiaries located abroad "largely for tax reasons," nor to the taxation of the U.S. parent on the profits which remain undistributed "largely for tax reasons." The proposals make no such distinctions. They are broad in their scope. Under the Treasury proposals, undistributed earnings of a contro'led foreign corporation would be taxed to its sharehlders, irrespective of the proved existence of substantial bona fide business reasons for locating abroad and for reinvesting such profits abroad. Under the bill, such earnings would be taxed to the shareholders under such circumstances, unless, in general, the earnings were reinvested in an underdeveloped country or in the same trade or business.

Among the reasons given for the proposed tax legislation is said to be a desire to achieve "greater equity." Would this objective. in fact, be achieved? Except in the case mentioned earlier with respect to foreign personal holding companies and in the cases mentioned where the shareholders or the corporation agree to such taxation, the United States does not now tax American shareholders on the undistributed profits of any corporation, domestic or foreign.

(2) *The proposals will not assure greater equity in taxation. Each would subject undistributed foreign earnings to greater U.S. taxation than domestic earnings*

The President's April 20, 1961, message to the Congress stated that "the desire to achieve greater equity in taxation," is one of the reasons compelling a critical examination of the treatment of foreign earnings of foreign corporations in which Americans are shareholders. It also stated that the current taxation of U.S. shareholders on their share of the undistributed earnings of foreign corporations "would subject the income from such business activities to *essentially the same tax rates* as business activities conducted in the United States." [Emphasis supplied.] Assurance of "tax neutrality between operations here and in other highly industrialized countries" is also referred to by the Secretary in his statement to the Senate Finance Committee (p. 51).

Both the bill and the Treasury proposals will fail to achieve these objectives for the following reasons:

(*i*) In taxing U.S. shareholders on undistributed earnings of a foreign corporation, the proposals approach the treatment required for partners in a partnership under the present U.S. tax laws. The similarity of this approach to the treatment of partners in a partnership stops when current losses rather than current earnings are present. Though partners are also able to take into account their appropriate share of the partnership's current losses, as well as its current earnings, neither proposal permits U.S. shareholders of foreign corporations to take into account their proportionate share of the foreign corporation's current losses. In this respect then each proposal resembles a one-way street.

(*ii*) Under existing law, a variety of other provisions exist which decrease the impact of the tax burden on income. Under the proposals such provisions will not be available in determining the amount of undistributed earnings subject to tax. Unless such provisions are made available, there can be no similarity in the burden of tax on undistributed earnings imposed on U.S. shareholders of controlled foreign corporations. The provisions referred to include the following:

(*a*) Provisions which allow a U.S. taxpayer to average his income, roughly speaking, over a period of some 9 years. This follows from the provisions allowing net operating losses to be carried back a period of 3 years and forward a period of 5 years. (In its January 31, 1962, press release, the Treasury recognized the inequity of not allowing the carryovers of net operating losses. On January 31, 1962, the Treasury announced a modification of its July draft dealing expressly with so-called tax-haven transactions. That modification would have allowed carryovers and carrybacks of losses from non-tax-haven transactions. Having thus recognized the inequity of not allowing carryovers of net operating losses, it seems apparent that the present proposals could not provide for equality of tax treatment without adequate provisions allowing carryovers of net operating losses.)

(*b*) Provisions which grant elections to U.S. taxpayers to treat as deductible expenses certain items which otherwise must be capitalized.

(*c*) Provisions which allow U.S. taxpayers to spread the amount of gain realized in certain transactions over a number of years. (The installment sale provisions are an illustration.)

(iii) The proposals would not only tax U.S. shareholders on income which they have not received, they would also change the character of the undistributed income. For example, capital gains realized by a controlled foreign corporation on the sale of its property would be taxed as ordinary income to the U.S. shareholders. Exempt life insurance proceeds received by the controlled foreign corporation on the death of one of its officers augment the earnings of the controlled foreign corporation, and as such, will have to be taken into income by the U.S. shareholders of such corporation.

(iv) The proposals to require a U.S. shareholder to include in his income undistributed earnings of a foreign corporation in which such person has an interest represent a major departure from the past to the extent it requires shareholders to include in income undistributed earnings, attributable to substantial bona fide business transactions, which are retained for substantial bona fide business reasons. U.S. shareholders of foreign corporations are singled out for this treatment. Foreign exchange prohibitions, foreign law prohibitions imposed for the protection of minority shareholders and load restrictions imposed for creditors provide no shield against the thrust of the legislation in this respect. Attention is again called to the Treasury Department's June 1961 memorandum[21] where the Treasury Department briefly discussed the impact of exchange controls. The Treasury Department there said the following:[22]

"Under existing regulations, a taxpayer who cannot convert foreign source income into dollars is not obliged to pay tax currently on that income. He may defer the tax until such time as his profits can be converted into dollars. *This provision could also be applied to the income that would be taxed under the Treasury's proposal.* Hence, when a foreign corporation cannot remit profits because of exchange controls, the U.S. shareholders would not be obliged to pay tax currently." [Emphasis supplied.]

This comment by the Treasury Department was made with reference to its original proposal for legislation. It is a recognition of the inequity of imposing a tax on income of taxpayers realized in foreign currency which cannot be converted into dollars. If this is so, the same principle should certainly apply to defer imposition of tax on earnings, attributable to substantial bona fide business transactions, which cannot be distributed for reasons other than foreign exchange controls.

Unless U.S. shareholders of controlled foreign corporations are given the privilege of such provisions for this particular purpose, the U.S. shareholders of controlled foreign corporations would suffer substantial disadvantages. If the principle of the proposed legislation is greater equity and equality of treatment. the proposed legislation will fall far short of its goal.

In defense of the legislation it proposed in April 1961 the Treasury urged that since income taxes paid abroad (or taxes paid "in lieu" thereof) are properly a credit against U.S. income tax, the net effect is to subject the income from such business activities to "essentially the same tax rates" as business activities conducted in the United States.

But this optimistic equality may not occur. If American corporations are to be taxed each year on their current share of the undistributed profits realized in that year by such subsidiaries, the aggregate income from the parent's total business activities may well be subject to considerably higher effective U.S. tax rates than income from comparable business activities conducted solely in the United States. This follows from the many differences in tax treatment of the profits earned by an American subsidiary and the profits earned by a foreign subsidiary of the U.S. parent, as indicated above. "Deferral" of tax, the subject of the proposed legislation, is only one of these differences, though it appears to have assumed decisive and perhaps undue emphasis in Treasury thinking.

But the other differences would remain—differences which work to the disadvantage of an American parent of a foreign subsidiary in relation to an American parent of a domestic subsidiary. And unless the proposals take into account all the major differences in tax treatment, they could not achieve the goal of tax "neutrality" between a dollar of profit earned outside the United States by a foreign subsidiary and a dollar of profit earned here by a domestic subsidiary.

Our purpose in stressing these other differences is to call to the attention of the committee the fact that unless they also are taken into account, the singling out of only the "deferral distinction" will not necessarily achieve "greater equity" or neutrality.

The existence of these inequalities raises a substantial doubt: Does the Treasury want to equalize incentives, or does it now want actually to penalize foreign investments in the economically advanced areas such as Western Europe? (Again reference is made to part II for a more thorough review of these considerations.)

(Not to be overlooked in this connection are the complexities of "matching" U.S. income concepts with foreign income concepts for the purpose of determining proper foreign net earnings available to minority foreign shareholders. The complexities of such matching could prove an administrative and informational task of frightening proportions, as well as a source of fierce irritations.)

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[21] Vol. 4, hearings, p. 3522.
[22] Ibid , p. 3531.

SECTION D. SECTION 482 OF EXISTING LAW PROVIDES THE FRAMEWORK FOR THE PREVENTION OF ABUSES OF THE U.S. TAXING JURISDICTION

(1) *Section 482*

The IEPA recognizes that abuses exist under present law under which income which has been earned or generated in the United States is being arbitrarily diverted from the United States to controlled foreign corporations. It believes that such abuses should be ended. Transactions between related corporations provide an environment in which abuse is possible simply because of the absence of arm's-length dealings between the parties. In recognition of this possibility, Congress many years ago enacted provisions dealing with the problem. The present provisions, section 482, provide that in any case of two or more organizations, trades or businesses owned or controlled, directly or indirectly, by the same interests (whether or not incorporated, and whether or not organized in the United States), the Secretary or his delegate may distribute, apportion or allocate gross income, deductions, credit 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 to clearly reflect the income of any such organization, trade or business.

The provisions of section 482 provide the framework within which the Treasury Department can prevent evasion of taxes on income assignable to an entity over which the U.S. Government has legitimate taxing authority, and require that the income of any such organization, trade or business be clearly reflected for taxing purposes.

(2) *The bill would amend section 482*

Although section 482 gives the Secretary the necessary authority to allocate income between a domestic parent and its foreign subsidiary, the House Ways and Means Committee concluded that, in practice, the difficulties in determining a fair price under this provision severely limit the usefulness of this power, especially where there are thousands of different transactions engaged in between a domestic company and its foreign subsidiary.

Because of such difficulty, section 6 of the bill would amend section 482 to authorize the Commissioner to allocate income, in the case of sales or purchases between a U.S. corporation and its controlled foreign subsidiary, on the basis of the proportion of the assets, compensation of the officers and employees, and advertising, selling, and sales promotion expenses attributable to the United States and attributable to the foreign country or countries involved. The proposed amendment will enable the Commissioner to make an allocation of the taxable income of the group involved, to the extent it is attributable to the sales in question, whereas in the past under the existing section 482 he has attempted only to determine the fair market price of the goods in question and build up from this to the taxable income—a process which the House Ways and Means Committee believed to be much more difficult and requiring more detailed computations than the allocation rule permitted by this bill. The proposed allocation rule would apply only to sales of tangible property within a group where one of the organizations is domestic and another is foreign (however, there may be more than one domestic or more than one foreign organization involved), if the organizations are owned or controlled directly or indirectly by the same interests. Under the general allocation rule provided by the bill the Secretary or his delegate is to allocate the income between the U.S. organization and the foreign organization on the basis of the proportion of the assets, the compensation of officers and employees and the advertising, selling, and sales promotion expenses of the group which on one hand, are not attributable to the United States, and which on the other hand, are attributable to the United States. For this purpose, only those assets, that compensation, and those sales, etc., expenses which are attributable to the property so sold or purchased are to be taken into account.

Under the bill, the allocation need not be based upon the above-mentioned factors alone. The provision specifically authorizes the inclusion of other factors such as special risks, if any, of the market in which the product is sold. In addition, if the taxpayer and the Commissioner can work out some other mutually agreeable method of allocating income, this alternative method is to be used instead of the rule referred to above.

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Generally, the value of the assets to be taken into account in the allocation method is to be the adjusted basis of these assets in the hands of the taxpayer. The assets to be included in this allocation formula are real property and tangible personal property except inventory and stock in trade. In addition real property and tangible personal property which are rented are to be taken into account for this purpose.

The allocation method described above is not to apply to any sale where the taxpayer can establish an arm's-length price. An arm's-length price for this purpose can be established under either of two procedures. First, the taxpayer can determine the arm's-length price by establishing the price at which similar or comparable property is sold in the same general marketing areas to unrelated persons either by the taxpayer or by third parties, if the conditions of sale are similar. Second, if the taxpayer cannot determine such a price, nevertheless he may still establish an arm's-length price by taking the price at which similar or comparable property is sold in either the same or other marketing areas where the marketing conditions or quantities sold may be different. In such cases such a price can be used, but only after adjustment is made for the material differences in area, quantity, or in marketing conditions (including custom duties and transportation costs) and in any other relevant factors. The adjustments, however, must be determinable.

The bill further provides that the Treasury is, by regulations, to set forth procedures which are similar in principle to those specified above which are to be applied where one of the organizations in the group receives a sales commission, rather than actually receiving title to goods and then selling them.

The bill also provides in the case of "sham" or "paper" corporations that no amount is to be allocated to a foreign corporation under this formula if its assets, personnel, and office and other facilities outside of the United States are grossly inadequate to provide for its activities outside of the United States.

In addition, the bill provides that the Commissioner may require the taxpayer to furnish information which may be "reasonably supplied" to the extent the information is needed to apply the allocation rule referred to above which makes use of assets, compensation, and selling expenses. Failure to supply this information can lead to the Secretary or his delegate allocating all of the income to the United States.

(3) *Section 6038 requires information about transactions between related persons*

In 1960 Congress enacted new provisions requiring domestic corporations to furnish certain information with respect to any foreign corporation which they control and with respect to any foreign subsidiary of any such foreign corporation. The information required includes information about transactions between the foreign corporation or foreign subsidiary and the following:

(i) Any foreign corporation controlled by the domestic corporation;

(ii) Any foreign subsidiary of a foreign corporation controlled by the domestic corporation; and

(iii) The domestic corporation or any shareholder of the domestic corporation owning at the time the transaction takes place 10 percent or more of the value of any class of stock outstanding of the domestic corporation.

Thus the provisions of section 6038 already require domestic corporations controlling foreign corporations to file such information as the Secretary or his delegate may prescribe by regulations relating to transactions with certain related persons. The year 1961 was the first year for which such information was required. The Congress in 1960 also amended the provisions of section 6046 requiring more information with respect to the creation, organization, or reorganization of any foreign corporation.

The Treasury Department has not even given the new provisions an opportunity to be tested to see whether they would go a long way in providing it with the factual information it needs to apply section 482.

(4) *The bill would amend section 6038 also*

In section 20 of the bill, the House Ways and Means Committee made further amendments to section 6038 of existing law. In general, the amendments broaden the scope of existing section 6038 to make it more effective.

(5) *More information is desired by revenue service to apply section 482*

In Commissioner Caplin's June 26, 1961, memorandum [23] submitted to the House Committee on Ways and Means, the Commissioner suggests that while much useful information will be obtained under the provisions of the new section 6038, it will still not be adequate for a number of reasons and that the present—

"* * * Internal Revenue Code does not provide the Service with the source data it really needs to effectively develop a sound enforcement program in the international area" (p. 3546).

In the same memorandum, the Commissioner states the following with respect to section 482:

"The *most difficult problem in applying the provisions* of code section 482 in an examination *involving foreign entities is that of obtaining factual and useful information relating to the foreign operations and activities.* This requires a high degree of cooperation on the part of the domestic taxpayer which is usually not received. The problem becomes more acute if the foreign subsidiary maintains its records in the foreign country" (p. 3547). [Emphasis supplied.]

He further states:

"Since we can ordinarily examine only one side of the case when foreign affiliates are involved, we are severely limited in our chances of adequately developing all of the facts necessary to prevent diversion of income to a foreign entity" (pp. 3548 and 3549).

(6) *New legislation ought to require whatever additional information is necessary to enforce section 482, rather than embark on a new and untried road*

If the principal stumbling block in applying the provisions of section 482 is that of obtaining factual and useful information relating to foreign operations and activities, as the Commissioner advises, the thrust of the new legislation ought to be directed toward providing the Revenue Service with the information it needs to effectively apply the provisions of section 482, rather than to embark on the new and untried method of taxation of such far-reaching consequences proposed by section 13 of the bill and by the Secretary. If the new information provisions, sections 6038 and 6046, enacted in 1960, do not provide the Revenue Service with adequate information for effective enforcement of the provisions of section 482, consideration should be given to amending those sections in whatever manner is necessary to provide the Revenue Service with the information it needs and to provide more effective sanctions, if more are necessary, than those presently provided for under the code for failure to file the information required. In recognition of this problem section 20 of the bill would make certain amendments to broaden the scope of sections 6038 and 6046 to make them more effective.

The House Ways and Means Committee recognized that the Secretary has the power under existing section 482 to allocate income between a domestic parent and its foreign subsidiary, although it believed that the difficulties in determining a fair price under this provision severely limited the usefulness of this power. The IEPA believes that if adequate information with respect to intercompany transactions was required to be furnished to the Revenue Service, under penalty of effective sanctions, it then would be in the same position to determine the application of section 482 to foreign operations as it presently is with respect to transactions between related domestic companies. The IEPA respectfully suggests that the Congress should adopt such an approach in curbing the abuses which have arisen out of non-arm's-length transactions between related parties, at least one of which is a foreign corporation, rather than to penalize all U.S. shareholders owning interests in foreign corporations because some have been guilty of abuse. Congress should improve existing machinery to make it more effective rather than experiment with untried theories.

[23] Vol. 4, hearings before the Committee on Ways and Means on the President's 1961 tax recommendations, p. 3545.

(7) *Comments on the proposed amendment to section 482*

Because the Secretary already has the necessary power under section 482 to prevent abuses of the U.S. taxing jurisdiction and the source of the difficulty is apparently the lack of information necessary to effectively apply that section, the IEPA believes that the amendment to section 482, proposed by section 6 of the bill and described above, is undesirable. In effect, the proposed amendment to section 482 provides a single fixed statutory formula for the allocation of taxable income under the circumstances described. Although the bill specifically authorizes the inclusion of other factors, such as special risks, if any, of the market in which the product is sold, it does not suggest the circumstances under which such other factors may be taken into account, or the weight to be given to such other factors. Consequently, the identification of such other factors and the weight to be given each of them is, in the last analysis, left to the unilateral discretion of the examining IRS agent.

Section 6 of the bill provides that if the taxpayer establishes, to the satisfaction of the Secretary of his delegate, that an alternative method of allocation clearly reflects the income of each member of the group with respect to intercompany sales of property, such alternative method shall be used in lieu of the fixed statutory formula provided by the bill. The test suggested by the bill is not the reasonableness of the alternative method, or one which, in the views of a court, would clearly reflect income, but simply one which establishes to the satisfaction of the Secretary, or his delegate, that it clearly reflects income. In practice this would probably require the agreement of the IRS agent examining the taxpayer's return. The examining agent would thus be given the power, by withholding his consent to any alternative method, to require application of the single fixed statutory method proposed by section 6 of the bill.

The IEPA believes that a single fixed statutory formula is much too rigid for application to all taxpayers under all the circumstances. It is unlikely that any one formula would be appropriate for all types of business. In one industry or in one type of business in a given industry, a given factor may contribute more heavily toward the income to be allocated than the same factor in some other industry, or in another business in the same industry. A given factor may be more important to a manufacturer than to a retailer. If section 6 is to be enacted, it should give taxpayers the right to use certain prescribed alternative methods. Such a program would inject a degree of flexibility necessary to prevent the application of the same formula to unlike situations. In any event if section 6 is enacted with the statutory formula therein provided, the property factor should not exclude inventory, stock in trade, and accounts receivable as the bill now provides.

(8) *In lieu of enacting a single fixed statutory formula of apportionment the committee should seriously consider granting the Secretary the power to prescribe regulations under section 482 which are similar to the regulations under section 863, setting forth processes or formulas of general apportionment*

The Treasury regulations under section 863 of the 1954 code provide a formula for the allocation of the income of a single taxpayer to sources within and without the United States. Such formula takes into account two factors; property within and without the United States, and gross sales within and without the United States. Under the regulations, the formula applies only where an independent factory price, as provided in the regulations, has not been established and where a taxpayer has failed to obtain permission to base its tax return on its books of account. The latter is permitted to a taxpayer who in good faith, and unaffected by considerations of tax liability, regularly employs in its books of account a detailed allocation of receipts and expenditures which reflects, more clearly than the processes or formulas prescribing in the regulations, taxable income derived from sources within the United States.

Since regulations under section 863 are regulations with which taxpayers and the Internal Revenue Service have had experience, and have generally proven proven to be satisfactory in the allocation of income of a single taxpayer to sources within the United States, on the one hand, and without the United States, on the other hand, the committee should give serious consideration to the application of a similar formula, with modifications and safeguards which may be appropriate (e.g., to take into account a payroll factor) to allocate income from sales and purchases between a U.S. corporation and its controlled foreign subsidiary and to incorporate therein a degree of flexibility no less than that presently incorporated in the existing regulations under section 863 rather than enact a new statutory formula.

While the IEPA believes that the Secretary has adequate power under existing law to prevent abuses of the U.S. taxing jurisdiction, if adequate information with respect to intercompany transactions was made available to him, and that enactment of the fixed statutory formula prescribed by section 6 is therefore unnecessary, if the committee believes that additional legislation is necessary to prevent such abuses, the objectives can be accomplished by granting the Secretary the power to prescribe regulations under section 482 which are similar to those under section 863, setting forth processes or formulas of general apportionment.

Section E. Discussion of Section 13

(1) The same trade or business test

(i) General.—In general under the bill, a U.S. tax will be imposed currently on U.S. persons who own 10 percent or more of the stock ("U.S. shareholders") in a controlled foreign corporation on the operating income of such corporation which is not used in the same, or substantially the same, trade or business of the corporation, unless the income is invested in any trade or business in less developed countries. The House Ways and Means Committee did not give any reasons for its action in requiring the earnings of the controlled foreign corporation to be reinvested in the same, or substantially the same, trade or business, if the earnings are not invested in any trade or business in a less developed country. The committee has simply said:

"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 business 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" (p. 58).

The bill does not impose a U.S. tax on earnings of a foreign corporation reinvested in the same, or substantially the same, trade or business because the committee presumably was convinced from testimony in hearings conducted by it that the location of investments in the economically developed countries of the world "is an important factor in stimulating American exports to the same areas" and because it appeared that to impose the U.S. tax currently on the U.S. shareholders of American owned businesses operated abroad "would place such firms at a disadvantage with other firms located in the same areas not subject to U.S. tax."

The committee concluded that, for competitive reasons, the controlled foreign corporation should be able to expand its investment in the same, or substantially the same, trade or business wherever it was located. Once the decision was reached to limit the reinvestment to the same, or substantially the same, trade or business (except for reinvestment in any trade or business in less developed countries), it became necessary for the committee to prevent avoidance of such a rule. In order to prevent foreign corporations from starting relatively small trades or businesses (at the price of "relatively small" penalties in denial of deferment) and then permitting additions in the later years to these investments to qualify as investments in the corporation's "trade or business," the bill provides a 5-year "seasoning" rule. Thus, only where the controlled corporation has engaged in a trade or business for the past 5 years will an additional investment qualify as the corporation's trade or business. (However, any trade or business in which the foreign corporation was engaged on December 31, 1962, will also qualify without regard to the 5-year rule.)

In determining whether or not a trade or business is the same, or substantially the same, trade or business during the applicable period we are advised as follows by the committee report:

"* * * all 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 subject to U.S. tax to diversify the business of the controlled foreign corporation, while permitting the controlled foreign corporation to compete in the 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" (p. A98).

(ii) *Effect on competition with foreign competitors.*—So long as the earnings from operations of a controlled foreign corporation are ordinary and necessary to the conduct of any trade or business and are used in the conduct of the trade or business, whether or not it is the same or substantially the same as that previously conducted, such earnings should not be taxed currently to the U.S. shareholders of the controlled foreign corporation. By hypothesis, such earnings are not being unreasonably accumulated, but are ordinary and necessary in the active conduct of a trade or business. The proper criterion should be whether or not the earnings are ordinary and necessary in the conduct of a trade or business.

If so-called deferral is proper in the first instance, in order to meet foreign competition, it is also proper in the latter instance.

Since foreign competitors of U.S.-owned foreign corporations are not subject to any such tests, the proposed bill will handicap U.S.-owned foreign corporations which will have to take into account whether or not the earnings are being invested in the same, or substantially the same, trade or business. If American investment abroad "is an important factor in stimulating American exports to the same areas," as the committee impliedly concedes to be the case by continuing the present tax treatment on income reinvested in the same, or substantially the same, trade or business, the present tax treatment should be continued with respect to all earnings reinvested in any business of the controlled foreign corporation, to the extent ordinary and necessary in the conduct of such business. If the stimulation of American exports is a desirable objective, such stimulation should not be restricted to incomplete measures for doing so.

(iii) *Effect on competition with American-owned foreign corporations.*—The requirement that the earnings be reinvested in the same, or substantially the same, trade or business of the controlled foreign corporation embodies within it a "grandfather" clause concept and thereby results in discrimination against American-owned controlled foreign corporations which are not engaged in a particular line of business on December 31, 1962. Under the bill, investments of earnings by a controlled foreign corporation in the same, or substantially the same, trade or business carried on by it on December 31, 1962, and continued by it from that date, may be treated as investments in qualified property. If a controlled foreign corporation, however, did not happen to be engaged in a particular line of business on that date, investments of its earnings in such a trade or business will not qualify. The effect of such a provision is not only to bar diversification, except at the price of losing the so-called deferral now available to earnings of the controlled foreign corporation, but at the same time impede competition as between two different controlled foreign corporations, one of which happened to be engaged in a particular line of business on December 31, 1962, while the other was not. The controlled foreign corporation which was not engaged in a particular trade or business on December 31, 1962, is thus placed at a disadvantage not only with respect to foreign competitors who have no similar restrictions imposed on their reinvestments of earnings in new lines of businesses, but also with respect to other American-owned foreign corporations which happen to be engaged in that line of business on December 31, 1962.

(iv) *Difficulties in determining whether a trade or business is the same as that previously carried on.*—The injection of a test of whether or not the business in which the earnings are invested is the same, or substantially the same, trade or business will require fine distinctions and create innumerable difficulties in ascertaining whether a particular change in the product or product line, method of operation, or even the location of plants will be regarded as a different trade or business for this purpose. We have had some experience with this type of test in certain provisions in the Internal Revenue Code today. Such a test exists under section 382, which eliminates the net operating loss carryovers, where through purchases of the stock of a corporation, there has been a 50 percent or more change of ownership of such stock, and the corporation fails to continue to carry on a trade or business substantially the same as that carried on before the change of ownership. Although enacted in August 1954, and this is March 1962, almost 8 years later, there are still no definitive Treasury regulations which have been issued under section 382 determining for that purpose whether or not a corporation has continued to carry on a trade or business substantially the same as that previously carried on. Undoubtedly, the delay in the issuance of such regulations is attributable, in part, to the inherent difficulties in determining when a particular trade or business is different from that which was previously conducted.

Because advances in the art and technological changes require continual improvement in the product and product line, a product today may bear little resemblance to the product produced 5 years ago. Will this result in a determination that the trade or business is no longer substantially the same? Will the discontinuance of a product or product line result in a determination that the trade or business which is continued is no longer substantially the same as that previously conducted

The proposed regulations under section 382 provide that a corporation has not continued to carry on a trade or business substantially the same as that previously conducted if the corporation discontinues more than a minor portion of its business carried on before such increase. (Under the proposed regulations, in determining whether discontinued activities are more than minor for this purpose, consideration should be given to whether the discontinuance of the activities has the effect of utilizing loss carryovers to offset gains of a business unrelated to that which produced the loss.)

Under such proposed regulations a corporation has not continued to carry on a trade or business substantially the same as that conducted before any increase in the ownership of its stock if the corporation changes the location of a major portion of its activities, and as a result of such change in location, the business of the corporation is substantially altered.

The following examples are given in the proposed regulations to illustrate the above statement:

"Example (1): X Corporation, a calendar-year taxpayer, is engaged in the business of manufacturing in State A and has sustained substantial net operating losses. On June 30, 1958, Y Corporation purchases all of X Corporation's outstanding stock. During 1959, X Corporation transfers its operations to State B which is several hundred miles distant from State A. In order to effect the change in location, X Corporation disposes of its plants and a large portion of its machinery located in State A. The distance between State A and State B makes it necessary for the majority of the employees of X Corporation to terminate their employment with X Corporation. During 1959, X Corporation resumes its manufacturing activites in State B and continues to make the *same product and serve substantially the same group of customers.* However, by reason of the change in location, employees, plant, and equipment, X Corporation, on December 31, 1959, *is not carrying on substantially the same trade or business* as that conducted prior to the increase in ownership.

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"Example (3): Z Corporation, a calendar-year taxpayer, operates a retail liquor store in town M, utilizing the services of 10 employees. On June 30, 1958, individual A purchases all of the stock of Z Corporation. During 1959, Z Corporation transfers its operations to town O, a distance of 5 miles from its former location. By reason of the change in location, Z Corporation disposes of its interest in the premises formerly occupied by it and also disposes of the license and franchise issued by town M. During 1959, Z Corporation transfers its inventory of liquor to its new location and resumes its retail liquor activities under a license and franchise issued by town O. Z Corporation continues to employ 5 of the 10 employees formerly employed in town M, but the corporation serves a substantially different group of customers. Under these circumstances, the *change of location results in a failure to carry on substantially the same trade or business* as that conducted before the increase in ownership." [Emphasis supplied.]

The difficulties in ascertaining whether a particular change in product, operation, or location results in a change in the trade or business are obvious.

There are additional difficulties in applying this test. If a controlled foreign corporation has a branch operation in England and a branch operation in France, each of which is engaged in manufacturing and selling the same product and the branch operation in England has been conducted for more than 5 years, while the branch operation in France has been conducted there for less than 5 years and was not conducted there on December 31, 1962, is each branch operation a different trade or business for purposes of the bill? For example, if the earnings from the branch operation in England are reinvested in the branch operations in France, is such an investment an investment in the same trade or business for this purpose? In essence, the problem is whether a branch operation in one country is to be regarded as a different trade or business from a branch operation in another country.

Further, if a controlled foreign corporation has a branch operation in England making another product and each branch operation has been conducted for more than 5 years, will each branch operation be considered a different trade or business? For example, if under these circumstances, the controlled foreign corporation reinvests some of the earnings from the branch operation manufacturing one product in the branch operation manufacturing the other product, will the earnings so reinvested be treated as reinvested in the same trade or business? If no, and the earnings from one qualifying trade or business are reinvested in another qualifying trade or business, will the U.S. shareholders be taxed on such earnings because the earnings were not reinvested in the same trade or business which generated the earnings? If the U.S. shareholders will be taxed on such earnings under these circumstances, the bill will force each controlled foreign corporation to fragmentize its present operation and to determine earnings with respect to each fragment which constitutes a separate trade or business in order to ascertain the earnings of each such fragment to determine whether those earnings have been reinvested in the same or in a different trade or business for purposes of this bill.

Apparently any trade or business carried on by the controlled foreign corporation almost wholly within one or more less developed countries will be considered as a qualified trade or business. However, if the character of the trade or business carried on within one or more less developed countries is the same or substantially the same as that carried on in one or more developed countries, it may be difficult to establish that the trade or business carried on in the less developed countries is carried on almost wholly within such latter countries. If the controlled foreign corporation is carrying on the business of making and selling one product in a less developed country and also in a developed country, is the business of making and selling that product in the less developed country carried on almost wholly with the less developed country?

The bill does not establish any criteria for making the necessary determination. Will this depend on whether the controlled foreign corporation can establish that the trade or business carried on in the less developed countries is separate from the trade or business carried on in one or more developed countries, even though the character of both businesses is the same? (The problem described here is essentially the same type of problem previously described in the discussion of a trade or business carried on in developed countries.) If this is so, all the problems now facing taxpayers under section 355, relating to corporate separations, which requires, under the Treasury's view two or more trades or businesses, will be faced by U.S. shareholders of a controlled foreign corporation engaged in business in a less developed country and in a developed country.

For reasons of tax administration alone, it would be undesirable to incorporate into the area under discussion any such test. If the Internal Revenue Service lacks the manpower to enforce the existing provisions of law in the foreign area, as the Commissioner has advised the Ways and Means Committee, the distinctions the bill will require will aggravate rather than alleviate administrative problems and invite litigation to resolve disputes in determining whether any given change results in a change in the trade or business.

(v) *Effect on relations with foreign minority shareholders of controlled foreign corporations.*—If a controlled foreign corporation has any foreign nationals as shareholders, the distinctions required to be made by the bill between the same and other trades or businesses will create unnecessary friction between the U.S. shareholder group and the foreign shareholder group, for when all other things are equal, the U.S. shareholder group would resist reinvestment of earnings in a different trade or business simply because of the difference in the tax consequences to them. This is not a case where the earnings are not returned as dividends to the shareholders because their distribution will result in the U.S. taxation of such earnings to the U.S. shareholders, but a case where the failure to reinvest them in the same trade or business, rather than in a different trade or business, will result in different tax consequences to the U.S. shareholders.

Such a deterrent to reinvestment in different trades or businesses is not in the best interests of the United States. Such a deterrent could merely serve to slow down, to a degree which cannot be predicted with any accuracy, diversification of American-owned foreign corporations. It will create an artificial stimulus to reinvestment in the same trade or business. Why diversification should be so discouraged is not apparent. If American investment located abroad aids U.S. exports abroad, as the Ways and Means Committee impliedly agreed, such investment should not be so artificially restricted to the same trades or businesses in which American-owned foreign corporations are now operating.

(2) *Foreign base company sales income*

One category of income of a controlled foreign corporation which is included in the income of a U.S. shareholder is described in the bill as "net foreign base company income." This is essentially personal holding company-type income (rents, dividends, interest, etc.) and income from certain sales, reduced by the increase in the investment in qualified property in less developed countries. The provisions dealing with this category of income apply only in the case of a controlled corporation in which five or fewer U.S. persons own, actually or constructively, more than 50 percent of the voting stock.

Perhaps the most important element in this category to many persons is the sales income, which the bill describes as "foreign base company sales income." "Foreign base company sales income" refers to income derived in connection with—

(*a*) the purchase of personal property from a related person and its sale to any person; or

(*b*) the purchase of personal property from any person and its sale to a related person.

This rule applies, however, only if—

(*a*) the property which is purchased is manufactured, produced, grown, or extracted outside the country under the laws of which the controlled foreign corporation is created or organized; and

(*b*) the property is sold for use, consumption, or disposition outside such foreign country.

(i) *When is property "purchased"?*—Although foreign base company sales income does not include income derived by the controlled foreign corporation from the sale of property which it did not purchase, the bill does not set forth a statutory rule for determining whether a given transaction constitutes a purchase rather than a manufacture of property. (There was a 20-percent added value test in the Treasury's July 1961 draft and a substantial transformation test in the Treasury's January 31, 1962, modifications of the July draft.)

The committee report indicates that "foreign base company sales income" means income from the purchase and sale of property "without any appreciable value" being added to the product by the selling corporation (p. 62). How much value is appreciable is not indicated. The committee report further states that this does not include cases where any significant amount of manufacturing, installation, or construction activity is carried on with respect to the product by the selling corporation (p. 62). According to the same source, activity such as minor assembling, packaging, repackaging or labeling would not be sufficient to exclude the profits from this definition. The definition of "sales income" does not apply to income of a controlled foreign corporation from the sale of a product which it manufactured. According to the committee report, in a case in which a controlled foreign corporation packages parts or materials which it then transforms or incorporates into a final product, income from the sale of the final product would not be foreign base company sales income if the corporation substantially transforms the parts or materials so that in effect the final product is not the property purchased (p. A94). According to the same source, manufacturing and construction activities (and production, processing, or assembling activities which are substantial in effect) would generally involve "substantial transformation" of purchased parts or materials (pp. A94 and A95).

The committee report thus incorporates for this purpose a test which was specifically included in the January 31, 1962, draft of the Treasury Department under which property which is substantially transformed by the controlled foreign corporation is not regarded as purchased by it for these purposes. It is not clear, however, whether substantial transformation is enough to exclude the transaction from these rules since the committee report also indicates that "foreign base company sales income" means income from the purchase and sale of property without any appreciable value being added by the controlled foreign corporation, or without any significant amount of manufacturing, installation, or construction activity. Perhaps a treble-barreled test is intended to be applied: (1) there must be a substantial transformation, (2) the value added must be appreciable, and (3) there must be a significant amount of manufacturing, installation, or construction activity. What rule will govern for this purpose? If the intent of the proponents of the legislation with respect to this issue is not clear, it apparent that the ambiguous naure of the test will create confusion in its application.

There undoubtedly will be endless disputes in determining whether, in a given case, there was a substantial transformation, a significant amount of manufacturing, installation, or construction activity, and an addition of appreciable value.

This is another instance in this legislation where taxpayers will find themselves unable at the time of the transaction to know with any reasonable degree of certainty whether a particular rule or test is applicable. This is hardly conducive to the best interests of the United States.

(ii) *When is property sold for use, consumption, or disposition outside the country?*—As indicated above, income is included as foreign base company sales income only if, among other things, the property is sold for use, consumption, or disposition outside the foreign country under the laws of which the controlled foreign corporation is created or organized. The bill itself does not set forth any standard for determining when property will be regarded as sold for use, consumption, or disposition outside such foreign country. The difficulties in making such determinations are obvious. The committee report states that a "destination test" applies for this purpose (p. A95). The latter further provides that generally property will be considered to be used, consumed, or disposed of in the country to which it is delivered, "unless circumstances indicate that the property is to be exported after it is so delivered" (p. A95).

The interpretation and application of such a requirement will lead to endless disputes and litigation. In this category it is contemplated that the use, consumption, or disposition by the immediate purchaser will be determinative or, on the other hand, is it contemplated that the use, consumption, or disposition by the ultimate consumer of all various purchasers in the chain of purchasers will be determinative? For example, if a controlled foreign corporation purchases property from a related person and sells it to an independent foreign manufacturer located in the same country in which the controlled foreign corporation is incorporated, and such purchaser incorporates the property into his finished product all of which he sells outside the country, is this a sale for use, consumption, or disposition outside the country under the laws of which the controlled foreign corporation is created or organized? When the controlled foreign corporation has knowledge that such purchaser will incorporate the personal property into his finished product for the purpose of reselling the finished product outside the country of incorporation of the controlled foreign corporation, is this an instance indicating, within the meaning of the committee report, that the property is to be exported after it is delivered within the country of incorporation?

Under one interpretation, it is and if this is the interpretation intended, a Herculean task will be imposed upon controlled foreign corporations, the U.S. shareholders thereof, and the Revenue Service to ascertain the ultimate destiny of the products or parts sold by the controlled foreign corporation in order to ascertain whether the use, consumption, or disposition was outside the country under the laws of which the controlled foreign corporation was created or organized. The task becomes magnified if this is the interpretation intended and the purchaser in the example above merely sells part of the product outside the country and the balance inside the country.

(iii) *Determination of amount of sales income will create additional administrative problems.*—The difficulties are not ended when the property which is purchased and sold is identified. Having identified the particular property which is subject to the provisions relating to sales income, the next task is to determine the amount of income derived in connection with the purchase or sale of such property. Neither the bill nor the committee report indicate the particular method by which such income is to be determined. In such a case it is not clear whether the income is to be determined by some means of allocation and if so in what particular way. Will allocation be made in different ways in similar circumstances? Will this vary with the identity of the examining agent? It may be impossible to prescribe any one standard for all the various cases which will arise. Yet, without some standard, endless disputes in the application of these provisions by taxpayers affected and in the administration by the Revenue Service will undoubtedly follow. For example, to what extent will general office and overhead expenses be taken into account in determining the amount of sales income?

(3) Income from patents, copyrights, exclusive formulas and processes substantially developed in the United States or acquired from related U.S. persons

Under the bill, income, actual or imputed, derived from patents, copyrights, and exclusive formulas and processes substantially developed, created, or produced in the United States or acquired from a related U.S. person, is taxed currently to the U.S. shareholders of the controlled foreign corporation whether or not such income is reinvested by the controlled foreign corporation in the same trade or business, or in a trade or business in a less developed country.

The House Ways and Means Committee reported 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" (p. 58). Among the provisions of the bill designed to meet "this problem of diversion of income from U.S. taxation" are the provisions taxing income derived by controlled foreign corporations from patents, copyrights, etc., developed in the United States (p. 58).

Under section 367 of existing law, a U.S. shareholder cannot transfer patents, or other property to a controlled foreign corporation, under the provisions of the law allowing any gain on the transfer to go unrecognized, without first establishing to the satisfaction of the Treasury that the transaction is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes, and receiving a favorable ruling from the Treasury with respect to the transaction. Where patents have been transferred to a controlled foreign corporation after such a ruling has been received, it is evident that the Treasury has satisfied itself that one of its principal purposes of the transfer was not the avoidance of the U.S. income taxes. Nevertheless, the bill would require the U.S. shareholders of the controlled foreign corporation, to which patents had been transferred pursuant to such a ruling, to take into their income the royalties, actual or imputed, of the controlled foreign corporation with respect to such patents. Since the case is obviously one in which the transfer was not made to avoid U.S. income taxes, U.S. shareholders should not be required to take into income royalties, actual or imputed, of the controlled foreign corporation with respect to such patents, copyrights, etc.

Under the bill, a controlled foreign corporation is required to take into account not only the income it actually receives from the license, sublicense, sale or exchange of certain patents, copyrights, etc., but also what might best be described as "imputed" rent or royalty. If, for example, a controlled foreign corportation uses the patents, copyrights, exclusive formulas and processes in its own operations, it is required to take into account, as subpart F income, the amount which would be obtained by it as a gross rent, royalty or other payment in an arm's-length transaction with an unrelated person for a similar use or exploitation of the patent, copyright, etc. The amount of such imputed rent or royalty is taken into account along with the rents and royalties actually received by it from third persons in connection with such patents, copyrights, etc.

Although the sale of the particular product is connection with which a patent was used by the controlled foreign corporation may have resulted in losses, the controlled foreign corporation nevertheless may have to take into account, in its subpart F income, an imputed royalty because of its use of the patent. This could happen even though, under the bill, the aggregate amount of subpart F income of a controlled foreign corporation of any year cannot exceed the earnings and profits of the corporation for the year. This is possible where the operations of the controlled foreign corporation in which the patent was not used resulted in profits, while the operations in which the patent was used resulted in losses, and the controlled foreign corporation ended up with net earnings for the year.

(4) The bill requires the U.S. shareholder to include in his income undistributed profits attributable to transactions occurring before he became a shareholder

Under the bill, the proportion of the profits of a controlled foreign corporation deemed to have been distributed to the U.S. shareholder owning a 10-percent or greater, interest in such corporation depends upon the proportion of such corporation's annual accounting period during which it was a controlled corporation and not upon the profits actually realized by it during the part of its annual accounting period during which it was controlled by such U.S. shareholders. This arbitrary method for determining the amount to be included in the income of U.S. shareholders means that profits actually realized in the calendar year, but prior to the time the foreign corporation became controlled by such American persons may be allocated to them. This result may occur because transactions between related persons may have occurred in the annual accounting period even through none were with corporations owned directly or indirectly at the time the transactions took place by such U.S. persons or any U.S. persons.

For example, 100 percent of the earnings of a foreign corporation during the month of January might be attributable to transactions with its subsidiaries and hence with related parties, even though during such month the corporation was controlled in its entirety, directly and indirectly, by foreign shareholders. If control of the foreign corporation is acquired by U.S. shareholders on February 1, and the foreign corporation has no further transactions with related persons in the year, the bill still requires eleven-twelfths of the profits attributable to the transactions in January between the related corporations in that month to be included in the income of the U.S. shareholders.

This result is not sound and should be changed. Otherwise transactions of the type described will be treated as proscribed transactions even though they occur between a foreign corporation and a related party which is also a foreign corporation and both are controlled completely, directly and indirectly, by foreign persons at the time they occurred.

A similar situation exists when control of a foreign corporation passes during its annual accounting period from one group of U.S. shareholders to another. Profits attributable to purchase and sales transactions which occur during the period of control by the original groups of U.S. shareholders apparently continue to be treated as proscribed transactions for determining the amount of earning to be included in the income of the new U.S. owners of the foreign corporation. The impact of the bill is upon the wrong persons in such cases. The benefits of any profits derived from such transactions in such cases were derived by the persons owning the foreign corporation at the time the transaction occurred. It seems dubious in principle to tax the undistributed earnings and profits attributable to transactions occurring prior to the time a U.S. shareholder became a shareholder (directly or indirectly) in the corporation and include such undistributed earnings attributable to such transactions in his income simply because he happens to be the owner of the stock of the corporation on the last day of the year during which it is a controlled foreign corporation.

The IEPA recognizes that under present law actual distributions to present shareholders of earnings generated by the distributing corporations in a period prior to the time the present shareholders became shareholders are properly included in income of the present shareholders as dividend income. However, the bill is extending this treatment to undistributed earnings. The latter treatment does not follow because the former is true. If the principle of the bill is broadly analogous to the treatment of partners in a partnership, it fails to meet even this rough analogy, for earnings of a partnership attributable to the period prior to the time a person became a partner in the partnership are not required to be included in the income of such person.

CONCLUSIONS

The International Economic Policy Association (IEPA) has presented in the foregoing pages a most carefully considered analysis of both the foreign corporation proposals of President Kennedy and the recommendations of the House Ways and Means Committee as embodied in H.R. 10650.

The IEPA summarizes its conclusions as follows:

1. The proposed current taxation of undistributed profits of controlled foreign corporations raises serious constitutional and jurisdictional questions. In view of the traditional approach of taxing a corporation as a separate entity and in view of the Supreme Court's position with respect to this principle, the judicial branch of our Government, under existing precedents, will conclude that, in general, undistributed profits of foreign corporations cannot be taxed to their shareholders.

2. The current taxation of undistributed profits of foreign subsidiaries of American corporations will place them at a competitive disadvantage with their foreign counterparts. Contrary to the claim of the administration that current taxation of foreign profits of foreign corporations will produce tax neutrality, the proposal will add another inequity in the law by burdening American business overseas with a heavy U.S. tax when their competitors are not so burdened.

3. The proposal imposes on U.S. shareholders an unfair tax, in many circumstances, since there may be no control by the U.S. shareholders over the remittance of earnings from foreign corporations in order to obtain money to pay it. Although the proposals refer to controlled foreign corporations, many situations can occur where U.S. shareholders will be subject to this tax without either having legal control or actual control of the activities of the foreign subsidiary. Furthermore, even where actual control does exist, foreign laws restricting the free use of the profits of the foreign subsidiary may prevent distributions to shareholders needed to satisfy the tax liability.

4. Current taxation of undistributed profits of foreign corporations organized in countries with which the United States has an income tax treaty, violates the most important treaty provision. The United States has committed itself in every income tax treaty that it will not tax a corporation organized in the other contracting country on its profits, except to the extent that they are allocable to a permanent establishment in the United States. By taxing U.S. shareholders on undistributed profits, these provisions are completely ignored and the spirit and purpose of the tax treaties are violated.

5. Instead of achieving neutrality, the Treasury proposals will subject foreign earnings of U.S. owned foreign corporations to higher and more burdensome taxes than domestic corporations will pay on their foreign earnings. For example, controlled foreign corporations will not be permitted to have net operating loss carryovers and carrybacks, U.S. shareholders will not be permitted currently to deduct losses of controlled foreign corporations, and capital gains of foreign subsidiaries will be taxed to U.S. shareholders at ordinary income tax rates, instead of at the usual 25 percent capital gains rate.

6. The policies embodied in section 13 will establish tax inequities among U.S. enterprises in competition with each other by treating some taxpayers more leniently than others, depending upon circumstances over which the taxpayers will have had no control.

7. The imposition of U.S. tax on earnings derived by controlled foreign corporations, which are invested in a new business, is unsound and is unfair. It is unsound in that it creates an unreasonably heavy financial burden on American business carried on abroad through foreign subsidiaries in competition with their efficient and modern foreign counterparts. It is unfair to foreign businesses which have not already diversified and desire to do so in order to meet their competition which has already done so.

8. The test of what is the same or substantially the same trade or business is too vague and ambiguous upon which to predicate a tax determination.

9. The treatment of royalties from patents, copyrights, formulas and secret processes is extremely and unnecessarily harsh. Elimination of current taxation with respect to such items of income as dividends, interest, rents, and royalties (other than from patents, etc.) is provided for if those items are invested in a less-developed country. But there is no provision which would eliminate current taxation on royalties. This is an unduly harsh treatment and should be liberalized at least to the extent of according the royalties treatment similar to other foreign base company income. The treatment of a portion of the controlled foreign corporation's profit as imputed royalty should be rejected, as impossible of fair administration.

10. Section 482 of existing law provides the framework for the prevention of abuses of the U.S. tax jurisdiction. The thrust of any new legislation ought to be directed toward providing the Internal Revenue Service with the information it needs to effectively apply section 482 rather than to embark on the new and untried method of taxation of such far-reaching consequences proposed by the bill and by the Secretary of Treasury.

11. A single fixed statutory formula proposed in section 6 of the bill for the allocation of taxable income under section 482 is too rigid for application to all taxpayers under all circumstances. If changes are to be made it should give the taxpayers the right to use certain prescribed alternative methods and thereby provide a degree of flexibility necessary to prevent the application of the same formula to unlike situations. In any event, if section 6 is enacted with the statutory formula therein provided, the property factor should include inventory, stock-in-trade, and accounts receivable.

12. The IEPA is cognizant that there are abuses designed to syphon off income legitimately within the taxing jurisdiction of the United States, and is strongly in favor of legislation for their elimination. It is our purpose to support measures for the elimination of flagrant tax avoidance schemes, but not to encroach upon legitimate business operations abroad.

PART II. ECONOMIC ANALYSIS

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Appendix A.

PART II. ECONOMIC POLICY MOTIVATIONS BEHIND PROPOSED TAXATION OF FOREIGN SOURCE INCOME

Neither the facts concerning the possible effects of the proposed taxes upon the balance of payments, nor the legal premises upon which the Treasury's program rests, stand up to rigorous analysis, as pointed out in our previous memorandum.[24] In spite of this, the Treasury Department persists in advancing a scheme of taxing income generated by foreign subsidiaries, notwithstanding the fact that the U.S. Government's constitutional jurisdiction is highly doubtful and the supposed adverse effect upon our balance-of-payments deficits is trivial. There must therefore be other motivations in the persistent effort to reach out into this uncharted area of taxation.

There seem to be three primary motives behind this drive: First, there is the assertion by the Treasury Department that some of the important governments of Western European countries favor the use of taxing power by the United States to control foreign investments by U.S. citizens and the reinvestment of profits in Europe and Canada. Second, it is asserted that it is desired to eliminate tax advantages as an incentive to investment in those areas, and erroneously, we believe, that such action will stimulate investment of capital, and therefore economic growth in the United States, resulting in the export of end products from the United States. Third, it is assumed in the light of the growing investment of U.S. capital in Western Europe that there is or will be an influx of imports, which can be stemmed if only we would make it less attractive for U.S. companies to go abroad. The "export of jobs" will be stopped.

THE POSITION OF EUROPEAN GOVERNMENTS

In a memorandum by the Treasury Department, transmitted by the Secretary to the Ways and Means Committee on June 29, 1961, it is stated:

"In the Treasury testimony, it was indicated that the major European governments believed that the United States would be justified in making adjustments in its tax system so that capital flows to Europe and the reinvestment of profits in Europe will not be dictated by tax considerations.

"* * * On the contrary, as indicated above, officials of the Common Market countries have urged action such as that proposed by the Treasury." [25]

The Secretary of the Treasury, in his testimony before the Ways and Means Committee, stated on May 3, 1961:

"In mid-January, during the height of our balance-of-payments difficulties, the finance ministers of the six Common Market countries met and discussed the U.S. balance-of-payments position. They were good enough to give us the general tenor of their thinking. In particular, the ministers informed us of their unanimous belief that the United States would be justified in discontinuing the fiscal incentives which encouraged the nonremittance of profits made in Europe." [26]

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[24] Hearings, Ways and Means Committee, vol. 4, pp. 2763–2836.
[25] "President's 1961 Tax Recommendations, hearings before the Committee on Ways and Means, 87th Cong., 1st sess." vol. 4, pp. 3532, 3533.
[26] Ibid., vol. 1, p. 33.

The Secretary enlarged on the European attitude in his testimony before the Senate Finance Committee on April 2, 1962:

"* * * in working bodies of the OECD which look on monetary affairs and balance of payments, when they talked about the United States one of the questions they asked, one of the things they did not understand, confess not to understand, is why the United States allowed the continuation of this specially favorable tax treatment for investment overseas particularly in Europe, and so there certainly will be no problem with these European countries if we adopt legislation of the sort that we are recommending now. In fact they all think it is long overdue."

Thus, the European governments, the Common Market finance ministers and their representatives in the Organization for Economic Cooperation and Development are of a single mind; they want U.S. enterprise doing business in their countries to be taxed at a higher rate than their own citizens who compete with the Americans.

This is rather an unusual position for leaders of European countries to take if they were interested in encouraging U.S. investments in their own countries. It is even more unusual to find finance ministers of these countries agreeing with the theory that the United States has the right to tax income generated in their own countries.

THE EUROPEAN RESPONSE TO U.S. NEEDS

The European governments have had several alternative means whereby they could have helped the United States in its balance-of-payments deficits. One of the principal reasons for the balance-of-payments deficit is the U.S. offshore military expenditure of $3 billion or more; one of the quickest ways in which these governments could help the United States would be to assume and absorb into their budgets the costs of U.S. military establishments in their own countries, stationed there for the defense of Western Europe. As of this writing, the European governments have refused to do this.

A second method which has been available to the balance-of-payments surplus countries to help the United States is the assumption of a part of the burden of foreign aid, the next most important reason for our balance-of-payment deficits. This, to be effective, would have to be accompanied by a comparable reduction of such expenditures abroad by the United States. Not only have the European countries not responded enthusiastically to repeated urgings by the U.S. Government, directly and through the Organization for Economic Cooperation and Development, but there is no evidence that the U.S. Government itself intends to reduce its foreign aid commitments by the amount of increased participation in this effort by other countries; in fact, the pressures are in the opposite direction. The net of it is that this method of reducing the U.S. balance-of-payments deficit has failed to encourage the enthusiastic support of our allies.

A third, equally effective, method whereby balance-of-payments surplus countries could help the United States would be to buy more U.S. goods. This could be achieved by the elimination of discriminatory treatment against U.S. exports on an unilateral basis. This is true in the case of German quotas on imports of coal from the United States; it is true in the field of agricultural products; it is true in the case of tariffs and franchise taxes on U.S. automobiles which practically exclude any substantial imports into Western Europe. On the contrary, instead of lowering barriers against imports from the United States, the first impact of the Common Market will be, on the average, to increase them.

The European countries have also opposed tying foreign aid to U.S. procurement, another means of conserving dollar exchange and improving our balance of payments. Although the U.S. AID legislation of 1961 put greater emphasis on this and it is now accepted national policy, $1.3 billion is still being spent abroad for this purpose, according to latest reports.[27]

The only substantial contribution made by the European countries to the improvement of our balance-of-payments deficit problem has been to prepay some of their debts to the United States and, in the case of Germany, to purchase more military hardware from the United States. There is under discussion the possibility also of persuading Germany to assume some of the costs of military assistance to Greece and Turkey, just as, after World War II, the

[27] Testimony of the Secretary of the Treasury before the Senate Finance Committee on advance refunding and debt management, Mar. 15–16, 1962. "The Economic Report of the President," January 1962, p. 156, puts the figure at $1.2 billion.

United States assumed the burden theretofore carried by Great Britain, for exactly the same reasons: balance-of-payments deficits.

Thus the record indicates that, in the practical means whereby the balance-of-payments surplus countries could have helped the United States, they have responded only modestly. Of all the means available to achieve this result, they have thrown their weight only behind the proposal to discourage U.S. private investment abroad, by encouraging the U.S. Government to extend its taxing power.[28]

It is interesting, therefore, to speculate why the European countries have not come to the assistance of the U.S. Government with greater alacrity, with practical means at their disposal. Instead, they have lectured the U.S. representatives, as in the IMF-World Bank meeting in Vienna, in September 1961, to put our house in order and have given unanimous support to the proposition to discourage private investments through taxation.

One must look at these suggestions from the point of view of the political and economic self-interest of our allies and of the United States. There may be some political motivation in the effort to discourage U.S. private investments. This, of course, was most frankly expressed in Canada, where public opinion has shown some restiveness over the degree of control of their economic enterprises by U.S. companies. There is less overt expression of this viewpoint in Europe, but one wonders whether there is not some underlying feeling similar to the Canadian viewpoint in Western Europe as well.

Most plausibly, however, the reason may be a very practical one; namely, that U.S. private investments, resulting in income which may be, and is, repatriated to the United States, goes contrary to the long-range historical balance of payments interest of Western Europe. European authorities have known for over 100 years that investment in other countries, on which they earn interest and dividends, is one way for them to secure purchasing power abroad with which to satisfy their import needs.

In almost every year during the period 1816–1913, Britain imported more than it exported, and over the total period Britain imported £6.8 billion more than she exported. She paid almost 70 percent of this excess of imports through interest and dividend receipts from foreign investments.[29] During the period 1880 through 1913, France's imports exceeded her exports by almost Fr25 billion, but she more than covered this deficit with net revenue from foreign investment of Fr30 billion.[30] Germany between 1894 and 1913, had imports in excess of exports equal to almost 2M25 billion and she covered 87 percent of this deficit through oversea interest income.[31]

During the 1930's, selected data show a similar story for Britain and France:

Percentage of excess imports over exports covered by interest and dividends [1]

	Britain	France
1930	57	15
1933	61	20
1936	59	46
1938	53	57

[1] Served from W. S. and E. S. Wzoytinsky, "World Commerce and Governments," (New York, Twentieth-Century Fund, 1955), p. 208.

[28] In all fairness, it should be stated that there have been other areas of cooperation, of a temporary or peripheral nature. (1) West Germany and the Netherlands revalued upward their currencies in March 1961 by 5 percent, with little immediate effect. (2) European central banks have coordinated interest rate policy with the United States, to discourage "hot money" movements. (3) They have agreed to expand the borrowing powers of the International Monetary Fund from balance-of-payments surplus countries (mostly Common Market countries) and lend to deficit countries (presumably the United States and Great Britain). This last proposal does not correct the basic balance-of-payments deficits of the United States, but merely creates machinery whereby private U.S. debts may be converted into public debts. It is a gigantic price-support program for the dollar in international markets, already initiated by the Treasury under its monetary stabilization program, good only temporarily until the basic imbalance is corrected. It is interesting that the borrowings will be in terms of dollars with fixed gold content, therefore not subject to devaluation.

[29] Derived from Albert H. Imlah, "Economic Elements in the Pax Britainnica" (Cambridge, Harvard University Press, 1958), p. 70 ff.

[30] Derived from H. D. White, "The French International Accounts" (Combridge: Harvard University Press, 1933), pp. 44, 120.

[31] Derived from H. G. Moulton and C. E. McGuire, "Germany's Capacity To Repay" (New York: McGraw-Hill, 1923), pp. 27, 268.

The European countries know the importance of investment income in their balance of payments.

The reverse of this situation—investment by other countries in Western Europe, on which income will be drawn over the long future, comes into direct conflict with this primary interest of European financial authorities. It is reasonable to expect, therefore, that rational analysis of this problem from the European viewpoint would lead them to prefer a method of solving our balance-of-payments deficit problem which is most desirable for them and least in conflict with their own long-range political and economic objectives.

The United States must exercise an equally hardheaded and realistic appraisal of its position in this area of international economic cooperation, and to adopt such policies as will insure the strength of the U.S. economy and its monetary system while, at the same time, it leads to greater political and economic cooperation with our allies.

AVAILABLE ALTERNATIVES

With this in mind, it is obvious that it would be more to the U.S. interest to solve this balance-of-payments deficit problem by unilateral agreement on the part of our allies to assume the cost of maintaining U.S. troops abroad, while we provide the hardware from U.S. sources without adverse impact upon the balance of payments.

A second possible way of helping solve the problem would be unilateral elimination of impediments to U.S. exports, particularly in the field of agriculture, coal, machinery, and automobiles, including the elimination of internal discriminatory taxes, so that we could sell them civilian goods sufficient to sustain our noncommercial expenditures abroad for military and foreign aid purposes.

Failing in this, another alternative that would be available to the United States would be to curtail the expenditure of U.S. funds on nonessential imports. The administration last year took a step in this direction in reducing the tourist exemptions from $500 to $100. This was essentially a free import program, limited to $500 per person—a privilege available only to those who had enough resources to go abroad. This limitation might be expanded to other nonessential imports. This would be, of course, one of the less desirable alternatives from the point of view of both the United States and our allies.

A stricter interpretation of the U.S. domestic procurement policies under the foreign aid program, promised by the President in numerous pronouncements—from the balance-of-payments message of February 6, 1961, to his speech before the National Association of Manufacturers on December 6, 1961—might save several hundred million dollars more; certainly much more than the anticipated savings of the Treasury under its original tax proposals of 1961, repeated before the Senate Finance Committee on April 2, 1962.[32]

The administration is, of course, and quite rightly, emphasizing the expansion of cash export sales as a means of solving the balance-of-payments problem. The limitations of this effort, however, must be well understood, as it would not help the cause of future stability to make an error of judgment with regard to the degree of possible effectiveness of this effort. A large part of the world is not available as a market for increased U.S. exports for cash. The Iron Curtain countries are a limited potential market for trade expansion for the near-term future; the underdeveloped countries do not have the resources to buy for cash—they are candidates for gifts and grants and so-called long-range, 50-year-low, or no, interest loans. Therefore our chance of selling more for cash is restricted pretty much to industrialized Western European countries and Japan.

The question is: Can these exports be increased, not on a reciprocal, but a one-way unilateral basis by between $3 to $4 billion? With regard to Common Market countries,[33] this much expansion in exports would require an almost

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[32] The Treasury, in its presentation before the House Ways and Means Committee, claimed annual average deficits in balance of payments caused by direct investments of $100 million with Western Europe and $150 million with Canada (1957–60 average, hearings, vol. I, p. 31), allowing for repatriated earnings, but without allowing for exports by U.S. companies of machinery, raw, and semifinished products to their foreign manufacturing establishments in Europe and Canada. The Treasury figures, subject to challenge, are but a fraction of the $1.3 billion drain on balance of payments through offshore procurement under foreign economic aid. (Testimony of the Secretary of Treasury before the House Banking and Currency Committee, February 1962.)

[33] These are the main dollar-surplus countries.

100 percent increase over 1961 exports of $3.6 billion. This raises certain questions: Will they allow us to expand our exports on a unilateral basis to such an extent? What will be the repercussions within their internal economy? What are the commodities in which, in a free market, we would have an opportunity of expanding exports, within a reasonably short time, by $3 to $4 billion? The greatest opportunity, of course, is in the field of agriculture, in which given a competitive pricing system, the United States would be able to undersell any European producer. On political grounds, however, this area of exports seems closed to U.S. efforts. There are limited opportunities in the exports of coal and automobiles. Again, these would require unilateral concessions on the part of our allies. In total, however, the immediate prospects do not come up to our needs.

It is not, therefore, enough merely to exhort American industry to export more, because it is not likely that the total solution of the balance-of-payments problem will be in this field, in the foreseeable future, as long as we have to maintain our Military Establishment and the scale of foreign aid expenditures at levels comparable to the present. Therefore, the United States must think in terms of a long-range solution to this problem by expanding U.S. earning power abroad in ways other than exports; namely, the sale of services, and the making of investments on which growing amounts of earnings may accrue and, in the normal course of business activity, be repatriated to the United States. The encouragement of private investments abroad in hard, convertible currency countries must become one of the major objectives of the administration, with as much emphasis as given to the encouragement of exports.

The administration seems to espouse the policy that our major effort in the export of capital should be to underdeveloped countries, both under public auspices through the media of lending institutions, both national and international, and through gifts and grants and noninterest loans, as well as private investments. However desirable this may be from a political point of view, and however consistent with one of the major U.S. commitments to the rest of the world, this will not solve our balance of payments problem. The United States cannot acquire purchasing power with which to pay its debts solely by making gifts and grants and 50-year low or no-interest loans to underdeveloped countries, and by insisting that private investors should direct their attention primarily to underdeveloped countries, with unstable political institutions and dubious security of private investments. In many instances, the contingent liabilities of the U.S. Government must increase when private investments, as is the case in many underdeveloped countries, will take place only under some form of guarantee against inconvertibility, expropriation, war or civil rebellion.

Thus, an increase in the export of capital to underdeveloped countries would obviously have a tendency to aggravate the balance of payments problem; and if U.S. business is to obtain the resources for investment in underdeveloped countries, it becomes increasingly important for U.S. business to have a prospect of receiving continuing and increasing inflow of resources from foreign countries.

In sober thought, the only way this program of aiding the underdeveloped countries may become practical in the long run is for U.S. citizens to acquire income-bearing investments in convertible currencies of industrialized nations. In view of the reluctance of these countries to participate directly in the aid program to any substantial degree, this may be the only way in which U.S. private capital will be able to assist the U.S. Government in earning enough abroad to pay for some of these politically necessary expenditures, without further aggravating the balance of payments deficits.

Invest in Europe must therefore become just as much a national slogan as export to Europe.

President Kennedy, in his message of February 6 on the balance of payments was right in including U.S. direct investment among the assets abroad which provide us with "a strong, solvent position." And Under Secretary of State George Ball, before the Senate Interstate and Foreign Commerce Committee, was right in saying "Nor is it true that private direct investment in Europe has had an adverse effect on our balance-of-payments position. * * *" [34]

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[34] Testimony of May 10, 1960 "Foreign Commerce Study, U.S. Trade and Common Market," p. 142.

THE FAVORABLE EFFECT OF DIRECT INVESTMENT ON THE BALANCE OF PAYMENTS

To the extent that we can measure the impact of direct investment on the balance of payments, the data clearly indicate a favorable effect. True, direct investment adds to our balance-of-payments deficit in any given year by the amount of direct investment undertaken in that year, and it adds to the deficit to the extent that U.S.-owned companies operating abroad export goods to the United States which otherwise would not be imported by the United States. But direct investment, on the other hand, reduces the U.S. balance-of-payments deficit to the extent that earnings on investments are transferred to the United States and to the extent that it stimulates exports to U.S.-owned companies abroad that otherwise would not occur.

According to the Department of Commerce, direct investment in the developed countries amounted to $8,125 million during 1950–60. Against this, remittances of income to the United States from direct investments in the developed countries amounted to $6,564 million, leaving a net unfavorable balance of $1,561 million.[35]

But the cumulative unfavorable effect over the 1950–60 period was smaller than the measurable part of the favorable trade effects of direct investment in 1959 and 1960 alone. The Department of Commerce estimates that exports from the United States to U.S.-owned subsidiaries in Canada and Western Europe in 1959 and 1960 were $2,713 million. Imports into the United States from subsidiaries, after eliminating imports of paper, pulp, and foodstuffs, were but $527 million, leaving a net favorable balance of $2,186 million which more than compensates for the adverse balance during the 11-year period when we consider only direct investment flows and remittances of earnings.[36]

There are of course a number of effects of direct investment on the balance of payments which cannot be measured. Direct investment may displace U.S. exports which otherwise would have occurred, and some of the products exported to subsidiaries might well have been exported to foreign buyers had the subsidiaries not provided a market. On the other hand, some of the imports bought from subsidiaries would have been provided by foreign suppliers had they not been supplied by U.S.-owned companies because of the basic market requirements and demands in the United States.

Any estimate of these immeasurable effects must of course be conjectural. We do know that a significant amount of U.S. private investment has been defensive, i.e., designed to prevent the loss of established markets previously supplied through exports from the United States. To the extent that this has been the case, we cannot say that investment has led to the displacement of exports. A Department of Commerce survey in 1952 covering 247 companies with investments abroad reported that 38 percent of the companies invested abroad for defensive reasons.[37] The problems created by the European Economic Community for U.S. exports to Europe and the uncompetitiveness of some U.S. exports in recent years suggest a continuation of this phenomenon.

As President Kennedy stated in his speech of December 6, with respect to the balance-of-payments problem, "A long-term deficit requires long-term solution * * *." And naturally any policy proposal to rectify balance-of-payments disequilibrium must consider not only the immediate effects but also the long-term consequences for the balance of payments. As with Britain in the 19th century—the only other major international investor—U.S. investment income has become an important source of support for the U.S. balance of payments. Prof. Paul Ellsworth summarized the role of investment income for the British as follows:[38]

"The British balance of payments had been under no strain from 1870 onward. Not only was a large and somewhat irregularly growing excess of imports over exports paid for out of the earnings of British foreign investments and those derived from the merchant marine and from insurance and banking

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[35] "President's 1961 Tax Recommendations, Hearing before the Committee on Ways and Means, 87th Cong., 1st sess.," vol. 4, p. 3523, table 2.

[36] President's 1961 tax recommendations, hearings before the Committee on Ways and Means, 87th Cong., 1st sess., volume 1, pp. 430 f., tables 1 and 2. The Department of Commerce segregates imports of paper, pulp, and foodstuffs from U.S. subsidiaries without explanation; however, it probably does this because it believes that these imports would have occurred even if U.S. companies abroad had not supplied them to the United States so that they should not be regarded as having been caused by direct investment.

[37] Barlow and Wender, "Foreign Investment and Taxation," p. 116.

[38] "The International Economy," New York: The McMillan Co., 1950, p. 423.

commissions, but there was also a substantial surplus available each year for additional investment overseas * * *.

"* * * A huge stake in foreign investment yielded a substantial annual revenue. Together with large earnings from services, this enabled the country to import each year far more than it exported and in addition to export a large sum of capital."

In the 20th century, Britain relied heavily, especially in the war years before the advent of Lend-Lease, upon her oversea investments to finance her war effort. Seliing some investments and putting others up as collateral for loans from the United States, by the end of the war Britain had shifted from a net creditor to a net debtor.

To the extent that we take action today to reduce U.S. investment abroad there will be less capital overseas on which to earn funds to remit to the United States in the future or to pay for extraordinary military and foreign aid expenditures abroad. The impact is by no means negligible. A one-shot investment of $1,000 today will produce, according to a hypothetical illustration in Secretary Dillon's submissions, 40 percent more annual income remitted to the United States in the 20th year after the investment if taxes are deferred on reinvested earnings than if they are not.[39] Given the important role that foreign investment income has come to play in the U.S. balance of payments in recent years, differences of this magnitude are significant.

There is, in addition, a danger that the unequal and inequitable tax treatment of income on U.S. investment in European subsidiaries may diminish the earning power of American companies operating there, to the extent that their foreign-owned competitors, enjoying more favorable tax treatment, may undersell, through competitive price reductions, the products of American-owned companies in Europe. Thus, the income on past investments, which the Treasury, in its assumptions, takes as a fixed item, uninfluenced by the current tax proposals, may in fact diminish, thereby reducing the amount of future earnings that may be repatriated. The Treasury has given no consideration to the long-range effect of this competitive disadvantage on the earnings and repatriation of dividends on past investments. It must be realized that the proposed competitive disadvantage will work, not only on new investments, but also on the earning power of investments already made. Although the proposed taxes may not diminish the outflow of investment capital, they may very well affect unfavorably the amount of earnings available for dividends in a fiercely competitive market most likely to develop in the European Economic Community. This will be of no help to U.S. balance of payments.

FURTHER COMMENTS ON EQUITY

The President stated in his tax message of April 20, 1961, to the House of Representatives:

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

"If we are seeking to curb tax havens, if we recognize that the stimulus of tax deferral is no longer needed for investment in the developed countries, and if we are to emphasize investment in this country in order to stimulate our economy and our plant modernization, as well as ease our balance-of-payments deficit, we can no longer afford existing tax treatment of foreign income." [40]

The Secretary of the Treasury supported this viewpoint in his testimony:

"* * * 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. I believe that reasons of tax equity as well as reasons of eco-

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[39] "President's 1961 Tax Recommendations, hearings before the Committee on Ways and Means, 87th Cong., 1st sess.," vol. 1, p. 80.

[40] President's 1961 tax recommendations, hearings before the Committee on Ways and Means, 87th Cong., 1st sess., vol. 1, pp. 8, 9.

nomic policy clearly dictate that in the case of investment in other industrialized countries we should give priority to tax neutrality in the choice between investment here and investment abroad." [41]

In its previous memorandum of June 6, 1961, the IEPA demonstrated that the proposed taxes on unremitted dividends to create a supposed equality of treatment between investments in the United States. and abroad are, in fact, inequitable. They do not provide for carry-back and carry-forward of losses; nor do they compensate for the greater emphasis on excise taxation in various foreign countries, such as franchise, turnover, stamp, and sales taxes.

American companies operating in Europe are subject to all the taxes owed, and all that are paid by their competitors. Since in the major market areas which they serve, they must compete with their European competitors, the principle of fairness and equality of competitive standards is met under present tax treatment of earned income. The American owners in the United States pay higher taxes, in most instances, than the beneficial owners of foreign companies abroad, insofar as U.S. rates on the repatriated portion of earnings are higher. In this sense, there is already an advantage in favor of the foreign owners. There seems little justification in equity to make things worse for U.S. enterprise trying to compete in foreign markets.

THE EXPORT-OF-JOBS ARGUMENT

The President has stated, in his speech in Miami before the AFL–CIO convention on December 7, 1961:

"Are we going to export our goods and our crops, or are we going to export our capital? That is the question that we are now facing * * *.

"We are attempting to repeal those tax privileges which make it particularly attractive for American capital to invest in Western Europe."

To prove that present tax treatment of income on private investment in Western Europe is causing "export of jobs" instead of goods, it is necessary to prove that (1) taxation is a primary motivation in locating plants and reinvesting earnings in Europe; and (2) by the elimination of tax deferral until earnings are remitted, more capital would be invested in the United States, thereby creating economic growth, leading to export of end products, instead of capital and jobs.

These are the assumptions, unproved, underlying exhibit III of the Treasury's presentation before the Senate Finance Committee on April 2, 1962.[42] There is no proof presented in the record of hearings before the Ways and Means Committee or the Finance Committee that our present tax treatment of foreign investments is a primary motivating reason in the investment of U.S. private capital in Europe, and that by the proposed new taxes a substantial amount of such capital would be invested in the United States and help economic growth at home.

Under Secretary of Commerce Edward Gudeman covered this point with candor in his statement before the Subcommittee on Foreign Economic Policy of the Joint Economic Committee on December 14, 1961: [43]

"Senator PELL. One further thought, question, is that I was wondering, Would your views be with regard to the thought of insisting that American corporation abroad pay income taxes at the American rates as earned, instead of waiting to be repatriated?

To my mind, that thought runs a little bit counter to the very philosophy we are trying to spread through the reciprocal trade program of more freedom of movement of capital and labor.

"Mr. GUDEMAN. * * * Frankly, I think that our viewpoint on taxing profits in American-owned foreign companies or partially owned foreign companies does not loom as a very important point to us one way or the other, sir. After all, those companies may pay foreign taxes, and we are talking about the developed countries now, not the less developed countries.

"Senator PELL. Correct.

"Mr. GUDEMAN. Because there we have a different viewpoint. But in the developed countries, the American companies pay a—pay foreign taxes and receive a credit on it over here. While those taxes are somewhat lower than our

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[41] Ibid., p. 34.
[42] Summary, pars. 3, 5, 8, main statement, pp. 14–16.
[43] Hearings on foreign economic policy, p. 402.

own, they are not materially lower, so that whether one taxes them that little bit or not, we do not believe affects materially at all foreign investment, and the company that wants to invest abroad is going to do so regardless of which way you gentlemen decide on that particular tax proposal. That is our viewpoint.

Inquiry of managements of a number of large companies operating plants in Europe indicates that tax treatment is not a major factor in the decision to invest there. More important are transportation costs, lower costs of production,[44] expansion of the European market,[45] a desire to "get in on the ground floor," and proximity to markets so as better to gage local tastes. In fact, many of the companies queried state that they would invest in Europe regardless of taxes, thus negating completely the Treasury's argument on balance of payments and the broader argument of "exporting jobs." Many products, such as soap, cement, mill products, and consumer hard goods, could not be manufactured and transported long distances, because of the controlling factor of transportation costs, unless there was a very substantial cost differential in favor of U.S. production for export, which is nonexistent or insufficient in most products vis-a-vis Western Europe, particularly the Common Market.

Thus it cannot be proved that tax deferral is a primary motivation in setting up plants in Europe, or that the elimination of tax deferral will materially alter the amount of U.S. private investment in Europe. The average of U.S. capital outflow to Western European subsidiaries 1957–60, estimated by the Treasury Department,[46] amounted to $437 million.[47] Even if it were shown, in some isolated case, that tax incentives were a factor in the investment decision, this could be of infinitesimal significanse in both the balance-of-payments or capital outflow picture, and equally inconsequential with respect to the major issue of economic growth in the United States. The "export of jobs" argument cannot be sustained by the facts.

PRIVATE INVESTMENT VERSUS FOREIGN AID

It is interesting that the cry of "export of jobs" is not raised in connection with the decade of development and Alliance for Progress foreign economic aid programs, both of them gigantic capital export projects estimated to provide, through various national and international agencies, for the export of $40 billions of capital in the next 5 years,[48] designed primarily to stimulate industrial development—mostly through gifts, grants, low- or no-interest loans. As the administration proposes to have free trade in industrial products to the Common Market and extend these privileges to other countries with most favored nation clauses in trade treaties, the "export of jobs" cry could with equal logic apply to foreign economic aid.

Nor were the present balance of payments arguments raised by spokesmen of the administration in connection with the foreign aid bill of 1961 and 1962. In fact, the original bill submitted by the State Department to Congress in 1961 provided, in case of both the military and the economic assistance funds, for procurement outside the United States. Thus the administration requested in the original bill $12,860 million, with discretion to spend anywhere in the world. It was Congress that brought balance of payments considerations into the framework of foreign aid policy by amendments to the bill.

It is difficult to see how private and governmental agencies can support unquestioningly billions of dollars of public appropriations for industrial investments abroad, without expressing concern for balance of payments and "export of jobs" and yet, with any intellectual consistency, pounce upon the much smaller amount of private investments in Europe as a means of rectifying the balance of payments problem, assisting U.S. growth, and preventing the "export of jobs."

After all, does export of public taxpayer financed capital cause any less drain on the balance of payments, or the economic growth and job potentials, if in-

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[44] The National Industrial Conference Board in its recent report, "Costs and Competition, American Experience Abroad," states (pp 92–93) that in the Common Market countries, "relatively low wage rates on the one hand and considerable technological sophistication on the other have made possible unit labor expenditure that in half the area observations was 55 percent of the U.S. level." Total unit costs averaged out at 96 percent of comparable U.S. costs.

[45] Expansion of consumers' markets should permit even lower production costs.

[46] "President's 1961 Tax Recommendation," hearings before the Committee on Ways and Means, 87th Cong., 1st sess.," vol. 1, p. 75.

[47] Including one large nonrecurrent investment of $360 million in 1960.

[48] Includes U.S. contribution through AID legislation, Public Law 480, contributions to international agencies, Alliance for Progress.

vested in Ghana for aluminum, in Mexico for irrigation to encourage cotton plantation, in India to build textile or pharmaceutical plants, than income producing investments in Western Europe?

The IEPA, in discharging its responsibility to the national security interests of the United States, is attempting to develop a consistant body of economic policy. For this same reason, we have supported the foreign aid program, with due regard to safeguarding our balance of payments; mobilization of U.S. capital and labor resources; and encouragement of the consumption levels of aid-receiving countries (to avoid reexporting aid-financed products back to the United States).

We equally favor giving encouragement to private capital investments in both developed and underdeveloped countries, for the same purpose of helping to lift the productive technology and consumption levels of the areas where capital is invested, with the additional advantage that, whereas public assistance is on a gift, grant, and low- or no-interest basis, with little likelihood of return, private investment will bring an earned income, which in the long run the United States will sorely need to carry out its other international responsibilities.

IMPACT ON TRADE

There is some evidence that import of foreign produced goods into the U.S. market is having an impact on many industries, and labor in those industries is therefore becoming restive under our present trade and tariff policies. Some labor leaders are therefore equating import competition with export of U.S. private capital, and asking for drastic curbs.[49] It is not impossible that, to defend its trade policy, and secure support for the new trade program, the tax proposals are intended as a tacit concession to this critical viewpoint.

If so, it is a misplaced emphasis. In quantity, American companies abroad reship but a very small percentage of their production back to the United States. All U.S. manufacturing subsidiaries in Western Europe did a total amount of sales of $9.3 billion in 1960, of this only $115 million was reexported back to the United States.[50]

It is unbelievable to charge that U.S. business has gone abroad for the specific purpose of reselling only 1.2 percent of their European production back to the United States, or that $115 million worth of such imports from U.S. subsidiaries causes any appreciable amount of unemployment or loss of jobs. Even if we assume the ratio of employment to sales that Mr. Stanley Ruttenberg of the AFL–CIO has presented, imports from U.S. subsidiaries of $115 million would be equivalent to 9,600 jobs. Of course, it cannot be assumed that if U.S. subsidiaries in Europe did not sell this amount of goods in the U.S. market that some other foreign national would not have supplied the same goods with similar effect. U.S. subsidiaries, therefore, cannot be held responsible for having caused displacement of so many jobs. This point is borne out by the fact that of the $115 million of imports from U.S. subsidiaries in Europe more than half was automobile parts and assemblies, and yet we know for a fact that the total automobile parts and assemblies shipped from Europe to the United States amounted to $541 million. This proves the point that if U.S. companies were not engaged in this trade, foreign companies would have supplied the market anyway.

While U.S. subsidiaries abroad were selling $115 million worth of goods to the United States in 1960, these same subsidiaries were importing $636 million worth of goods from the United States[51] and thereby creating, on the same basis, 53,000 jobs, a net increase subtracting the imports of 43,400 jobs.

It has been alleged by the Treasury Department and labor spokesmen that much of the $9.3 billion total sales by U.S. subsidiaries in Europe constitutes a substitution for possible exports direct from the United States, and they propose to correct this through the recommended changes in taxation for foreign source income. This allegation assumes that these subsidiaries went abroad to undertake legitimate manufacturing enterprise because of the difference in tax rates, and that the proposed taxes will correct or reverse this motivation.

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[49] See speech by Albert Hayes, president, International Association of Machinists, in Washington, D.C., Nov. 27, 1961, as reported in the Washington Post and Times-Herald of Nov. 28, 1961.

[50] Survey of Current Business, September 1961. Also, letter to Chairman Mills from Under Secretary of Commerce Gudeman, June 22, 1961; hearings, Ways and Means Committee, on "President's 1961 Tax Recommendations," vol. 1, p. 427.

[51] Ibid. Gudeman letter, June 22, 1961.

How much of a motivation is the difference in tax rates between the United States and Europe in investments in manufacturing facilities over there? Income taxes in Western Europe in 1957 (the only year for which such data is available) comprise 4.8 percent of total manufacturing costs, as against 63.6 percent for material and services, and 20.9 percent for wages and salaries. Now the income tax rates average 43 percent in Europe as compared with our 52-percent rate in the United States. The difference between the average European rate of 43 percent and the U.S. rate of 52 percent would equal nine-tenths of 1 percent of total manufacturing costs. Compare these with differences in wage rates between the United States and Western Europe of 300 percent, affecting 21 percent of total costs. It is advanced as a serious argument by the Treasury and labor spokesman that nine-tenths of 1 percent difference in expenses is a real cause for the expansion of U.S. manufacturing enterprise in Western Europe, instead of differences in wage rates, transportation costs, duties and many other facts that influence business decisions regarding location of industry, and that the elimination of this nine-tenths of 1 percent differential in total costs will reverse this trend.

From the foregoing, it can be deduced without contradiction that the $9.3 billion worth of sales of U.S. subsidiaries in Western Europe, if not undertaken by American-owned enterprise, would have been in all likelihood supplied by European-owned enterprise. If American subsidiaries are discouraged from entering this market, then foreign companies will fill the needs. The United States would lose in tax revenues on dividends and would lose the beneficial effects of repatriated income on the balance of payments.

Most of the exports to the United States are by foreign-owned producers beyond the taxing power of the United States. Even if not a single American company were operating abroad, we would probably have the same amount and kinds of imports as we have now. There is enough capital and technological knowledge in Europe, Canada, and Japan to produce any consumer products and export them to the United States without participation of U.S. management and capital.

With education and training a cardinal objective of our AID programs, with massive amounts of capital being made available by U.S. taxpayers for industrial development, and possibly, in the next decade, Soviet Russia, Czechoslovakia, and other Communist countries, too, all of these things will be a factor in international competition. We must not get into the mental attitude, as when we thought we could keep atomic secrets a U.S. monopoly, that by keeping U.S. private capital at home, we shall hold our technological advantage with an imaginary economic Maginot line around the United States, thereby solving the problem of foreign competition.

The answer to the questions posed for U.S. competitive strength by the surge of industrial development all over the world lies in other areas—domestic tax policy and depreciation policy, wage and budgetary programs at home, and above all, trade policy. In each case, the questions must be asked, will each of these policies lower costs and prices, will they create conditions of competitive equality, will they create economic growth, prevent raids on the U.S. economy and assist in balancing our external payments and supporting our political and military commitments?

In each case private organizations, the Executive, and the Congress must be very sure that policies recommended or adopted achieve these national purposes.

CONCLUSIONS

1. The proposed taxes on foreign source income of subsidiaries will not materially assist in solving the balance-of-payments deficits in the short run, and will definitely have a serious adverse effect on our balance of payments in the long run.

2. The proposed taxes on foreign source income of subsidiaries will affect U.S. exports adversely, without appreciable diminution of imports.

3. U.S. private investment abroad does not export jobs, but creates new markets for exports of U.S. products and is, therefore beneficial to employment in the United States.

4. If U.S. companies are discouraged by taxation or any other device from setting up plants abroad, the result will not be to shift production to the United States, but to give up their opportunities for market penetration in Europe and other continents to their foreign competitors, with detrimental effect on American workers, the U.S. Treasury and the balance of payments.

5. The recommendations of European Ministers and other officials to use taxa-

tion as a means of discouraging U.S. investments in Europe are in line with the political and long-range economic interests of European countries, but not necessarily consistent with U.S. interests in the present juncture of our international financial position.

6. There are other more promising means of correcting the balance of payments deficits, of creating economic growth and job opportunities than the proposed taxes on foreign source income of U.S. subsidiaries abroad; such as sharing foreign aid and military expenditures with our allies, stricter controls over foreign aid expenditures, curtailment of unnecessary expenditures abroad for luxuries.

RECOMMENDATIONS

1. As the U.S. balance-of-payments deficits are due primarily to U.S. military expenditures abroad and cash out-payments under the foreign aid program, the immediate solution for this problem is in these two areas:

(*a*) Establish tighter legislative and administrative controls over the expenditure of aid money abroad, as long as our balance-of-payments deficits persist, by limitation or prohibition of balance-of-payments loans to other countries, by restricting appropriated aid funds to be spent for procurement in the United States, by confining U.S. aid to specific projects and that portion of such projects that require purchases of U.S. materials and equipment.

(*b*) By directing the President and the State Department to negotiate an arrangement with members of the Organization for Economic Cooperation and Development for equitable sharing of foreign aid burdens, this to be accompanied by a commensurate reduction of U.S. commitments to the extent that other countries agree to undertake a portion of the foreign aid requirements.

2. Direct the President and the State Department by appropriate legislation or resolution to negotiate an equitable arrangement for the sharing of our offshore military expenses with our allies.

3. Substitute in part cash procurement by our allies of military assistance given NATO countries under the AID bill to the extent that such military assistance is still appropriated for balance of payments surplus countries.

4. Encourage exports by specific forgiveness or relaxation of taxes on that portion of industrial production that is exported, and revise the treatment of allocation of profits under section 482 of the Internal Revenue Code to accomplish this result.

5. If the foregoing measures do not prove sufficient to balance U.S. international payments, then attention should be directed to curtailment of luxury imports, instead of curtailment of investments abroad. Under present programs, including the proposed Trade Expansion Act which proposes unlimited imports under free trade conditions for 185 million consumers in the United States together with the tax program to discourage U.S. investments abroad, the Nation will have adopted the profligate policy of encouraging imports for consumption from abroad while discouraging the prudent policy of savings and investment in income-bearing assets abroad. If the choice has to be made, and we hope we do not reach this predicament, then it will be better to curtail unneeded luxury imports, easily procurable in the United States, perhaps at a higher cost, instead of discouraging the prudent policy of saving and investing abroad on which we can earn a return into the indefinite future.

6. Confine corrective legislation with respect to foreign operations of U.S. individuals and companies to elimination of blatant abuses of our tax laws, consisting of devices and schemes to siphon off income generated through transactions, in purchase or sale of licensing of goods, services and patents, where one end of the transaction is in the United States and therefore legitimately within the taxing jurisdiction of the United States.

Appendix A. On "Gross-Up"

Testimony of N. R. Danielian, President, International Economic Policy Association

I am appearing today on behalf of the International Economic Policy Association as its president. With me is Mr. John Walker of Jones, Day, Cockley & Reavis, as counsel. The membership of the association consists of American companies and individuals with a common interest in encouraging the development of effective U.S. international economic policies and programs, in bolstering the national security, and in stimulating economic development abroad through private invesment and private ownership. The association was formed upon the premise that given a condition of military stalemate or deterrence of terror, the struggle between totalitarian systems and free nations will continue in an intensified form in the area of political and economic institutions.

We believe that the United States is now confronted with the necessity of reexamining its international economic policies, to determine whether they will accomplish our national aspirations to encourage the evolution of stable governments, in the direction of political and economic freedom, against the determination of other ideologies to subvert country after country and establish state ownership of all the means of production, with consequent enslavement of individuals to the state.

OBJECTIVES OF THE ASSOCIATION

To assist in this reexamination the association has adopted the following four basic objectives, or yardsticks, whereby to evaluate proposed policies and programs:

(1) The maintenance of adequate U.S. and free world deterrent military power.

(2) The strength and continuous growth of the U.S. domestic economy.

(3) The viability of the economies of our allies and independent nations and the rapid economic development of underdeveloped countries, encouraged with particular attention to the creation of complementary rather than competitive economies.

(4) The pursuit of these objectives within the framework of private ownership of property and private enterprise—the historical foundations upon which the institutions guaranteeing individual freedom, protection against arbitrary action of government, and parliamentary representative governments have developed.

We try therefore to evaluate proposals affecting international economic policies in the light of these four principles. We shall try to do this here specifically with regard to H.R. 10859 and H.R. 10860. These proposals do not materially affect the first and second of the above stated objectives. They would definitely concern the third and fourth points.

THE ASSOCIATION OPPOSES THE PROPOSED H.R. 10859 AND H.R. 10860

The association is opposed to the legislation now before this committee because we believe that its passage would inhibit the pursuit of objectives three and four, and thus impede the encouragement of effective U.S. international economic policies and programs.

These bills would have the effect of increasing taxes on dividends from foreign investments, and thus will tend to discourge private investment abroad by U.S. investors.

Why this legislation, in our opinion, is undesirable may best be illustrated by considering these questions:

(1) What is the declared policy of the Government and the Congress regarding the position of private enterprise in international economic development?

(2) Why is this particular proposal being brought before the Congress at the present juncture of our history?

(3) What would be the effect of the proposed changes upon the declared international economic polices of our Government?

PREVIOUS U.S. POLICY HAS FAVORED ENCOURAGING U.S. PRIVATE INVESTMENT ABROAD

With respect to the first question there is a long history of affirmation by the Congress and the executive branch of the U.S. Government to encourage the utilization of private enterprise in international economic growth and development.

The President has stated the administration policy on this point as follows:

"Through increasing two-way international trade and stimulating in every practical way the flow of private investment abroad, we can strengthen the free world, including ourselves, in natural and healthy ways. * * * By so doing, we can lessen and ultimately eliminate the heavy burden of foreign aid which we now bear."[52]

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[52] Reference in regard to President Eisenhower's statement. Statement of Hon. Henry Kearns, Assistant Secretary of Commerce for International Affairs, hearings before the Subcommittee on Foreign Trade Policy entitled "Private Foreign Investment," House of Representatives, 85th Cong., 2d sess., December 1958, p. 12.

The Congress adopted the policy of encouraging U.S. investment abroad by including section 413 in the Mutual Security Act of 1954 (as amended):

"Encouragement of free enterprise and private participation: (a) The Congress recognizes the vital role of free enterprise in achieving rising levels of production and standards of living essential to the economic progress and defensive strength of the free world. Accordingly, it is declared to be the policy of the United States to encourage the efforts of other free nations to increase the flow of international trade, to foster private initiative and competition, to discourage monopolistic practices, to improve the technical efficiency of their industry, agriculture, and commerce, and to strengthen free labor unions; and to encourage the contribution of the United States enterprise toward economic strength of other free nations, through private trade and investment abroad, private participation in the programs carried out under this act (including the use of private trade channels to the maximum extent practicable in carrying out such programs), and exchange of ideas and technical information on the matters covered by this section."

This policy regarding foreign investment has recently been supported and reiterated without exception by the responsible officials of our Government who are in charge of our foreign economic policy, namely Mr. C. Douglas Dillon, Under Secretary of State, Mr. Henry Kearns, until recently Assistant Secretary of Commerce who spoke for his department, Mr. David Lindsay, Assistant Secretary of the Treasury, as well as spokesmen of the Department of Defense and Department of Agriculture. Their statements are included in an attached appendix.[53]

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[53] Hearings before the Committee on Ways and Means, House of Representatives, 86th Cong., 1st sess., on H.R. 5, "Foreign Investment Incentive Act," July 1959:

Representative from the State Department, Hon. C. Douglas Dillon, Under Secretary of State, p. 78: "Free private enterprise is the very basis of our free system. On this foundation stands the freedoms we hold so dear—freedom of thought, freedom of expression, freedom of religion, and freedom of the individual. This system of ours is now facing a formidable challenge from totalitarian communism. In the underdeveloped world this challenge now largely takes an economic form. If our free system is to prevail we must show the people of these lands that the private enterprise system is in their best interest. This can only be done if our American private enterprise plays a substantial role in the development process. This in turn requires adequate incentives for our private businessman."

Representative from the Department of Commerce, Hon. Henry Kearns, Assistant Secretary of Commerce for International Affairs, p. 9: "American business has amply demonstrated that it will support our national foreign policy. But in the strictly economic sense, American companies invest abroad for just one reason—to make money by better serving the consumer. If it is in the national interest to promote U.S. private investment abroad, and I believe it is, we must not forget this economic fact of life."

Representative from the Department of the Treasury, Hon. David A. Lindsay, Assistant to the Secretary of Treasury, p. 35:

"The need to enlist resources and talents of American enterprise in helping to improve the economies of the less developed countries is particularly important today, with a hostile Communist bloc actively pressing a massive economic offensive against the free world.

"Secretary Dillon stated, in testimony before your committee's Subcommittee on Foreign Trade Policy last December, that he regards the problem of achievement in freedom of higher living standards in the less developed as the primary economic and political problem of the 20th century. He observed that it is a problem in which the interests of our Government and our business community coincide, so that a real opportunity exists for a joint effort in attacking it."

Hearings before Subcommittee on Foreign Trade Policy, Committee on Ways and Means, House of Representatives, 85th Cong., 2d sess., entitled "Private Foreign Investment," December 1958.

Representative from the International Cooperation Administration, Hon. James H. Smith, Jr., Director, p. 36:

"What I have said during my 14 months as International Cooperation Administration Administrator is summarized better than I could, in a statement which your chairman made to the National Foreign Trade Council 2 weeks ago. He stated:

" 'Private investment of American funds abroad is preferable to Government spending for many reasons, not the least of which is the fact that such investment assures the most economic use of limited U.S. resources. The plain truth is that the need for capital by the free nations of the world is far larger than the amounts which our taxpayers can reasonably provide. For this reason alone private American capital must be encouraged to go abroad and take upon itself the task of preserving in the world the free system which we earnestly believe deserves to be fostered and preserved.' "

Representative from the Department of the Treasury, Hon. Dan Throop Smith, Deputy to the Secretary of the Treasury (in charge of tax policy), p. 54:

"One additional point, if I may, Mr. Chairman: In this prepared statement I have dealt entirely with tax aspects. I did so only because of the testimony submitted earlier

That it is in the national interest to stimulate private investment abroad has been the conclusion of numerous studies recently completed, including the report on "Expanding Private Investment for Free World Economic Growth," submitted in April 1959 by Ralph I. Straus;[54] the report of the Committee on World Economic Practices of the Business Advisory Committee of the Department of Commerce, chaired by Mr. Harold Boeschenstein, submitted January 22, 1959;[55] the Rockefeller Report on "Foreign Economic Policy of the 20th Century," completed in 1958[56] and such earlier studies as the Randall report completed in 1954.[57]

Not only is this a declared policy of the Government but in the administration of the Development Loan Fund it is now being put into effect. Appropriations made available to DLF are as much as possible being lent through private

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by the State Department, the Commerce Department, the International Cooperation Administration, dealing with other aspects of the problem.

"I should, of course, like to associate the Treasury Department with the opening remarks of Secretary Dillon dealing with the importance of private foreign investment and the importance of maintaining balance in the various foreign investments."

Representative from the Department of Defense, Hon. Robert H. Knight, Deputy Assistant Secretary of Defense for International Security Affairs, pp. 64 and 65:

"In the vast less developed areas of the world, it would appear that, under appropriate circumstances, a tremendous opportunity for reward awaits the U.S. businessman willing and able to contribute to their development. Assuming, as would appear in the long-range interest of the private investor as well as of the United States, the host country was enabled to participate suitably in the economic benefits arising out of such investments, such investments should contribute materially to the economic growth and stability of such areas—and hence to the welfare of the United States.

"Here again, and largely for the reasons previously cited, private enterprise in the United States, appropriately encouraged, could substantially and profitably contribute to our national defense support objectives with either resultant savings to the public or more effective results in the achievement of national goals.

Increased investment abroad by private enterprise of capital, machinery, and industrial techniques could also contribute effectively to this country's military assistance program."

Representative from the Department of Agriculture, Hon. Max Myers, Administrator, Foreign Agricultural Service, p. 73;

"With respect to the general topic of U.S. private investment abroad, it is, of course, clear that the net outflow of U.S. private investments contributes to other countries' buying power for U.S. products, including agricultural products. However, it is very difficult to identify any particular share of our export trade in general, or in agricultural products in particular, with the fact or the extent of U.S. private capital investment abroad. Such capital movements add to the dollar supply abroad potentially available for imports from the United States. Many of these investments contribute to financing economic growth abroad; and one of the results of economic growth in the world at large, is the growth of international trade."

[54] "Expanding Private Investment for Free World Economic Growth," prepared by Mr. Ralph I. Straus, as special consultant to the Under Secretary of State for Economic Affairs, Washington, D.C., April 1959, p. 1:

"This report is based on the conviction that, even in countries which have adopted a large measure of central economic direction, the encouragement and release of private initiative will greatly accelerate the rate of growth. Furthermore, dispersion of economic power is important in preserving and enlarging the scope of freedom and individual dignity."

[55] "Report of the Committee on World Economic Practices," under the direction of Mr. Harold Boeschenstein, Business Advisory Committee of the Department of Commerce, January 1959, p. 1:

"Use of private enterprise: It is of the utmost importance that new and greater use be made of the resources and initiative of private enterprise. In this report, therefore, the Committee has indicated ways in which private energies of the United States and its allies can be more effectively mobilized in the free world's economic programs, and through which the private sectors of the less developed countries can be strengthened."

[56] The Rockefeller report on U.S. international economic policy entitled "Foreign Economic Policy for the 20th Century," report of the Rockefeller Brothers Fund special studies project, 1958, p. 57:

"In addition, we recommend that the U.S. Government take direct action to encourage the flow of private funds into international investment by providing appropriate tax incentives for foreign investment. At the very least, the advantage now provided to Western Hemisphere corporations of a 14-point reduction in the corporate income tax should be extended to the rest of the world."

[57] Commission on Foreign Economic Policy Report to the President and the Congress, under the chairmanship of Clarence B. Randall, Jan. 23, 1954, p. 16:

"Fortunately, the economic welfare of the United States would itself be directly promoted by an increased movement abroad of sound investment by U.S nationals and corporations. Such a flow, if well conceived and directed, would not only contribute to an increase in international trade, but would assist in the maintenance of high levels of economic activity and employment within our own country. It can increase our national income by taking advantage of opportunities for more profitable investment. It can aid in the development abroad of primary resources to meet the ever-increasing civilian and defense needs of the United States and the free world. And, since private U.S. investment usually carries with it management and technical skills, it can contribute strongly to the economic development of foreign countries.

"Such an increased flow of private investment abroad can also assist in attaining U.S. foreign policy objectives through strengthening the economy of the free world, and can reduce the burden of military aid by increasing productivity abroad."

foreign institutions to encourage private industries abroad. One needs only to review the list of projects and loans approved by the DLF for the past several months to realize that this is, as far as this particular agency is concerned, a definite working policy of the Government.

It has been therefore an established national policy, supported by the Congress and the Executive and substantiated by both official and private studies, to encourage foreign economic development through private investment.

THE TIMELINESS OF THIS PROPOSAL

It is reasonable therefore to inquire why this proposal is before the Congress at this time. Certainly it is apparent that H.R. 10859 and 10860 are not intended to abolish an unintended tax benefit. Section 902 and its predecessors have been part of the income tax laws for almost 40 years. They have always operated to reduce the overall income tax rate below the prevailing U.S. rate of corporate tax in cases where the foreign tax rate was lower.

In December 1958 and July 1959 extensive consideration was given by this committee to legislative proposals designed to give incentives to U.S. private investments and trade abroad. The original proposals then before the committee were intended to implement the declared international economic policies of the Government. However, instead of implementing the national policy through the adoption of positive incentives, it is now proposed to reverse the direction of our legislative policy in one area, at least, by withdrawing a long-established tax incentive. Instead of devising appropriate means to encourage an increase in private U.S. enterprise abroad, we are considering a change in the tax rules that can only act as a deterrent.

It may be said that this change in section 902 is desirable to increase tax revenues. The revenue requirements of the Treasury must of course be met but there are many different ways of accomplishing this result. Why has this particular proposal been chosen? Why has this particular segment of the American community been singled out?

It may be said that this is a technical correction. Again there are many technical corrections to be made in the Internal Revenue Code. Why is this particular proposal brought up separately at this time out of context of overall Internal Revenue Code revisions?

THE PROBABLE EFFECT OF THIS LEGISLATION

These questions are of concern to us particularly in the light of the fact that the effect of the proposed changes would be to handicap the effectuation of a declared policy of the U.S. Government, for by any standard of measurement one must admit that the enactment of this legislation would diminish incentives to investment abroad. Furthermore, it would impose a burden not reasonably to be anticipated on those who have ventured into foreign markets believing in the authenticity of the declared Government policy. U.S. business abroad has enough problems because of political instability and severe competition from third country competitors. We should not at this time add one more handicap by withdrawing from them an advantage they have enjoyed for 40 years.

We have all come to recognize that the other countries of the world are going to obtain the means of economic development one way or another. They will secure their capital from Europe, from Japan, from the Soviets. They will secure, if they can, additional capital from our various Government aid programs, to which the U.S. Treasury is a major contributor. In the last 2 years, Congress has made capital available to international programs in the amount of close to $14 billion. These funds are currently being advanced for development of projects all over the world, many if not most of them being state-owned projects.

We believe that in attempting to meet the Communist economic threat, we must give thought not only to the type and amount of economic growth necessary to forestall the advance of Communist influence in underdeveloped areas but also to the institutions through which that development is to occur. The net result of government-to-government economic assistance programs without providing in addition adequate incentive to private business will be a failure to develop the multiplicity of employment units and private ownership necessary for the encouragement of democratic institutions. The development of a growing middle class of property owners is the best assurance against Communist success in these countries.

In theory and in fact what Communists are out to destroy is private ownership of property and enterprise. We have approved for a long time the use of American taxpayers' money in the development of Government-owned projects abroad, which, as the major device to oppose communism, leaves many of us feeling quite insecure. Yet when it comes to encouraging private ownership abroad, which is the only force or institution to take certain and permanent issue with communism we seem to throw both theory and practice to the winds.

We subsidize foreign economic development 100 percent when we make a nonrepayable grant or loan—including soft loans in that category. We likewise subsidize foreign economic development even when we make hard loans at perhaps 5 percent in countries where the going rate of interest may be 20 percent. But when it comes to incentives for private U.S. enterprise to assume risks that are even greater than those the U.S. Government assumes in making its advances, we find ourselves moving backward and considering a deterring change in the tax laws.

It is axiomatic in private business ventures that anticipated profits must be commensurate with risks, and no one can claim that investments through foreign corporations abroad enjoy the security and protection that similar undertakings have in the United States. That the rate of earnings must be greater than could be received from similar ventures in this country must be one of the motivating factors stimulating foreign investment. We must not, therefore, view any differences in the overall rates of taxes between domestic enterprises and those who have ventured abroad as a special tax "loophole" but as an incentive to domestic capital to assume the additional risks of foreign operations. The Treasury will lose far less through a tax concession than the amount needed for the same economic development financed through foreign aid; and at the same time the important objective of increased private ownership abroad will be served.

In short, we must make up our minds as to what we are trying to achieve abroad. Are we committing ourselves to a philosophy of economic and technological development through U.S. taxpayer contributions as a means of keeping the free world free through projects which in most instances turn out to be Government owned? Or are we trying to inject seed money and know-how under an institutional framework of individual enterprise, American as well as native, which will expand and develop into a middle class of traders, shopkeepers, farmers, small businessmen, subcontractors, etc. This is the real battle front between communism and our form of society, and in our opinion it behooves us to reexamine our policies and practices in relation to private enterprises abroad, to encourage them instead of deterring them.

As pointed out earlier the DLF is moving in that direction in the loaning of Government funds. However, since the greater source of capital is in private hands, we will serve our country best by persuading private capital to go abroad and carry out this development work. As the President has stated, such a policy will ultimately reduce the taxpayers' contribution. The passage of this legislation, however, will give notice to the American business community that the Government has no real interest in the growth of private business ventures abroad and that in fact changes in the rules may be anticipated from time to time that may further handicap such ventures.

CONCLUSION

Because we are convinced that the encouragement of private business activity abroad and the resulting creation of a growing class of private property owners in the underdeveloped countries is the best and surest way to combat the spread of Communist economic and political influence, and because this proposed legislation would be a step in the opposite direction, we urge that these bills be tabled and that immediate attention be directed to giving new incentives to private participation in international economic development.

The CHAIRMAN. The next witness is Mr. Winthrop R. Munyan. Please proceed, Mr. Munyan.

STATEMENT OF WINTHROP R. MUNYAN, ATTORNEY (CURTIS, MALLET-PREVOST, COLT & MOSLE)

Mr. MUNYAN. I have submitted a statement, Mr. Chairman.

Mr. Chairman, my name is Winthrop R. Munyan. I am a member of Curtis, Mallet-Prevost, Colt & Mosle, attorneys at law in New York City.

What I have to say to you represents my personal views. I am not acting as representative of anyone else. It represents substantially, however, the thoughts of numerous other persons whom I know and who work in this field.

I wish to speak to one aspect of the revenue bill of 1962 only. That portion concerns the proposed current U.S. taxation at ordinary rates of certain undistributed income of controlled foreign corporations, as defined in the bill, and the ordinary income tax treatment of certain amounts received in the liquidation or sale of shares of such controlled foreign corporations. The sections of the bill involved are sections 13 and 16.

My specific interest in the problems presented by this bill may be simply stated. My firm, since well before 1900, has been deeply interested and active in foreign legal matters—substantially in Latin America but also elsewhere in the world both at the private and at the governmental level.

I, personally, for several years, particularly in the tax field, have been concerned with the legal aspects of foreign business ventures by U.S. entities.

I believe that, from a technical standpoint, several portions of the bill may be properly criticized and raise sufficiently serious problems so that it should not be enacted. I wish to mention only two technical points, one of which I have not heard previously discussed:

First. How are outstanding loans to be paid off by controlled foreign corporations? When the personal holding company sections were enacted, provision was made for this problem by what is now section 545(b)(7) of the code. I see no comparable section in the present bill, and it seems to me quite inequitable.

Second. What is the position of the U.S. shareholder who cannot find out whether the foreign corporation is a controlled foreign corporation? Stockholder lists of many foreign corporations are not available and cannot be obtained; many foreign corporations have bearer shares. Both of these points raise serious questions of equity.

However, my statement is not directed to the technical aspects of the bill but to what I believe is a fundamental conceptual point.

This fundamental point relates to the potentially adverse effect of this bill on the world posture of the United States in a critical period.

In his testimony before the House Ways and Means Committee in May 1961, concerning the President's 1961 tax recommendations, from which this bill finally emerged, the Secretary of the Treasury said the following:

> There is absolutely no thought of penalizing private investment abroad which rests upon genuine production or market advantages (p. 27).

The Secretary further said in the same statement:

During the postwar period, the promotion of private foreign investment in both advanced and less developed countries was in the public interest. Times have changed, and the need to stimulate investment in the advanced countries no longer exists. Hence, there can be no proper claim that preferential treatment should be continued merely to perpetuate a private gain (p. 3).

The administration has also taken the position that the excess outward gold flow caused by an adverse balance of payments is a short-term reason for current taxation of undistributed foreign-source income.

One of the administration's stated contentions, as expressed above by Secretary Dillon, is that there is no longer the need to stimulate investment in the advanced countries. Yet, how is this position consistent with the current administration effort to have U.S. industrial companies put plants in West Berlin?

What Secretary Dillon has called a stimulant to foreign investment; namely, the deferral of taxation of foreign source income until received by a U.S. person, has been a part of the U.S. law since the inception of the income tax. It is a universally accepted principle of international taxation. This is not a new tax benefit recently granted to undistributed foreign-source income.

If we look at what reasonably may be deemed to be the net effect of the controlled foreign corporation sections of this bill, I submit to you that it will have two principal effects:

(*a*) It will substantially inhibit foreign investments by U.S. entities in sales and manufacturing activities abroad.

(*b*) It will place a heavy burden on the ability of U.S. industry to compete in foreign markets.

I submit the following observations and reasons why sections 13 and 16 of the bill should not be enacted:

1. From statements made by representatives of the administration, I discern that the administration believes that this is a most critical hour for the United States in its world posture.

2. The administration has advocated and actively assisted in developing the economic and political unity of Western Europe. It recognizes, however, that the European Community is becoming a great expansive trading bloc which threatens U.S. industry with the most severe competition.

A personal experience recently in connection with competitive bidding for a foreign steel mill gave me ample firsthand evidence that our European friends can give our American manufacturers a stiff beating. Most bids went to the foreign competitors. And I may say that one of the important factors which permitted the European manufacturers to take that business was the strong and flexible tax and financial assistance which their governments were giving to the particular manufacturers involved and to other private business engaged in foreign operations.

3. Despite substantial problems within the Communist bloc, the Soviet Union has made clear its intention with respect to economic competitive coexistence. With certainty this is an aggressive economic challenge in the world markets.

This Soviet challenge is not private; it has the strength of state trading organizations, backed fully by the power of Soviet Government resources. Soviet forays in oil, in barter deals, and in its growing machine tool strength make the challenge of Soviet economic competition a growing threat.

4. In this area of world economic competition it is not the U.S. Government but U.S. industry which must compete. The administration recognizes this. Witness the extreme lengths to which the administration recognizes this. Witness the extreme lengths to which the administration has gone to have its current trade bill favorably considered by the Congress. It is thus trying to overcome the potentially higher tariff barriers which might preclude our products from the Common Market. Does it make sense, in the light of the critical factors stated above, to open areas of competition, as proposed in the trade bill, and reduce the effectiveness of U.S. business which must compete?

This is the challenge that U.S. industry faces abroad. Even more importantly, it is the United States, itself, which finally must take up this challenge if industry is unable to do it.

It is a challenge requiring the greatest of skill, the most abundant effort, the greatest strength within industry itself; the unremitting support of the U.S. Government should be given to the private sector to meet this growing competition.

How does this tax bill provide that the challenge be faced?

The portion of the bill which I am considering will seriously hamper U.S. industry in representing the United States abroad and in strengthening the position of the United States abroad.

Despite Mr. Dillon's statement that investment based on genuine production should not be penalized, this bill is based on the assumption that this is a time to inhibit foreign investment whether it is based on genuine production or not. I question this basic assumption. I contend, to the contrary, that active competitive foreign investment will strengthen the overall U.S. economic position in the world and must be encouraged at this particular juncture.

5. Prior testimony has demonstrated that investment in manufacturing facilities abroad by U.S. industry tends to increase U.S. exports and that such activities, looked at on their own, have resulted in a net favorable balance of trade over the past several years. Mr. Dillon on April 2, in his recent testimony before you, emphasized that foreign subsidiary sales displaced U.S. export sales. The experience of companies with which I am familiar indicates that without the activities of the foreign subsidiary the sales so made would not have been made at all.

The bill as it stands flies in the face of experience as to the way foreign business investment frequently develops. Facts have already been submitted to the Congress that a normal method of carrying on and expanding foreign operations consists in a combination of activities in which the foreign manufacturing subsidiary manufactures part of a line and sells other parts of the production line, thus stimulating export sales from the United States. Further, the subsidiary assists in exploiting know-how and trademarks and provides service arrangements for the U.S. manufacturer. The flexibility of this type of combined operation is a necessity in the face of growing foreign competition. To strike at one portion negates the viability of the whole.

It may be contended that under section 13 of the bill as passed by the House, the net income of foreign manufacturing subsidiaries, if reinvested in qualified property, will not be taxed to U.S. shareholders. However, not only is this exception severely limited, but the Secretary of the Treasury has now requested its elimination where a so-called developed country is involved.

6. There has been much talk of tax equality and of deferral of tax upon foreign income as a tax benefit. In the context in which I am considering the matter, I respectfully suggest that both of these slogans miss the mark as to what is in issue before the Congress. The philosophy of the present income tax law has been based upon the premise that taxation is to be used to accomplish governmental objectives with the aim of equality of taxation where possible. I welcome steps toward tax equality, but the situation of the manufacturer protected within the United States and selling within the confines of that market and the position of the U.S. manufacturer contending in world markets against the type of competition to which I have pointed should not be considered together in discussing tax equality. The problems represented are in separate spheres.

Further, the question may properly be asked: Why does the U.S. segment of the extractive industries located abroad consistently, unless prohibited by local law, use U.S. corporations or branches in carrying on the extractive process? The answer is quite simple—statutory percentage depletion and the write off of intangible costs. Can the administration talk of tax equality and tax neutrality as a basis for the present bill and not face up to the question of percentage depletion?

But, as I have already pointed out, these questions still beg the basic point.

At this critical juncture, can the United States afford to place substantial additional burdens on that portion of our society which, as the representative of the United States, is at present contending with a growing world economic challenge from the European Community and from the Soviet bloc?

The United States cannot afford to retreat. It must continue to advance in the world not only politically, but economically. It cannot do so by placing burdens on present established bona fide foreign business operations and by curtailing seriously the foreign activities and opportunities of the U.S. business community.

It is with this broad policy point foremost in mind that I believe the Congress must review the portion of the present bill which I have been considering. In this light, the answer to me is clear if the United States is to maintain and to strengthen its competitive position in the world. Sections 13 and 16 of the bill should be rejected.

I thank you for granting me the opportunity of stating these convictions to you.

The CHAIRMAN. The committee will adjourn until 10 o'clock tomorrow morning.

(By direction of the chairman, the following is made a part of the record:)

STATEMENT OF DONALD E. LYNCH, EXECUTIVE DIRECTOR OF THE PUBLIC RELATIONS SOCIETY OF AMERICA, SPECIFICALLY TO THE SECTION DEALING WITH THE DEDUCTIBILITY OF EXPENDITURES FOR PUBLIC RELATIONS AND ADVERTISING ACTIVITIES

MEMBERSHIP AND GOALS OF THE SOCIETY

The Public Relations Society of America is a professional association whose 4,500 members represent every facet of the Nation's cultural and economic activity. It has high standards of eligibility and an enforced code of professional ethics. Ethical public relations is deeply concerned with coordination of private interests with the public interest through education and communications.

HARTKE-KERR BILL PREFERRED

The Hartke-Kerr bill should be substituted for the provisions of the House tax bill dealing with deductibility of legislative costs to correct the House bills' serious and unfair discrimination against business and industry, and particularly small business.

There is only one issue posed by the legislative provisions of the House tax bill and that is this discrimination against business and industry. It penalizes business in its efforts to protect itself from harmful legislative proposals. It also penalizes business when it offers its support in behalf of legislation helpful to the community such as bond issues for housing or community development. It actually promotes "undercover" lobbying by imposing costly tax penalties on legislative activities carried out in the open.

The Constitution protects the right of business to petition a legislature and thus to present its case through any form of communications. All authorities agree that the use of advertising and other communications by business to tell its story on legislative issues is appropriate and in the public interest. In fact, the Federal Lobby Registration law clearly recognizes the legality and public interest involved in such communications and provides only for a method of reporting such activities.

Therefore the sole question is whether or not the expenditures for advertising and other communications dealing with legislation should be allowable as costs of doing business under the income tax laws.

The Public Relations Society of America believes that reasonable costs of advertising and communications to the public concerning legislative issues of importance to all business, are among the most essential expenses a business must incur. Ofter the expenses for communications about legislative issues are more important to the survival and financial health of a business than are almost any other costs now allowable.

PENALIZES ALL BUSINESS

Many legislative proposals regarding such matters as licensing, zoning, tariffs, patents, and various efforts to put the Government in competition with private business could, if enacted, force affected concerns to close their doors. Other legislative proposals may threaten numerous businesses and industries.

Obviously, the expenses of defending a business against such legislative proposals are as valid as the costs of fire insurance, property protection, defense against damage suits, and many other expenses now allowed without question.

It has been estimated that during the biannual sessions of the State legislatures, between 90,000 and 100,000 bills are introduced proposing important regulations or controls over business and industry. This is a measure of the need to incur expenses for advertising and communications about legislative problems. Employees, stockholders, customers, suppliers, and neighbors in the communities in which a business operates, should be informed about such regulations or legislation. This can be done only through advertising or other communications that cost money.

The proponents of disallowance of legislative expenses mostly concede that expenditures for communications about legislative problems are appropriate. They simply contend that such expenses should not be allowed as a cost of doing business but should be paid out of profits.

The assertion that legislative expenses should be paid out of profits involves a most unfair discrimination against business and industry. It would, in effect, establish profitability as a gage for access to the legislative process.

Most legislative proposals that would impose costly and burdensome restrictions upon business and industry result from the activities of certain organized groups. But most of such groups are not subject to income taxes.

The Government itself proposes and energetically supports many such burdensome or restrictive measures. Labor unions frequently carry on educational and advertising campaigns to develop their economic philosophy, as do tax-exempt cooperatives. Other programs are supported by nationwide campaigns carried on by voluntary committees, which likewise are not subject to income taxes. All these campaigns by labor and tax-exempt groups require tax-paying organizations to defend their positions.

Thus, in a typical legislative controversy, the House tax bill would penalize business by disallowing these costs while the opponents of business in such controversies, being tax exempt, would incur no such penalty.

DISCRIMINATES AMONG BUSINESSES

The House tax bill involves a discrimination as among individual businesses and industries. Obviously, a business or industry that regularly earns substantial profits can far better absorb the costs of legislative activities out of those profits than can smaller businesses or business and industries that historically earn modest or marginal profits.

The House tax bill's provisions, therefore, discriminate against all business and industry, but single out small businesses and those indutries and firms with modest or marginal profits, for particularly unfair penalties.

These unfair discriminations, inevitably resulting from the House tax bill, would be removed by substitution of the Hartke-Kerr provisions for those now contained in the House measure. The Hartke-Kerr bill recognizes that all reasonable costs for communicating about legislative proposals of importance to business or industry, should be allowed in full as a cost of doing business. This is fair in that it would remove any discrimination as among businesses, and also involves no discrimination as between business and industry as a whole and other groups in the population.

Senator Hartke has pointed out that many businesses often lend their support to measures highly important to community betterment. Industries often give advertising support in campaigns for bond issues to build schools, libraries, parks, and redevelopment projects. Many companies, for example, are supporting the President's new foreign trade program.

HARTKE-KERR BILL IN PUBLIC INTEREST

All these activities are highly desirable in the public interest, yet the House tax bill would disallow the cost of all such efforts, however beneficial to us all.

It is ridiculous and highly unrealistic to contend that the allowance of expenses for communication about legislation would give business the power to influence and control the course of legislation thereafter. Those who so contend feel that the Congress could be persuaded merely by the advertising and other communications to ignore the public interest. The safeguards built into our legislative processes, and the integrity of our elected representatives, all together provide ample protection against such a fancied danger.

On the contrary, to rectify the situation would bring out into the open many more legislative campaigns and tend to reduce the effectiveness and the attractiveness of campaigns conducted less openly and less frankly. To encourage, rather than to discourage, open and public appeals is to bulwark the functioning of the Republic.

STATEMENT ON H.R. 10650 BY JOHN T. CONNOR, PRESIDENT, MERCK & CO., INC., RAHWAY, N.J., CONTAINED IN A LETTER OF APRIL 18, 1962, TO SENATOR CLIFFORD P. CASE, REPUBLICAN, OF NEW JERSEY, TOGETHER WITH AN ARTICLE FROM THE ECONOMIST OF MARCH 17, 1962

The worst provisions from our point of view, and I sincerely believe from the national point of view, are those that relate to the taxation of income earned overseas. We also are deeply concerned about the proposed investment credit which is being offered as an exchange for the other proposals.

The foreign tax provisions of H.R. 10650 go far beyond a mere attempt to reach so-called tax-haven income abroad, to plug loopholes, or to reach tax evaders. They would:

(1) Tax at the foreign operating level as if it were current domestic income:

(*a*) Earnings derived from all expansions of U.S. industries in developed countries, unless confined to the same trade or business carried on since December 31, 1962, or for a consecutive 5-year period;

(*b*) All operating revenues from all new investments made by U.S. industry in developed countries after December 31, 1962, and for at least 5 years thereafter;

(*c*) The operating income of centralized multicountry selling companies formed to market U.S. products made abroad;

(*d*) A large variety of the ordinary operating income of foreign subsidiaries of widely owned U.S. parent companies, such as interest on loans and installment sales, rentals of equipment, and dividends from local operating affiliates. It would accomplish this by classifying such income as "personal holding company income";

(2) Tax U.S. manufacturing firms overseas on their foreign operating income deemed by the Treasury Department to be attributable to the use of American technology such as patents, copyrights, and processes; and

(3) Grant to the Treasury Department, in cases where there are no arm's-length transactions, the authority to adjust the price on sales between a U.S. company and an affiliated foreign company on the basis of an arbitrary formula involving the relative amounts of assets, payroll, and selling expenses located in the foreign country and in the United States. This would thereby subject an arbitrary portion of the consolidated profits on such transactions to U.S. taxation even though such profits may already have been taxed in the foreign country.

These provisions would put U.S. industry at a substantial competitive disadvantage in these countries, primarily in the European Common Market. Foreign-owned competitors will be able to expand normally into new competitive product lines and operations without being subject to additional tax burdens such as this. They will be able and, in fact, are encouraged by their own governments to sell in countries through one multicountry selling company. Their other operating business income will not be subject to the tax proposed to be imposed here on U.S.-owned companies.

The additional proposal to attribute foreign operating income to the use of American technology is unreasonable and probably unworkable. It would pose particularly serious problems where foreign governments have disallowed or restricted royalty payments to recipients outside of the foreign country.

The proposal with respect to the allocation of sales prices through the application of a formula is unnecessary and arbitrary. At the present time the Internal Revenue Code in section 482 provides that sales to subsidiaries must be at an arm's-length price and gives the Treasury authority to adjust the sales price on any transaction between the parent and the subsidiary where this basis is not used. An allocation on the basis of the proposed formula which depends on assets, payroll, and selling expenses is not a determination of what would have been an arm's-length sales price. Particularly inequitable allocations will result in cases where sales to foreign subsidiaries are of intermediates used in further processing overseas, a situation we often encounter.

The Treasury has advanced various justifications for the foreign tax proposals. These include balance-of-payments considerations, achievement of equality with other U.S. taxpayers, loss of exports, and the export of jobs. It is difficult to understand any of these arguments.

The proposals cannot properly be justified on the grounds of balance-of-payments considerations. Our own experience supports the facts developed by the Department of Commerce and those submitted in the hearings last year before the House Ways and Means Committee. We have 32 foreign subsidiaries in many countries of the world. We have 19 plants in foreign countries producing largely from intermediates or bulk chemicals supplied to them from the United States. We found it necessary to establish these companies in order to maintain, gain, or expand a market which would not otherwise have been available to us. They were not set up for tax reasons. The direct foreign investments were relatively small initially. The major part of the current value of these companies has been created with the earnings of the subsidiaries themselves which expanded as justified from local aftertax earnings. During the 5 years ending in 1960 our U.S. dollar foreign investment requirements amounted to $13 million. During this same period the inflow of dollars from sales to our foreign operating subsidiaries, and from dividends and royalties they paid us, amounted to $82 million.

We can see no justification for the tax proposals on the grounds of equality with other U.S. taxpayers. These subsidiaries operate in foreign countries and are subject to a variety of taxes which would not be considered income taxes. Their competition in the markets in which they sell is primarily from other producers in those same areas, both foreign and American owned. Any additional taxation imposed by the United States, or limitations on expansion of the operations of these subsidiaries through the imposition of taxes, to which foreign producers are not subject, would put us at a distinct competitive disadvantage.

We do not believe there is any merit to the argument that the establishment of these foreign subsidiaries has resulted in the loss of exports from the United States or in the export of jobs. As I mentioned above, we established these companies because we had to in order to maintain or expand existing markets or to enter into new ones. Rather than resulting in the loss of exports or of jobs, our establishment of these companies has resulted in an increase in our exports from the United States and greater employment here and, on these export sales alone, a favorable flow in the balance of payments. The following is indicative:

(1) Two of the most important products produced in our Rahway plant, which employs 1,150 people, are vitamin B_6 and vitamin C. We estimate that 45 percent of our production of the former and 25 percent of our production of the latter are exported.

(2) Our Danville, Pa., plant employs about 900 people. Three of its most important products are steroids, penicillin, and high-grade silicon. We estimate that 40 percent of our production of steroids, 30 percent of our production of penicillin and 20 percent of our production of silicon are exported.

(3) Our plant in Elkton, Va., employs 600 people. Its three most important products are amprolium, streptomycin, and dihydrostreptomycin, and vitamin B_{12}. About 30 percent of our production of amprolium, 50 percent of our production of streptomycin and dihydrostreptomycin, and 35 percent of our production of vitamin B_{12} are exported.

(4) The 2 most important products produced at our plant in Albany, Ga., which employs 110 people, are chlorothiazide and hydrochlorothiazide of which about 10 percent is exported.

It is our firm conviction that a substantial part of these exports and the jobs attributable to them would not have been available had we not established our foreign operating and other subsidiaries.

I would particularly call attention to the dramatic fact that this tax bill would directly conflict with the objectives of the pending trade bill (H.R. 9900). Foreign trade and foreign investments are working partners. If it is right that there should be more freedom in the movement of trade, and I believe there should be, there should be more—not less—freedom in the movement of capital.

The investment credit is not likely to serve its intended purpose of encouraging new investments. We plan to make substantial capital investments during the forthcoming year, mostly in the United States but some abroad. The decisions to make these investments rest on sound economic and business considerations and we will make the investments whether or not the investment credit provisions become law. I have talked with many other business executives and they tell me that their position is the same. There is a real danger, too, that once enacted, such credit would be used by the Treasury as an excuse for delay-ing a more realistic approach to depreciation which, as you know, is presently inadequate to allow for the needed modernization of plants through the replacement of older equipment. The depreciation allowed for tax purposes in most industrialized foreign countries is substantially higher than that allowed in the United States.

In summary, we believe that the tax bill is unworkable, unrealistic, not justified by facts, and is likely to put American industry at a substantial competitive disadvantages abroad at the same time that the administration is trying to encourage U.S. trade with the Common Market countries. We believe that it will result in the loss of exports and the resulting loss of jobs and have an adverse effect on the balance of payments. The enclosed article "Why Businessmen Leave Home" from the March 17, 1962, issue of the London publication the Economist presents the matter realistically and succinctly.

[The Economist, Mar. 17, 1962]

Why Businessmen Leave Home

(From an American correspondent in Europe)

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 mythmakers. 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.

For example, President Kennedy, in an understandable effort to promote his new trade bill, has given fresh currency to the myth that firms establish branches or subsidiaries in Europe to "get inside" the tariff wall around the European Economic Community. In fact, they do nothing of the kind. They establish subsidiaries in Europe because the market is large and growing. Finding an American company, whose main incentive for setting up an operation in Europe was the new tariff, is like trying to find a needle in a haystack.

The EEC has, of course, been an inducement to foreign investors for another reason: it holds out prospects of a much larger European market for any given concern in any one of the six countries. But even this can be exaggerated. In spite of the prospect of complete free trade, German firms are investing sizable amounts in other countries belonging to the Common Market. Many American firms are setting up shop in more than one European country. In numerous cases—in Italy, for example—a large and growing domestic market provides foreigners with sufficient inducement to invest.

Myth No. 2 involves the balance of international payments. Here Europeans, including even such august figures as central bankers, have been as much victims of the myth as have Americans. Without allowing for any of the many offsets on the receipts side, the total cost to the American balance of payments of the "invasion" of the Common Market in the peak year of 1960 was only $280 million. This compares with total payments by the United States of $31 billion, a payments deficit of $3,900 million, and an outflow on direct investment account of $1,700 million. Moreover, the figures usually cited give the total value of the new investment, not the impact on the American balance of payments. A great deal of the money comes from reinvestment of earnings by firms already established overseas or is raised locally. A firm moving into Belgium, for example, would be mad to use dollars when it can cover as much as two-thirds of the investment with loans raised locally at subsidized rates of interest.

Needless to say, American investment in Europe also generates income—not only in dividends and royalties, but also in the form of exports of both equipment and components. One recent study of 19 large American firms showed that they alone sold more than $150 million of exports to their oversea affiliates in each of the past 4 years, or enough from these companies alone to close the "gap" in the balance of payments between dollar outflow for new direct investment in economically advanced areas and the present return from dividends.

The third myth relates to taxation. The idea prevails that the present law, which permits payment of American taxes on corporate income earned abroad to be deferred until it is repatriated, was adopted in the postwar period as an "incentive" for private investment. In fact the provision has been in the law for several decades. What is more, it "induced" very little investment in Europe until it became plain to all that Europe was booming. Now that investment in Europe has proved profitable and become fashionable, there is little reason to believe that a change in the tax law would curb it significantly. Businessmen in the United States continue to fight against a change, for the good reason that the present law gives them much more flexibility in their operations abroad. But tax considerations are by no means paramount in the basic calculations that go into the typical decision to plunge into a new market. An American who had just set up a subsidiary in Belgium remarked recently, "We took all their tax subsidies with pleasure. What they didn't know was that we would have come anyway without them."

The final myth is the most difficult to combat factually, though this does not mean that it contains more truth. The myth is that investment in Europe means less investment (and fewer jobs) in the United States. The unanimous response of businessmen to this allegation is that establishing plants in Europe has been imperative to preserve or create markets that would otherwise have been lost to European competitors; for reasons which differ according to industries, there was no prospect of supplying these markets with goods made in the United States. Labor costs, transport costs, the need for close knowledge of local conditions (and once in a great while tariffs) are the sorts of reason given.

This argument cannot be shrugged off. One significant evidence of its truth is that, in spite of a few widely publicized examples, exports back to the United States from manufacturing subsidiaries established abroad have been trifling. To supply the home market businessmen invest at home; domestic investment is still 10 times as large as that overseas, even allowing for the portion of foreign investment financed by means other than dollars from the United States. To supply the foreign market, businessmen sometimes have to invest abroad. For better or worse, the flow of American firms to Europe will continue until saturation point has been reached, almost regardless of tariff changes and tax changes. And, of course, this will strengthen the position of American business in the world—as many Europeans are well aware.

(Whereupon, at 4:05 p.m., the committee recessed, to reconvene at 10 a.m., Tuesday, May 1, 1962.)

REVENUE ACT OF 1962

TUESDAY, MAY 1, 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 Flood Byrd (chairman) presiding.

Present: Senators Byrd (chairman), Kerr, Douglas, Gore, Talmadge, Williams, and Butler.

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.

Senator KERR. Mr. Chairman, I would like very much to have the opportunity to present the first witness this morning who is Mr. T. Dwight Williams of Oklahoma, a very distinguished accountant, and a member of the firm of Arthur Young & Co., with whom I have been acquainted for a period of such duration that I am not disturbed about, but in view of the fact that he is probably under compulsory retirement, maybe as a courtesy to him I should not mention just how long it has been, but it has been long enough to learn that he is one of the finest men I know of, and I am happy to introduce him to the chairman.

The CHAIRMAN. We are very happy to have you, Mr. Williams. Take a seat and proceed.

STATEMENT OF DWIGHT WILLIAMS, PARTNER, ARTHUR YOUNG & CO., OKLAHOMA CITY, OKLA.

Mr. WILLIAMS. Thank you, Mr. Chairman.

My name is Dwight Williams. I reside in Oklahoma City, Okla. I have been actively engaged in the practice of public accounting as a certified public accountant since 1925. That will disclose some of the information that Senator Kerr withheld from you.

During that period of time our practice was in the Southwestern States, principally Oklahoma and Texas. The majority of our clients were small business people, individuals, partnerships, and corporations. In 1961 our firm merged with Arthur Young & Co. and I am at the present time a partner of that accounting firm. I would like to say now that the views I express here today are solely mine.

I should like to make two points for the consideration of the committee. The first is the need of business in general, and particularly small business, for a fixed policy and procedure of determining the depreciation deduction used in computing taxable income. Second, the need for an additional tax deduction equal to the increased cost, caused by inflation, of replacing equipment.

Before entering into a discussion of either of these two points, I should like to state here that I have had the privilege of working with a great many people in the Internal Revenue Service, not only at the local level, but in the last few years at the national level. I have never known a group of people more dedicated to their jobs and to the proposition that the tax liability of taxpayers must be determined as fairly and collected as expeditiously and painlessly as possible.

I might say here that since April 15, I am quite certain they will never attain the goal of making the collection of taxes painless. Mr. Dillon and Mr. Caplin and their predecessors are to be congratulated on the character and quality of the personnel, taken as a whole, of the Internal Revenue Service.

Now, to get to the first point, computation of the depreciation deduction has provided examining agents probably the greatest area for making changes in the income tax returns which they examine. Such changes have, over the years, resulted in collecting little additional tax but merely in shifting the tax between years.

The allowance for depreciation is a source of funds, particularly for small business concerns, now used in financing the equipment needed for replacement of equipment retired from service. The purchase of new equipment is frequently financed by bank loans or by the equipment dealer or manufacturer, and payments often keyed to the amount of the estimated depreciation deduction.

Earnings of the taxpayer, after taxes, are of course important in this financing but funds available from the depreciation deduction are of equal importance. Because this is true a reasonable and accurate determination of depreciation which can be projected for a period of years is necessary. In the past such a determination has been impossible because examining agents are people with varying experience and ability to properly evaluate the factors involved in determining the "reasonable allowance for depreciation" provided by the present statute.

The service has for a long time held that the taxpayer is in possession of all the facts surrounding the use of equipment and, therefore, should establish the depreciation rates or "reasonable allowance." In spite of this view, agents consistently and frequently proposed changes in the rates established by the taxpayer. These changes have either been accepted by the taxpayers (many times because they result in no ultimate increase in taxes over a period of a few years) or have been the subject of long drawn out controversies.

The majority of these controversies have been settled after considerable cost in time and money to the Service and the taxpayers. Many times such settlements allow the taxpayer a major portion of the depreciation claimed. These controversies have been the source of much annoyance to taxpayers and certainly have not built goodwill for the Service.

The administration in 1953 recognized that changes in depreciation deductions were not actually changes in the overall liability of a taxpayer but merely resulted in shifting his liability between years. In that year it issued revenue rulings 90 and 91 designed to minimize changes by agents in depreciation claimed by the taxpayer. These rulings have curtailed such changes but have not eliminated them. One of the most frequent changes now being made is in the provision for an estimated salvage value which may be realized when the equipment is retired; another, the elimination of the depreciation deduction in the year of sale if the sales price of the asset exceeds its adjusted basis.

I might say, too, the determination of salvage value of equipment with a long life at any time is rather difficult, and highly questionable.

Taxpayers have no assurance that the policy established by revenue ruling 90 will be continued. The policy can easily revert to the one established in the early thirties by T.D. 4422.

The code provides for "a reasonable allowance for depreciation." The Commissioner has prescribed in Bulletin F what I hope are minimum rates. These rates insofar as they apply to certain industries have recently been amended by providing shorter lives for the equipment used in those industries. It is my understanding studies for other industries and, perhaps for most of the items listed in Bulletin F, are presently being made.

However, as long as establishing rates of depreciation remains an administrative function, the depreciation deduction will continue to be a major source of controversy between taxpayers and the Service.

Depreciation rates, probably by classification of equipment, high enough to provide liberal depreciation deductions should be established by legislative action. Taxpayers using these rates should have the assurance that the depreciation deduction claimed will not be changed. Taxpayers using higher rates, resulting from estimated shorter useful lives of the equipment, should have the burden of supporting the rates claimed.

I understand that at the present time industries engaged in manufacturing items for space exploration have a terrific problem in determining proper depreciation rates with obsolescence being the high factor it is.

If this is done, taxpayers can with assurance make projections of at least a minimum depreciation deduction which they so often need to arrange the financing of new equipment. This treatment could be somewhat along the lines of the Canadian system and this system could be used as a guide. A summary of the Canadian classification and rates, together with a brief explanation of the depreciation provisions of their law, is set out on pages 6, 7, and 8 of the attached pamphlet which is "Canadian Income Tax—A Concise Explanation, October 1961."

Those pages have been photostated and are attached to the copy of the memorandum the Senators have.

The credit for investment in depreciable property which is a part of the 1962 revenue bill provides relief as a temporary measure but it does not solve the problem for the long haul. Only the setting of rates by legislation can do this.

Mr. Dillon in his statement before the Joint Committee on Internal Revenue taxation in discussing depreciation said:

Depreciation is one of the most difficult items of business costs to deal with under income tax accounting. As a charge against income or addition to business costs, it is designed to spread the cost to business of using depreciable capital assets over their useful economic lives. Its purpose is to charge to each accounting year a proportion of the original cost of each asset so that over the life of the asset there will be reflected its loss of value due to wear and tear, including the destructive forces of the elements, and obsolescence.

He said nothing to the effect that depreciation is a means of providing funds for replacement of equipment. I am sure he would not deny that this is true. If one of the purposes of depreciation is to match costs—the Secretary said "original costs"—against revenues and thus provide funds for maintenance of the present capacity, it should be obvious this cannot be done unless adequate consideration is given to the fact that, due to inflation, replacement costs have increased and to the recovery of these additional costs. The immediate recovery of these additional costs is particularly important to those smaller taxpayers who finance these purchases on a short-time basis.

It is my understanding that certain bills recognizing this principle are now pending before this Congress. One of these is S. 720 the Hartke-Keogh bill which provides for reinvestment depreciation. This type of depreciation would allow an immediate deduction for the increased cost of replacement due to inflation as determined by applying an index number representing the change in value of the dollar to the original cost of the equipment. There are probably other methods of treating this increased cost but the method provided in the bill should furnish the relief needed.

Perhaps the tax credit provisions of the bill under consideration grew out of the recognition that these additional replacement costs exist, without giving consideration to the difference between the original costs and the inflated replacement costs.

I might point out that this consideration has already been approved in inventory items where the Congress has provided for last-in, first-out inventory pricing methods, and it seems to me, if, it is applicable to quick moving items such as inventory, it should be more applicable to these long-term capital items.

I appreciate the opportunity of presenting to the committee my thoughts on the need for a fixed policy and procedure of determining the depreciation deduction and for an additional deduction to cover the increased cost caused by inflation of replacing depreciable property. I trust you will give the points favorable consideration and recommend to the Senate the legislation needed to supply the remedy.

Thank you.

(The attachment to Mr. Williams' statement follows:)

Deductions

Depreciation

Under the Income Tax Act applicable to 1949 and subsequent years, depreciation is required to be computed by the declining-balance method at rates not in excess of the maximum prescribed by regulation for various broad classes of assets The maximum rates and an indication of the type of assets included in each class are as follows:

Class I—4 percent: Bridges, canals, roads, parking areas, dams, etc.

Class II—6 percent: Electric, steam, and water generating equipment, and electric, gas, steam, and water distributing equipment and pipelines.

Class III—5 percent: Buildings (see also class VI) and equipment, docks, trestles, etc.

Class IV—6 percent: Railway and tramway systems.

Class V—10 percent: Pulp mills, except hydroelectric plants and equipment.

Class VI—10 percent: Frame, log, and corrugated buildings, fences, storage tanks, etc.

Class VII—15 percent: Scows, marine railways, ships, and equipment.

Class VIII—20 percent: Machinery and equipment, office furniture, fixtures and equipment, and other depreciable tangible assets not included in another class.

Class IX—25 percent: Radio and nonutility electric generating equipment.

Class X—30 percent: Automotive and contractor's equipment, mining, logging, and oil and gas well equipment, etc.

Class XI—35 percent: Leased electric advertising signs.

Class XII—100 percent: Tableware, dies, jigs, patterns, molds, uniforms, tools costing less than $50, and underground mine shafts constructed after production has begun.

Class XVI—40 percent: Aircraft, aircraft equipment, and spares.

Class XVII—8 percent: Telephone and telegraph systems.

Class XVIII—60 percent: Motion picture film.

The basis to which these rates are applied is the net balance in the class at the end of the taxable year (including construction in progress) before deducting depreciation for the current year. Thus, on additions, a full year's depreciation is allowed in the year of acquisition even though the asset might have been acquired on the last day of the year. Where assets are acquired from persons with whom the taxpayer is not considered to be dealing at arm's length, the basis for depreciation in the hands of the taxpayer cannot exceed the depreciated tax basis in the hands of the transferor. Upon subsequent sale by the taxpayer the cost to the non-arm's-length vendor is used to calculate depreciation recaptured.

Although the regulations prescribe the maximum allowable rates of depreciation which may be claimed, the taxpayer may claim any lesser amount or none if he wishes. Thus it may be expedient in loss years to claim less than the maximum amount of depreciation so that more can be deducted in future years beyond the period of loss carryover. The amount allowable does not depend in any way on the amount of depreciation deducted in the accounts.

Leasehold improvements are amortized over the term of the lease but where there is a right of renewal the amortization period includes the initial term and the next succeeding term. In any event, the improvements may not be written off over less than 5 years. Leasehold improvements are required to be amortized on the straight-line rather than on the declining-balance method. If the lessee makes major improvements, such as the erection of a building on leased land, such costs are depreciated at statutory rates rather than amortized over the term of the lease.

Patents, licenses, and franchises are subject to amortization, in the same manner as in the United States, on a straight-line basis.

Accelerated depreciation at 150 percent of the normal rates will be allowed for the year of acquisition in respect of depreciable property acquired in the period June 21, 1961, to March 31, 1963, to the extent such expenditures exceed "base" expenditures measured by the expenditures in the last year ending before June 21, 1961 or the average expenditures for the last 3 years ending before that date, whichever is less.

In the case of the first new subsidiary in Canada of a nonresident company not already carrying on business in Canada, the additional depreciation will apply to all capital assets purchased in the period (the "base" expenditures being zero).

Also, extra depreciation equal to 100 percent of 1 year's normal depreciation may be claimed in respect of fixed assets acquired for production of products not previously produced in Canada or for businesses commencing operations in "surplus manpower areas."

Certain shipping and defense production facilities may quailfy for further accelerated depreciation.

Government approval is required prior to claiming an extra or accelerated depreciation.

The CHAIRMAN. Thank you very much, Mr. Williams. You have made a very interesting statement.

Now, in your statement I note you say that the credit for investment in depreciable property which is a part of the 1962 Revenue Act provides relief as a temporary measure but it does not solve the problem for the long haul. Is it your judgment that the adoption of this tax credit would delay a reform and modernization of the depreciation schedule?

Mr. WILLIAMS. I should not think the adoption of this credit would need to delay it, Senator Byrd.

The CHAIRMAN. But it is not a temporary problem; it is not something temporary in the view of the administration. It is permanent.

Mr. WILLIAMS. I think that is true, but I do not think it provides the amount of relief that will be required.

The CHAIRMAN. I agree with you.

I just wondered if you adopt this, which is going to cost $1.4 billion a year, wouldn't that defer or postpone indefinitely the modernization of the depreciation schedule which you think should be done?

Mr. WILLIAMS. Well, I would certainly hope it would not. I should think there would be no need for it.

The CHAIRMAN. You would think what?

Mr. WILLIAMS. I should hope it would not, and I see no reason why it should.

The CHAIRMAN. Well, one reason is that it costs $1.4 billion, and it is not going to be—this is not proposed as—a temporary expediency by the administration; it is a permanent solution.

Mr. WILLIAMS. I understand that, and if we have revision of depreciation, while it might result in greater allowances for depreciation than even a credit, I think it is something to which the taxpayers are entitled, and I would hope certainly that this committee would not let the passing of the credit delay the other needed reform.

The CHAIRMAN. It is a question of costs frequently, you know; you can only lose so much revenue.

Mr. WILLIAMS. I understand that.

The CHAIRMAN. If you allocate $1.4 billion to the tax credit, it would seem to me that it would certainly delay the other modernization that you speak of, which would be costly to the Treasury, too.

Mr. WILLIAMS. I appreciate your view, but I still say that I see no reason for it to delay it.

The CHAIRMAN. Well, do you favor the tax credit?

Mr. WILLIAMS. I beg your pardon?

The CHAIRMAN. Do you favor the tax credit?

Mr. WILLIAMS. Well, I would rather see our reinvestment depreciation provision put in than the tax credit. But if we have to have one or the other, and can only get the tax credit, I would take it. I think the tax credit will be helpful, but I think the provision for reinvestment depreciation will be more helpful.

The CHAIRMAN. All right. Thank you very much.

Mr. WILLIAMS. Yes, sir.

The CHAIRMAN. Senator Kerr.

Senator KERR. What you are saying is on the basis of adequate incentive, in your judgment, reinvestment depreciation would be a more equitable and more effective incentive than the tax credit.

Mr. WILLIAMS. I think that is true, Senator.

Senator KERR. And, therefore, as between the two you think it would be more beneficial to whatever industry was affected?

Mr. WILLIAMS. I think it is more equitable because it gives relief to those people who have owned equipment for a long time, that have inflation that has hit them to the point that maybe it would cost them twice as much as it originally did to properly upgrade their plants and modernize them, whereas this other credit would only allow them a portion of that.

I really think the reinvestment depreciation is more equitable and would better serve the economy of the country; yes, sir.

Senator KERR. You think it is a better approach; you are not advocating it as a substitute, you are just advocating it as what you believe to be the more equitable approach, and an approach which would be more effective and which you think is just.

Mr. WILLIAMS. I think it would be a happy situation if the taxpayer might have the option to take one or the other.

Senator KERR. But you think in the overall picture reinvestment depreciation would be more equitable and more advantageous than the tax credit if the choice were between the two.

Mr. WILLIAMS. Yes, I do.

Senator KERR. That is all.

The CHAIRMAN. Senator Williams.

Senator WILLIAMS. Mr. Williams, if you think this tax credit is fair and equitable and should be approved, do you think it should be extended to buildings as well as machinery or do you think it is fair to just confine this tax credit to machinery only?

Mr. WILLIAMS. Are you talking about the 7-percent tax credit, Senator?

Senator WILLIAMS. That is right.

Mr. WILLIAMS. I really had not given that a great deal of consideration. I think any reinvestment depreciation should be extended to building and plant and all the assets that the industry needs, but the 7-percent tax credit—I really had not considered it.

Senator WILLIAMS. Why would you extend one to all and not extend the other, if they are——

Mr. WILLIAMS. I would extend the reinvestment depreciation to building and plant for the reason that you cannot modernize plant without having the buildings to put it in.

If you are talking about the 7-percent credit for rental properties and that sort of thing, I am not sure that I would advocate that.

Senator WILLIAMS. But you cannot modernize a plant with new machinery without modernizing the building under the investment credit proposal either.

Mr. WILLIAMS. That is quite true, and if the 7-percent credit is for the purpose of encouraging the modernization of plants, it should necessarily go, I think, to the buildings which would house the plant.

Senator WILLIAMS. That is the point. But you think if it is going to be kept in the bill it should be expanded to include buildings as well as machinery?

Mr. WILLIAMS. Yes, I think so.

Senator WILLIAMS. Yes.

Mr. WILLIAMS. But if you are talking about rental property such as shopping centers and that sort of thing, I do not think it need apply to those.

Senator WILLIAMS. Of course, in the event we extended this to buildings, and assume we kept it in the bill, it would cost us practically double the amount of the $1.4 billion which has been estimated on machinery.

Do you have any suggestions as to how we can make up that deficit in revenue?

Mr. WILLIAMS. I would not attempt to try to advise on that. I do not have enough information on that.

Senator KERR. Would the Senator yield?

Senator WILLIAMS. Yes.

Senator KERR. You would yield to the wisdom of the committee in that regard?

Mr. WILLIAMS. I certainly would.

Senator WILLIAMS. If the wisdom of the committee moved in the direction of adopting a change in the corporate rates or a change in the depletion rates for oil, you would still underwrite the wisdom of the committee?

Mr. WILLIAMS. I think I would be willing to even risk depletion allowance to the committee.

Senator WILLIAMS. And the Congress?

Mr. WILLIAMS. And the Congress.

Senator WILLIAMS. How do you feel about changing the depletion allowance?

Mr. WILLIAMS. Well, sir, I do not think it would be advisable. I recall shortly after the Battle of El Alamein, I talked with one of the prominent oilmen of the country, who said that that battle would go down as the turning point of the war, and that if we had lost it we would fight the war over here, and I think if we do not keep our oil reserves up we will probably fight the next war over here.

Senator WILLIAMS. You think if we keep our oil reserves up there won't be any war over here then?

Mr. WILLIAMS. I think it would go a long ways toward keeping it away, yes, sir.

Senator WILLIAMS. Do you suppose if we exempted the oil industry from taxation in its entirety it would give us permanent peace?

Mr. WILLIAMS. If that were possible and necessary, I think I would; yes, sir.

Senator WILLIAMS. Thank you. No further questions.

Senator KERR. You found one witness who knew what he was talking about, didn't you? [Laughter.]

Senator WILLIAMS. Out of respect for the witness and the Senator from Oklahoma, I will express no opinion on the conclusions of the witness in that particular connection.

Mr. WILLIAMS. Thank you.

Senator DOUGLAS. Mr. Williams, in your testimony you propose the maximum depreciation rates be set by legislation rather than established by administrative order; is that correct?

Mr. WILLIAMS. Yes, I think that is correct, Senator Douglas, the effect of it.

Senator DOUGLAS. On the basis that this is done in Canada?

Mr. WILLIAMS. It is done in other places, I think, but Canada is an example I cited; yes, sir.

Senator DOUGLAS. It is rather complicated, is it not, to find out the rate of depreciation and obsolescence of machinery and equipment in various lines and to establish varying rates?

Mr. WILLIAMS. What I was saying, I think was that if we could establish minimum rates by legislation in classifications and brackets, then if the taxpayer wanted to go outside of those rates he would have the burden of establishing it. As long as he stayed within those rates they would be accepted.

Senator DOUGLAS. Do you mean by a minimum rate—what do you mean by a minimum rate?

Mr. WILLIAMS. Well, I mean to say, for example, if the schedule provides that a piece of machinery can be recovered in 10 years, that is what I would call a 10-percent rate, which would be the minimum rate.

If a taxpayer decided, due to some unusual circumstances, such as obsolescence, that 5 years was proper for the useful life, he would have the burden of proving it.

Senator DOUGLAS. On the sheet which you submitted as an appendix——

Mr. WILLIAMS. Yes, sir.

Senator DOUGLAS (continuing). Which, I take it, is the Canadian provision——

Mr. WILLIAMS. Yes, sir; that is the Canadian provision.

Senator DOUGLAS (continuing). The first paragraph says that the maximum rates and indication of the type of assets included in each class are as follows, and then they give 18 classes varying from 4 to 100 percent.

Now, the Canadian law uses the term "maximum rate."

Mr. WILLIAMS. That is the maximum rate that you can take without the rate being questioned. If you want a higher rate than that the burden is on the taxpayer to establish it.

Senator DOUGLAS. I see.

Mr. WILLIAMS. To establish a shorter life. Their maximum is my minimum. I guess I am speaking from the taxpayer's standpoint.

Senator DOUGLAS. I see.

You have a great deal of confidence in Congress that we can determine the correct depreciation and obsolescence rates of the whole gamut of American industry.

You have much more confidence in our ability than I have in my own.

Mr. WILLIAMS. I think you could do it, Senator.

Senator DOUGLAS. No, no. I ask to be excused from that. I think the most we can do is to lay down general principles, and have an administrative group carry out the details. As a matter of fact, as you know, the Internal Revenue Service has been working for years on a revision of Bulletin F.

Mr. WILLIAMS. Yes, I know.

Senator DOUGLAS. They have gone into quite some detail on this matter.

Mr. WILLIAMS. I understand it is about ready to come out.

Senator DOUGLAS. Do you really think this should be determined by legislation?

Mr. WILLIAMS. Yes, I do.

Senator DOUGLAS. What makes you think that? Do you believe you can get a better break from Congress than you can from the Internal Revenue Service?

Mr. WILLIAMS. Well, Senator, for one thing, I do not know how many revenue agents there are, but there are a great many in the

United States, and their experience, as I say, varies from time to time or from man to man, rather; and I think really unless you go through a long-drawn-out process of appeal and working it out in conferences with the reviewers, you won't get as good treatment with the agents as I am sure the Senator would give it.

Senator DOUGLAS. Did you say—repeat that.

Mr. WILLIAMS. I say I do not think you would get as good treatment with the agents as I think the Senators would give us. Now, when we get up to the top echelon—

Senator DOUGLAS. The Senators know less about it than the agents.

Mr. WILLIAMS. When we get up to the top echelon, I think all these questions can be solved and have been solved. But you waste a lot of time doing it, and that was really the point I wanted to make.

Senator DOUGLAS. You frighten me, and I see the prospect of at least 1,000 visitors coming to every Senator's door with a determination of specific depreciation rates.

Would you favor having Congress establish transportation rates for the railways?

Mr. WILLIAMS. Well, I had not really considered that.

Senator DOUGLAS. Well, the whole development of administrative law, of course, has been for Congress to lay down general principles, and for administrative agencies to take on the specific applications. If we take on specific tasks, I just shudder at the prospect.

That is all, Mr. Chairman.

Senator KERR (presiding). The Senator from Tennessee.

Senator GORE. No questions.

Senator KERR. Thank you very much, Mr. Williams.

Mr. WILLIAMS. Thank you.

Senator KERR. I would like to say, Mr. Williams, that the Senator from Delaware has said that while he did not agree with all you said, he thinks you have a very high quality name, and with that the Senator from Oklahoma wants to agree.

Mr. Eric A. Johnston, Motion Picture Association of America.

Mr. Johnston, we are glad to have you, sir.

STATEMENT OF ERIC JOHNSTON, PRESIDENT, MOTION PICTURE ASSOCIATION OF AMERICA; ACCOMPANIED BY RAYMOND FREEDMAN AND HERBERT ERLANGER

Mr. JOHNSTON. Thank you, Senator Kerr and members of the committee.

My name is Eric Johnston. I am president of the Motion Picture Association of America and the Motion Picture Export Association of America. My address is 1600 I Street NW., Washington 6, D.C.

I want to thank the committee for the privilege of testifying today on certain proposals in the Revenue Act of 1962. In my statement, I shall not go into detailed recommendations. Those are set forth in an accompanying memorandum which I am submitting.

I am aware of the monumental task—some even call it impossible—that this committee faces in striving to equate governmental needs, public policy, and taxpayer troubles. And I shall be brief.

Primarily, I am here today to try to clear up a misconception about the American motion picture industry.

This misconception, in my opinion, has caused the motion picture industry to be covered by a provision of the new tax bill as if we were an enterprise that did not engage in active trade and business abroad.

More specifically, section 13 of the proposed law would tax us in the same way it would tax the recipients of so-called passive income. It would tax us for passive ownership of copyrights even though this does not apply to us. We do not turn over our copyrights to foreign corporations to avoid taxation of income. But this bill would put us in a tax category with those who do.

As a result, the motion picture industry's foreign operations would not be taxed as they should be—namely, the same as the foreign operations of any other American trade or business.

When first informed of this new tax provision, we in the motion picture industry were puzzled. We asked: "Why such treatment?" We asked: "Why such discrimination?"

Perhaps, we concluded, we are simply there because of misconceptions about how we do business.

If this is so, let me try to remedy that now.

If our product was a toaster or a washer, or any other patented or processed commodity, it would be clear that we should be treated like all others engaged in a trade or business. But our product is a motion picture—entertainment, art, an image of light and shadow projected on a screen. This—the nature of our product—regulates how we have to do business overseas, and it may make many of our business operations difficult to understand.

I'll be specific. Here's how it works: Our oversea subsidiaries do not own copyrights. They merely distribute, or license the use of, motion pictures which are protected by copyrights.

These subsidiaries cannot sell the positive prints of motion pictures. The prints must be circulated from theater to theater, and the copyright must be protected at all times against unauthorized users.

Our subsidiaries do not receive passive income. On the contrary, they must solicit exhibition contracts from motion picture theaters, and they must supply the positive prints to fill these contracts. Certainly, this is the active conduct of a trade or a business.

In support of this, I should like to point out to the committee just how active we are. Our member companies operate through subsidiaries in 46 countries of the world. They maintain more than 700 offices in these countries. They employ more than 16,000 men and women. In addition, they distribute motion pictures in 21 other countries through nonaffiliated distributors.

Clearly, this is a sizable, active trade and business in 67 countries of the world. This business generates about 52 percent of the gross rentals of our member companies.

These rentals abroad amount to about $300 million a year. While we are required to spend some of this money overseas, the Department of Commerce estimates that we bring back to this country from $215 to $220 million a year. We bring back most of this money as soon as it is earned, as soon as conditions permit.

Contrast our remittances with the fact that in the last few years our member companies together have sent abroad something less than $25–$30 million each year. This means that almost 90 percent of the dollars brought back by American motion picture corporations represent net dollar earnings for this country's balance of payments.

Relatively speaking, American movies may well be the largest dollar earner of all American enterprises abroad, bringing back almost 10 to 1 in earnings over expenditures abroad.

We know, for example, that our dollar ratio of 10 to 1 is higher than some of the giants of industry operating overseas, such as Standard Oil and General Motors. Standard Oil's ratio is about 4 to 1, and General Motors is about 3.5 to 1.

From an economic standpoint, then, I think one thing is clear: Our subsidiaries abroad are no different from those of any other active American trade or business. And yet, in the new tax bill we seem to be singled out for special and inequitable tax treatment.

I fail to see how this is justified. Right now our country needs more and better export industries. We are an important one. Our country needs dollar earners to help its balance of payments. We make a major contribution.

Our Government is going all out to stimulate and to promote expanded foreign trade. Should an industry such as the movies—an industry that has been remarkably successful in foreign markets—be penalized by a tax bill that could only serve to restrict or shrink these markets, that could only result in sharply reducing the dollars this industry brings back to help the balance of payments?

Mr. Chairman, this concludes my statement. I ask permission to put the accompanying memorandum in the record.

Senator KERR. Very well, sir; it will be put in the record.

Mr. JOHNSTON. It was prepared by our tax committees, a group of some 24 lawyers and accountants who have a thorough knowledge of international operations and tax problems.

The memorandum includes these specific legislative proposals:

Appropriate changes to remove the motion picture industry from a category in which it does not belong;

A change in the provision on qualified property which under the bill would prevent our member companies from using their funds earned abroad for the legitimate operations of nondistributing subsidiaries;

A clarification to permit the deduction of certain costs of doing business in the same way that amortization and depreciation are allowable deductions for other businesses;

Deletion of a provision which seemingly would prevent the cost of prints, titling, and dubbing from being considered as ordinary and necessary expenses of doing business;

A change to provide more flexible treatment of losses in controlled foreign corporations;

A proposal that the companies not be required to pay taxes on blocked income.

Along with these specific proposals, the memorandum cites two sections of the bill that it recommends should be deleted. These are: Section 11 dealing with "gross-up," and section 21 which proposes that the provisions of this bill supersede treaties. It further suggests a modification of section 16, the proposal in the bill which deals with the liquidation of foreign corporations.

It is our considered judgment that these changes in the tax bill would assure fair and equitable tax treatment for the motion picture industry.

I have with me two members of our tax committee, Mr. Raymond Freeman, of Columbia Pictures, and Mr. Herbert Erlanger of the association. They will be happy to answer any questions.

After that, Mr. Lawrence E. Tryon, treasurer of Walt Disney Productions, will testify on specific problems that his company would face under the proposed tax bill.

I thank you very much, gentlemen.

(Mr. Johnston's statement and attachments follow:)

STATEMENT OF THE MOTION PICTURE ASSOCIATION OF AMERICA, INC., AND THE MOTION PICTURE EXPORT ASSOCIATION OF AMERICA, INC.

This statement is submitted by the Motion Picture Association of America, Inc., and the Motion Picture Export Association of America, Inc., whose members include the principal U.S. producers and oversea distributors of motion pictures. (A list of these member companies is appended.) The Export Association is an export trade association within the meaning of the Export Trade Act of 1918 and duly registered with the Federal Trade Commission under that act. Its membership includes the international subsidiaries of the members of the Motion Picture Association.

This statement concerning certain proposals in H.R. 10650 represents the reasoned views of the tax committees of the two associations. The members of the tax committees are the tax experts of each member company who are intimately familiar with foreign and domestic tax laws and deal daily with these matters on behalf of their own companies.

The associations believe that sections 13 and 16 of H.R. 10650 should not be enacted into law in their present form, and that sections 11 and 21 should not be enacted into law in any form.

I. SECTION 13. CONTROLLED FOREIGN CORPORATIONS

The association and its member companies believe this section should be substantially modified before its enactment into law.

1. Basic treatment of motion picture distributors

The problem.—Under the bill, as now written, it could be contended that the income of foreign subsidiaries of our member companies would be includible under section 952(a) (1) (B) as being derived from copyrights.

The intent of this portion of section 13 of the bill seems to be directed against what may be termed the passive ownership of copyrights whereby we mean copyrights held by foreign corporations, which do not conduct any active trade or business in connection with these copyrights, and where the main reason for the fact that these copyrights are held by a foreign rather than a domestic corporation is a desire to avoid the taxation of income derived by the licensing of these copyrights to other foreign corporations.

This intent would appear to result from what is said on page 61 of the House report to accompany H.R. 10650.

We submit that although our practice is much closer to what the House report considers desirable, we are nonetheless treated in exactly the same fashion as copyright owners who place the ownership of their copyright in a foreign corporation that is a mere passive owner thereof and where the intent is the avoidance of taxes on license fees received from foreign licensees.

The foreign incorporated distributing subsidiaries in our industry merely distribute (i.e., license the use of) motion pictures which are protected by copyrights. They do not own copyrights themselves. They merely hold licenses from the copyright owner, directly or indirectly. They conduct an active business and are, economically speaking, no different than the foreign sales subsidiaries of other American industries except that due to the nature of the product distributed by the motion picture industry the subsidiaries cannot sell the positive prints which must circulate from theater to theater and whose copyright must be protected against unauthorized users. The reason why foreign subsidiaries are used in some instances is due either to the legal requirements or the custom of certain foreign countries, or else it is due to historical reasons where the changeover to a domestically incorporated subsidiary would be too expensive or too inconvenient.

In any event these subsidiaries do not receive passive income but rather derive their income from the active conduct of a trade or business which consists in the solicitation of exhibition contracts from motion picture theaters and the supplying of positive prints to fill these contracts.

The foreign market is vital to the U.S. motion picture industry and, in addition, provides large amounts of foreign exchange for the United States. About 52 percent of the gross rentals on U.S. motion pictures are derived from foreign markets. The total of these rentals is estimated at about $300 million per year.

A portion of this money is required to be spent abroad for distribution expenses, foreign taxes and the like, but the U.S. Department of Commerce estimates that remittances from abroad have amounted to around $215–$220 million in each of the last few years. We estimate that the annual amount of dollars sent abroad in connection with production and other commitments does not exceed an average of $25–$30 million by all of our member companies together in each of the last few years. This means that almost 90 percent of the dollars remitted to the United States augments dollar earnings toward the U.S. balance of payments.

Section 952(a)(1)(B) appears to be directed at recipients of passive income. We submit that we are not amongst those who were intended to be included in these provisions, and we believe that inasmuch as we are substantially conducting the same activities as sales subsidiaries in other American industries, we should be treated the same as they and have the income of our controlled foreign subsidiaries considered as being derived from sales.

The solution.—Our problems could be met by inserting in section 952(c) the following new subsection (4):

"(4) EXCLUSION.—For purposes of subsection (a)(1)(B), the term 'income from United States patents, copyrights, and exclusive formulas and processes' shall not include income received from the active conduct of a trade or business, which trade or business is the licensing of and physical distribution of property protected by copyright."

As an adjunct to this amendment, we would also suggest the insertion of additional language in the following sections:

(*a*) at the end of section 952(e)(2):

"For purposes of this paragraph (e) the terms 'sale' and 'purchase' shall include the licensing and physical distribution of property protected by copyright, whether or not such property is sold."

(*b*) At the end of section 952(e)(3):

"No amounts shall be included hereunder which are received from the active conduct of a trade or business, which trade or business is the licensing of and physical distribution of property protected by copyright."

In addition to the arguments set forth immediately above, certain specific problems exist because of the language proposed.

2. Blocked income

The problem.—At present the bill provides no relief where income otherwise includible is blocked by action of a foreign government. There is presently in existence a mimeograph dealing with the tax deferral of blocked income, but it is doubtful whether this mimeograph could apply to income includible under section 952. Income includible under section 952 should be accorded the same treatment as income includible under IRC section 61 by Mimeograph 6475, 1950–51, CB 50, as amended.

The solution.—We therefore recommend the inclusion of language such as the following proposed subsection 952(a)(4):

"(4) EXCLUSION OF CERTAIN FOREIGN INCOME.—Subpart F income does not include blocked income arising in countries which have monetary or exchange restrictions until the restrictions are removed or the income is actually remitted or utilized."

3. Losses

The problem.—If the tax consequences of operating through a foreign subsidiary are to be equated to the tax consequences of operating through a branch of a domestic subsidiary, the same results should follow in the case of losses as in the case of gains. In the case of losses, the application of the proposed legislation to the foreign subsidiary would result in different tax consequences from the application of existing law to the consolidated return filed on behalf of the parent company and the domestic subsidiary. In the latter case, an offset is permitted for losses of the domestic subsidiary.

Furthermore, the provisions appear to have been drafted on the theory that a dividend distribution will be considered as having been made if it might have been made, either out of current or out of accumulated earnings and profits. Where a company has a deficit in accumulated earnings and profits, a dividend distribution however is normally not made out of current earnings and profits unless and to the extent that the current earnings and profits exceed the accumulated deficit.

Should, for example, a subsidiary in its first 4 years of operation alternately incur an operating loss of $10,000 and make a profit on operations of $10,000, the net economic effect is that the subsidiary will have accumulated earnings and profits of zero at the end of year 4. If the subsidiary in U.S. incorporated, no tax would have been due for any of the 4 years through the application of the loss carryover provisions. In the proposed treatment of foreign subsidiary operations, a tax would be due on the $10,000 profit of year 2 and on the $10,000 profit of year 4, without any offset for the $10,000 loss in year 1, or the $10,000 loss in year 3.

For tax purposes, losses can be treated with in one of three ways:

(1) Offset against past or future profits in that controlled foreign subsidiary (loss carryovers and loss carrybacks).

(2) Taken into account in computing the taxable income of the affiliated group where a consolidated return is filed.

(3) Taken into account in computing the taxable income of the taxpayer, whether attributed to him under proposed section 951 or otherwise includible in gross income where a consolidated return is not filed.

The solution.—We would like to suggest that the exact treatment be a matter to be left to the regulations but that the law clearly indicates an intention to permit the three types of treatment of losses in controlled foreign corporations. This could be done by adding the following subsection 952(a)(5):

"(5) LOSSES.—In the case of a corporate shareholder an allowance shall be made, in accordance with regulations prescribed by the Secretary or his delegate, for carryforward and carryback of losses incurred by the controlled foreign corporation, and for the deduction of such losses by the corporate shareholder or any corporation controlled by the latter."

4. Costs and expenses

The problem.—The language of subsection 952(c)(2) does not make it clear that the deductible cost to the controlled foreign corporation of the property or rights from which the income is derived, may be expressed in terms of royalties or other analogous sums. The language of the subsection incorrectly implies a flat cost which would then be subject to amortization or depreciation.

The solution.—This defect could be cured by inserting in this subsection the words: "royalties or other analogous payments made for such property or rights or any", at page 111, of H.R. 10650 at the end of line 8.

5. Print costs

The problem.—Motion picture positive prints are often manufactured locally, because the law or regulations of the foreign government so require or because the customs duties on imported positive prints are so high as to make the importation uneconomical. In addition, subtitles, dubbed sound tracks, and similar materials frequently must be prepared locally under the laws and regulations of the foreign countries and, in any event, cannot properly be prepared in the United States.

The language of subsection 952(c)(2) appears to preclude the allowance of such costs as ordinary and necessary expenses. These costs are obviously necessary for the operations in any given foreign country since this operation consists in the distribution of these prints. This type of cost should be allowed even if paid by the licensor and charged back to the subsidiary under the franchise agreement.

The solution.—We therefore suggest that lines 11 to 13 at page 111 of H.R. 10650, which read: "but not including any production, manufacturing, or similar expenses incurred in the use or other means of exploitation of such property or rights.", be deleted and left to regulations prescribed by the Secretary or his delegate, which authority is already granted in the same paragraph.

6. Qualified property

The problem.—Proposed section 953(b)(2) limits the investment in qualified property to that property which is "ordinary and necessary for the active conduct of a qualified trade or business carried on by a controlled foreign corporation." By thus limiting the investment to the same controlled foreign subsidiary, our member companies would be precluded from utilizing funds abroad for the legitimate operations of nondistributing subsidiaries located in the same foreign country, such as a subsidiary which owns theaters.

The solution.—This defect could be cured by adding at the end of section 953 (b)(2)(A) the words "or by a related person" and by adding the same words in section 953(b)(3)(A)(i) after the first word of line 9 at page 120 of H.R. 10650, and again in section 953(b)(3)(A)(ii) after the first word of line 16 at page 120 of H.R. 10650.

II. SECTION 16. GAIN FROM CERTAIN SALES OR EXCHANGES OF STOCK IN CERTAIN FOREIGN CORPORATIONS

The association and its member companies feel that this section should be substantially modified to provide equality in the treatment of both gains and losses on the transactions covered by this section. If the gains are to be treated as ordinary income or as dividends to the extent set forth in section 16, then the losses should be treated in the same fashion. Not every sale or exchange of stock results in a gain, particularly in the case of a liquidation.

As this section is now worded, corporate owners are virtually denied the deduction attributable to a loss on the liquidation.

III. SECTION 11. DOMESTIC CORPORATIONS RECEIVING DIVIDENDS FROM FOREIGN CORPORATIONS

The association and its member companies join with the rest of American business in opposition to the enactment of section 11. The argument has frequently been advanced that this proposal is in conflict with the majority of the existing tax treaties. We subscribe to this view.

IV. SECTION 21. TREATIES

We are opposed to the enactment of section 21. This provision is of doubtful constitutional validity at the very least. It will undoubtedly be contested in the courts. Most important, however, is the effect that this provision will have on all U.S. treaties. It negates the American tradition that the United States will live up to all treaties it concludes with other nations.

MOTION PICTURE ASSOCIATION OF AMERICA, INC.

Allied Artists Pictures Corp.
Columbia Pictures Corp.
Walt Disney Productions.
Metro-Goldwyn-Mayer, Inc.
Paramount Pictures, Corp.
Twentieth Century-Fox Films, Corp.
United Artists Corp.
Universal Pictures Co., Inc.
Warner Bros. Pictures, Inc.

MOTION PICTURE EXPORT ASSOCIATION OF AMERICA, INC.

Allied Artists International Corp.
Buena Vista International, Inc.
Columbia Pictures International Corp.
Metro-Goldwyn-Mayer, Inc.
Paramount International Films, Inc.
Twentieth Century-Fox International Corp.
United Artists Corp.
Universal International Films, Inc.
Warner Bros. Pictures International Corp.

Senator KERR. Thank you very much, Mr. Johnston.

Are there any questions?

Senator DOUGLAS. Mr. Johnston, in volume 1 of these hearings, on page 222, there are listed some 78 cases of American citizens claiming bona fide residence abroad, and asking for exemption of $100,000 or more under the provision that a bona fide resident does not have to pay any income tax at home.

Now these include people in various occupations. I do not want to single out the movie industry to be the sole whipping boy in this connection, but there are a number of cases in the movie industry which give me concern.

Do you have a copy of this record?

Mr. JOHNSTON. I do not have it with me. I have seen it, Senator Douglas, but I do not have it with me.

Senator DOUGLAS. Would you give to Mr. Johnston a copy of the record. I am referring to page 222.

Mr. JOHNSTON. Yes.

Senator DOUGLAS. I invite your attention to cases C–33 and C–34.

C–34 is an actor living in Switzerland who claimed an exemption, and secured it, in 1960 on an income of $1,099,791.

In the line above, there is a housewife, also resident in Switzerland, who claims and received exemption from taxation in the identical sum of $1,099,791, so I presume that is husband and wife.

I think I can say that this is not Mr. Chaplin because, I believe, he is not an American citizen. But here is a total income of approximately $2,200,000 which escapes American taxation.

Now I have had the staff collect figures on the Swiss and other countries income taxes, and I am going to ask consent to have them inserted in the record at this point.

Senator KERR. Very well; they may be inserted.

(The information referred to follows:)

SWITZERLAND CORPORATE INCOME TAXES

The maximum corporate income tax rate at the national level in Switzerland is 8 percent. The effective rate may be less than this because the rate varies with the rate of return on profits and because taxes paid in the prior year are allowed as a deduction.

Assuming investment of 200,000 Swiss francs and a profit of 100,000 Swiss francs the combined national and cantonal taxes would be:

[Thousands of francs]

Canton	Canton and communal taxes	Federal tax	Total tax	Canton	Canton and communal taxes	Federal tax	Total tax
Zurich	24.6	5.8	30.2	Basle	18.6	6.2	24 8
Bern	21 6	6.0	27.6	Vaud	19.6	6 2	25.6
Lucerne	24.2	5.8	29.8	Neuchatel	27 4	5.6	33.0
Glarus	18.8	6.2	24.8	Geneva	23 0	5 8	29.0
Zud	12 6	6.6	19 2	Uri	11.8	6.6	18.6
Friburg	19 0	6.2	25 2				

NOTE.—In most cases where the income is earned outside of Switzerland the canton tax does not apply.

Source: Treasury Department.

Switzerland individual income taxes

1. Federal income tax:

Income		Rate (percentage)
Francs	Dollars	
7,500	1,732	0.13 graduating to rate below.
85,000	19,640	12.0 graduating to rate below.
120,000	27,720	8.

2. Federal tax of 0.05 to 0.35 percent of the value of an individual's total estate, including real and personal property, is imposed on property located in Switzerland.
3. Canton income tax. For example, Zurich: 1 percent up to 1,000 francs ($231) graduating to 7½ percent over 90,000 francs ($20,790).
4. Apparently, a person in Zurich will pay roughly a 20-percent tax on a $20,000 salary, plus a property tax.

Source: U.S. Treasury.

MEXICO

Individual income tax on salaries and wages

Monthly gross income	*Rate (percent)*
500 pesos ($40) to 600 pesos ($48)	1.7
3,000 pesos ($240) to 4,000 pesos ($320)	5.1
8,000 pesos ($640) to 9,000 pesos ($720)	10.1
14,000 pesos ($1,120) to 18,000 pesos ($1,440) ($17,280 annual)	22.0
22,000 pesos ($1,760) to 28,000 pesos ($2,240) ($26,880 annual)	30.0
34,000 pesos ($2,720) to 40,000 pesos ($3,200) ($38,400 annual)	40.0
Over 70,000 pesos ($5,600) ($67,200 annual)	50.0

Source: U.S. Treasury.

LEBANON

Individual income tax on salaries

	Percent
Up to 4,800 pounds ($2,189)	2
4,800 F to 8,400 F ($3,832)	3
24,000 F ($10,944) to 36,000 F ($16,416)	6
36,000 F ($16,416) to 48,000 F ($21,888)	8
Over 48,000 F ($21,888)	10

Source: U.S. Treasury.

VENEZUELA

	Percent
1. Income tax:	
Salaries of residents	1
Salaries of nonresidents	6
2. Surtax (graduated as follows) (applies to corporations also):	
8,000 bolívares ($2,388)	2
38,000 bolívares ($11,343) to 50,000 bolívares ($14,925)	5
200,000 bolívares ($59,700) to 280,000 bolívares ($83,580)	10½
Over 28,000,000 bolívares ($8,258,000)	45

Source: U.S. Treasury.

BRAZIL

1. Schedular tax: on wages, 1 percent; other income from gainful occupations, 5 percent.
2. Annual complementary tax (for 1960) [1] on income over 240,000 cruzeiros ($1,250), graduates as follows: Rates begin at 3 percent on 240,000 ($1,250); 17 percent on 500,000 ($2,500) to 600,000 ($3,000); 29 percent on 1,000,000 ($5,000) to 1,200,000 ($86,000); 38 percent on 2,000,000 ($10,000) to 2,500,000 ($12,500); 50 percent over 4,500,000 ($22,500).
3. Special surcharge of 15 to 25 percent on tax payable is refundable in 20 years, with taxpayers receiving 5 percent Government bonds.

[1] 1961 is different, but information unavailable to describe.

Source: U.S. Treasury.

Senator DOUGLAS. The Federal income tax in Switzerland on income of $27,320 would be 8 percent. The Canton tax——

Senator KERR. The what?

Senator DOUGLAS. The Canton corresponding to the American States, in Zurich, which is chosen as an illustration, would be 7.5 percent on approximately equal income.

Now it is obvious, therefore, that these people pay very little foreign income tax and escape American taxation completely.

Now this is not the only case for the movie people. Here is an actress in Venezuela with an income of $996,200, and the income tax——

Mr. JOHNSTON. Which one is that, Senator?

Senator DOUGLAS. Venezuela, pardon me.

Mr. JOHNSTON. Which number is that, C what?

Senator DOUGLAS. Excuse me, C–28–S, the first line.

Mr. JOHNSTON. Yes, I see it.

Senator DOUGLAS. The Venezuela income tax to nonresidents has a base of 6 percent, and 10.5 percent up to $83,000, and 45 percent only after $8 million.

There are many other cases here, and a sufficient number of cases of movie actors and producers so as to raise very serious questions, Mr. Johnston, and I was wondering what your attitude is on the proposal to tax the income of American citizens resident abroad claiming permanent status abroad.

Mr. JOHNSTON. Senator Douglas, this is not within the purview of my testimony here today relating to section 13, but I will certainly give you my personal opinion on this. It is that I am very much opposed to people escaping or avoiding their just American income taxes. As American citizens with the privilege and benefits they get as American citizens should be willing to pay their taxes, and I think that probably the motion picture industry, as a whole, may get, perhaps, a bad reputation because of the actions of some few individuals in the industry.

Senator DOUGLAS. I want to make it clear there are others besides the people in the industry.

Mr. JOHNSTON. I understand that.

Senator DOUGLAS. But, unfortunately, a considerable number of the people are in the industry.

Mr. JOHNSTON. So I believe personally that the section exempting incomes of $20,000 for the first 3 years and $35,000 thereafter is a fair and equitable provision, and I would personally be for it.

Senator DOUGLAS. That is a very statesmanlike attitude, Mr. Johnston, thoroughly in keeping with your general attitude on public affairs.

Let me ask you this question: is not the lower rate of income taxation abroad one of the inducements why many movies are made abroad and, therefore, if the hope of avoiding taxation could be removed from American producers, actors, and actresses, would not this lead to greater production of movies here at home?

Mr. JOHNSTON. Senator Douglas, this is what is called in the trade runaway production, which is a very hot subject in Hollywood today.

There are, in my opinion, three principal causes for so-called runaway production. One is locale; the second is costs which include subsidies; and the third is talent, in other words, the people here that you have mentioned who prefer to live abroad. Undoubtedly whatever may mitigate escape from taxation that makes foreign residence so desirable may be helpful in reducing foreign production but not necessarily increasing domestic production. In other words, talent pressure is one cause of foreign production. I am not sure how important it is, but it certainly is one of them.

Senator DOUGLAS. Thank you very much.

The passage of this section of the proposed bill would not only bring in greater revenues to the Treasury and build up taxpayer morale to a greater degree, but also stimulate American production.

Mr. JOHNSTON. It is possible.

Senator DOUGLAS. Thank you very much.

The CHAIRMAN. Senator Gore?

Senator GORE. Mr. Johnston, I notice on page 5 of your memorandum with respect to subpart F income you end the sentence this way: "The income is actually remitted or utilized." I understand what remitted means. I am not sure what you mean by utilized.

Mr. JOHNSTON. Where is that, Senator?

Senator GORE. That is in the paragraph dealing with exclusion of certain foreign income. I am asking about the word "utilized."

Mr. JOHNSTON. I just wanted to be sure we were talking about the same thing.

Senator GORE. It is a little difficult here.

Mr. JOHNSTON. "Utilized," I see. Income does not include blocked income arising in countries which have monetary or exchange restrictions until the restrictions are removed or the income is actually remitted or utilized.

Well, income could be utilized in many ways, Senator Gore. It could be utilized for the purchase of theaters, it could be utilized for the making of pictures or the making of prints for payment of local taxes; it could be utilized for many things.

Senator GORE. You mean if it is "utilized" abroad it is not to be subject to taxation?

Mr. JOHNSTON. It is subject to taxation locally or here when remitted; it should be. That is what we say.

Senator GORE. You treat "utilize" then in the same way as "remitted"?

Mr. JOHNSTON. Yes.

Senator GORE. You have lawyers there?

Mr. JOHNSTON. Yes.

Senator GORE. Would you ask one of them to spell out a definition of what you mean by "utilize"?

Mr. FREEDMAN. This is a concept we live with right now in dealing with blocked income.

As you know, many foreign countries restrict the remittance of local currency or the exchange of local currency into U.S. dollars. But they do permit us to use the currency to dub U.S. pictures into their language, to print positive prints which are needed to project a picture onto the screen, and so on. The Internal Revenue Service permits us to defer this blocked income until it is remitted or utilized.

Now the proposed bill is unclear but seems to have a different effect.

Mr. ERLANGER. I would say "utilized" is synonymous with "spent."

Senator GORE. In other words, according to your proposal here it would be left to you entirely as to how you dispose of it?

Mr. ERLANGER. The idea is this, Senator, if we spend it any way it becomes taxable to use. If we either remit it to the United States or we spend it locally in any way then it becomes taxable, but not before.

Senator GORE. Any way?

Mr. ERLANGER. Yes.

Senator GORE. This would not have a bearing upon liquidation and distribution?

Mr. ERLANGER. No, it would not. It would just be spending it. We do not normally liquidate our foreign subsidiaries. This is such a rare occurrence that I cannot remember in many years that it has ever happened.

Senator GORE. I am not suggesting that you normally do, but even in case you did do so, you do not think that "utilized" would in any way be affected?

Mr. ERLANGER. Well, there is a special section in the law, Senator, that deals with the liquidation of foreign subsidiaries, and we did not mean this to tie in with that at all. This utilization would mean spent in the normal course of business. The moment we part with the money it becomes taxable.

Senator GORE. Thank you very much.

The CHAIRMAN. Senator Talmadge?

Senator TALMADGE. No questions.

The CHAIRMAN. Thank you very much, Mr. Johnston.

Mr. JOHNSTON. Thank you, Senators.

The CHAIRMAN. The next witness is Mr. Lawrence E. Tryon of the Walt Disney Productions.

Take a seat, sir, proceed.

STATEMENT OF LAWRENCE E. TRYON, TREASURER, WALT DISNEY PRODUCTIONS

Mr. TRYON. Mr. Chairman and members of the Senate Finance Committee, my name is Lawrence E. Tryon. I am treasurer of Walt Disney Productions.

We have filed a formal statement with respect to the proposed tax bill. I do not wish to take the time of the committee to read it.

However, I would like to make some comments as related to our company.

Our company has actively carried on its business on a global basis for over 30 years. We are engaged in the production and distribution and marketing of motion pictures for worldwide exhibition in theaters and on television, and the worldwide exploitation and marketing of characters, music, and other values flowing from our theatrical and television motion pictures. In addition, the company owns and operates Disneyland Park in California.

In the conduct of our worldwide business, the company has and continues to touch and influence a great many people.

Our basic approach in the production of motion pictures has been, and is, to give wholesome family-type entertainment that reflects a true impression of the United States to people around the world.

We feel certain that Congress does not want to take any action which will have an adverse effect on this industry or our company which so directly carries to the rest of the world the way of life of this country.

Although we do business in more than 65 countries in the world, we have a total of only 9 foreign subsidiaries in 8 countries.

Our English subsidiary was formed in 1931. In 1959 we purchased a Japanese subsidiary from RKO. It was originally formed in the early 1930's.

The English and Japanese companies distribute our motion pictures in those territories.

Other subsidiaries not involved in film distribution are located in France, West Germany, Denmark, Sweden, Italy, and Canada.

Our film business is worldwide, and it also includes character merchandising, publications, music, and phonograph records, all protected by copyright, with the main objective to exploit values so that the company can obtain maximum return on its creations.

In most foreign countries our motion pictures are distributed through unrelated third-party corporations.

The largest portion of the company's foreign subsidiary income results from film distribution.

Motion pictures distribution contracts between the parent company and its foreign subsidiaries are substantially the same as those which the company enters into with unrelated foreign companies.

They provide for maximum return and prompt remittance to the United States of picture earnings permitted by the foreign government.

In addition to film distribution and the other ancillary activities previously mentioned, at least one of our foreign subsidiaries is engaged in producing motion pictures.

Recently the foreign market has been producing approximately 40 percent of the company's gross revenues from its theatrical motion pictures, with resultant blocked currency in many countries.

The amounts of blocked moneys vary widely from time to time due to the prevailing foreign currency restrictions and upon the company's distribution schedule.

We are familiar with the statement of the Motion Picture Association and concur in its opinions and suggestions.

However, I would like to emphasize three points briefly touched upon in the MPAA statement.

First, this section subjects gross income, section 13, that is, from rentals to taxation without providing adequately for the deduction of costs of producing the income.

Second, the earnings of the foreign subsidiaries are to be taxed to the parent company in the United States even though the earnings might be blocked due to local currency restrictions and are not available for payment of taxes.

And, third, no provision is made for U.S. tax consideration being given to the current or accumulated losses incurred by the foreign subsidiary.

The effect of the first two objections might best be illustrated by an example. You gentlemen may remember our picture "The Absent-Minded Professor" which dealt with the problems of a professor who developed a rather amazing substance called flubber.

Senator KERR. Called what?

Mr. TRYON. Flubber. This was one of six pictures which we released for worldwide distribution in 1961.

By way of illustration, let us refer to the territory of Japan. In order to properly distribute the picture in Japan we needed 20 prints, and certain advertising accessories such as lobby displays, posters, press books, and the like, all of which cost our Japanese subsidiary about 10 million yen or in dollars $28,000.

The picture resulted in gross income of $325,000 to our subsidiary RKO Japan.

Under Japanese law our distribution contract with the subsidiary is very closely regulated and provides for the division of distribution receipts of 30 percent to RKO Japan and the balance to Walt Disney Productions.

It might be noted that if we did not have the foreign subsidiary in Japan we would probably deal with a Japanese distributor, as we did formerly, and under Japanese law pay a distribution fee of 40 percent or more, thus reducing taxable U.S. income.

Sixty percent of the gross income is presently blocked by Japanese currency regulations.

We have had some success in using this money or getting portions of it released. We cannot be certain when or how much may be available to us.

Had section 13 of the 1962 revenue bill been applicable with respect to this income, not only would Walt Disney Productions have been taxed on this blocked money but it appears as though we would not be table to deduct costs for prints which were used to obtain the revenue.

In choosing this particular example, we have not chosen an extreme at all. As a matter of fact, the print costs for a black and white subject such as this are about 40 percent of a motion picture.

We, as one of the smaller motion picture companies, release five or six theatrical features annually.

When applied to the entire motion picture industry or all of its products throughout the world, the cumulative effective becomes staggering.

With respect to the loss situation, Japan also furnishes an example which points up the unfairness of the proposed legislation.

We originally acquired the Japanese subsidiary from RKO in 1959. The company showed a loss during its first year under our ownership, but since that time has been a profitable operation.

As we understand the proposed legislation, had this act been in effect during the period in question, the loss incurred during the fiscal year 1960 would not be available to carry forward against the profits during the fiscal year 1961 or thereafter.

In summary, we feel that although there is merit in the proposed legislation, probably through inadvertence and as a result of a lack of understanding of all of the full ramifications of some of the provisions, inequities have crept into the act.

We would respectfully request that appropriate amendments be made to the bill in order to avoid the imposition of a tax on moneys that are blocked either by a direct freezing of remittances or by required investments in the foreign country.

Second, that the exception in section 952(c)(2) excluding certain expenses be amended so as to allow deductions for ordinary and necessary expenses incurred in the production of income by the controlled foreign corporation.

And, finally, provision be made with respect to full tax consideration for losses incurred by the foreign subsidiary.

Thank you for this opportunity to present our comments.

(The prepared statement of Walt Disney Productions follows:)

STATEMENT OF WALT DISNEY PRODUCTIONS IN RE CORPORATE FOREIGN-EARNED INCOME PROVISIONS OF THE REVENUE ACT OF 1962 (H.R. 10650)

WALT DISNEY PRODUCTIONS,
Burbank, Calif., April 26, 1962.

Hon. HARRY F. BYRD,
Chairman, Senate Finance Committee,
Washington, D.C.

DEAR MR. CHAIRMAN: Walt Disney Productions, a California corporation, directly and through subsidiaries is engaged in the business, among others, of producing, distributing, licensing, and renting copyrighted motion picture films including features and short subjects, both live-action and animated, "True Life Adventures," "People and Places," educational and documentary, for theatrical and television release throughout the world. The company is also engaged in licensing the publication of many types of books, magazines, and comic strips and various and sundry articles of merchnadise, all on a worldwide basis. Its foreign operations are carried on through several foreign subsidiaries, with officers and personnel in Japan, Canada, the United Kingdom, Italy, France, West Germany, Denmark, and Sweden.

The primary source of foreign income is through film rentals collected by the foreign subsidiaries as a result of their distribution activities under arrangements whereby the foreign subsidiaries generally are licensed to reproduce and rent the films, with a division of the gross rental receipts between the subsidiary and parent on the same basis as where the foreign distributor is not a subsidiary.

We are familiar with the statement of the Motion Picture Association of America, Inc., to the Finance Committee on H.R. 10650 and concur with the opinions and suggestions therein expressed. Rather than reiterate what is there stated concerning the fairness of placing the motion picture industry under section 952(a)(1)(C) instead of under section 952(a)(1)(B), we are setting forth hereinafter three basic constructive criticisms of the foreign income provisions of the current tax bill as they would seem to apply to our business, which we will appreciate having the committee consider:

1. The definition of subpart F income in section 952(c) relating to gross rentals and royalties from copyrights does not seem intended to include as allowable expense the cost of making film prints.

The general rule under section 952(c) as applied to our business would require the inclusion in the parent company's gross income the gross amount of all film rental receipts abroad, less the cost and expense allowance provided for in section 952(c)(2). The cost and expense allowance is stated to be one for "ordinary and necessary expenses incurred by the controlled corporation in the receipt or production" of the film rental income, including taxes and the amortization of the cost to the foreign corporation of the copyright, "but not including any production, manufacturing, or similar expenses incurred in the use or other means of exploitation of such property or rights." As applied to our film distribution business, it would be manifestly unfair not to allow as a cost of producing the rental income the cost of producing the film prints which are the subject of the rental or the cost of producing the advertising and promotional material. Even though section 952(a)(3) limits the amount of subpart F income which must be recognized to the amount of the earnings and profits of the foreign subsidiary generating the subpart F income, where the particular foreign subsidiary has income other than subpart F income, the effect of not allowing the cost of making prints would be to require us to pay taxes on the other income which might not otherwise be currently includible in domestic U.S. income under the other provisions of subpart F.

2. Under the provisions of section 951, current profits generated in foreign countries having restrictions on the remission of profits would require the current payment of U.S. taxes on blocked funds even though those funds may never be received in the United States.

It is our view that in the case of blocked currency the profits represented by such blocked funds should, under section 953(b) (2) (A), be considered ordinary and necessary for the active conduct of the qualified trade or business, or the provisions of section 953(b) (2) (D) should be changed by deleting the reference to "less developed countries." If any investment is required by the laws of a foreign country, including a blocked bank account, it should be deemed to be "qualified property" and hence not subject to current U.S. taxes. The existence of foreign restrictions or requirements should be sufficient, whether or not the country imposing the requirements is to be considered as developed or underdeveloped. It should go without saying that nearly all of the countries listed in section 953(b) (5) have had in the past, or have now, or are likely to have in the future varying restrictions upon the convertibility or the remission of their currencies to this or other countries If the purpose of subpart F is to impose U.S. tax on unreasonably accumulated or voluntarily unremitted foreign earnings, then it would hardly seem reasonable or just to tax earnings of foreign subsidiaries which a parent company cannot legally obtain or use.

3. Subpart F will have the effect of imposing U.S. taxes on the earnings or profits of foreign subsidiaries, with no U.S. tax consideration being given to current or accumulated losses in the foreign subsidiary.

Section 951(a), subject to the exceptions later incorporated, will have the effect of requiring the U.S. parent company to include in its gross income the current earnings of its foreign subsidiaries. On the other hand, current or accumulated losses in the foreign subsidiaries are nowhere allowed as a current deduction from the U.S. corporation's gross income. This will be manifestly unfair and introduces the new concept into U.S. income tax law of taxing profits but ignoring losses. For example, a foreign subsidiary may be established and operated several years at a loss, creating in effect a deficit surplus. Any subsequent profits which would be utilized to reduce the deficit surplus could, under section 951, be deemed as a nonqualified investment and therefore be currently taxable to the parent company. The fact that the foreign country might have loss-carry-forward provisions in its tax laws would only operate to reduce the foreign taxes and hence increase the foreign profits to be taxed here. Such losses would never be given any U.S. tax effect unless the foreign subsidiary were to be liquidated prior to its becoming a profitable operation.

We wish to thank you for considering our points of concern and also for the opportunity of stating our case orally before the committee.

Very truly yours,

WALT DISNEY PRODUCTIONS.

The CHAIRMAN. Thank you, Mr. Tryon. Senator Kerr?

Senator KERR. No questions.

The CHAIRMAN. Senator Gore?

Senator GORE. I have no questions.

I would like to state that it is my own personal view that the committee will be well advised to consider extending the carry-forward and carryback provisions to losses of foreign subsidiaries. This would remove one of the objections which you have.

Mr. TRYON. Yes, sir.

Senator GORE. Thank you very much.

Mr. TRYON. Thank you.

The CHAIRMAN. Senator Talmadge.

Senator TALMADGE. Thank you very much, Mr. Tryon.

Mr. TRYON. Thank you, sir.

The CHAIRMAN. Thank you very much.

The next witness is Mr. Hardwick Stires on behalf of Registered Foreign Investment Cos.

Mr. Stires, we are glad to have you.

STATEMENT OF HARDWICK STIRES, ON BEHALF OF REGISTERED FOREIGN INVESTMENT COMPANIES

Mr. STIRES. My name is Hardwick Stires. I am a general partner of Scudder, Stevens & Clark, and president of Scudder Fund of Canada, Ltd., a registered Canadian investment company. This statement is made on behalf of a group of 10 Canadian and 3 other foreign investment companies [1] registered with the Securities and Exchange Commission under the Investment Company Act of 1940.

This statement has two purposes:

(1) To urge that the committee adopt certain technical and substantive amendments to section 15 of the bill and make certain clarifying statements in its report to carry out properly its stated objective; and

(2) To explain to the committee the origin of the companies in response to the calls of previous administrations to encourage private investment abroad as an aid to our allies and particularly to our neighbor, Canada.

I

The first purpose is to present to the committee certain suggestions covering technical and substantive amendments to section 15 and certain clarifying statements that might be made in reporting the bill to the Senate in order to bring the language and the effect of section 15 into closer accord with its object as stated in the report of the Ways and Means Committee to the House of Representatives. These suggestions, detailed in appendix A to this statement, have been submitted to, and discussed with, the staffs of the Treasury Department and the joint committee.

The object of section 15 has been stated by the House committee to be to accord to registered foreign investment companies, "to the extent practicable, the same tax treatment as that provided for domestic regulated investment companies." In accordance with this object we have in appendix A suggested—

(1) Certain revisions in the language of section 15 to correct technical defects;

(2) A proposed addition to section 15 of provisions which would enable a registered foreign investment company to elect to make the foreign tax credit available to its shareholders in substantially the same manner as in the case of shareholders of similar domestic corporations under section 853 of existing law;

(3) Clarifying statements in the committee report on the bill to the effect that—

(*a*) Reincorporation of registered foreign investment companies as domestic companies is consistent with the purpose of section 15 and should be encouraged, and that favorable rulings should be issued by the Commissioner under section 367 to permit these companies to become domesticated; and

(*b*) Registered foreign investment companies in determining income to be distributed may rely upon estimates and

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[1] These are the 13 registered foreign investment companies referred to in Secretary Dillon's testimony before this committee (hearings on H.R. 10650, Apr. 2, 1962, pt. I, p. 251).

opinions of independent certified public accountants and other experts disclosed by reports filed with the Securities and Exchange Commission.

II

The second purpose of this statement is to explain the origin and function of these companies.

The House committee report, in stating the reasons for section 15, says:

The tax avoidance occurring in the case of these foreign investment companies is a matter with which your committee has been concerned for many years. For example, in November of 1956, in one of your committee's press releases, the tax treatment of these foreign investment companies was listed as a tax avoidance scheme needing attention. Since that time the seriousness of this problem has increased substantially. This also is a problem referred to by the President in his tax message last year. At that time the President stated:

"For some years now we have witnessed substantial outflows of capital from the United States into investment companies created abroad whose principal justification lies in the tax benefits which their method of operation produces. I recommend that these tax benefits be removed and that income derived through such foreign investment companies be treated in substantially the same way as income from domestic investment companies."

We wish to note that the House committee's press release of November 7, 1956, did not then refer to the foreign investment companies as "a tax avoidance scheme"; the subject of foreign investment companies was referred to as a "problem" and the committee invited comment. A group of Canadian investment companies responded to this invitation by filing with the Ways and Means Committee a comprehensive memorandum (submitted herewith as app. B) covering the origin and history of the Canadian investment companies and demonstrating that, far from being a "problem", the creation and development of these companies was an effective implementation of an important foreign policy objective of the United States—strengthening the economies of free world nations through private U.S. investment abroad.

Beginning in the Truman administration and continuing throughout the Eisenhower administration, encouragement and stimulation by tax incentives and otherwise of private investment abroad was a major point of the Government's foreign policy having bipartisan support.[1] For example, in 1955 the Joint Committee on the Economic Report to Congress said that—

it has been easier to encourage direct investments abroad than those of the portfolio type, and yet the latter have a very useful place which should not be neglected.[2]

In this favorable climate of national policy and public and private opinion, the first registered Canadian investment company, Scudder Fund of Canada, Ltd., was launched under the sponsorship of my firm in 1954, after thorough consideration of all its aspects by the Securities and Exchange Commission and the Treasury Department, and with the encouragement of the Department of Commerce and other interested Government agencies. Despite its juxtaposition to the United States, its common language and other similarities to our

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[1] The expressions of this policy by President Truman, President Eisenhower, and committees of Congress and the exhortations to the business community to invest abroad are fully documented at pp. 4 and 8 of app. B.

[2] "Foreign Economic Policy," report of the Joint Committee on the Economic Report to the Congress of the United States, S. Rept. 1312, 84th Cong., 2d sess. (1955), p. 22.

own country, certain profound differences in investment techniques and customs as between the United States and Canada suggested strongly the organization of a Canadian company, staffed by Canadians, versed in the techniques of executing transactions in the Canadian securities markets, with Canadian directors knowledgeable in the corporate life of Canada. With this beginning a small number of other similar companies were established.

These companies brought to some 100,000 U.S. shareholders an opportunity for foreign investment which was otherwise available only to large corporations through foreign subsidiaries or to a limited number of wealthy individuals. They have provided these shareholders with informed and experienced management and a most effective means of achieving investment diversification—a more pressing consideration with respect to foreign investment than domestic investment because of the uncertainties and peculiarities involved in foreign investment.

These registered Canadian investment companies offered the small investor an opportunity for diversified portfolio investment in a hospitable economy with the added attraction of local tax incentives. The fact that under Canadian law income could be accumulated, and when and if the American stockholder sold or redeemed his shares this income would be subjected to capital gains taxes, was noted as an added attraction to this form of investment. It was attractive to the American stockholder because the accumulated income could be reinvested; it was attractive to the Canadians because, unlike certain other large direct investments, profits were not syphoned off but were plowed back. All this was done with the full knowledge and approval of the administration, which urged in President Eisenhower's 1955 and 1956 Economic Reports, as in earlier statements, that the U.S. Government "encourage investment in all countries whose desire to speed their economic development has led them to create a hospitable climate for business investment."[1]

The House bill proposes to reverse this policy with respect to both direct investment and portfolio investment. If this committee should deem it wise in the national interest to reverse this policy, we submit that what previous administrations called desirable tax incentives should not now be called tax avoidance schemes. Certainly those who now respond to the tax incentives contained in H.R. 10650 should not in later years be condemned as having engaged in tax avoidance schemes. Similarly, we respectfully urge that in the current bill this committee take into account the fact that the foreign-registered investment companies responded to the call of previous administrations to form a vehicle by which the foreign investment incentives of existing tax law could be made available to a large group of private investors and thus reduce the need for governmental aid programs.

The wisdom of the sharp change in the Government's attitude toward private investment abroad we believe is debatable. But whatever the ultimate policy decision may be, it is important that Congress take no action which would seriously affect the securities markets and the economy of Canada, particularly since failure to exempt

[1] 1955 Economic Report of the President, Washington: 1955, U.S. Government Printing Office, p. 53; 1956 Economic Report of the President, Washington: 1956, U.S. Government Printing Office, pp. 90–91.

registered foreign investment companies and their shareholders from the proposed change in the law would produce a relatively insignificant amount of revenue, probably less than $1,750,000 per annum. (See app. C, submitted herewith, for the computation of this estimate.)

Wholesale liquidation by American shareholders of their investments in the Canadian regulated investment companies would obviously have serious repercussions on the Canadian economy, particularly since its economy and its securities markets are very much smaller than our own. Withdrawal of capital from these companies has been continuing in recent months at a very high rate, much accelerated over prior years. It is of the utmost importance, therefore, that no action be taken by Congress that would precipitate a run on these registered foreign investment companies by increasing demands for redemptions of their outstanding shares and thus forcing sale by them of their portfolio securities to provide funds to meet such redemptions. The companies have already been hurt by the Government's change in attitude, and I urge this committee, as a minimum, to adopt the suggestions contained in appendix A.

Thank you, Mr. Chairman.

The CHAIRMAN. We thank you, Mr. Stires.

(The appendixes accompanying Mr. Stires' statement follow:)

APPENDIX A

MEMORANDUM OF COMMENTS RE SECTION 15 RELATING TO FOREIGN INVESTMENT COMPANIES IN H.R. 10650 (REVENUE ACT OF 1962)

I. Suggested revisions to correct technical defects:

1. Clarification of applicable date in 1246(a)(1).
2. Relief from exact proof of earnings and profits in 1246(a)(3).
3. Clarification of definition of "foreign investment company" in 1246(b)(2).
4. Specification of decendent's share of accumulated earnings and profits going to reduce basis in 1246(e)(1).
5. Increase in time for reporting undistributed capital gains, and limitation of definitional test thereof, in 1247(a)(1)(B).
6. Operative provision for shareholders' treatment of capital gains, in new 1247(d).
7. Relief from double taxation for nonqualifying shareholder in 1247(d) (to become (e)).
8. Clarification of earnings and profits adjustment for pre-1963 redemptions, in 312(l).

II. Proposed addition to bill of a provision enabling a registered foreign investment company to elect to make foreign tax credit available to its shareholders.

III. Suggested clarifying statements with respect to registered foreign investment companies to be included in the committee report—

(*a*) To encourage domestication of such companies by the issuance of favorable rulings under section 367; and

(*b*) To recognize that such companies may, in determining income under the standards of the Internal Revenue Code required to be distributed rely in good faith upon estimates and opinions of independent certified public accountants and other experts which are also used in financial statements filed with the SEC.

I. SUGGESTED REVISIONS TO CORRECT TECHNICAL DEFECTS

(Page and line references are to those in the print of March 12, 1962, in the form in which the bill was introduced in the House of Representatives)

1. Section 1246(a)(1) in its present form could be construed as applying to a sale or exchange of stock in a foreign corporation which was a foreign investment company prior to December 31, 1962, even though not subsequent to that date. The committee report indicates, however, that the section is intended to

be applicable only to foreign corporations which are foreign investment companies at any time after December 31, 1962, and should not apply to corporations which may have been investment companies in prior years.[1]

It is suggested that in order that the statutory language may more clearly reflect the legislative intent the words "after such date and" should be inserted on page 148, in line 18, following the words "at any time."

2. Section 1246(a)(3) apparently places upon the shareholder the heavy burden of establishing the full and exact amount of his company's earnings and profits (and his ratable share thereof), on pain of having the entire gain from his sale or exchange of its stock taxed at ordinary income rates.

The imposition of this burden is at odds with the general equitable principle justifying the assignment of the burden of proof to the taxpayer elsewhere in the code, namely, that it rests upon his having the pertinent information peculiarly within his disposition. If despite these equitable considerations the provision is retained in the statute, it should at least be modified to make it clear that gains taxable at ordinary income rates can be avoided to the extent that the taxpayer establishes some portion, even if not all, of the part of his gain not attributable to his ratable share of accumulated earnings and profits.

To accomplish this clarification, it is suggested that the words "actual or maximum" be inserted between "the" and "amount" in line 11 on page 149.

The committee report should make it clear that a taxpayer may demonstrate the portion of the gain which represents his pro rata share of unrealized appreciation in the assets of the company in order to delimit the maximum possible earnings and profits of the company.

3. The alternative definition of "foreign investment company" in subsection (b)(2) is unwarrantedly and unworkably comprehensive, in that it adopts the definition in subsection (a)(1) of section 3 of the Investment Company Act of 1940, without recognition of the essential limitations upon that definition elsewhere in section 3. For example, the proposed code definition ignores the exceptions to this subsection that the Investment Company Act provides for brokers, banks, small loan companies, and companies holding securities of wholly owned subsidiaries.

It is submitted that all but one of these exceptions contained in section 3 of the act are properly applicable to the definition of "foreign investment company." Accordingly, it is suggested that the parenthetical clause on lines 7 and 8 of page 150 be expanded to read as follows: "(within the meaning of section 3(a)(1) of such act, as limited by paragraphs (2) through (15) of section 3(c) thereof)." It is submitted that this change would accomplish the evident legislative purpose of including in the alternative definition those smaller foreign corporations of a type that would be required to register under the 1940 act if they made a public offering of their securities in the United States.[2]

4. The present language of section 1246(e)(1) would apparently require a reduction in the basis of foreign investment company shares acquired from a decedent by the amount of the decedent's ratable share of all of such company's accumulated earnings and profits, and not such share of only those accumulated after December 31, 1962. The reports of the Ways and Means Committee make clear that this is not the intent of the drafters of the provision.[3] If the provision is to express clearly the drafters' intent, as expressed in the committee reports, the word "accumulated" before "earnings" should be deleted, and the words "accumulated after December 31, 1962" should be inserted following "company," in line 1 of page 152.

5. Section 1247(a)(1)(B) requires an electing foreign investment company's designation of the excess of its net long-term capital gains over net short-term capital losses to be mailed to shareholders within 30 days of the close of its taxable year. The calculation required before this mailing can be made is considerably more demanding than that for a domestic regulated investment company under present section 852(b)(3)(C), since under the latter the corporation, if uncertain as to the full amount of the excess, is free to designate a lesser part. Many domestic companies have nonetheless found themselves strapped in complying with the time limit of the current provision, and a request for an amendment extending the period is under consideration. In view of the

[1] See H. Rept. 1447, p. A116.
[2] See H. Rept. 1447, p. A117.
[3] See H. Rept. 1447, pp. 73 and A118.

more difficult nature of the computations required under proposed 1247(a)(1)(B) and the operating delays to which many foreign investment companies are subject on account of divisions of their records and personnel, the time limit in the proposed legislation should be 45 days.

Section 1247(a)(1)(B) would also determine the excess of capital gains over losses for a foreign investment company as if it were a domestic corporation. By this test many of the transcations in which such a company would normally engage, such as participation in a corporate reorganization or the mere ownership of securities in a foreign corporation which are converted in a reorganization into securities of a successor foreign corporation, would presumably result in the company's realization of gain, unless an advance ruling under section 367 were obtained. In such a situation the entire transaction is by hypothesis outside the ambit of the Federal income tax. Accordingly, section 1247(a)(1)(B) should be revised by changing the parenthetical expression in lines 18 and 19 of page 153 to read: "(determined as if such corporation were a domestic corporation, and without the application of section 367)."

If, however, subparagraph (B) should be left in its present form, the committee report should make it clear that it is expected that the Secretary or his delegate will issue rulings under section 367 to foreign investment companies in transactions in which rulings would be issued to such companies if they were domestic corporations.

6. Section 1247 nowhere contains an operative provision prescribing how either distributed or undistributed capital gains of an electing foreign investment company are to be treated by shareholders who are U.S. taxpayers.

To remedy the omission, there should be inserted in section 1247 a new subsection (d) (and present subsections (d) and (e) should be relettered (e) and (f)), to read as follows:

"(d) TREATMENT OF DISTRIBUTED AND UNDISTRIBUTED CAPITAL GAINS BY SHAREHOLDERS.—

"(1) Every shareholder of a foreign investment company for which an election pursuant to subsection (a) is currently in effect shall include, in computing his long-term capital gains in his return for his taxable year in which it is received, his pro rata share of the distributed portion of the excess of capital gains over losses referred to in subsection (a)(1)(B) of the company for any taxable year for which a written notice pursuant to subsection (a)(1)(B) is mailed to its shareholders.

"(2) To the extent that a shareholder of a foreign investment company for which an election pursuant to subsection (a) is currently in effect includes in his return for a taxable year his pro rata share of the undistributed portion of the excess of capital gains over losses referred to in subsection (a)(1)(B) of the company for its taxable year ending within or with such taxable year of the taxpayer, such share shall be included in his gross income as gain from the sale or exchange of a capital asset held for more than six months."

7. Section 1247(c)(2) permanently disqualifies a U.S. person as a qualified sharehold if for any taxable year he fails to include in his return any portion of his share of the foreign investment company's undistributed capital gains, and section 1247(d) (to be relettered (e)) makes the adjustments in both earnings and profits and basis of shareholder's stock that it provides dependent upon qualified status. In this form the provisions are not only unnecessarily harsh but actually punitive, since they could result in double taxation, once at capital gain and again at ordinary income rates, of a shareholder who had regularly reported his share of undistributed capital gains but omitted to do so (or to do so in full) in any year prior to selling or exchanging his shares. To eliminate this potentially punitive feature, which is clearly at odds with the purpose of the bill,[4] subsection (d) (to be relettered (e)) should be revised to provide that these adjustments are to be made in the case of any shareholder to the extent that he includes undistributed capital gains in gross income. The suggested corrective language is as follows:

"(e) ADJUSTMENTS.—Under regulations prescribed by the Secretary or his delegate, proper adjustment shall be made—

"(1) in the earnings and profits of the electing foreign investment company and a shareholder's ratable share thereof, and

"(2) In the adjusted basis of stock of such company held by such shareholder (whether or not qualified)—

[4] See H. Rept. 1447, p. 73.

to reflect such shareholder's inclusion in gross income of undistributed capital gains."

The committee report should make explicit the intent under this provision to have any shareholder's inclusion of undistributed capital gains in gross income reflected by an increase in the adjusted basis for his stock and a decrease in his ratable share of earnings and profits accumulated after December 31, 1962. In this manner double taxation of a shareholder who had reported undistributed capital gains in part but had failed to remain qualified would be avoided.

8. Paragraph (3) of proposed new section 312(1) provides for a reduction in a foreign investment company's earnings and profits to take into account amounts distributed in partial liquidation or redemption measured by the ratable share of the earnings and profits attributable to the shares redeemed. Subparagraph (B) of this paragraph, however, restricts its application to distributions made after December 31, 1962.

While the new measure for reduction in earnings and profits prescribed in subparagraph (A) seems appropriate, the purpose the new provision is intended to achieve is left uncertain both on its face and in the committee reports. Most registered foreign investment companies are of the open-end type, in which shareholder redemptions have been taking place continuously since their inception. The effect of all such redemptions made prior to January 1, 1963, presumably is now, and is to continue to be, governed by present section 312(e). However the proposed new language raises a question as to whether a foreign investment company's earnings and profits account is intended to receive any credit for redemptions prior to 1963, despite the indisputable economic effect that such redemptions will have had.

The possibility that the new language may be interpreted as denying any credit for pre-1963 redemptions is particularly troublesome in the case of a company that elects to qualify under section 1247, since the committee report makes clear [5] that the overriding purpose of section 1247 is to make possible the avoidance of the new legislation's ordinary income treatment on the part of a fully complying company and its shareholders. Certainly for a company for which a section 1247(a)(1) election is currently in effect, and probably for other foreign investment companies as well, the test under subparagraph (A) is equally appropriate to liquidations and redemptions prior to 1963, and accordingly subparagraph (B) should be eliminated. If this is not done, it should be made more clear in the statute or the committee report that the effect of such previous liquidations and redemptions is to continue to be determined pursuant to section 312(e).

II. PROPOSED ADDITION TO BILL OF A PROVISION ENABLING A REGISTERED FOREIGN INVESTMENT COMPANY TO ELECT TO MAKE FOREIGN TAX CREDIT AVAILABLE TO ITS SHAREHOLDERS

The foregoing portions of this memorandum have pointed out what are believed to be technical infirmities in the present bill, in particular points at which its language seems at variance with, or not clearly to reflect, the drafters' intent as indicated in the committee report. In addition the bill suffers from a major omission, of another order of magnitude from these defects, if it is to achieve its professed and desirable objective of enabling a registered foreign investment company, through section 1247, to elect tax treatment "substantially identical" with that of a U.S. regulated investment company.[6] This is the failure to provide for a registered foreign investment company an election whereby its qualified shareholders will be able to claim credit for foreign taxes paid by the company, such as is available to a domestic regulated investment company under section 853(c) of the code. Such parity for registered foreign investment companies could readily be achieved by adding to proposed section 1247 the following additional subsections (g), (h), and (i), which embody provisions comparable to those contained in section 853:

"(g) ELECTION BY FOREIGN INVESTMENT COMPANY WITH RESPECT TO FOREIGN TAX CREDIT.—A foreign investment company which has made the election provided in subsection (a)(1) and more than 50 percent of the value (as defined in section 851(c)(4)) of whose total assets at the close of the taxable year consists of stock or securities in foreign corporations may, for such taxable year, elect

[5] See H. Rept 1447, p 73.

[6] See remarks of Representative Boggs in Congressional Record appendix, p. A1947, Mar. 14, 1962.

the application of this subsection with respect to income, war profits, and excess profits taxes described in section 901(b)(1) which are paid by the foreign investment company during such taxable year to foreign countries and possessions of the United States. If such election is made—

"(1) with regard to the foreign investment company—

"(A) its taxable income shall for purposes of subsection (a)(1)(A) be computed without any deduction for taxes paid to foreign countries or possessions of the United States,

"(B) the amount of such taxes shall be treated, for purposes of applying subpart A of part III of subchapter N and subsection (h)(1), as having been paid to the country in which the foreign investment company is incorporated, and

"(C) the amount of such taxes shall for purposes of subsection (a)(1) be added to the amount the company has distributed to its shareholders;

"(2) each qualified shareholder of such foreign investment company shall—

"(A) include in gross income and treat as paid by him his proportionate share of such taxes, and

"(B) treat as gross income from sources within the country in which the foreign investment company is incorporated, for purposes of applying subpart A of part III of subchapter N, the sum of his proportionate share of such taxes and the portion of any dividend paid by such foreign investment company which represents income from sources without the United States.

"(h) NOTICE TO SHAREHOLDERS.—The amounts to be treated by a qualified shareholder, for purposes of subsection (g)(2), as his proportionate share of—

"(1) taxes paid to the country in which the foreign investment company is incorporated, and

"(2) gross income derived from sources without the United States,

shall not exceed the amounts so designated by the foreign investment company in a written notice mailed to its shareholders not later than 30 days after the close of its taxable year.

"(i) MANNER OF MAKING ELECTION AND NOTIFYING SHAREHOLDERS.—The election provided in subsection (g) and the notice to shareholders required by subsection (h) shall be made in such manner as the Secretary or his delegate may prescribe by regulations."

The method proposed above for allowance of foreign tax credit is designed to facilitate application and administration of the credit through avoidance of complex source of income determinations. A registered foreign investment company may derive income from and pay taxes to many foreign countries. The difficulties inherent in tracing and allocating dividend income received by qualified U.S. shareholders to the sources from which the registered foreign investment company derived its income are manifest. These difficulties are eliminated in the recommended provisions by aggregating all the foreign taxes and foreign income of a registered foreign investment company and arbitrarily allocating them to the foreign country in which the company is incorporated. The most important aspect of the simplified method of allocation that is recommended is that the result produced thereunder does not differ, except in situations believed to be highly uncommon, from that which could be achieved by any qualified shareholder by his electing the overall limitation available under section 904(a)(2) of the code.[7]

For example, in the case of a registered Canadian investment company, all foreign taxes paid by the company would, under the recommended provisions, be deemed to be Canadian taxes and the dividends paid by the company (to the extent consisting of income derived from sources without the United States) would be treated as income from Canadian sources. Under section 904 of the Internal Revenue Code, either the per-country limitation or the overall limita-

[7] The only situation in which the simplified allocation formula might (if coupled with election of the per-country limitation) yield a greater credit than that available to a taxpayer electing the overall limitation would be that in which a shareholder had on his own incurred losses in one of the countries in which the foreign investment company paid taxes. On the other hand, the simplified formula might yield a lesser tax benefit where the shareholder had on his own incurred losses in the country of the foreign investment company's incorporation. These possible variations, in cases that would probably arise most infrequently, are far outweighed by the tremendous saving in computing the credit which the simplified formula would permit all parties concerned.

tion may be applied, at the election of the taxpayer, in computing the limitation on the foreign tax credit. The effect of his electing the latter is to assign all of his foreign taxable income and all of his foreign taxes to a single source for purposes of applying the limitation, a result indistinguishable from that under subsections (g) and (h) of the proposed addition unless the taxpayer has suffered losses in connection with other activities or investments abroad.

How the proposed foreign tax credit would apply

Most of the registered foreign investment companies that would be eligible to elect treatment under section 1247 are Canadian, and to illustrate the operation of the foreign tax credit that it is here suggested should be added to that section, some discussion of Canadian taxes is appropriate. Some of these companies have invested almost exclusively in Canadian stocks and securities, while others have significant holdings in other foreign countries.

Liability of the company for Canadian and other foreign taxes.—A registered Canadian company more than 95 percent of whose shareholders are non-Canadians can, under present Canadian law, elect to be taxed either as an ordinary Canadian corporation or as a "non-resident-owned investment corporation" (an NRO company) under section 70 of the Canadian Income Tax Act. An NRO company is subject to a flat 15 percent Canadian tax on its taxable income from all sources. Foreign taxes paid by such a company on its income from non-Canadian investments may be deducted in computing taxable income, but may not be taken as a credit against the 15 percent Canadian tax. The taxable income of an NRO company includes dividends on Canadian stocks, but does not, under Canadian law, include gains realized upon the sale of stocks or securities held for investment.

A registered Canadian investment company which does not elect NRO treatment under section 70 of the Canadian act is subject to tax at the rates applicable to ordinary Canadian corporations—presently 21 percent on the first $35,000 of taxable income and 50 percent on taxable income in excess of that amount. Such a company is not subject to tax on most Canadian dividends which it receives since, under Canadian law, an ordinary corporation is permitted, in computing its taxable income, to deduct the amount of dividends received from other taxable Canadian corporations. In addition, a company which does not elect NRO treatment can claim credit against its Canadian tax for foreign taxes paid on income from non-Canadian investments.

A registered Canadian investment company that derives a large part of its ordinary income from non-Canadian investments or from interest-paying Canadian securities will normally find it advantageous to elect NRO treatment. Unless this election is made, the company will be subject to Canadian income tax on such income at rates, as indicated above, up to 50 percent. By making the NRO election, the company will limit its tax liability to the 15 percent Canadian tax plus such additional foreign taxes which it may pay by withholding or otherwise on the portion of its income which consists of dividends and interest from non-Canadian investments. On the other hand, some registered Canadian investment companies that derive the bulk of their ordinary income in the form of dividends from other Canadian corporations have refrained from electing NRO treatment since the tax they pay as an ordinary Canadian corporation is less than the 15 percent tax paid by an NRO company.

Application of the credit.—The manner in which the suggested foreign tax credit provisions would operate for a holder of 100 shares in a registered Canadian investment company is presented for illustrative purposes. The figures used are based upon the most recent taxable year of one of the registered Canadian companies.

Exhibit A hereto sets forth the position of such a shareholder. It shows his proportionate share of the net income before taxes derived by the company from various foreign countries (a total of $30.80), and his proportionate share of the foreign taxes paid by the company (which is $6.13). It also shows the U.S. tax to which he would be subject (before allowance of foreign tax credit) upon a distribution of his proportionate share of such net income of the company grossed up by his proportionate share of the foreign taxes paid by the company.

The actual dividend received by the shareholder would be only $24.67 ($30.80 less $6.13) because the foreign taxes paid by the company would reduce the cash available for distribution. However, an electing registered Canadian investment company would under the suggested subsections send a simple form of advice to the shareholder, advising him that his share of foreign taxes paid by the company was $6.13, that this amount should be added to the dividend of $24.67 which he actually received, and that he should report the receipt of $30.80

of Canadian dividends on his individual return. His $6.13 share of foreign taxes paid by the company would then be treated as Canadian tax paid by him for which he could claim credit subject to the limitations of section 904 of the Internal Revenue Code.

In the example presented in exhibit A, the aggregate foreign taxes paid by the registered Canadian investment company are slightly less than 20 percent of the company's taxable income from foreign sources. And, as shown in the table, the U.S. tax payable upon such a distribution by any shareholder subject to U.S. tax at an effective rate of 20 percent or higher would be greater than his proportionate share of the foreign taxes paid by the company; accordingly, under the suggested new subsections such a shareholder would be entitled to claim credit for his entire $6.13 proportionate share of the foreign taxes paid by the registered Canadian investment company.[8]

The result would be substantially the same under a statutory provision more closely akin to section 853 of the code which would necessitate far more complex foreign tax credit computations. Section 853 provides that a shareholder in a domestic regulated investment company must account separately for his proportionate share of the income which the company derives, and the foreign tax which the company pays, in each foreign country. As indicated in the regulations under section 853, the Treasury Department regards dividends received from a foreign corporation in a particular foreign country as constituting income from sources within that country. In the situation considered in exhibit A hereto the registered Canadian investment company receives income from corporations in seven foreign countries. The amount of income received from some foreign countries is substantial, while the amount derived from others is relatively inconsequential. As the economies of the countries of the free world become more developed, it may be expected that registered foreign investment companies will hold investments in many more foreign countries.

If each U.S. shareholder is required to report separately his share of the income derived by the registered foreign investment company in each of these foreign countries, the registered foreign investment company will be required to distribute to its shareholders, and each such shareholder will have to report on his individual U.S. tax return, information that is both lengthy and complicated. A heavy increase in the burden of audit upon the Internal Revenue Service can be expected to result. And yet it seems virtually certain that all of these additional pains on the part of all parties concerned will not result in any significantly different, certainly not any significantly greater, amount of revenue since each shareholder will be free, by taking the trouble, to achieve substantially the same result as that proposed for himself by electing the overall limitation.

Even if an individual shareholder did for some unanticipated reason elect the per-country limitation for foreign tax credit purposes, the credit available for foreign taxes on a separate country reporting basis would not in the situation considered in exhibit A be significantly different from that allowable under the suggested statutory provisions. In the case of shareholders in the lower tax brackets (who are most unlikely to have any reason to elect the per-country limitation), the difference might be less than one-twelfth of the available credit; for example, a shareholder subject to a 20 percent effective tax rate, who accounted separately on a per-country basis for his share of foreign income from and foreign taxes paid to the seven countries from which the registered Canadian investment company derived its income, would be entitled to a credit of $5.68 as compared with a maximum credit of $6.13 that would be available under the suggested subsections. For a shareholder subject to an effective U.S. tax rate of 30 percent, the available per-country credit would be $5.95 as compared with a maximum credit of $6.13. Even this small difference disappears entirely in the case of a shareholder subject to an effective U.S. tax higher than 50 percent.

Thus, a high bracket taxpayer will receive full benefit of the foreign tax credit regardless of (1) his election of the per-country as opposed to the overall limitation and (2) the type of the statutory provision that is adopted to provide the

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[8] A shareholder subject to tax at an effective rate below the lowest bracket would lose a portion of the credit for his share of the company's taxes; but such an individual would also lose the benefit of the credit to the same or a greater extent under either of the present sec. 904 limitations.

credit for shareholders of a registered foreign investment company. This credit will, of course, merely effect a small reduction in the substantial U.S. tax to which a high bracket taxpayer will be subject on dividends from the company. A low bracket taxpayer too should, in substantially all cases, receive the full benefit of the credit so long as the overall percentage of tax paid by the registered foreign investment company does not exceed his effective U.S. tax rate; in any case the amount of benefit to him under the proposal will not differ significantly from that which he could otherwise obtain. It is clear, therefore, that revenue considerations are not significant in determining the form of the foreign tax credit which should be provided for shareholders of registered foreign investment companies, and the adoption of a simplifying provision of the type suggested is strongly urged.

III. SUGGESTED CLARIFYING STATEMENTS TO BE INCLUDED IN COMMITTEE REPORT

A. Registered foreign investment companies should be encouraged to domesticate

One of the purposes of section 15 of H.R. 10650 is to permit a registered foreign investment company "to elect tax treatment substantially identical with the tax treatment of a U.S. regulated investment company, thereby providing current tax on the dividends and 'pass through' treatment for the capital gains on a current basis." [9]

For this reason, some of the existing registered foreign investment companies may wish to reorganize into domestic regulated investment companies by way of a tax-free reorganization. Any foreign investment company desiring to domesticate in this manner would, under section 367 of the Internal Revenue Code, be required to obtain an advance ruling from the Commissioner of Internal Revenue declaring that the reorganization was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes. As the reason for domestication in such a case would be to subject the company and its shareholders to taxation under the regulated investment company provisions of the code, which are substantially identical in purpose with the provisions in the bill covering registered foreign investment companies, income tax avoidance would obviously not be one of the purposes of domestication. From the standpoint of simplicity of administration, it would be in the best interests of the Government to encourage registered foreign investment companies to domesticate. It is suggested, therefore, that the committee report on the bill make it clear that domestication of registered foreign investment companies is not only consistent with the purposes of section 15 of the bill, but is to be encouraged, and that the Commissioner should take this into account in passing upon applications for rulings under section 367 by those registered foreign investment companies that seek to domesticate in transactions which fall within the reorganization provisions of the code.

Accordingly, it is proposed that the following sentence be included in the Senate Finance Committee report to accompany H.R. 10650 with reference to proposed new section 1247:

"Since the purpose of the new section 1247 is to provide tax treatment for registered foreign investment companies and their shareholders substantially similar to that applicable to domestic regulated investment companies and their shareholders, it is believed that the companies should be encouraged to become domestic corporations and that favorable rulings should be issued to them by the Commissioner of Internal Revenue pursuant to section 367 to permit the companies to become domesticated."

B. Reliance in good faith on opinions of independent certified public accountants and other experts in determining income required to be distributed

It is respectfully suggested that the following sentence be included in the Senate Finance Committee report accompanying H.R. 10650 in regard to proposed new section 1247 to make it clear that registered foreign investment companies may, in determining the income required to be distributed, rely in good faith upon estimates and opinions of independent certified public accountants and other experts which are also used for purposes of their financial statements filed with the Securities and Exchange Commission under the Investment Company Act of 1940:

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[9] Remarks of Representative Boggs in Congressional Record Appendix, p. A9147, Mar. 14, 1962, setting forth the summary of the bill prepared by the staff of the Committee on Ways and Means. See also H. Rept. 1447, p. 73.

"It is recognized that registered foreign investment companies may experience difficulties in ascertaining the extent to which distributions which they receive on investments in stocks of other foreign corporations represent income to them under the standards of the Internal Revenue Code, particularly with respect to distributions from foreign mining companies. The bill provides that the company will not be disqualified under section 1247 if its failure to distribute 90 percent of its income is due to reasonable cause and not due to willful neglect. If, in determining its income, the company relies in good faith upon estimates and opinions of independent certified public accountants or other experts which are also used for purposes of its financial statements filed with the Securities and Exchange Commission under the Investment Company Act of 1940, such reliance would constitute reasonable cause for this purpose."

EXHIBIT A

Table showing income and taxes attributable to 100 shares in a typical registered Canadian investment company

Foreign countries in which foreign investment company derived income	Foreign net income, before deduction of foreign taxes, derived by foreign investment company	Foreign taxes paid by foreign investment company	U.S. tax payable by the shareholder on foreign income without deduction of foreign tax and before allowance of foreign tax credit		
			At 20 percent rate	At 30 percent rate	At 50 percent rate
Canada	$25.41	$4.61	$5.08	$7.63	$12.70
Great Britain	.72	.27	.14	.22	.36
Holland	2.75	.55	.55	.83	1.37
West Germany	1.50	.50	.30	.45	.75
Trinidad	.35	.19	.07	.11	.18
France	.05	.01	.10	.02	.03
Australia	.02	.004	.004	.006	.01
Total	30.80	6.134	6.154	9.266	15.40

APPENDIX B

MEMORANDUM ON REGISTERED FOREIGN INVESTMENT COMPANIES

(Presented by Canada General Fund, Ltd., Canadian International Growth Fund, Ltd., Investors Group Canadian Fund, Ltd., Keystone Fund of Canada, Ltd., New York Capital Fund of Canada, Ltd., Scudder Fund of Canada, Ltd., Templeton Growth Fund of Canada, Ltd., United Funds Canada, Ltd.)

REGISTERED FOREIGN INVESTMENT COMPANIES

On November 7, 1956, Mr. Colin F. Stam, chief of staff of the Joint Committee on Internal Revenue Taxation, and Mr. Dan Throop Smith, then special assistant to the Secretary of the Treasury, submitted to the chairman of the Subcommittee on Internal Revenue Taxation of the House Ways and Means Committee a document prepared by their respective staffs entitled "List of Substantive Unintended Benefits and Hardships and Additional Problems for the Technical Amendments Bill of 1957." This list included a number of "Problems for Which No Solutions Are Suggested."

Included in the category of "Problems for which No Solutions Are Suggested" was topic 17, entitled "Foreign Investment Companies," and the "problem" with respect to foreign investment companies was described as follows:

"17. FOREIGN INVESTMENT COMPANIES.—Some foreign countries have provided especially low tax rates for investment companies having nonresident stockholders in order to attract investment funds to their countries. Canada, for example, provides that investment companies, incorporated in Canada, at least 95 percent of the value of the stock of which is held by nonresidents and which meet certain other requirements are to be subject to a maximum tax of 15 percent as contrasted to the general corporate rate in Canada of 45 percent. Investment companies with U.S. stockholders have organized in foreign countries under laws of this type, have registered with the Securities and Exchange Commission in order to sell securities in this country, and follow the announced policy of paying little or no dividends and plowing back the dividend and other income they receive into additional investments. In these cases the only taxes applicable are the capital-gains tax paid to the United States upon the sale of the investment company stock by the U.S. stockholders, and the nominal corporate tax paid to the foreign government. If such companies were incorporated under U.S. laws, they would be treated in one of two ways. Either they would be required to distribute most of their earnings currently as regulated investment companies, in which case the ordinary individual income tax would be applicable, or the regular corporate income tax would be applicable with the additional risk that the accumulated earnings tax might be applied."

We understand that no specific proposal has been advanced as a "solution" for the "problem." As recent press reports indicate, however, that the matter is still under consideration, it seems appropriate to present a memorandum on the question of whether there is any "problem" at all. This memorandum will point out that—

(1) The registered foreign investment companies implement an important foreign policy objective of the United States—strengthening the economies of free world nations through private U.S. investment abroad.

(2) The form of private investment represented by these companies—portfolio investment involving reinvestment of earnings and realized gains—not only has permitted the general investing public, including thousands of small U.S. investors, to participate in the implementation of this important objective, but it has been welcomed by the foreign countries concerned as the most desirable kind of investment—even preferable to direct investment.

(3) Without the aid of any special U.S. tax legislation and without any distortion of consistent U.S. tax policy these companies have given the U.S. portfolio investor the same opportunities to participate in foreign investment as are now given the direct U.S. corporate investor.

(4) To enact U.S. tax legislation directed against these companies would discriminate against, discourage, and impair this most welcomed form of investment—to the detriment of the declared foreign policy of the United States.

For these reasons the registered foreign investment companies—pioneers in effective foreign portfolio investment—are not a "problem." Rather they offer an opportunity for implementing U.S. foreign policy. To legislature against these companies is to reject the opportunity and to deny the policy.

The case for U.S. private investment abroad

Since the end of World War II it has been the consistent policy of the United States to assist in the economic development of the nations of the free world. And both Democratic and Republican administrations, as well as congressional leaders, have realized in recent years that unless the U.S. Government were to assume the whole burden and were to engage in a myriad of foreign enterprises, direct governmental aid must be supplemented by substantial U.S. private investment. To this end both administrations have fostered numerous studies[1] (the latest of which was published this month), have proposed to Congress numerous measures (some of which have been adopted[2] and some of which are still under study[3]), have asked foreign nations to cooperate, and have exhorted U.S. businessmen to contribute ideas and their influence on the business community—all to encourage private U.S. investment to go into the other countries of the free world.

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[1] E.g., Gordon Gray, "Report to the President on Foreign Economic Policies," Washington: 1950, U.S. Government Printing Office; "Partners in Progress," a report to President Truman by the International Development Advisory Board, New York: 1951, Simon and Schuster; "Resources for Freedom," a report to the President by the President's Materials Policy Commission, Washington: 1952, U.S. Government Printing Office; Commission on Foreign Economic Policy, "Report to the President and the Congress," Washington: 1954, U.S. Government Printing Office; "Report of President's Citizen Advisers on the Mutual Security Program," New York Times, Mar. 6, 1957, p. 16.

[2] E.g., additional tax credits for foreign taxes paid, U.S. Revenue Act of 1951, sec. 332, and U.S. Internal Revenue Code of 1954, sec. 853; expanded definition of Western Hemisphere trade corporation, U.S. Internal Revenue Code of 1954, sec. 921; Government guarantees of private investment against such risks as nonconvertibility and expropriation; e.g., Gordon Gray, "Report to the President on Foreign Economic Policies," supra, p. 13 (enacted in part).

[3] E.g., reduction of 14 percentage points in taxation of corporate income from all foreign sources, 1955 Economic Report of the President, Washington: 1955, U.S. Government Printing Office, p. 53; postponement of tax on U.S. corporation foreign branch income until returned to the United States, H.R. 8300, 83d Cong., 2d sess. (1954), secs. 951–958.

In 1950, for example, President Truman recommended certain changes in the U.S. tax laws in order to "provide real stimulation for the expansion of U.S. investment abroad,"[4] and Secretary Snyder presented the President's program as part of "our policy of encouraging private investment abroad."[5] The tax proposals, Secretary Snyder pointed out, "should not be viewed as the only necessary incentives for the participation of private capital in foreign economic development. Their potential effects will be realized only if foreign countries take positive steps to create conditions under which private capital can operate satisfactorily."[6]

The Eisenhower administration has been no less conscious of the need for encouraging U.S. private investment throughout the free world. As early as June 1953, the Secretary of the Treasury and the Secretary of Commerce gathered together a group of the Nation's "top business leaders familiar with international trade and investment problems" for the purpose of obtaining suggestions on means "to speed up the development of plans for enticing American 'venture capital' to go abroad."[7] And President Eisenhower, in his 1955 Economic Report to the Congress, restated the case for foreign investment in the candid terms of the U.S. national interest:

"We can strengthen our own economy and that of the free world by increasing the flow of capital to nations that are able to use it productively for their development. The expansion of foreign investment would speed the growth in foreign countries of industries whose output is needed to meet our own increasing requirements of raw materials and other products. By augmenting our exports, it would help to maintain prosperity at home. Above all, it would provide a convincing demonstration of our desire for economic partnership with countries seeking to improve their economies."[8]

Commenting on this report, a joint committee of Congress recognized both the difficulties and advantages involved in stimulating private U.S. investment in foreign countries. In discussing the advantages the committee said:

"Private investment has many advantages. It is more likely to be put into projects which can be justified on economic grounds by earning the highest possible return, which is the useful characteristic of the market system for allocating resources to those purposes which are most efficient in meeting human needs. Another advantage of some private investments is that they carry with them automatically the necessary technical knowledge the receiving country needs. Private investments may be less likely to carry the threat of political control with them, and also are more likely to be extended indefinitely, avoiding the complications of repatriation of capital which may be required of many public investments. It has been easier to encourage direct investments abroad than those of the portfolio type, and yet the latter have a very useful place which should not be neglected."[9]

That U.S. private investment, including portfolio investment, must play a larger and more important role in free world economic development has thus become basic U.S. policy. President Eisenhower has succinctly summarized this policy. In his 1955 and 1956 Economic Reports he urged that the U.S. Government "encourage investment in all countries whose desire to speed their economic development has led them to create a hospitable climate for business investment."[10]

The creation and continued growth of the eight foreign investment companies now registered under the U.S. Investment Company Act are a dramatic demonstration of what can be done by private enterprise, even without special U.S. tax legislation, in implementing this policy.

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[4] Committee on Ways and Means, 81st Cong., 2d sess., "Hearings on Revenue Revision of 1950," vol. 1, p. 6.

[5] Committee on Ways and Means, 81st Cong., 2d sess., "Hearings on Revenue Revision of 1950," vol. 1, p. 27.

[6] Id. at vol. 1, p. 28.

[7] New York Times, June 21, 1953, p. 1.

[8] 1955 Economic Report of the President, Washington: 1955, U.S. Government Printing Office, p. 53.

[9] "Foreign Economic Policy," Report of the Joint Committee on the Economic Report to the Congress of the United States, S. Rept. 1312, 84th Cong., 2d sess. (1955), p. 22

[10] 1955 Economic Report of the President, Washington: 1955, U.S. Government Printing Office, p. 53; 1956 Economic Report of the President, Washington: 1956, U.S. Government Printing Office, pp. 90–91.

Implementation by the registered foreign investment companies

Because Canada has had a "desire to speed" its economic development and has created a "hospitable climate for business investment"—evidenced in part by the tax treatment afforded non-resident-owned investment companies [11]—within the past 3 years eight Canadian investment companies have registered under the U.S. Investment Company Act, have received from almost 100,000 U.S. investors some $260 million for investment, and have invested $240 million of this $260 million in Canada and the remaining $20 million in other nations of the free world.

Most of this $260 million has represented new U.S. private investment that otherwise might not have been placed in the channels of foreign economic development. The eight Canadian investment companies have attracted new money for three basic reasons:

1. They have offered the smaller U.S. investor an opportunity to obtain diversification and informed investment management with respect to foreign securities—where peculiar risks are often involved and where complete information frequently is relatively difficult for individual U.S. investors to obtain.
2. They have offered U.S. investors an opportunity to avail themselves of certain tax incentives offered by Canadian tax laws, incentives unimpaired under present U.S. tax laws.
3. They have offered U.S. investors an opportunity to make foreign investment without being subjected to many of the inconveniences that ordinarily arise in connection with foreign investments.[12]

Although both management and diversification might have been available through the ordinary U.S. investment company, the investment abroad of the ordinary U.S. investment company has been negligible in recent years.[13] And prior to 1954 only two registered U.S. investment companies of any importance had concentrated in Canadian investments and none had concentrated in investment in other free world countries. These two companies raised approximately $30 million of U.S. capital through underwriting syndicates, but, although they both made continuous public offerings following their initial underwritings, each soon came to a plateau where each was paying out slightly more in redemptions than it was receiving for new shares issued.

Prior to 1954 some wealthy Americans had grouped together to form Canadian investment companies that presumably had all three advantages mentioned above. But these companies did not make public offerings in the United States and hence were not open to the average U.S. investor. In some instances it may be supposed that there was no desire to bring in additional investors. In any event, these companies could not make a public offering in the United States unless they registered under the Investment Company Act, and this was possible for a foreign company only if the U.S. Securities and Exchange Commission should find that "by reason of special circumstances or arrangements" the provisions of the act could be made enforcible, as a practical matter, against the company and that registration was "otherwise consistent with the public interest and the protection of investors." [14]

Some foreign investment companies had attempted to register, but until 1954 no foreign company had been able to satisfy the Commission that sufficient protections had been set up to justify an order permitting registration to issue. The sequence of events that finally led to registration by the eight presently registered foreign companies is significant.

In November 1952, the investment counsel firm of Scudder, Stevens & Clark first proposed to the SEC certain special arrangements to insure the protection of investors and, at the suggestion of the SEC, in February of 1953 requested a ruling from the U.S. Treasury Department as to the U.S. tax status of a foreign investment company adopting the proposed arrangements.

On April 27 and May 26, 1953, the Treasury issued rulings to the effect that the company would not be "engaged in trade or business within the United States," either with respect to its portfolio transactions or with respect to its own stock, which meant that the company would be recognized under U.S. tax law as a nonresident foreign corporation.

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[11] Income Tax Act, sec. 70.
[12] Kenneth J. Bialkin, "The Renascence of the Investment Company in Foreign Investment," International Investment Quarterly, vol. 1, No. 1 (summer 1956), pp. 16–20.
[13] Id., at pp. 11–12.
[14] Sec. 7(d), Investment Company Act of 1940, 15 U.S.C. 80a–7(d).

In June of 1953, Scudder, Stevens & Clark caused Scudder Fund of Canada, Ltd., to be organized as a Canadian company, and Scudder Fund of Canada, Ltd., filed a formal application to the SEC for an order permitting registration under the Investment Company Act of 1940.

In September of 1953 counsel for Scudder Fund of Canada, Ltd., were advised that the Commission was considering the feasibility of a rule setting forth the requirements to be met in order to obtain an order authorizing registration of Canadian investment companies, which course, it was said, "may better serve the overall administration policy of encouraging foreign investment."

Finally, after consulting with the Treasury Department and other Government agencies, the SEC in June of 1954 issued a rule setting forth requirements to be met in order to obtain an order requiring registration of a Canadian investment company [15] and at the same time issued an order permitting registration by Scudder Fund of Canada, Ltd.

Shortly thereafter Scudder Fund of Canada, Ltd., made a public offering of its shares in the United States, and within the next 2 years seven other companies obtained orders permitting registration, registered, and offered their shares in the United States.

The case for foreign portfolio investment

On December 31, 1956, the eight registered foreign investment companies, representing almost 100,000 U.S. investors, had more than $320 million invested in 197 companies operating in 25 countries of the free world. Approximately $300 million consisted of investment in Canadian and other foreign companies operating primarily in Canada. But about $20 million was invested in companies operating primarily in countries of the free world other than Canada and the United States.

None of this investment constituted control of any company; all of it was portfolio investment. This significant feature of the registered foreign investment companies has made them even more welcome in foreign countries than direct investment and suggests the enormous possibilities available in countries where direct investment has lagged.

The nationals of many countries, including Canada, have shown some sensitivity, perhaps hypersensitivity, with respect to direct U.S. investment. Some Canadians, for example, have been particularly disturbed about the number of U.S. corporations which have set up Canadian subsidiaries in which Canadians have neither investment nor management participation.[16] The U.S. portfolio investor, who takes a minority position, is more welcome in Canada and elsewhere. And even when he buys the mature securities of foreign countries, he frees local capital to take any number of desirable directions.[17] Some displaced local capital will seek employment in local developmental projects, so that the American portfolio investor thus indirectly encourages local development without intruding on local development decisions. More venturesome local capital will move toward the more underdeveloped countries, and the U.S. portfolio investor may thus set off, without taking extraordinary risks, a chain reaction that takes new money throughout the free world.

Portfolio investment and the registered foreign investment companies

Although in the implementation of U.S. policy U.S. portfolio investment has, in the words of the Joint Committee on the Economic Report, "a very useful place which should not be neglected," it has lagged considerably behind direct investment in recent years.[18] In Canada, for example, as the following table shows, long-term U.S. portfolio investment has steadily declined in proportion to U.S. long-term direct investment, and from 1951 through 1953 even declined in absolute amount. This relative decline was slowed and the absolute decline was reversed only in 1954. This is at least partly attributable to the fact that in 1954 the registered foreign investment companies began to pour more than $200 million into Canadian portfolio investment.

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[15] Rule N–7D–1, "Rules and Regulations," Investment Company Act of 1940, 17 C.F.R. 270–7d–1.

[16] See New York Times, Apr. 15, 1956, sec. 1, p. 32, col. 1.

[17] See, e.g., Gordon Gray, "Report to the President on Foreign Economic Policies," Washington, 1950, U.S. Government Printing Office, p. 4.

[18] U.S. Department of Commerce, Survey of Current Business, August 1956, pp. 15, 18, 19; August 1955, pp. 12, 16; May 1954, p. 12.

U.S. private long-term investment in Canada

[Millions of U.S. dollars]

	Direct	Portfolio	Total	Portfolio (percent)
1946	2,472	2,976	5,448	54.6
1947	2,628	2,755	5,383	51.2
1948	2,907	2,858	5,765	49.6
1949	3,146	2,865	6,011	47.7
1950	3,579	3,414	6,993	48.8
1951	3,972	3,621	7,593	47.7
1952	4,593	3,532	8,125	43.5
1953	5,242	3,326	8,568	38.8
1954	5,871	3,642	9,513	38.3
1955	6,464	3,880	10,344	37.5

While comparable figures for 1956 have not yet been published, preliminary reports indicate that U.S. portfolio investment in Canada has again increased and that the eight registered foreign investment companies have again played an important part. And their importance with respect to portfolio investment in Canadian equities has been recognized in a recent publication of the Dominion Bureau of Statistics as follows:

"Their holdings of Canadian securities, mainly common stocks, rose in market value during the year [1956] by some $85 million. A part of this sum represented capital appreciation of their portfolios and is not reflected in the net sales of Canadian securities to residents of the United States. Nevertheless, incomplete data suggest that these investors probably accounted for about $70 million or more than 90 percent of the net sales balance of $76 million from trade in outstanding Canadian common and preference stocks with the United States. In 1955 the proportion was about 60 percent. *It is of particular interest to note that during the second half of 1956 these funds appear to have added to their holdings of Canadian stocks at a time when other U.S. investors as a group were reducing their portfolios.*" [19] [Emphasis ours.]

These companies have been, in a sense, pioneers. They started in Canada because the U.S. investing public had more confidence in Canada and because the SEC believed that controls could be more effectively exercised over a Canadian company than over companies incorporated in other foreign countries. But the question at hand necessarily involves all foreign investment companies and all investments throughout the free world, not just Canadian investment companies and Canadian investment. To simultaneously penalize investment in Canada and encourage investment in other countries would not only be unthinkable, as a matter of foreign relations, but it would ignore the tremendous importance to the United States of Canada's economy and the continued development of Canada's great natural resources. The friendship and strength of Canada, perhaps more than any other free world country, are vital to the United States, and the Canadian reservoir of raw materials stands out, for its variety and its size and its proximity,[20] as a source for supplementing the U.S. diminishing resources of strategic and other raw materials.

In any event, although the eight presently registered foreign investment companies are Canadian companies and are invested primarily in Canada, they are not by any means limited to Canadian investment and their potential goes far beyond Canada throughout the world. Even now, after only 3 years, substantial amounts of the capital in these companies are directly at work in other free world countries, and the company most recently organized is committed to investing 20 percent of its assets in free world countries outside of Canada and has retained discretion to invest an additional 30 percent in those countries.

[19] "Sales and Purchases of Securities Between Canada and Other Countries, December 1956, and Review of Security Trading During 1956," Ottawa, 1957, p. 4.

[20] Canada today supplies a significant portion of the total free world production of many necessary minerals: Aluminum (28 percent), copper (10 percent), fluorspar (8 percent), lead (10 percent), magnesium (6 percent), nickel (80 percent), and zinc (16 percent). Canada is a substantial producer of asbestos, bismuth, cobalt, and uranium. In addition, Canada has large reserves of iron ore, tungsten, columbium, and titanium and will, with proper development, become an important producer of these minerals as well. "The Outlook for Key Commodities," vol II of "Resources for Freedom," a report to the President by the President's Materials Policy Commission, Washington, 1952, U.S. Government Printing Office, pp. 18, 28, 29, 47, 59, 75, 77, 90, 186–200.

Thus these companies are making a significant contribution toward increasing portfolio investment abroad, and they represent perhaps the most effective way in which this welcome form of foreign investment can be expanded in aid of U.S. policy.

The case for continued reinvestment through registered foreign investment companies

The portfolio investment of the registered foreign investment companies has not only been more welcome than direct investment, but has been even more welcome than ordinary portfolio investment. Instead of draining local economies by continuously taking out earnings and capital, these companies have enabled the U.S. investing public to maintain a steadily increasing revolving interest in those economies.

Primarily this has been possible because these companies have the declared policy of reinvesting their earnings and realized gains. By following this policy, they have been able to take advantage of rights offerings by companies in which they are already invested, as well as to respond to offerings of new securities and to purchase outstanding securities in the open market, thus giving a continuing impetus to local expansion and development.

And when individual U.S. investors have withdrawn from the companies, either by selling their shares in the U.S. securities market or by redeeming them with the companies, these investors have been more than offset by other U.S. investors buying their shares or new shares offered by one or another of these companies. Coupled with this continued confidence of U.S. investors in these companies, their reinvestment feature has meant that the new money placed in foreign economies by the registered foreign investment companies has not only been put to work, but has stayed at work, and the level of their foreign investment has continued to rise. Thus, their foreign investment is insulated against the charge so often leveled against foreign investment—that it is attempting to milk, rather than develop, the foreign country where it is investing.

The case for nondiscrimination

The registered foreign investment companies not only are welcome where they invest, but they now serve the foreign investment needs of some 100,000 U.S. shareholders. They provide these shareholders, many of them small investors, with informed and expert management and a most effective means of achieving investment diversification—a more pressing consideration with respect to foreign investment than domestic investment because of the uncertainties involved in foreign investment. Thus, these companies have a real and important economic significance. They have done a job for the general U.S. investing public and foreign portfolio investment that the U.S. investment companies have not been able to do.

There is no doubt that tax incentives have played an important part in the success of these companies in inducing the flow of new investment abroad. In the first instance, these incentives have been provided by Canada—which does not tax capital gains or corporate accumulations of earnings and which has made available special treatment for non-resident-owned investment companies.[21] And the effectiveness of these incentives remains unimpaired so long as the United States adheres to its traditional tax treatment of the foreign income of foreign corporations having U.S. shareholders.

The U.S. tax position of a U.S. investor in a registered foreign investment company does not differ from that of a U.S. corporate investor making direct foreign investment through a foreign operating subsidiary. The foreign subsidiary pays no U.S. taxes on its foreign earnings,[22] and the U.S. parent company pays no U.S. taxes on those earnings until it brings them home. Moreover, whether the subsidiary puts its foreign earnings into capital improvement or uses them to invest in the securities of other foreign companies, neither the U.S. parent company nor its foreign subsidiary is subject to any U.S. tax on income accumulations with respect to those foreign earnings. And, if prior to receiving any of those earnings as dividends, the U.S. corporation should sell its interest in the subsidiary or dissolve the subsidiary, its only U.S. income tax on its foreign investment would be at capital gain rates.

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[21] Income Tax Act, sec. 70.
[22] United States Internal Revenue Code of 1954, sec. 882(b).

The direct corporate investor is thus encouraged to place new capital abroad through foreign subsidiaries and to plow back foreign earnings into additional foreign investment. The similar treatment given the registered foreign investment companies makes it possible for the U.S. investing public to do the same thing through the avenue of portfolio investment.

Both avenues remain fully open under present U.S. tax law, and it is highly desirable that they stay open. To throw up roadblocks in the way of either form of investment—by making a change in the U.S. traditional tax treatment of foreign corporations and foreign income—would run directly in the face of the policy of both Democratic and Republican administrations with respect to private investment abroad. It would discourage, rather than encourage such investment for a long time to come.

It has not been suggested that the tax treatment of the direct corporate investor with a foreign subsidiary is a problem, and we agree that it is not. Yet there is no reason, as a matter of consistent U.S. tax policy, to block the avenue of portfolio investment while leaving the avenue of direct corporate investment completely open.

Any legislation changing adversely the U.S. tax status of registered foreign investment companies and their shareholders that did not similarly affect direct corporate investment through foreign subsidiaries would be manifestly discriminatory. It would set up a tax inequity between direct corporate investment and portfolio investment. And it would be discriminatory against the form of investment—portfolio investment—that most needs encouragement, the form that should be encouraged above all other forms because it is the more welcome where the investments are made.

Not a problem but an opportunity

Tax legislation directed against the registered foreign investment companies and their stockholders would not only cut down prospects for increased portfolio investment abroad, but it might well cause the withdrawal of much of the registered foreign investment company capital now invested in foreign countries. Such a withdrawal would obviously have a serious effect on the Canadian securities market and, perhaps, on the Canadian economy. It also could have an adverse effect in other free world countries.

But regardless of these effects, the passage of any such discouraging legislation would be deplorable because it would represent a breach of faith. Every public pronouncement of U.S. public officials within the past years has been to invite U.S. private investors to put their money abroad in the interest of the prosperity of our neighbors and of other countries of the free world and to invite American businessmen to exercise their imagination in creating means for such investment.

The registered foreign investment companies were organized in good faith, with full disclosure to the interested public authorities, against this background of official encouragement and of long-standing U.S. tax law. To now label as a loophole what has been in the U.S. income tax law since its inception, to now treat foreign investment as if it were identical to U.S. investment when it has always been treated differently would not only be absurd but could be a doleful prophecy of what might happen to anyone responding to a tax incentive designed to implement governmental policy.[23]

And what if nothing is done? It is difficult to estimate how much revenue would be gained by the Treasury by discriminatory legislation aimed at the registered foreign investment companies. The revenue difference is bound to be inconsequential, particularly in relation to the advantages that will flow from the continuance of present policy. The net income yield (after expenses and Canadian taxes) from the investments made by the registered foreign investment companies has thus far averaged well under 2 percent of portfolio value, and this low rate of yield is likely to continue because the investments are for the most part in "growth" securities. This income, when realized by the shareholder through sale or redemption of his shares, will be taxed at capital gain rates along with the realized appreciation on the shares so sold or redeemed. On the other hand, current taxation of the ordinary income, if it did not cause the capital producing it to be diverted to other investments from which no taxable income is realized, would in the end produce only the dif-

[23] See "Foreign Economic Policy," report of the Joint Committee on the Economic Report to the Congress of the United States, S. Rept. 1312, 84th Cong., 2d sess. (1955), p. 4, par. (c).

ference between the ordinary income rate and the capital rain rate on a relatively small amount of ordinary income. And as many of the eight registered investment companies' shareholders are small investors and as the average investment in these companies has been approximately $2,700, the revenue consideration is, therefore, minimal.

Balancing this consideration against the advantage of the United States of having hundreds of millions of dollars coursing through the economies of Canada and other free world nations makes it clear that what appears to some to be a "tax loophole" is in reality an effective means of implementing an important policy in an area, portfolio investment, that most needs implementation.

What of the figure? Suppose these registered companies increase in size and investment—what of the revenue loss then? Whatever increase in the lost revenue will be more than offset by the increase in the developmental effect of the private investment abroad and the saving to the U.S. taxpayer of the additional Government money that otherwise would be required to do the job.

It is respectfully submitted that the tax status of the foreign investment companies is not a "problem," but an opportunity. To give these companies a chance to grow is to give private foreign portfolio investment a chance to demonstrate its utility to the U.S. investor and to the implementation of U.S. foreign policy throughout the free world. To legislate against them would be to reject the opportunity and to deny the policy, and it would be to discriminate against a form of foreign investment most welcomed by foreign countries.

APPENDIX C

Estimated net assets of 13 registered foreign investment companies [1]	$422,000,000
Income per annum at 2 percent assumed rate	8,440,000
Total Federal tax liability at 40 percent assumed rate	3,376,000
Increased tax revenue after allowing for eventual capital gains tax at assumed rate of 20 percent	1,688,000

[1] See Secretary Dillon's testimony before the Senate Finance Committee; hearings on H.R. 10650, Apr. 2, 1962, pt. I, p. 254.

The CHAIRMAN. The next witness is Mr. Emil Gould of the National Association of Home Builders.

Mr. Gould, take a seat, sir, and proceed.

STATEMENT OF EMIL GOULD, CHAIRMAN, TAX STUDIES COMMITTEE, NATIONAL ASSOCIATION OF HOME BUILDERS

Mr. GOULD. Mr. Chairman and gentlemen, my name is Emil Gould. I am a resident of and a homebuilder in Miami, Fla. I appear here today on behalf of the National Association of Home Builders, in place of and by authorization of the president of this association, Mr. Leonard L. Frank of Long Island, who is currently out of the country. I am the chairman of the association's tax studies committee. With me are the general counsel of our association, Mr. Herbert S. Colton, and our tax legislative counsel, Mr. Leonard L. Silverstein.

We are here to present the views of the homebuilding industry with respect to the impact of H.R. 10650 on real estate investment. Since time is limited, I should like to confine my discussion to the proposal of Secretary Dillon before this committee to add to the bill a new provision severely limiting depreciation and changing the present capital gains treatment of income-producing real property.

This same general proposal was considered in detail and passed over by the House Ways and Means Committee, which chose at this time not to amend the code in H.R. 10650 with respect to real property.

THE NATIONAL ASSOCIATION OF HOME BUILDERS

This association is the sole national spokesman of the homebuilding industry in the United States. Our membership totals more than 40,000, affiliated in 370 States and local associations located in every State as well as Puerto Rico.

Our members build the vast bulk of residential construction in the United States. During 1961 we estimate the work of our member homebuilders resulted in a direct contribution of approximately $15 billion to the gross national product. Since the multiplier effect of homebuilding is estimated to equal at least its direct contribution, our builders can be said to account directly and indirectly for about $30 billion of economic activity.

This production involves both homes for sale and multifamily dwellings for rental purposes, ranging from the two-family house to large apartment developments. In 1961, rental housing totaled 26.5 percent of all new housing starts, compared with less than 10 percent as recently as 1956. By contrast, the production of one-family units in 1961 reached the lowest ebb since 1946.

Therefore, our members have a vital interest in Secretary Dillon's proposal to add to H.R. 10650 a new provision which could readily and adversely affect the flow of investment funds into, and the consequent production of, multifamily rental housing. We are also concerned with the adverse impact of the proposal upon other kinds of income-producing property which flow from or depend upon the construction of housing projects, for example, shopping centers and small commercial buildings.

HOUSING PRODUCTION—A BASIC NATIONAL OBJECTIVE

In his special message to this Congress a year ago on housing and community development, which resulted in the Housing Act of 1961, President Kennedy recognized the economic importance of homebuilding in these words:

> The housing industry is one of the largest employers of labor. Residential construction alone accounts for 30 percent of total private investment in this country. The housing market absorbs more private credit than any other single sector of the economy. Other important industries and services, including those concerned with building materials, appliances, furniture, and home improvement, depend largely and directly on new housing construction.

The President stated that national housing policy must be directed toward accomplishment of a basic national objective—

> to encourage a prosperous and efficient construction industry as an essential component of general economic prosperity and growth.

We believe that the proposal made in the Secretary's testimony respecting taxation of income-producing real property runs counter to this objective and, if adopted, may well prevent its attainment.

At the very outset we want to make clear that our interest is concerned with the effect of the bill on production. We do not argue on behalf of companies which specialize in acquiring existing properties to be used as "depreciation shelters."

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

Do you oppose changing the law——

Mr. GOULD. We do not argue on behalf of companies which specialize in acquiring existing properties to be used as "depreciation shelters." We are representing the production of investment properties.

Senator GORE. Do you oppose changing the law so as to prevent the kind of abuse to which you refer?

Mr. GOULD. Our position is that one of the problems of this act is that it does not differentiate between the two. That is one of the shortcomings which we point out further in the statement.

Senator GORE. Do you favor some change in the law?

Mr. GOULD. For the abuses, yes.

Senator GORE. I beg pardon?

Mr. GOULD. I say to correct for possible abuses that there may be. But again we are concerned, and our members are concerned with the production end of this, and to our mind the abuses do not apply to the productive end of this industry.

Senator GORE. Thank you.

Mr. GOULD. Vast amounts of income-producing properties are owned by small investors and not by corporate operators. We believe the effort to tax depreciable real estate, as outlined in the Secretary's proposal, will necessarily and gravely inhibit construction of new and rehabilitated rental housing which the national housing policy of the administration seeks to encourage.

To restrict—and in our opinion to run the risk of destroying—the market for existing properties will automatically restrict and perhaps kill new production, unless great care is taken to distinguish between the two. This the proposal does not effectively do.

We believe this matter should be presented to and considered by the Congress at a later date in orderly fashion as part of the administration's further overall tax reform program stressed by the Secretary in his testimony. We cannot agree that the proposal as now advanced before the committee constitutes "an appropriate remedy" or, as the Secretary states, "that it would be unwise to delay action." Rather we believe that the economic repercussions are so serious as to warrant thorough analysis and extensive study before proceeding further with so drastic a change in this area of the law.

For this reason we expressed before the House Ways and Means Committee, and we reiterate here, our willingess to cooperate with the staffs of both the Treasury and congressional committees in working on this matter as a part of the comprehensive tax legislation anticipated to come before Congress a year or so from now. The complexity of developing a detailed, equitable, and workable solution is underscored by the Secretary's acknowledgement that the House failed to act "largely because of difficulties in reaching a consensus on the appropriate remedy."

THE ADMINISTRATION'S PROPOSAL

The consequences of the administration's proposal may be readily summarized:

Real property would be limited in its choice of depreciation methods to so-called straight-line depreciation. This would deprive it of declining balance methods, including those determined on a 200-percent and a 150-percent base, as well as any other consistent method which does not constitute the straight-line method.

A further provision would tax part of the profits from sale of real property at ordinary income rates. This is a limited provision depending upon the number of years the property is held and the amount of depreciation previously claimed.

Under the proposal, however, continued ownership for 14⅔ years is required before tax consequences on disposition will reach the same capital gains results as under present law. In real estate ownership 14 years is virtually a lifetime. It is a far longer period than necessary to assure the investment nature of the ownership.

Further adding to the adverse impact of this proposal, if enacted, is its application to depreciation claimed for years beginning after December 31, 1961, and for sales made after that year. In other words, present holders of real property, who have made their investments and operate their properties on the basis of an understanding of existing law, would be seriously "locked in."

In order to understand our concern with the proposal it is appropriate to point up the Treasury's reasons. It was stated before this committee that this constitutes a "reform" needed to "eliminate an unfair tax advantage" to those who depreciate property at a rate in excess of actual decline in market value and then proceed to sell the property. It was also noted that real estate is readily transferable without excessive cost, in a way that factory production line machinery and equipment are not, and further, that real estate "has a broader market than most specialized equipment."

REAL PROPERTY—A HIGH-RISK INVESTMENT

The stated tax results in the Treasury's testimony, however, represent consequences of successful enterprises only. Ignored entirely are realty investments where actual rentals do not fulfill future projections. Moreover, even in the most optimistic projections reflected in the Treasury exhibit, it soon becomes apparent that after a relatively limited number of years, the taxable income exceeds any cash flow payable to the owners of depreciable real property. The "excessive" depreciation benefits, therefore, are purely temporary in nature.

Real estate as an investment is comparatively nonliquid. No organized market exists for transfers as in the case of securities. This is a serious deterrent to investment and is reflected in the demand by investors for a substantially higher return from realty than from bonds or other more liquid securities.

Equity investment in the construction of income-producing residential property carries with it far more economic hazard than most other forms of investment, including the securities of business concerns. Initially, capital must be committed to a new rental property venture without any expectation of return for a period of many months, often as long as 2 years. Thereafter, the degree of return will depend upon the economic situation at that later indefinite date when and if the building is constructed and fully rented.

Assuming that a building has been properly constructed, a chief attribute which will either create or possibly destroy desirability is the physical location of the land on which the building is constructed.

The maximum rental flow which can be generated by the building is tied much more to the value of the location, than to the ingenuity, efficiency, or general business capacity of the owners or operators of the building. In contrast to manufacturing enterprises, for example, there is no opportunity for capital appreciation stemming from new product development, or development of trade secrets.

Because of the special hazards of investment in apartment property, only high risk—after tax—equity capital becomes available for a realty venture.

We believe the differences between our position and that of the Treasury on this issue stem from the fact that the Treasury has approached the problem solely in terms of technical tax effects, without fully appreciating supervening considerations of national housing policy and dependent industrial activity.

We further believe that the technical aspects of the problem should not be separately treated at this time. Such an approach ignores the fact, well known to this committee, that the present structure of the Internal Revenue Code—which developed in a historical framework over many years in response to the needs of various segments of the economy—contains a host of uneven tax effects.

To segment one aspect of the code's operation without compensatory adjustment in other areas serves only to heighten distorted tax and economic effects. For example, equity capital will tend to shift even further to the already heavily favored securities market.

The issue should properly be considered in a much broader context and from three standpoints: national housing policy, real estate construction activity, and overall tax reform. Consideration of the one aspect alone will do serious harm to the more basic national considerations we have just described.

Accordingly we urge the committee to concur in the action of the House in rejecting the recommendation for new provisions to be added to H.R. 10650 drastically and adversely limiting depreciation and changing present capital gains treatment of depreciable real property.

We very much appreciate this opportunity to present our views and we will be pleased to answer any questions which the committee may have. I would appreciate permission to file a supplemental statement on other aspects of the tax bill of interest to our industry.

Thank you very much.

The CHAIRMAN. Thank you, Mr. Gould.

Senator Talmadge?

Senator TALMADGE. No questions.

The CHAIRMAN. Senator Butler?

Senator BUTLER. No questions.

The CHAIRMAN. Thank you very much, sir.

Mr. GOULD. Thank you, sir.

(The material referred to follows:)

NATIONAL ASSOCIATION OF HOME BUILDERS,
Washington, D.C., May 1, 1962.

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

DEAR SENATOR BYRD: We appreciate the permission accorded during our oral testimony this morning to file a supplemental statement on other aspects of H.R. 10650 of interest to the homebuilding industry. This supplemental statement is enclosed for the record.

Also enclosed for inclusion in the record as a supplement to our testimony is an article by Miles L. Colean from the July 1961 issue of Architectural Forum. This contains an analysis of the proposal to alter present tax treatment of depreciable real property. It should be considered in conjunction with the reference to an earlier article by Mr. Colean referred to in a footnote in exhibit VI to Secretary Dillon's testimony (p. 354 of pt. 1, of the hearings) before the Committee on Finance on H.R. 10650.

In addition, for the further information of the committee, there is enclosed for the record a brief table and graph showing the trends in construction of privately financed rental housing.

Sincerely,

EMIL GOULD,
Chairman, Tax Studies Committee.

SUPPLEMENTAL STATEMENT OF NATIONAL ASSOCIATION OF HOME BUILDERS

This statement is submitted as supplementary to the testimony of the National Association of Home Builders submitted to the committee by Mr. Emil Gould in the hearing on May 1. The oral testimony was confined completely to the proposal of Secretary Dillon to add to the bill a new provision severely limiting depreciation and changing the present capital gains treatment of income-producing real property. This proposal was rejected by the House Ways and Means Committee and we urge the Committee on Finance to concur in the action of the House.

In addition, the members of this association, who build the vast bulk of residential construction in the United States, are vitally concerned about the availability of mortgage funds with which homeowners and home buyers may finance a continuing high rate of residential construction. Therefore we are concerned with the impact of a quick and heavy increase in taxes on mutual thrift institutions coupled with the imposition of withholding upon the pool of interest and dividend funds which are currently reinvested as mortgage funds.

During the decade ahead, the conservative estimates as reflected in the report of the Senate Subcommittee on Housing, "Study of Mortgage Credit," indicate a need for about $150 billion of net new mortgage credit during the decade to provide a proper flow of mortgage funds to meet the housing requirement of our people. This net requirement for the 1960's is approximately equal to today's total 1–4 family mortgage debt outstanding and is more than 50 percent greater than the amount required during the decade of the 1950's.

The savings and loan and mutual savings bank tax proposals, now before Congress, seem principally to be the product of competitive conditions in the banking field. While it is the position of NAHB that every segment of the economy, including real estate, should bear its fair share of the U.S. income burden, the measure of the fair share of Federal taxation borne by each segment of the economy must be determined in the light of the particular circumstances of the industry concerned. We believe that the essence of the present Internal Revenue Code structure reflects a recognition that the particular needs of particular economic activities differ.

We are apprehensive that the changes referred to your committee will have a number of sharply adverse effects on the ability of homeowners and prospective home buyers to obtain a sufficient flow of mortgage funds at reasonable rates. Any decrease in savings, through impairment of the ability of mutual institutions to attract savings funds, will reduce the supply of mortgage funds. This in turn may well increase the pressure on mortgage costs and interest rates, both invading the pool of available funds for mortgages generally and raising housing costs for the families concerned. The impact quite obviously will also be felt by the homebuilding industry.

Up to the present time, nearly one-half of all mortgage finance for new homes has been supplied by the savings and loan institutions and mutual savings banks. If mortgage interest rates are permitted to rise, we know from bitter experience that building will be seriously set back. The resulting effects on the economy always have been severe. We hope such a situation can be avoided now.

We understand that when representatives of the mutual institutions appeared before your committee they asked for a transition period of several years before the increased taxes would take their full effect. This would seem a more reasonable approach and would certainly create a trial period during which the gradual results of the proposed changes would be tested in the market. In this way their cumulative effect on mortgage rates and homebuilding can be gaged.

We are confident that your committee, in considering the presently proposed provisions, will bear this problem in mind. We feel that it is of the utmost importance that the mutual thrift institutions be permitted to play the same kind of full role in residential mortgage finance that they have in the past, and that any possible encouragement for them to expand their financing operations should be given.

In addition, however, we would suggest that the committee might well study other devices which will encourage the flow of funds into mortgage credit including tax incentives for additional commercial bank investments into mortgages. We would be pleased to have the opportunity to work with the committee on devising proposals for this purpose.

We should also like to direct the committee's attention to the impact of the proposed new withholding on dividends and interest, particularly as this applies to mutual savings banks and other comparable thrift institutions.

As with the proposal to increase taxes on mutual thrift institutions, the imposition of withholding will draw tax funds directly from a pool of presently available mortgage funds. At the present time, it is our understanding a substantial source of the mortgage funds invested annually by mutual savings banks and other comparable institutions comes from earned interest or dividends which remain within the institution for reinvestment.

The administration has presented a formidable combination of substantially increased taxes on mutual thrift institutions, the largest single supplier of mortgage funds, of imposed withholding on earned interest or dividends which presently form a favorable pool of reinvestment mortgage funds, and of the proposal of Secretary Dillon to add to H.R. 10650 a drastic revision in the capital gains treatment of depreciable real property (discussed in detail in our primary statement).

We respectfully request the committee to consider thoroughly the impact of this combination upon the attainment of our recognized national housing goals which depend almost completely upon a high annual rate of housing production and an increasing supply of available mortgage funds.

The Threat to Real Estate Investment—Changes in the Federal Tax Law Proposed by the Administration Would Penalize Developers of Apartment and Commercial Properties

(By Miles L. Colean)

Federal tax proposals now being considered by the Congress contain a provision that, if passed, would create severe tax penalties to present holders of commercial and apartment properties, impede the transfer of such properties, and present a strong deterrent to the development of new properties.

The recommendation, as stated in the President's tax message of April 20, is that "capital gains treatment be withdrawn from gains on the disposition of depreciable property, both personal and real property, to the extent that depreciation has been deducted for such property by the seller in previous years, permitting only the excess of the sales price over the original cost to be treated as a capital gain. The remainder should be treated as ordinary income. This reform should immediately become effective as to all sales taking place after the date of enactment."

A similar proposal was considered by the previous administration, but real property was excluded from its applicability. Now, real property becomes the primary target, as is made clear in the testimony of the Secretary of the Treasury that "the proposed withdrawal of capital gain treatment from gains on the disposition of depreciable property that reflect prior depreciation would eliminate much of the present tax advantage attaching to investment in so-called depreciation shelters, which exist primarily in the real estate area."

"For example," Secretary Dillon says, "during the first few years after acquisition of a building by a real estate syndicate, the total of depreciation allowances and mortgage interest will often exceed the rental income, so that distributions of income during this period are tax exempt in the hands of the investor. When the distributions substantially cease to be tax exempt, the building is sold, a capital gains tax paid on the gain attributable to the depreciation allowances, and another building is acquired to provide another depreciation shelter. Withdrawal of capital gain treatment from the gain on sale of the building, to the extent of prior depreciation allowances, will substantially eliminate this kind of tax trafficking."

The Secretary is quite clear as to his intentions, but his method is a good deal like killing the chickens in order to keep the weasel from the henhouse. At the time of the enactment of the present depreciation provisions, the special hazards in real estate investment were pointed out, as was the importance of some form of escape from the extreme tax impact on this kind of investment (Forum, April 1955: "Realities of today's real estate investment"). It was also predicted that the liberalized depreciation formulas of the Revenue Act of 1954 would stimulate activity and somewhat encourage equity investment.

The evidence of a stimulating effect after 1954 on the building of all types of income-producing property is strong. (See chart.) It may be noted, too, that there has been an observable shift over this period from direct investment by insurance company and labor union funds (which have a built-in tax shelter) to true risk enterprise. This recent activity, in spite of whatever tax shelter it might temporarily have received from the depreciation arrangements, could not have added considerably to both local and Federal income.

Moreover, the evidence of real investment motivation is certainly as great as that of Mr. Dillon's "tax trafficking." What he would do now would be not only to eliminate the benefit of the liberalized depreciation formulas but also to eliminate capital gain treatment even on the basis of the old straight-line depreciation formula, which was demonstrated to be inadequate as a spur to a broad interest in this form of activity.

In its focus on its own assumption of what is a typical and, in its view, a reprehensible situation, the Treasury's argument overlooks the difference in the characteristics of personal and real property and the peculiar nature of real estate as a commingling of depreciable and nondepreciable assets.

An income-producing property is, in the first place, not like a tool or a piece of machinery for which a salvage value is reasonably calculable. The economic life of a structure extends so far into the future and is subject to so many vicissitudes that an estimate of salvage value is purely an exercise in appraisal theory. The salvage value of a fully or even a partially depreciated structure may actually be a negative quantity because of the usual net cost of demolition. If the residual value of the land is taken to represent the ultimate salvage value of the property as a whole, the calculation is no easier. The value of a particular site may appreciate or depreciate over a period of time, depending upon the future desirability of the site, the cost of clearance, the extent of inflation over a period of time, the impact of local taxation, and many other factors not ascertainable in advance and not applicable in anywhere near the same degree to other classes of property. The taxation of gains in real estate must take into account these important differences.

The most significant peculiarity of real estate is that the value of an income-producing property at any given time is made up of the following elements: (1) the suitability of the structure for its purpose; (2) the attractiveness of the site for both its present and alternative uses; and (3) the quality of the management of the property and the prestige that this may have created.

Changes in value over a period of time may be due to any one or a combination of these elements. From either a practical or a legal point of view, however, these elements are inseparable. It is possible for the value of the total property to increase while the structure was actually losing value because of obsolescence or deterioration, or for the value of the total to decrease in spite of the most careful management because of a shift in neighborhood preferences. The depreciation allowance on the structure is the only protection available against a wide range of unfortunate contingencies; and the denial of capital gains treatment to the depreciation deduction may in effect eliminate the benefit of a capital gain, or a hedge against capital loss, on the nondepreciable elements of property. This may be an unscientific way of accomplishing the purpose, but it is the only one available and has proved to be a satisfactory expedient.

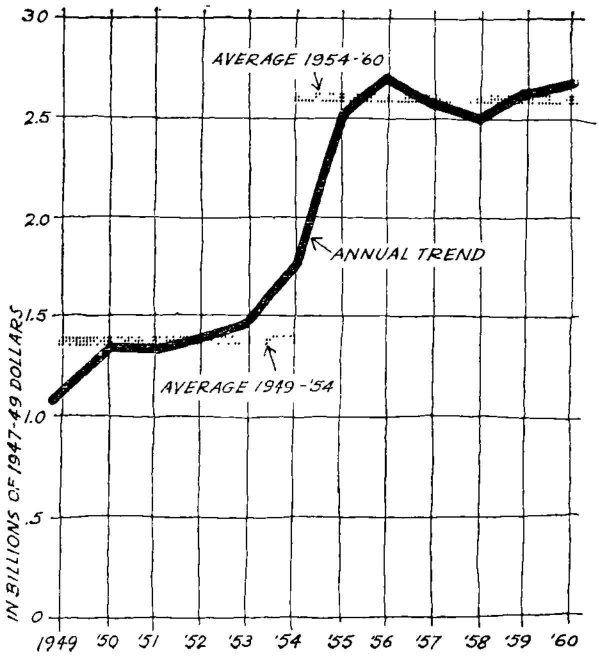
Under the proposal to deny capital gains treatment to the amount taken in depreciation deductions, an accumulating penalty is created on the holding of income-producing property. As time passes, the penalty may, in fact, become so severe that the long-term investor may find himself either frozen into his investment or, in case of necessity to sell, faced with a harsh levy (see chart). In view of these prospects, an incentive will be created to unload the property at the earliest feasible date. Sound construction, careful maintenance, and long-term investment will alike be discouraged, since the advantage of building up value over a period of time will be largely lost.

The so-called "depreciation shelter" to which Secretary Dillon refers may as often as not be the only difference between the survival or collapse of the enterprise. The first years of an income-producing property are normally the most risky period in its existence. These are the testing years for the practicality and acceptability of the whole concept in terms of the maximum income that may be developed. Any such property is certain to be more valuable after passing this test.

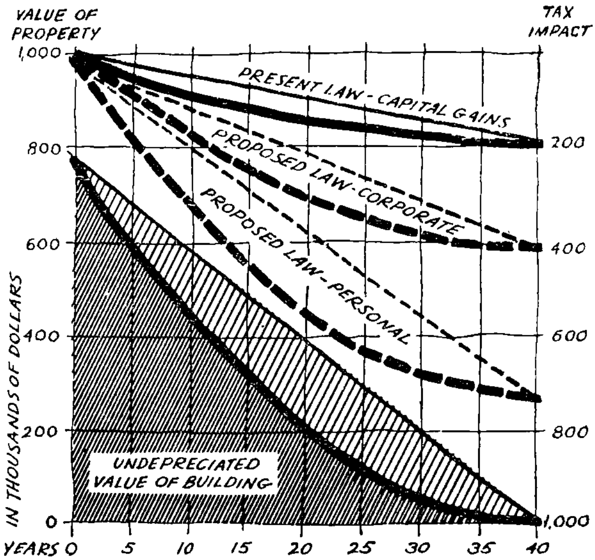
The present scope of capital gains treatment is a fair measure of the potential reward that is necessary to induce an investor to accept the risk involved. Without the possibility of such a reward, in this form or in some other form, the risk will be much less likely to be taken. The removal of this possibility would, by discouraging this hazardous type of enterprise, probably result in a loss of tax revenue rather than a gain as claimed. The implications of the proposed change are particularly serious for the expansion of investment in urban renewal areas, where the risks are especially great and where incentives have to be correspondingly evident.

The whole issue is not one of fine-spun logic but rather one of what is necessary to keep investment in this vital area at a high level. The present combination of providing liberal depreciation allowances and of permitting the undepreciated value to be the basis for capital gains tax treatment has been proved a useful instrument for this purpose. Its removal would create an imbalance between risk and potential reward, and thus discourage risk taking. It would add to the illiquidity of realty investment and hence discourage the flow of equity funds into this area. It would remove an important stimulus to economic growth. It would make urban renewal under private auspices more precarious.

For the dubious potential gain of $200 million in revenue, which is all that it claimed for the change, these seem like serious chances to take. Fortunately, there is still time for second thoughts before Congress acts.



Commercial building, stimulated by enactment of the present tax law in 1954, has been running at an average annual expenditure rate of $2.6 billion, compared with $1.4 billion for the preceding 6 years. Similarly, construction of multifamily housing has increased since 1954: the 6-year average since then has been 149,000 units per year, compared with 113,000 units for the preceding 6 years.



Impact of taxation on capital gains under the present and proposed systems is illustrated in this chart. It is based on a property having an original cost and final sales price of $1 million, of which $800,000 represents the depreciable structure. All gains, if any, in excess of the original cost will continue to be taxed at the 25-percent capital gains rate. Gains represented by the amount of depreciation taken accordingly to the straight-line method of depreciation and the sum-of-years' digits method (the latter allows the maximum deduction in the early years) are currently taxed at the capital gains rates shown by the uppermost straight and curved lines, respectively, for any given year of sale. Under the proposed plan, such gains would be taxed as income. The upper set of dotted lines indicates the amounts of tax for any year in which the sale was made if charged at the full 52-percent corporate income tax rate. The lower set of dotted lines indicate the maximum 91-percent tax that might have to be paid by an individual in the highest income bracket.

Under the new plan, the tax would have to be paid in the year of sale on the basis of current income, if the owner is a corporation, and on the basis of income averaged over the year of sale and the 2 preceding years, if the owner is an individual. In the mildest situation, the tax impact under the new system is almost certain to be greater than under the old.

Type of structure—Private nonfarm housing starts, including NAHB estimates of back data, Apr. 6, 1962 (2d edition)—Annual data

[Thousands of units]

	Total starts	1-family units	2-family units	Multi-family units	Rental housing (cols. 3 and 4)	Rental units as percent of total
Private nonfarm:						
1946	916	838	27	51	78	8.5
1947	1,139	1,026	37	76	113	9.9
1948	1,209	1,048	51	110	161	13 3
1949	1,285	1,076	38	171	209	16 3
1950	1,721	1,505	47	169	216	12.5
1951	1,284	1,147	44	93	137	10.6
1952	1,318	1,179	50	89	139	10.5
1953	1,292	1,146	46	100	146	11.3
1954	1,428	1,294	38	96	134	9.4
1955	1,536	1,408	36	92	128	8.3
1956	1,268	1,147	34	87	121	9 6
1957	1,132	969	36	127	163	14.4
1958	1,287	1,064	43	180	223	17.3
1959	1,495	1,212	56	227	283	18.9
1960	1,230	972	44	214	258	21.0
1961	1,276	938	44	294	338	26.5
Public housing:						
1959	37	17	3	17	20	53.7
1960	44	14	7	23	30	67.2
1961	52	15	6	31	37	71.4
Total nonfarm:						
1959	1,531	1,229	58	244	303	19.8
1960	1,274	987	50	237	287	22.5
1961	1,327	952	50	325	375	28.3

NOTE.—Source of 1959–61 data is Bureau of the Census. Data prior to 1959 are NAHB estimates based on adjustments of BLS "Old Series" data for undercoverage.

[Economic News Notes Special Report 62–1, Feb. 23, 1962]

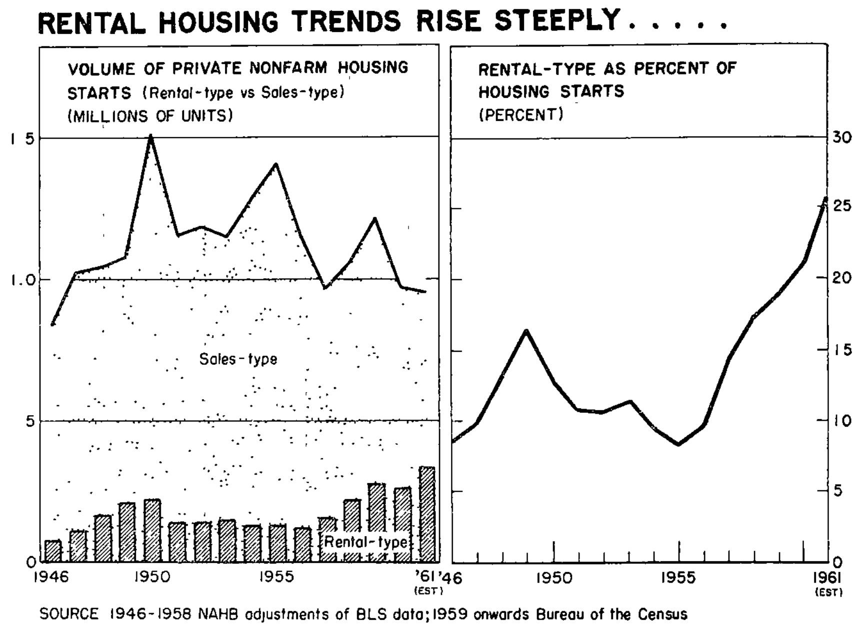
MULTIFAMILY HOUSING TRENDS

RENTAL HOUSING SHARE OF THE NEW HOUSING MARKET REACHES POST-WAR HIGH

Rental housing in 1961 reached nearly 26 percent of the total nonfarm private starts. During the first 10 years following World War II rental housing had accounted for only about 11 percent of private starts volume. The current trend began after 1955 and the rental housing share of the new housing market has been climbing steeply ever since.

Rental housing as used in these statistics customarily includes all housing units other than one-family structures. (It is assumed that duplex and apartment units sold for owner occupancy roughly offset the one-family units built for rental.) Statistics which distinguished between housing of heavy and light construction types or building heights, etc., might be more meaningful from the point of view of construction methods or materials markets involved, but such data is not readily available.

Rental housing units in 1961 are estimated at 330,000—a postwar high, and a gain over 1960 of about 28 percent. Of these, 43,000 units were in duplexes and 287,000 were in multifamily structures. The 287,000 multifamily units represent a 34-percent increase over the 214,000 built in 1960. Duplex units at 43,000 are at approximately the same level as 1960's 44,000. One-family units on the other hand declined by about 3 percent—from 972,000 in 1960 to 945,000 in 1961.



The CHAIRMAN. The next witness is Mr. E. W. Kuhlman of the Caterpillar Tractor Co.

Take a seat and proceed.

STATEMENT OF E. W. KUHLMAN, MANAGER, TAX DEPARTMENT, CATERPILLAR TRACTOR CO.

Mr. KUHLMAN. I am E. W. Kuhlman, manager of the tax department of Caterpillar Tractor Co. with headquarters in Peoria, Ill. I wish to express my appreciation to the committee for the opportunity to testify in opposition to the provisions of H.R. 10650 concerning the taxation of income of controlled foreign corporations. The sections of the bill which we oppose are section 6, amendment of section 482, and section 13, controlled foreign corporations.

Caterpillar Tractor Co. and its subsidiaries manufacture and sell throughout the entire free world earthmoving machinery such as crawler and wheel tractors, bulldozers, scrapers, motor graders, and so forth.

In 1961 Caterpillar's consolidated sales were $734 million of which $336 million or 46 percent were outside the United States. The major portion of the foreign sales represented products manufactured in and exported from the United States. Caterpillar ranks, we believe, in the top 10 U.S. manufacturing companies in the volume of exports. It currently has 31,000 employees in the United States and 5,000 employees abroad. The importance of the export market to Caterpillar and the U.S. employment and economy is obvious when it is noted that although 46 percent of Caterpillar's sales were made abroad only 15 percent of its employees were outside the United States. Approximately 12,000 of our employees in the United States depend upon our exports for their livelihood.

We also have more than 5,000 suppliers in the United States, many of whom may think that their business is completely domestic and not affected by exports. They and their employees throughout the United States have a vital stake in our export business. For example, in 1961 we purchased 445,000 tons of steel and steel castings from U.S. suppliers. The approximately 3,600 people required to produce this steel certainly have an important interest in our export business.

Caterpillar has four foreign subsidiaries operating manufacturing plants and parts warehousing and distributing facilities in Australia, Brazil, France, and Great Britain. We also have a domestic subsidiary operating as a Western Hemisphere trade corporation and a Swiss subsidiary with headquarters in Geneva, Switzerland, which operates a parts warehouse in Brussels, Belgium, and distributes in the free areas of the Eastern Hemisphere Caterpillar products made in the United States, United Kingdom, and France.

Since World War II Caterpillar has spent, on plant and equipment, $450 million in the United States and $56 million abroad.

Section 6 of the bill would amend section 482 of the Internal Revenue Code to provide a formula for the allocation of profit among a parent company and its subsidiaries on any intercompany sales.

The crux of the problem is to determine on some theoretical basis the portion of the profit that each of the companies would earn if they were independent and unrelated.

The allocation formula proposed for this purpose is wrong because it fails to take into account many factors involved such as—

(1) The relative importance of sales, service, and promotional efforts for the various products.

(2) The importance of design and adaptation of the product.

(3) Credit risks.

(4) Investment required for carrying inventories and receivables.

There are many other factors than those mentioned. The factors included in the formula are actually those of lesser importance.

The proposed formula could well encourage expanding employment and productive facilities abroad in order to increase the foreign proportion, to the detriment of the U.S. economy and domestic employment.

I respectfully suggest that if the law is to be amended, it should be done by establishing a principle such as "the profit should be allocated among the companies on the basis of the relative value of the contribution of each company toward earning the profit." With that principle in the law, the facts in each case could be examined to determine the equitable result.

The stated purposes of section 13 are to improve the balance of payments and increase income tax revenues by—

(1) discouraging foreign investments by U.S. industry;

(2) forcing immediate return of disposable foreign earnings to the United States; and

(3) taxing profits earned abroad and reinvested in developed countries.

The earnings of profitable foreign subsidiaries would be taxed but the losses of unprofitable foreign subsidiaries would be ignored under the proposal.

The proposal is not only wrong in principle and contrary to long-established tax law (upon which U.S. business has in good faith relied) but will fail to accomplish the stated purposes.

The effect of the bill is to increase taxes on those companies investing abroad. This will give them less money to invest anywhere and accordingly only the most urgent investments will be made.

Senator GORE. May I ask a question at that point?

Mr. KUHLMAN. Pardon?

Senator GORE. Doesn't taxation of business here at home have the identical effect? Would you reread what you just said?

Mr. KUHLMAN. The effect of the bill is to increase taxes on those companies investing abroad.

Senator GORE. Now the next sentence?

Mr. KUHLMAN. This will give them less money to invest anywhere and accordingly only the most urgent investments will be made.

Senator GORE. Don't you think the same effect flows from taxation of a company in the United States?

Mr. KUHLMAN. Only to a partial degree. The proposal would subject the foreign subsidiary, in effect, to both the United States and the foreign tax.

Senator GORE. No. The bill would not do that; but, generally speaking, the levying of a tax means that when and if the tax is paid the taxpayer has a little less money after he pays his tax.

Mr. KUHLMAN. That is right.

Senator GORE. That is true whether it is a foreign subsidiary or a domestic corporation or an individual taxpayer.

Mr. KUHLMAN. That is right.

Senator GORE. Thank you.

Mr. KUHLMAN. Because of the intense foreign competition, foreign investments must be made by companies, such as Caterpillar, to maintain their competitive position in foreign markets. In short the amount available for investment in the United States will be decreased not increased by this part of the bill.

Foreign investments are made by U.S. companies for the purpose of earning an income, a part of which must be returned to the U.S. parent. This will in turn increase the U.S. tax revenues and improve the balance-of-payments position of the United States. This arises from the simple fact that the very purpose of such foreign investments by U.S. companies is to improve their own balance of payments; that is, bring back more than their investments abroad.

I wish to point out that none of our products are completely manufactured abroad; many of the components such as engines, transmissions, et cetera, are produced in our U.S. factories and exported to our foreign plants. If we did not manufacture the product abroad, the sale would not be made at all by us but would be made by a foreign competitor who would use no components manufactured in the United States. The significance of this factor is emphasized when it is noted that—

(1) Our exports to Great Britain in 1960 were over four times those of 1950, the year before our subsidiary began operation;

(2) Our exports to Australia in 1960 were more than double those of 1955 when the subsidiary was formed; and

(3) Our exports to Brazil in 1960 were more than five times those of 1956 when manufacturing began in Brazil.

Caterpillar's investments abroad were required, first, by import restrictions and nationalistic economic policies of the developed countries, which were impeding our ability to maintain our position in highly competitive markets. Caterpillar's investments have all been made in developed countries, with the exception of Brazil, because these provided the best cases from which to meet the most intense foreign competition. (As a practical matter our kind of product can only be made in a well-developed industrial country.)

The problem of price competition in a developed country can be shown by an example of the price in France of a U.S.-manufactured tractor contrasted with the price of a comparable Fiat tractor of Italian manufacture. The cost to our French dealer of a Caterpillar model D4, equipped with customary attachments, manufactured in Illinois, is approximately $17,200 (including freight and duty). To this, of course, the dealer must add his markup. The comparable Fiat model AD7, similarly equipped, is sold to users by the Fiat dealer in France at a price of about $14,000—$3,200 less than our dealer's cost. Such a differential is normally too great to be overcome by the established user preference for Caterpillar products. (The pending trade expansion bill, at best, would permit a decrease of the differential by only $900 through negotiated tariff reductions.)

There must be presumed to be in any equitable system of taxation, the ideal of a quid pro quo in which the tax is equated with the cost of the Government services rendered to the taxpayer. The Treasury Department has, in fact, claimed this to be one of the objectives of its proposals. But any such desirable equality of consideration is simply not possible as between a foreign and a domestic investment. Thus the national defense program which necessarily requires the collection and expenditure of so much tax money is directed only to the defense of domestic wealth and not to foreign investment. Two other extremely significant risks will illustrate this point:

(1) Risk of confiscation—witness what has occurred in Cuba and what is currently taking place in Brazil.

(2) Risks of currency devaluation—when we began manufacturing in Brazil in 1956 the value of the cruzeiro was 60 to the U.S. dollar. Today the value of the cruzeiro is more than 300 to the U.S. dollar. This represents a decline in exchange value of 80 percent.

The taxes on domestic and foreign investments should be different because the consideration for the taxes is different and the proposals professing to seek only equality seem to us to be based on fallacious reasoning.

When a company is established in a low tax rate country, such as Switzerland, it is foreign tax and not U.S. tax that is being avoided. This choice in the long run would benefit the U.S. tax revenues when the income is repatriated because the lower of foreign tax on income when earned abroad the higher the U.S. tax when the income is returned as dividends. Thus, companies with bona fide operations should be applauded not castigated for locating in low tax rate countries.

The effect of section 13 of the bill will be to decrease the U.S. tax revenues and balance of payments:

(1) Foreign countries will tend to raise their rates of tax to equal the U.S. rates.

(2) U.S. companies would tend to move their locations to the United Kingdom or other developed countries which in general are in higher tax rate countries and very little, if any, tax would ever be payable on the profits remitted to the U.S. parent company.

I do believe that the principle of an immediate tax on the accumulation abroad of profit beyond the reasonable needs of the foreign business of the enterprise is sound. However, I earnestly recommend to your committee for consideration that investments of earnings of foreign subsidiaries in companies 40 percent or more owned by the U.S. parent, directly or indirectly, regardless of location should be treated as accumulated for the reasonable needs of the foreign business and exempt from immediate taxation.

The CHAIRMAN. Thank you very much, Mr. Kuhlman.

In the event the House bill is enacted, have you made an estimate of the increased tax that your company would pay?

Mr. KUHLMAN. No, I have not, Senator Byrd.

The CHAIRMAN. Senator Kerr?

Senator KERR. How many foreign subsidiaries does your company own? Is that stated in your statement?

Mr. KUHLMAN. Pardon? I mentioned five in the statement. We have actually several more. I can count them.

Senator KERR. Approximately?

Mr. KUHLMAN. Seven.

Senator KERR. Each owned by your American parent corporation?

Mr. KUHLMAN. With two exceptions. The manufacturing subsidiary in France is a wholly owned subsidiary of the Swiss trading company. It is a supplier of product to the Swiss trading company outside the country of France. The second exception is a Brazilian subsidiary of the Brazilian subsidiary.

Senator KERR. Do you think that the Congress should look in any different manner upon a structure consisting of a parent corporation with a group of their individual subsidiaries in, each in, a different foreign country, and a structure where an American corporation owns a Swiss corporation which, in turn, owns subsidiaries?

Mr. KUHLMAN. Your question was, Should Congress look upon the two varieties with any difference, in essence?

Senator KERR. That is one way to interpret the question.

Assuming that the committee takes the position that a subsidiary in Germany should be permitted to be able to compete on equal terms either with another subsidiary in the same business in Germany owned by some American or some other parent corporation in some other country, or with a German corporation; and assuming that the committee should decide that income should not be taxed until received or in the reasonable operation of the subsidiary should be made available to the parent corporation in a manner of return of profits to the American parent corporation.

Do you think that there should be a different treatment under our tax laws if an American parent owns a Swiss company that owns a group of subsidiaries or if that same American corporation owned directly each of the subsidiaries in each of the foreign countries?

Mr. KUHLMAN. I do not believe there should be any distinction. They should both be treated alike.

Senator KERR. Is it possible that if an American company set up a Swiss company to own a group of subsidiaries which, in turn, paid dividends into the Swiss company, the only purpose of which is to own foreign subsidiaries, you think those earnings should be given as favorable treatment insofar as the American parent that owns that Swiss company as if each of the foreign operating companies were owned by the American parent, and its earnings either reinvested or paid out to the parent?

Mr. KUHLMAN. Well, I had not explored that particular area because I was particularly concerned with our own manner of operation.

You are speaking of a pure holding company.

Senator KERR. Sure.

Mr. KUHLMAN. Whereas our Swiss company is a business company, a trading concern distributing our products throughout the entire Eastern Hemisphere. That company has 241 employees.

Senator KERR. In Switzerland?

Mr. KUHLMAN. They are in various countries throughout the world.

Senator KERR. Throughout the world.

Mr. KUHLMAN. There are 49 field representatives, for example, scattered all over the Eastern Hemisphere near the territories they cover.

Senator KERR. What territory do you get businesswise by having it done by a Swiss corporation that you could not have done by an American corporation insofar as your competitive position in the foreign market is concerned?

Mr. KUHLMAN. Well, we are dealing only with foreign countries, only with foreigners, and we are able to merchandise more effectively through a foreign corporation than we could with an American corporation based in some foreign country.

Senator KERR. You mean that if your German subsidiary gets its products by the brokerage route through a Swiss company it is in better position than it would be if it got them direct from an American parent?

Mr. KUHLMAN. No; I did not mean to imply that, Senator.

Our sales are made directly to the dealers by this trading Swiss subsidiary.

Senator KERR. How is that?

Mr. KUHLMAN. The trading subsidiary makes the sales of products directly to the dealers that we have spread around the world.

The only products that move through the manufacturing subsidiaries in general are component parts that are shipped abroad to be further manufactured and incorporated into completed products.

Senator KERR. What benefit do you get by owning one trading corporation in Switzerland doing business with dealers in many countries that you would not obtain by having a subsidiary in each one of those countries doing business with the dealers in those countries?

Mr. KUHLMAN. The administrative costs and duplication of personnel would be tremendous, which would, in turn, decrease the income of the total enterprise.

Senator KERR. What personnel would be duplicated?

Mr. KUHLMAN. Administrative personnel at all levels—sales, service, finance, and accounting employees.

We have found, as a matter of fact, to have multiple corporations is tremendously expensive. That is the reason we operate in the United States with only three subsidiaries. We operate basically through the parent corporation in the United States.

Senator KERR. I think a holding company that is set up as a tax haven should be treated differently from a subsidiary that is set up in another country in order to be able to compete with other operating companies in that country.

Mr. KUHLMAN. I think I would agree with you.

Senator KERR. I believe that is all, Mr. Chairman.

The CHAIRMAN. Senator Gore.

Senator GORE. How old is your French subsidiary?

Mr. KUHLMAN. The French subsidiary was formed in the fall of 1960. We purchased a manufacturing plant with its employees to establish a manufacturing operation within the Common Market.

Senator GORE. Of what value is this subsidiary investment?

Mr. KUHLMAN. Of what value—you mean in dollars?

Senator GORE. Yes.

Mr. KUHLMAN. Approximately $10 million.

Senator GORE. What were the profits in 1961? Are you on a fiscal or calendar year basis?

Mr. KUHLMAN. The foreign corporations are on a fiscal year basis. The first fiscal year would have ended September 30, 1961. It had a loss in starting-up operations.

Senator GORE. How old is your Swiss trading company?

Mr. KUHLMAN. The Swiss trading company corporation was formed in 1960 as a result of a reorganization of a 1957 formation.

Senator GORE. What has been the experience of this corporation as to profit and loss?

Mr. KUHLMAN. The profits have been substantial, Senator. For competitive reasons we would prefer not to disclose them at this hearing.

Senator GORE. Well, I shall not press the point. You say the profits have been substantial. In what canton is it domiciled?

Mr. KUHLMAN. Geneva.

Senator GORE. What is the tax rate that you pay?

Mr. KUHLMAN. We pay a full tax, Federal and cantonal, on the business within Switzerland, and a lower rate on business without Switzerland. The composite is approximately 7 percent.

Senator GORE. What percentage of your business is within and what percentage is without?

Mr. KUHLMAN. Approximately 5 percent in Switzerland.

Senator GORE. In Switzerland.

Mr. KUHLMAN. Right.

Senator GORE. Is there a tax on the profits earned outside Switzerland?

Mr. KUHLMAN. Yes, sir.

Senator GORE. What is that rate?

Mr. KUHLMAN. I am trying to recall; approximately 3 percent, as I recall, effective.

Senator GORE. Does your Swiss subsidiary have contracts with any subsidiary other than its own subsidiary in France?

Mr. KUHLMAN. What type of contracts do you mean, Senator?

Senator GORE. Any type.

Mr. KUHLMAN. It has contracts with the British subsidiary.

Senator GORE. What does it perform for the British subsidiary?

Mr. KUHLMAN. It sells the British manufactured product in the Eastern Hemisphere outside of the United Kingdom.

Senator GORE. What commission does the British subsidiary pay to the Swiss subsidiary?

Mr. KUHLMAN. Five percent.

Senator GORE. Gross?

Mr. KUHLMAN. Five percent of the selling price.

Senator GORE. The shipping is handled by the British subsidiary?

Mr. KUHLMAN. That is right.

Senator GORE. What has been the profit and loss experience of your British subsidiary?

Mr. KUHLMAN. I do not recall the figures, Senator.

Senator GORE. With what other subsidiary does your Swiss subsidiary have a contract?

Mr. KUHLMAN. The French subsidiary, its own subsidiary to market French-made products outside the country of France.

Senator GORE. These are the only two?

Mr. KUHLMAN. In Europe, yes.

Senator GORE. Does your Swiss subsidiary have a contract with the parent corporation in the United States?

Mr. KUHLMAN. Yes.

Senator GORE. What services does it perform for the parent corporation?

Mr. KUHLMAN. It acts as distributor for the product in the contract with the trade, the dealers throughout the entire Eastern Hemisphere.

Senator GORE. And you pay a commission to the trading corporation to do that?

Mr. KUHLMAN. The trading corporation buys and resells the products manufactured in the United States.

Senator GORE. I did not understand, I am sorry.

Mr. KUHLMAN. The trading company buys the products from the U.S. corporation and sells them to the dealers.

Senator GORE. Well, I wish to make no allegations, but this is certainly a familiar device for the transferring of profits to the Swiss subsidiary, even from the parent corporation. I am not saying that is the case. But this is clearly a pattern that many people follow.

Mr. KUHLMAN. Well, the trading company performs a function, a service. It has 49 field representatives contacting the dealers and servicing the product, aiding with design and adaptation, meeting with the dealers and potential customers for the use of the products.

A distribution function is a very real one, and it handles the accounts receivable, the credit risks, whatever they may be, handles its advertising and its promotion.

Senator GORE. Was your trading company organized ab initio in 1960, or was it moved from some other country?

Mr. KUHLMAN. It was moved.

Senator GORE. Was it not, in fact, located in Venezuela before?

Mr. KUHLMAN. That is right.

Senator GORE. How long was it located in Venezuela?

Mr. KUHLMAN. Three years.

Senator GORE. Had it been moved from some other place than Venezuela?

Mr. KUHLMAN. No, sir. It was formed in 1957.

Senator GORE. What was its profit-and-loss experience in Venezuela?

Mr. KUHLMAN. It was profitable. I do not recall the figures.

Senator GORE. Now this, it seems to me, casts an interesting light upon the question which Senator Kerr submitted as to why a subsidiary in Venezuela could, for 3 years, do a better selling job than the parent corporation in the United States.

I do not quite understand the facility that the location in Venezuela would add to the utility of a sales organization in the Eastern Hemisphere.

Mr. KUHLMAN. Well at the time we located in Venezuela that was our largest single foreign market, and the Government was stable at that time.

In the intervening 3 years the Government became unstable and the market shrunk to practically nil.

Senator GORE. Well, now, if the employees of the Swiss subsidiary are located, as you told Senator Kerr, all over the world, why could not that company be located in France as well as in Switzerland? Its principal sales are from the French plant, I believe you said.

Mr. KUHLMAN. No, they sell the products manufactured in France and manufactured in Great Britain and manufactured in the United States.

Senator GORE. Does your Swiss subsidiary handle sales from the parent United States concern to dealers in Great Britain?

Mr. KUHLMAN. No. The trading company does not sell within a country where a manufacturing subsidiary is located.

Senator GORE. Does the Swiss subsidiary, trading company, handle sales to South America?

Mr. KUHLMAN. No, sir.

Senator GORE. How do you handle your sales to South America now?

Mr. KUHLMAN. A Western Hemisphere Trade Corp.

Senator GORE. Where is it domiciled?

Mr. KUHLMAN. In the United States.

Senator GORE. You have no subsidiary in the Western Hemisphere at this time?

Mr. KUHLMAN. No. That was not your question. The sales to South America other than Brazil are handled by the Western Hemisphere Trade Corp. There is a Brazilian manufacturing subsidiary which, in turn, has another subsidiary of its own to handle certain repair parts.

Senator GORE. Well, you have presented an interesting picture. I shall not press you on the profits of your Swiss trading corporation. I would like to ask you if any of the profits from the Swiss trading corporation have been remitted to the United States.

Mr. KUHLMAN. The company has paid regular annual dividends.

Senator GORE. Can you give us some indication of the dividends in relationship to the investment? What investment have you made in your Swiss subsidiary?

Mr. KUHLMAN. About $5 million.

Senator GORE. $5 million?

Mr. KUHLMAN. Right.

Senator GORE. What dividends have been remitted?

Mr. KUHLMAN. I cannot recall the total, but the past year it was about $1 million.

Senator GORE. The past year was $1 million?

Mr. KUHLMAN. Right.

Senator GORE. This is quite profitable, is it not?

Mr. KUHLMAN. Yes.

Senator GORE. You must handle a lot of sales. What have been the sales of, the volume of sales of, your Swiss trading corporation?

Mr. KUHLMAN. Well, again, for competitive reasons, Senator, I prefer not to disclose that. It is obviously a very substantial figure. I think I can give you an idea of the volume that was involved if we assume that the sales are the same per employee, which is not necessarily true. But 15 percent of our employment or about one-seventh is outside the United States.

Our total sales were $734 million, which would mean about $105 million roughly manufactured in the foreign manufacturing plants out of a total of $336 million, leaving $231 million as representing U.S.-manufactured products exported through either the Swiss trading company, the parent company, or the Western Hemisphere Trade Corp. That is an approximation.

Senator GORE. Well, Mr. Chairman, I shall not press further. I am not acquainted with the detailed operation of this company.

Obviously, we have a pattern here of a Swiss trading company into which is funneled vast profits and on which the taxes are small.

I do not know whether you have had difficulty or arguments with the Internal Revenue on the allocation of commissions and fees or not. Would you mind stating whether you have?

Mr. KUHLMAN. These years are currently under review at present.

Senator GORE. So you are having an argument now.

Mr. KUHLMAN. Well, discussions at this stage, Senator.

Senator GORE. All right. From what you have said here, I think there is ample room for it.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, Mr. Kuhlman.

Mr. KUHLMAN. Thank you, sir.

The CHAIRMAN. The next witness is O. Kenneth Pryor, Price Waterhouse & Co.

Mr. Pryor, will you take a seat, sir, and proceed.

STATEMENT OF O. KENNETH PRYOR, MANAGING PARTNER, PRICE WATERHOUSE & CO.

Mr. PRYOR. I am O. Kenneth Pryor, of Hillsborough, Calif., a certified public accountant and managing partner of Price Waterhouse & Co. My firm practices public accounting in some 43 offices in the United States. Through firms generally practicing under the same name, and correspondents, the international organization of Price Waterhouse & Co. operates in some 160 offices in 54 countries throughout the free world.

Because of our familiarity with the interrelationships between the national interest and the business operations of American enterprise abroad, I wish to express my firm's deep concern over the proposed legislation, now before you, on tax treatment of foriegn income. I do not represent or speak specifically for any taxpayer, but rather as a representative of my firm.

We believe it is in the national interest of the United States that its citizens participate actively in international affairs, and that one important aspect of this is a healthy, active, successful position in world trade. We assume that this is accepted national policy. My comments are based upon this belief and assumption.

My purpose in appearing before your committee today is to urge rejection of the new concepts in the taxation of foreign income as embodied in the Revenue Act of 1962, particularly section 13 dealing with controlled foreign corporations.

It is an unfortunate fact that inducing widespread public interest in a proposal or cause often requires the use of slogans or labels. The foreign tax proposals now before this committee are a case in point—they are labeled as an effort to remove the advantages of tax havens and to eliminate so-called preferential treatment accorded earnings from foreign operations.

Accurate and descriptive labels and slogans can serve a useful purpose. Inaccurate or distorted, however, they can obscure the true issues and lead to grave mistakes. The labels "tax havens" and "preferential treatment" do not apply to the vast majority of foreign operations conducted by U.S. citizens and companies. To consider the rules of taxation for this vast majority under these labels is akin to guilt by assumed association. To restrict and harass legitimate foreign operations because of a few abuses which can be specifically controlled is comparable to assessing a fine on an entire family for the transgressions of a wayward cousin.

"TAX HAVENS"

Let me make it clear that my comments are directed to the circumstances of business corporations organized and operating abroad for substantial business reasons. I hold no brief for sham corporations, or for practices such as artificial manipulation of income by recording intercompany transactions at unrealistic prices. I am told by technicians in my own firm and others that the present rules, if vigorously administered, are generally adequate to prevent such abuses. In fact business organizations of which I have personal knowledge have been and are being examined closely by representatives of the Internal

Revenue Service to inquire into the propriety of intercompany prices and the like.

Be that as it may, however, if the administration and the Congress believe that further statutory provisions are necessary to prevent or curb such abuses, they should have them. But if the transactions and the form of organization are with substance, the provisions proposed should not be enacted.

PURPOSE OF FOREIGN INVESTMENT

The business enterprises which I and my firm serve engage in international operations not for tax reasons but for the purpose of making a profit which they cannot achieve except by operating abroad. The Secretary of the Treasury expressed the same thought based on his own experience when he appeared before this committee last month. I know of no businessman who organizes a business abroad merely for the dubious pleasure of taking on the additional management responsibilities, the difficult personnel problems, and the real additional risks, including currency devaluation and expropriation. The official of a company takes on these added burdens in an effort to earn money which otherwise would not accrue to his corporation, and since he is working for the shareholders his decisions and activities are based upon the intention that the earnings will be repatriated when business and financial conditions make this possible and desirable. Shareholders of American corporations expect dividends, and they want them in dollars—not foreign currencies. If this sounds like a defense of business profits earned abroad, I intend it to be. In my opinion the national interest is served if investment are made abroad which return over a period of time more dollars than are sent abroad.

GOVERNMENT INTERVENTION

I am concerned by what seems to be a developing change in the role of Government as to control of business activities. Whether or not it is intended, it seems to me that these provisions go further than necessary or proper in injecting our Federal Government into business decisions. It has been said often that the power to tax is the power to destroy, and for many enterprises enactment of these proposals would destroy their entirely legitimate foreign subsidiaries. But beyond this, use of the tax power to direct the business community where to invest and where not to invest, what reinvestment policy should be, and what their relationship with non-U.S. partners or stockholders should be strikes at the foundation of our free enterprise system and our international trade and seems to start a kind of currency control in the guise of a taxation measure. If the administration wishes to impose currency controls, it should advocate legislation for that specific purpose and not attempt to accomplish currency controls indirectly through the use of internal revenue laws.

I do not question the obligation of the business community to serve our national interest in all its actions, but we shall only go backward if business freedom and policy are taken from the hands of those whose capital and services are devoted to it, and policy direction is placed with those who cannot be expected to be fully informed on the problems of conducting business operations abroad.

I urge you to recognize that the harm which would be done by enactment of these provisions cannot be undone by their repeal next year or later. A basic denial of the freedom of the business community to base its business judgment on the hazards of the marketplace will change the structure of our foreign business operations built up over many decades, and loss of this position could not be restored for many years thereafter. Business once lost does not wait for its recapture. All the power of the U.S. Congress cannot stifle the competitive nature of international trade in which we have played so large a part.

When the Secretary of the Treasury appeared before this committee on April 2, he said:

> 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.

In this statement the Secretary was espousing enactment of an investment credit for domestic American business. But surely if we are to be a factor in international trade, his well-stated philosophy should be considered equally when the foreign income provisions are under advisement. Otherwise, the United States would move back to a position of isolationism in trade, and this would not only be directly contrary to the administration's announced policy and objectives on free trade but also would hinder expansion of our domestic economy.

PREFERENTIAL TREATMENT

Now I would like to direct my comments to some of the specific provisions in the foreign income area, the objective sought, and the effects which are likely to result. In this connection, I believe we are somewhat bedeviled by the semantics employed by the Treasury Department in its own statements on this area of the proposed Revenue Act. No one can quarrel with espousal of "equity" or "equality," or with the removal of "special privilege" and "preferential treatment." But the facts are that these proposals would create burdensome inequities and inequalities and no case has been made that "special privileges" or "preferential treatments" generally exist.

The proposed statute is couched in the form of an additional tax on domestic taxpayers which control or have an equity interest in subsidiaries organized and operating outside the United States.

The proposals would levy a U.S. income tax, in dollars, on purely foreign earnings of a foreign corporation carrying on a substantial and proper business abroad. These earnings could not even be offset by losses of the same foreign corporation in other years, or by current losses of other controlled foreign corporations. Thus, inequitable as it would be, the domestic corporation could owe an "income tax" in an amount that would be greater than the total income actually realized by it and its foreign affiliates. If a foreign subsidiary has income but is not in a position to remit dollars, the funds for the payment of the tax would have to come from the parent's resources otherwise available for investment in the United States. Thus, either the foreign subsidiary's competitive position will be injured, or private capital will be siphoned from the domestic economy.

The present statute recognizes the integrity of legitimate foreign corporations organized under the laws of foreign states. It provides, in accordance with our long-established tax structure, that a U.S. tax is imposed on earnings when realized, which means when the U.S. corporation receives dividends or other income in dollars. The proposed provisions would impute such income to the United States when earned abroad as determined under our tax and accounting rules.

The Treasury Department's position is that the present statute is inequitable, provides special tax preferences, is a subsidy to American business in international operations, provides at the very least interest-free loans, and is an artificial tax inducement to investment abroad. These assertions, in my opinion, are simply not in accordance with the facts.

NATURE OF FOREIGN COMPETITION

The primary competition of an enterprise operating abroad, whether or not U.S. controlled, comes from other enterprises operating in the same territory. Equity, neutrality, and common business sense require that such an enterprise should not, simply because its control rests with a U.S. company, be placed in an unfavorable competitive position. Foreign governments seek to put their own businesses in the most advantageous position possible to compete with others, and with the growth of country groupings in Europe and elsewhere, these governments recognize as a matter of policy that tax and other burdens should be neutralized to make it possible to meet existing and prospective competition.

It is not healthy for the future of our own economy to reason that if a U.S.-owned enterprise has to bear a greater tax burden than its competition, all that happens is that it may have to pay this additional tax from U.S. earnings, or from new capital. In either event, funds otherwise available for investment at home are taken away.

This committee needs no reminder of the need for any enterprise, domestic or foreign, to earn a profit. In order to remain competitive, expand operations, conduct research, and justify the risk of capital, the income of a foreign subsidiary of a U.S. company should not be burdened with income taxes higher than its competitors. Increased volume, cost reduction programs, and the legitimate and proper minimization of its overall tax burden, are objectives of any successful business enterprise. If the American-owned enterprise has to bear a tax burden greater than its competitors, by virtue of paying the same local taxes and in addition the punitive taxes proposed by the bill, they necessarily are subject to rapid erosion of their business opportunities. The objective sought by our foreign enterprises is to obtain the greatest possible income abroad, eventually to be available to U.S. corporations and their shareholders, and to the U.S. taxing authorities. Foreign governments are sophisticated enough to take the opportunity to increase taxation on our foreign enterprises so as to capture for themselves funds which would otherwise eventually become available to our Government.

Our growth pattern abroad has been founded on exporting American products and technical skills. We have thus created a demand which, in turn, has resulted in further exports of machinery and products and in more jobs at home. We can expect an ever-increasing spiral if U.S. business is given a fair chance to compete. The foreign income provisions constitute a reversal of the Government's long-standing policy of actively encouraging American industry to expand its market areas and to develop new outlets abroad for its capital and energies.

Now, I wish to comment on the administrative and technical burdens which would be imposed by these proposals. Foreign subsidiaries will continue to be subject to the accounting and income tax rules of the foreign jurisdiction in which they operate. There would be superimposed upon them the entirely different U.S. concepts as to computation of taxable income, adjusted basis of assets, earnings and profits, and all the other particular U.S. concepts.

I hesitate to say that these problems are completely insoluble, but at the moment many of them seem so. Compliance with the administrative and technical provisions of the bill would range between the impractical and the impossible.

Probably the greatest danger to the American way of life created by the proposals stems from the extraordinary powers given to the Treasury Department. It is clear that no matter how sincere the effort made by the companies involved to translate their financial data to conform to American concepts, the results must be fully acceptable to the U.S. Treasury, or else it will make its own determinations of the amount of income to be imputed to the U.S. controlling corporation. Since the U.S. shareholder will have to use his best judgment in developing income and investment figures from available data, probably based on auxiliary accounting records, accuracy and complete compliance will simply not be possible. This will be particularly so in the case of many of our subsidiaries abroad where for sound business purposes or by operation of law the management is local, or where for the same reasons substantial foreign interests are involved. The result can only be long-drawn-out controversy, years of uncertainty as to the tax liabilities of major segments of our business community, and possible eventual dictatorial imposition of tax liabilities with no adequate opportunities for appeal or review.

An extremely troublesome and burdensome area will be the proposed additional requirements for submission of information with respect to foreign entities, with the blanket authorization given to the Treasury to require a taxpayer to furnish "any other information which is similar or related in nature to that specified." Coupled with this is the provision for drastic penalties for failure to comply.

Consider subsection (a) of section 20, revising the present section 6038. Under the present section 6038, a U.S. company must file an information return on controlled foreign subsidiaries but only down to the second tier. It appears that the Lower House wished to require reporting by the controlling U.S. corporation as to foreign subsidiaries below the second tier. However, by incorporating by reference into 20(a) the full constructive ownership or attribution rules of section 318 of the code, a U.S. subsidiary of a foreign corporation would be required to file information returns not only on its own foreign subsidiary, if any, but also on its foreign parent and all of the subsidiaries of its foreign parent. This would be required even though this information would have no bearing on the generation or retention of income subject to control by the U.S. corporation and, further, even though such information would not be under the control of and probably would not be made available to the reporting U.S. corporation.

To illustrate, if a Canadian corporation owned subsidiaries in the United States, Belgium, and France, the U.S. subsidiary would have to provide to the U.S. Treasury financial data on the Belgium and French corporations and on business transactions between these two European corporations even though the U.S. corporation had absolutely no business dealings with either of these European corporations. The penalty for noncompliance would be a punitive tax on the U.S. corporation, through loss of its foreign tax credit.

Subsection (b) of section 20 also imposes unrealistic requirements, burdensome to U.S. citizens and residents, and of no value to the U.S. Treasury. It would impose on every U.S. citizen or resident who is an officer or director of a foreign corporation the obligation to submit information in respect of the foreign corporation solely as determined by the Secretary of the Treasury. Under the provision the Secretary could demand such information even if it related to transactions which took place long before the citizen or resident became an officer or director, in fact even if the transactions took place before this person was born.

The duties of many U.S. citizens who are officers or directors of foreign corporations have no connection at all with transactions of that corporation with U.S. enterprises, or in any other way which would be of value to the Treasury Department. In fact, the U.S. citizen resident abroad may have no knowledge of the requirements imposed on him. The provision would impose a legal requirement on the individual, under civil penalties, to report to the U.S. Treasury information on his foreign employer when to do so would be in conflict with his duties of trust and confidence. It could require him to give up his job to retain his citizenship.

The proposals for taxation of foreign income would do great harm to our national economy and welfare. They would put us at a disadvantage in worldwide competition for business. We must not destroy a valuable segment of our economic structure. I respectfully urge the committee to reject the foreign income proposals embodied in the bill before it and the further burdens on foreign business recommended by the Secretary of the Treasury.

The CHAIRMAN. Thank you very much.

Mr. Pryor, Senator Talmadge was called away from the committee and he has asked me to propound certain questions to you.

Mr. PRYOR. Yes, sir.

The CHAIRMAN. This is for purposes of the record.

The first one is: What would be the scope and nature of the information which the U.S. corporation would be required to report on its "upstream" foreign affiliates?

Mr. PRYOR. Let me set up a hypothetical situation to illustrate that, Senator Byrd.

Let us assume that there is a British corporation organized in Great Britain and owned by British citizens.

Let us suppose that it organizes a U.S. subsidiary to operate in this country, and, further, that this U.S. subsidiary has, we will say, a Mexican subsidiary.

Say that that British corporation also controls a company in Germany, and another company in France.

Then the information that the Secretary might require would relate to cumulative profits, earnings, income, the deductions on all other items taken into account in computing that income, and even a balance sheet of such foreign corporations, so that the U.S.-controlled company would be under an obligation in that case to furnish information about the French company and the German company where, perhaps, they had absolutely no dealings with them, might even be refused the information by their British parent on transactions as between them. That is the way I read the law.

The CHAIRMAN. Now, the second question is: What penalties would be applicable if the U.S. corporation was unable to file this report because it did not have this information within its control?

Mr. PRYOR. The principal penalty there, I think, could be the loss of anything from 10 to 100 percent of the foreign tax credit which it would otherwise receive on its income from the Mexican subsidiary.

The CHAIRMAN. Well, is there any criminal penalty involved in it?

Mr. PRYOR. Yes; there is a criminal penalty involved. I am not a lawyer and I do not know how the courts might hold on the criminal penalty in the case where it was not a willful refusal to furnish information, if the information was not made available to the U.S. subsidiary.

The CHAIRMAN. The next question is: How broad a revision of the bill would be required to eliminate this requirement of "upstream" reporting?

Mr. PRYOR. I believe that I would prefer not to try to draft technical legislation. I am told it would be a simple thing to do, and I am sure it could be easily taken care of by draftsmen.

The CHAIRMAN. Another question: Does this information which U.S. citizens or residents would be required to file, if they are officers or directors of foreign corporations, relate to their own income tax liabilities to the United States or is it information regarding the affairs of the companies they work for?

Mr. PRYOR. It would only be in connection with the affairs of the company that he worked for.

The CHAIRMAN. Another one: Are these individuals required to give this information to the U.S. Treasury even though the foreign corporation is not controlled in any way by Americans?

Mr. PRYOR. Yes.

The CHAIRMAN. Another question: If the foreign corporation refuses to permit its officers or directors who are U.S. citizens to divulge the information to the U.S. Treasury about its affairs, is the individual subject to penalties in the United States?

Mr. PRYOR. Yes; he is subject to an imposition of $1,000 civil penalty. Again, I do not know how strict the courts might be in interpreting as willful rather than as being impossible to get the information as being willful failure to give it.

The CHAIRMAN. Senator Williams.

Senator WILLIAMS. No questions.

The CHAIRMAN. Thank you very much, Mr. Pryor.

Mr. PRYOR. Thank you, sir.

The CHAIRMAN. The committee will adjourn until 10 o'clock tomorrow morning.

(By direction of the chairman, the following is made a part of the record:)

BARRETT HIBBARD & CO.,
La Jolla, Calif., April 25, 1962.

Senator HARRY F. BYRD,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D.C.

DEAR SENATOR BYRD: We are extremely concerned and vitally interested in regard to the public hearings that your committee began on April 2 covering the House revenue bill of 1962 (H.R. 10650).

Our concern stems mainly from Mr. Dillon's desire to impose ordinary income treatment on gain from sale of buildings to the extent of depreciation taken on buildings after 1961 and limit depreciation of buildings hereafter acquired to the amount allowable under the straight-line method. This will cripple the income property developer and equity holder. There will be no method by which an income property owner can generate additional capital for reinvestment in additional income property.

I heartily request that you reject Mr. Dillon's proposal regarding this matter.

Respectfully yours,

RICHARD D. HIBBARD.

COMMENTS ON TREASURY DEPARTMENT'S STATEMENT SUPPORTING EXCLUSION OF ELECTRIC UTILITIES FROM THE TAX CREDIT

(Memorandum submitted by Donald C. Cook, president, American Electric Power Co., Inc., 2 Broadway, New York 8, N.Y., supplementing his oral testimony presented on April 9, 1962, discussed on p. 952 in pt. 3 of printed hearings on this bill)

In his April 2, 1962, statement on H.R. 10650 to the Committee on Finance, Secretary of the Treasury Dillon urged that nontransportation utilities be excluded from the tax credit, and filed exhibit I–C to his statement in support of this position.[1]

In testifying before the committee on April 9, 1962, I stated that I believed this exhibit I–C was inaccurate and was based on a lack of knowledge of the electric utility business. I was requested by the chairman to submit a memorandum pointing out these inaccuracies.

Most of the reasons for my disagreement with the arguments and conclusions in exhibit I–C, and which support my view that the availability of the tax credit would stimulate capital investment by electric utilities, probably more so than in any other industry, were brought out in my testimony before the committee. I will not repeat all of this testimony or attempt to answer irrelevant and immaterial arguments in exhibit I–C, but will confine this memorandum to pointing out the basic misconceptions and more important inaccuracies in the Treasury Department's statement, and, more specifically, in exhibit I–C.

The points made in exhibit I–C tend to overlap and to be repetitive and can best be dealt with by grouping the related points and statements, as follows:

1. The statements in exhibit I–C that "Utilities' Investment Needs Are Determined by Public Demand" and that "Utilities Will Not Raise Investment Significantly in Response to the Credit" (see points 1 and 3 of the detailed argument in exhibit I–C)

These statements are domonstrably inaccurate and indicate an obvious lack of knowledge of the economics and operations of the electric utility business.

(*a*) The fact is that while an electric utility must, at any given time, be able to supply the energy requirements of its customers, there are many optional capital expenditures which are entirely within the discretion of management.

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[1] Exhibit I–C appears at pp. 123–143 of pt 1 of the transcript of the hearings on H.R. 10650 before the Committee on Finance. This portion of the Treasury Department presentation, incidentally, is for the most part virtually identical in outline, arguments, and language with a memorandum entitled "The Case Against Inclusion of Regulated Utilities Under the Investment Credit," inserted by Representative Al Ullman, of Oregon, without attribution, in the Congressional Record of Mar. 28, 1962 (pp. 4895–4898), 5 days before the presentation to this committee. The only substantial difference is that exhibit I–C contains three additional points; Nos. 14, 15, and 16 which do not appear in the memorandum submitted by Representative Ullman.

Such optional expenditures will be made only when they are economically justifiable.

Fixed charges associated with the industry's capital expenditures represent a major portion of the industry's costs; and Federal income taxes represent an important part, about 28 percent, of fixed charges. The tax credit would serve, in effect, to reduce the fixed charges or carrying costs of capital investment. It would thus advance the dates when optional capital expenditures would become economically feasible and would make economically justifiable expenditures which otherwise might never be made at all.

In my direct testimony to the committee, as a concrete illustration of the type and magnitude of optional expenditures which would be made in response to the tax credit, I stated that a 3-percent credit would result in the immediate increase of our budgeted capital expenditures in amounts totaling almost $9 million, and that, if the credit available to electric utilities were 7 percent, rather than 3 percent, the American Electric Power System would forthwith embark upon additions to its scheduled construction projects in a total amount in excess of $21 million. In each case I set forth, in detail, the precise projects which were included in these figures.

It is, therefore, wholly inaccurate to state that utilities' capital investments are flexible and will not be significantly affected by the availability of a tax credit.

(*b*) Exhibit I–C refers to what it characterizes as the "unsatisfactory" experience with the accelerated amortization program in regulated industries (see point 4 of exhibit I–C). The significant fact, which is not brought out, is that the accelerated amortization program was offered as a tax incentive to induce capital investment for a large reserve of generating capacity for national defense purposes; and that the objective of this tax incentive was successfully and dramatically achieved in inducing the electric utility industry to increase reserve generating capacity, which grew from 6.2 percent in 1950 to 28.6 percent in 1960 (see app. D to exhibit I–C). Indeed, this experience furnishes conclusive evidence of the inaccuracies and invalidity of exhibit I–C in stating that a tax incentive will not induce electric utilities to increase their capital investment.

(*c*) Exhibit I–C makes the point that the investment credit is intended as a stimulus to investment. It then states that the utility industry is not in any "special need" of such a stimulus (see point 9) and, further, that the investment credit would "stimulate less investment in the utility sector than in other industries" so that the revenue loss cannot be justified (see point 14).

The facts are, first, that the investment credit has not been proposed or designed to be made available only where there is some "special need" but, rather, has been proposed and designed to be made available where it will stimulate capital investment. As I showed in my testimony, because of its capital-intensive nature and the high carrying cost of its capital investment, the stimulus to capital expenditure would be more effective in the case of electric utilities than in the case of any other industry.

2. *The statements in exhibit I–C, on the one hand, that the benefits of the credit would be passed on to consumers and would, therefore, provide little incentive to utility investment (see point 2) and, on the other, that tax reductions resulting from the credit would be paid out to stockholders as dividends resulting in a "windfall" (see point 15)*

(*a*) In the first place, these two statements are mutually incompatible; if the benefits were passed on to consumers they could not be paid to stockholders as dividends.

(*b*) In the second place, it is a complete non sequitur to argue that if the benefits of the credit were to be passed on to consumers, the credit would represent no incentive for the utility. As I testified, there is nothing better for our customers, our communities, our investors, the health of our companies, and the welfare of the country as a whole than reductions in prices on all goods and services whenever they can be justified; we intend to take advantage of every possible opportunity to reduce both our fixed charges, including our tax expenses, as well as all of our other expenses in the hope that this will enable us to offset other increased costs and to reduce rates; the availability of a tax credit would be of great help in this connection and we would certainly take full advantage of it.

(*c*) Finally, the reference to "windfall" payments to stockholders, apart from its validity which is disproved by other statements in exhibit I–C itself,[2] is wholly irrelevant. The essential point is whether the tax credit will or will not be an incentive for electric utilities. Even if it were to be assumed, contrary to the fact, that stockholders would obtain an immediate benefit by way of increased dividends from the credit, this would provide an even greater incentive for them to make the capital expenditures which would entitle them to the credit.

3. The reference in exhibit I–C to the "Insignificant Effect of the Credit on Consumer Demand" (see point 6)

(*a*) This statement assumes that rate reductions made possible by the tax credit would be filed "across the board" and would provide only an insignificant reduction for any particular customer, and concludes that the effect on demand would, therefore, be insignificant.

This is merely another indication of a lack of knowledge of the utility business. The writer of exhibit I–C is apparently completely unaware of the possibilities of selective rate reductions which would have a very material effect in increasing demand, for example, rate reductions for space heating in the past have had, and could in the future have, a substantial effect in increasing the number of electrically heated homes and the demand for electric power. Similarly, a rate reduction for certain types of large powerloads could lead to a material increase in the demand for industrial power.

(*b*) The statement that the demand for electric power is not likely to be materially affected by price and that "reliable estimates are not available" on this point (see pt. 6, exhibit I–C) is not only inaccurate, but has been demonstrated to be inaccurate by the experience and data accumulated over the years by Federal agencies which are in the electric power business.

In my testimony to the committee, I showed that electric energy is very much subject to competition; that the demand for electric energy, in terms of future growth, is, indeed, elastic and that such demand has been, and would continue to be, very responsive to price. I pointed out that areas where the price of electric energy is well below the national average, such as in the territory served by the Tennessee Valley Authority and the Bonneville Power Authority (where rates need not include any income taxes), have shown phenomenal growth in the use of electric power, so that, for example, their annual residential consumption is more than double the national average. This is irrefutable proof of the elasticity of demand in response to price.

Another illuminating example is a comparison of the use of railroad passenger service and the use of electric service by residential customers over the last decade. During the 1950–60 period, total passenger miles traveled decreased 33.4 percent as class I railroad fares per passenger-mile increased 17.5 percent.[3] In contrast, for the total electric utility industry during the same period, the average residential consumption of electricity increased 109 percent as the average price decreased 14 percent.[4]

4. The statement in exhibit I–C that the "Investment Credit Would Tend To Be Passed on to Consumers and in the Process would Gravely Complicate Rate Regulation" (see point 5)

(*a*) In my testimony to the committee, I pointed out that the principal importance of the tax credit to an electric utility is not in increasing cash flow but, rather, in offsetting fixed charges associated with investment, and that the benefit does not turn on whether amounts equal to the tax reductions are retained by the utility or passed on to its customers.

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[2] The statement that the tax reductions might be paid out as dividends, resulting in a "windfall" to stockholders, ignores the fact that the tax savings would reduce the utilities' operating expenses, with a consequent effect on the rate of return and, therefore, on the propriety of the rates charged. The fact is that, even in the case of liberalized depreciation and accelerated amortization, where there is merely a temporary tax saving, almost all regulatory commissions have ruled that consumers will receive the benefit of either all or a major part of the temporary tax reduction. This is done in rate proceedings by reducing the allowable tax expense to only the actual taxes paid in the particular year; by reducing the rate base by the amount of any accumulated tax "deferrals" and thus allowing no return on such amounts; by assigning a zero cost of capital to any accumulated tax deferrals; or by reducing the overall rate of return to reflect the fact that the tax deferrals were accumulated by the utility without incurring any capital cost therefor.

[3] The Economic Almanac, 1962, of the National Industrial Conference Board, p. 294.

[4] Edison Electric Institute, Statistical Yearbook of the Electric Utility Industry for 1960, pp. 50–51.

I also made clear my view that the tax credit saving should not be "normalized" over the life of the new investment, but should be given full effect in the year in which the reduction in tax is allowed.

(*b*) Exhibit I–C argues that the credit should be denied to utilities because of assumed complications which otherwise would be raised for regulatory agencies. This assumption again evidences a lack of knowledge of the utility business and of utility regulation. It overlooks the fact that the ratemaking process involves a continuing consideration of a changing rate base, revenues, overall operating expenses, and other factors. There are constant changes in all operating expenses, including taxes, and in the other components involved in arriving at just and reasonable rates. Regulatory commissions are continually dealing with changes in all components which go to make up the rate regulation process. Changes in tax expenses from year to year, including fluctuations in the amount of the tax credit due to varying capital expenditures, would introduce no new problem and no new complication.

5. The statements in exhibit I–C that "the credit is not discriminatory to public utilities" (see point 10); that "industries would not construct their own utility facilities to obtain advantage of the credit" (see point 12); and that the "competitive position of the utilities in relation to other energy suppliers who will receive the full amount of the credit" will not be hurt (see point 16)

(*a*) Here again, the writer of exhibit I–C evidences a lack of knowledge of the electric utility business, its actual experience, and its operations.

The electric utility industry is, in fact, engaged in intensive competiton with other forms of energy which are to receive the tax credit, and with existing or potential customers who have in the past decided, and may in the future decide, after consideration of all relevant economic factors, to provide their own power facilities.

Excluding electric utilities from the tax credit, or granting them a credit less than that made available to other industries, would, therefore, be highly unfair and discriminatory. It would deny an industry which has competition from many sides an equal opportunity to reduce its fixed charges and thus the cost of its service, in spite of the fact that it provides a service with a flexible demand which can be expected to show additional growth at least proportional to the reduction in price which would be made possible by a nondiscriminatory tax credit. Unequal treatment of electric utilities would give an unfair advantage to competing fuel and energy sources, and an unfair impetus to private generation of electric power. Such treatment would materially, unfairly, and unjustifiably distort and upset existing competitive relationships.

(*b*) Appendix F to exhibit I–C indicates that privately owned nonutility generating capacity, such as by industrial corporations, has been declining as a percentage of the total generating capacity of such owners and investor-owned electric utilities. This schedule also shows, however, that the amount of self-generation has been increasing in absolute terms, to almost 18 million kilowatts. This is a very significant block of power and represents an obvious and important competitive opportunity for the utility industry. And while self-generation has not been increasing as rapidly as total generating capacity, this trend might well be reversed by the distoration of the technological-economic fators favoring large central station generation if electric utilities were to be denied a tax credit available to those who must give constant consideration to whether or not to continue operating existing generating capacity or to install new generating capacity for their own needs.

6. General

(*a*) *The statements throughout exhibit I–C that utilities have "guaranteed" or "assured" rates of return.*—Throughout exhibit I–C, there is frequent reference to the concept that utilities are "guaranteed" or "assured" a reasonable rate of return after taxes. (See e.g., points 2, 3, 4, and 17.)

The fact is that there is no such "guarantee" or "assurance" of any given rate of return. Regulatory agencies have the duty to permit rates designed to give the utility an opportunity to earn a fair return on its investment, but there is certainly no guarantee or assurance that such earnings can or will, in fact, be realized. No one familiar with the experience of the transit industry or the railroad industry would argue that regulated utilities are "guaranteed" a fair rate of return.

(*b*) *The statement in exhibit ICC that the purpose of the tax credit is to strengthen the international competitive position of American industry and is primarily applicable to businesses other than public utilities (see point 11).*—(*a*) In the first place, the tax credit was initially proposed, and the provisions of the bill are designed, primarily to stimulate the economy of the United States. There is nothing in the original proposal of the administration, or in the text of the bill under consideration by the committee, which attempts to confine the availability of the tax credit solely to industries which are engaged in international trade. Since the availability of the tax credit to electric utilities would induce capital investment, probably more so than in the case of any other industry, the principal objective of the credit would be materially frustrated if the credit were not available to the electric utility industry.

(*b*) Moreover, the availability of the credit to electric utilities will, in fact, further the objective of assisting our industry to meet foreign competition. As Secretary of the Interior Udall stated in an address delivered on March 5, 1962, "We must continue to develop low-cost energy which will enable us to trade abroad and compete more successfully in the markets of the world." The importance of an abundant supply of low-cost electric energy is particularly apparent in the case of industries in which electric energy is a substantial element of cost; for example, the electrochemical and electrometallurgical industries. But it is also true that an abundant supply of low-cost electric energy can and will increase consumer demand for a large variety of products which will increase the domestic market for the manufacturers of such products, make possible an increase in their production, and thus improve their competitive position with foreign industry. Finally, it is of major importance to the health of the national economy—and, therefore, to our competitive position in international trade—to have a strong, efficient, and thoroughly modern electric utility industry.

(*c*) *The reference in exhibit I–C to the rates of return of electric utilities.*—Table 2 of exhibit I–C purports to set forth certain data (on which various conclusions are based), to show rates of return of public utilities. Even if this data were accurate and meaningful, it is of doubtful relevance. But, what is more significant, is the fact that the data have been compiled in a way which makes it completely meaningless; and that it is not conceivable that anyone having any familiarity with the utility industry would derive rates of return, as is done in table 2, by taking the ratio of net profits after taxes and after interest charges to total assets depreciated. The rates of return which have been derived in table 2, on their face, would indicate their absurdity to anyone familiar with the utility business.

While it is customary and meaningful to take operating income, after taxes, but before interest charges, as a percentage of depreciated plant plus working capital, or to compute the return on the equity segment by itself, any comparison of the return on the equity segment to the total assets of a utility is completely meaningless. This is so, as anyone versed in utility financing and operations would know, because a substantial part of a utility's capital structure (running as high as 60 to 65 percent) may be represented by debt capital.

CONCLUSION

The reasons given in exhibit I–C to support the exclusion of electric utilities from the tax credit are based on a failure to understand that utility capital investment is largely optional in character; why and how optional capital expenditures become economically justifiable; the true nature of the rate regulation process; the degree of competition to which electric utilities are subject; the degree to which sensitive competitive relationships would be distorted and upset by making the tax credit available to its competitors while excluding electric utilities; the flexible nature of the demand for electric energy; and the responsiveness of such demand to lower price.

Denying an equal tax credit to the electric utility industry, which is the most capital-intensive of all our industries and, therefore, able to show the greatest response to a tax incentive for capital investment, would be contrary to the objectives of the credit.

STATEMENT OF HENRY DULAURENCE, CHAIRMAN, LEGISLATIVE COMMITTEE, NATIONAL APARTMENT OWNERS ASSOCIATION, INC.

Chairman Byrd and members of the committee, my name is Henry DuLaurence, of Cleveland, Ohio, and on behalf of the National Apartment Owners Association, Inc., a nonprofit organization, I am presenting this statement as chairman of its legislative committee. Our association is vitally interested in H.R. 10650 and appreciates the privilege of being able to present its views on the bill.

The bill, H.R. 10650, is one that, as originally presented to Congress, contained dangerous provisions which are again being urged, and which, if enacted, could be a deathblow to the free enterprise system. Just where these provisions would lead us requires an examination of the fundamentals of economics and capitalistic society. In other words, we must find out what makes a capitalistic economy work.

We must remember there are two very basic, fundamental differences between a democratic form of government and communism. Communism operates all business and production facilities and discourages the accumulation of savings. Ownership is in the state. The primary incentive to work for communism is the power and alleged glory of the state. A democratic form of government is based on private ownership of business and production facilities and encourages the accumulation of savings. The incentive to work is not only private gain and subsistence, but a permissive accumulation of savings for future use and prosperity.

The Communist-Socialist economists will contradict this—but primitive societies raise their standards of living in direct ratio to the possessions they can own and accumulate. There is every indication that man first began to reach for his present high standard of living when the ownership of property and various media of savings were developed and allowed to exist through the protection of the state. Contrariwise, there is every indication that a Communist state cannot survive over the long term without such an incentive. Our own Pilgrim Fathers were unable to do it in spite of the persevering faith that led them to this land. A close examination of the Russian economy will indicate a slow surreptitious relaxation toward personal gain and permissive savings. During the 40-odd years of communism, Russia has learned that slavery and virtual economic enslavement of a people by work direction and mandated labor will not produce work comparable to a fluid work force free to choose its work for best personal gain (both immediate and such permitted to be saved for the future).

Our immediate concern is the Treasury-proposed provision to tax as regular income part of the capital gains coming from the sale of real estate held as a capital investment (savings). This is risk capital or investment and has played no small part in the development of the United States, and continues to play a major part in maintaining and improving its standard of living. We believe it is self-evident that if money were hoarded in banks without being borrowed for capital uses it would fail to serve the Nation by failing to promote the development and construction of business properties, apartments, and homes (long-term capital investments). On the other hand, only a small portion of savings are borrowed for short-term business uses—the majority being borrowed for long-term capital expenditures. Any increase in the taxation of this long-term type of investment would be an immediate deterrent to real estate construction and promotion and would adversely affect an industry vitally necessary to the economic welfare of the Nation. Even more importantly, it would act as a deterrent to the gradual upgrading of a standard of living which has risen through the encouragement of savings and its resultant advantageous profits.

The need for the preservation of capital and its encouragement to grow must be emphasized from a different facet. It has always been important in the raising of standards of living, as evidenced by history and the comparison of "have" and "have not" countries of today. But even more importantly, we must recognize that our development has reached such a stage of complexity that small sums of money are completely inadequate to initiate new developments or even modernize old ones.

If we are to continue to grow from our present development to the higher standards and tremendous future we now can easily foresee, we must understand that this can only be achieved by having the necessary building blocks represented by capital with which to accomplish this. Not only is real estate capital necessary to make possible this development of a size never before reached or needful to man—but all capital will be needful for this same purpose. An added and very real danger exists that if capital gains on real estate are to be taxed as ordinary income—the same will be true ultimately of all capital investment. There is little reason to tax one differently from the other. This could be highly undesirable. We would be eating and spending our stock in trade.

Such a course would lead to only one possible conclusion—the erosion of capital, especially the large capital which modern civilization needs so badly. Take, as example, the sum of $200,000. As a capital sum it is very small indeed in our multibillion-dollar economy—and yet this sum as profit, after years of careful nursing, would require a minimum payment to the tax collector of $135,000 at regular income tax rates. In other words, if you were successful, two-thirds of the profit would go to the Government. If you lost, you lost alone. Such a situation would discourage investment and erode the capital available in the United States (what with intermittent losses and investors' personal use of capital because of discouragement over high taxes). And, just as importantly, it would encourage the export of capital to other countries (such as Canada) which do not have any capital gains tax and which recognize such a profit as nontaxable. The recent "hot money" movements causing our gold problems are only a small indication of what would happen if our real estate capital gains were to be taxed at regular income rates. A reputed 5 billions of dollars of international "hot money" is making some of the greatest financial powers walk a financial tight rope with disaster still not surely avoided. It does not take much imagination to see what might and probably would happen if only a small part of the reputed 300 billions of dollars invested in capital real estate became disenchanted with our tax structure and develops a desire for investment in more favorable climates; i.e., foreign countries that have no capital gains tax, or where the tax collector isn't nearly as efficient or is more tolerant than our own.

The next matter of important analysis is to determine upon whom this burden of change of taxation on real estate capital gains would fall. This is important only if we believe in the democratic and capitalistic system. In complete honesty we must agree this is under fire from ever-increasing numbers of people from without, and from gradual but consistent deterioration from within. It is our opinion that the elimination of the capital gains on real estate would fall on the strongest prop and support of our democratic-capitalistic Government—the great middle class. (The members of the middle class are the Nation's most persistent and vital entrepreneurs.)

It is generally admitted by students of government that the strongest bulwark of capitalistic democracy is the great middle class. Karl Marx acknowledges this and indicates that the landlords, the property owners, and the great middle class must be (destroyed) in order to destroy productive capitalism (and effectuate the Communist state). Marx must have known, and his subsequent followers certainly know, that the power to tax is the power to destroy. The Constitution can prevent the taking of private property; but high taxation can neatly circumvent the Constitution by making property valueless and subject to foreclosure by the mortgage holder or the tax collector. And, sadly enough, this can be done by persuading the well-meaning and sometimes gullible voters that these confiscatory taxes are necessary for government and/or the general good, by the consistent and continuous repetition of unproven but high sounding half truths.

Census figures readily indicate that real estate does not represent the savings of the rich but of the great middle class. There are exceptions, of course, in the comparatively few downtown buildings and the even fewer highrise luxury apartments found in most cities. As an example, let us take the ownership of the 20 million odd rental housing units found in the United States. It is unfortunate that the 1960 census figures have not been published. However, they can vary in only small percentage points from the 1950 figures. In round figures these show that the approximate 19 million rental units existing in 1950 were owned by an approximate 2,600,000 people. The average rental ownership indicates about 7-plus suites per owner, or truly a modest capital investment in a multibillion-dollar economy. On an average valuation basis, this would represent a value of between $40,000 and $50,000.

There is no doubt that the legislation submitted was not presented for this purpose, and yet we must recognize that it would follow one of the major precepts of Karl Marx for the destruction of capitalism—the ultimate erosion and destruction of capital by destroying the large aggregate capital of the great middle class who are also the country's most dynamic and speculative promoters. (The rich have made theirs and can afford to sit back and buy Government bonds.)

There is one other very strong reason for voting against the provision for taxing capital gains at regular rates—its effect on the general economy. Most economists agree that good and bad times are created not by a sudden scarcity of dollars but by an increase or decrease in the velocity or turnover of the dollar. The imposition of a regular income tax for capital gains on top of normal earnings would freeze most of the present ownership of property. This capital real estate, though not individually large, represents a very large sum in the aggregate. Any stifling of activity would thereby not only slow sales, but diminish future development and construction investment—and of necessity thereby would decrease the velocity of the dollar and act as a depressant on the general economy with its resultant undesirable effects.

The National Apartment Owners Association is therefore strongly opposed to the proposed change in the taxation of capital gains emanating from real estate. There is, of course, no sound basis for the distinction made between this type of investment and any other capital asset. Our American sense of fair play is outraged. However, even more important, our objection is based on the very serious effect this would have on the basic and economic welfare of the Nation—and perhaps its very existence.

With our great debt, our many obligations, our very high Government costs, it is of extreme importance that we husband our resources. The tax dollar should be collected only when necessary. Once turned over to government it loses its character of being a productive dollar. Our capital, on which the welfare of our economy is dependent, must be cared for and kept intact even more carefully. Karl Marx truthfully said "it was extremely important for bourgeois economy to promulgate the doctrine that the accumulation of capital is the first duty of every citizen," and further, "Exclusion of money from circulation would also exclude absolutely its self-expansion as capital."

Capital today is our greatest asset. Its nonproductive consumption (taxation) and its destruction (loss of savings incentive and confiscatory taxes) would be one of the greatest tragedies that could befall this Nation.

Statement of Adolph Weil, Weil Bros., Montgomery, Ala.

PROPOSED TAXATION OF FOREIGN SOURCE INCOME

I. The pending bill would make a radical (and probably unconstitutional) change in present law

Under the present law the United States does not tax the income of foreign corporations except to the extent that such income is from U.S. sources. However, if such foreign corporations are owned by U.S. shareholders, then their earnings are taxed when they are returned in the form of dividends. This tax treatment of foreign income has stood without substantial change since the enactment of the first Federal income tax in 1913.

Now, the proponents of the pending tax bill (H.R. 10650) characterize this traditional concept as the "tax deferral privilege" and as an "interest free loan" by the United States. Section 13 of the bill, as it was passed by the House of Representatives, would impose a 52 percent tax on the U.S. shareholders of foreign corporations to the extent that the income of the foreign corporation is not reinvested in certain types of qualified property or in underdeveloped countries. Section 13 of the bill would, in effect, prevent diversification of U.S.-owned foreign corporations, and would penalize all trading activities of such foreign corporations.

The so-called tax deferral privilege which the bill would end is in no sense a privilege, since the foreign source income of foreign corporations is not, and never has been, subject to the taxing jurisdiction of the United States. Recognizing this fact, the drafters of the bill have set about to tax the U.S. shareholder on his proportionate share of the income of the foreign corporation rather than taxing the foreign corporation itself. Thus, the only "privilege" which the bill would terminate is the privilege of not being taxed on a dividend which one has not received and may never receive. Surely this is not a privilege. It is the right which all Americans enjoy under the law, whether they are shareholders of domestic corporations or foreign corporations.

In 1920, the Supreme Court (in *Eisner* v. *Macomber*, 252 U.S. 189) held that Congress could not tax shareholders on a stock dividend, since such a dividend did not constitute "income" within the meaning of the 16th amendment. Exactly the same objection can be made to this attempt to tax American shareholders on the undistributed income of foreign corporations. The following language from *Eisner* v. *Macomber* is directly on point:

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

Eisner v. *Macomber* has never been overruled and although subsequent decisions may have distinguished it and limited its impact in certain areas, it would certainly seem to prevent the type of tax which section 13 of H.R. 10650 would impose.

Thus, while the sponsors of the bill speak of ending a "privilege," they are actually asking Congress to impose an obligation of doubtful constitutionality.

II. Section 13 of the bill would create difficult problems of compliance and administration

On its face, the imposition of this tax on undistributed earnings of foreign corporations will create a trenmendous hardship for corporations attempting to comply with it and an almost impossible administrative burden for the Government.

Determining what are the earnings and profits of a foreign corporation located in a country having different concepts of earnings, different types of deductions, different forms of depreciation, etc., and then accurately anticipating whether the reinvestment of such earnings is ordinary and necessary for the active conduct of the same qualified trade or business will constitute the most difficult compliance problem in the area of Federal taxation. The dilemma will be more serious for a company which manufactures a thousand different products or components of products. Whether profits from the manufacture of product A can be reinvested in the manufacture of product B will be a source of constant doubt and confusion.

Section 13 would be subject to less criticism if experience with the administration of the "section 102" tax (sec. 531 et seq. of the 1954 code) had not already conclusively established that a tax on accumulations of profits is unworkable, even with respect to domestic corporations. It is amazing that the administration would foster a similar provision for purposes of taxing foreign income.

The enactment in 1960 of sections 6038 and 6046 of the Internal Revenue Code imposed upon U.S. shareholders of foreign corporations reporting requirements which created difficult compliance problems not yet fully solved by many taxpayers. Treasury has had no experience with the administration of these sections (since they are prospective and are only now coming into operation) and does not know to what extent the enforcement of present law (including sections 6038 and 6046) may obviate the necessity for further legislation. In seeking additional legislation such as section 13 of the bill before the Government and the taxpayers have learned how to administer and comply with the intricacies of present law, the Treasury is inviting a chaotic situation.

III. Section 13 of the bill is a punitive measure intended to discourage foreign investment and is based on false economic premises

The bill contains a number of provisions (secs. 5, 6, 7, 9, 11 and 12) which would amend specific areas of tax law applicable to foreign income. Taken together, these provisions would correct the real abuses in the foreign tax area.

Section 13, on the other hand, goes well beyond the closing of loopholes. The purpose of that section is to discourage foreign investment, as Secretary of the Treasury Dillon clearly stated in his testimony before the Senate Finance Committee. The Treasury Department has attempted to rationalize the use of the tax laws to penalize foreign investment on the grounds that foreign investment is largely induced by the "tax deferral privilege". This is clearly untenable and is contradicted by the brief submitted by the Treasury Department to the Senate Finance Committee wherein it is stated that "Presumably only a small proportion of new capital outflow over this period (1952 to 1960) was actually tax induced." (See Senate hearings, Revenue Act of 1962, pt. I, p. 194).

Section 13 of the bill can be justified, if at all, purely on short-range economic grounds. The long-range economic effect of putting American-owned corporations domiciled in foreign countries at a disadvantage with respect to their foreign-owned competitors may be disastrous. Markets will be lost and profits which would otherwise be available to the U.S. parent corporation for payment of dividends to its shareholders will go into the pockets of foreign-owned corporations. Even the U.S. Treasury would lose, since it would be deprived of the tax on the two levels of dividends as the profits are repatriated and then paid to the U.S. shareholder.

What temporary advantage could possibly justify risking the long-term economic welfare of the country? The sponsors of the bill apparently have in mind three current economic problems which they hope will be solved or alleviated by section 13: (1) the imbalance of payments, (2) the relatively high level of unemployment, and (3) the competition of foreign-made imports. These are indeed serious problems, but section 13 of the bill cannot cure or alleviate them and, in fact, may even make them worse, at least in the future.

(*a*) *The imbalance-of-payments problem.*—The extent (if any) to which a U.S. capital investment in Western Europe and other developed countries has contributed to the balance of payments deficit has not been established by competent evidence. The Secretary of the Treasury points to the fact that American industry made $1.7 billion in investments in Western European subsidiaries during the period from 1957 to 1960, whereas $1.3 billion was repatriated as dividends. The annual deficit over the 4-year period resulting from investments in Western Europe amounts to $100 million a year under this type of computation. By comparison with the approximately $3 to $4 billion annual balance of payment deficits for these years, the percentage of the deficit which can be attributed to private investments in Western Europe is infinitesimal. Even the $100 million figure arrived at by subtracting repatriated dividends from new direct investment may be too high, however, since it does not take into consideration a great many variables which, if data were available with respect to them, might well establish that the capital investment in Western Europe has actually improved the balance of payments situation. Among the variables would be the extent to which the U.S.-owned Western European factories are using U.S.-manufactured machines and equipment purchased in the United States. Another variable which is not taken into consideration in the Treasury Department's $100 million annual deficit figure is the fact that many of the products turned out by the European plant have been purchased as semifinished goods from a related U.S. manufacturer. Both of these factors would have contributed to U.S. exports and in all probability would more than exceed the $100 million deficit.

Attacking the balance-of-payments problem by pouncing on U.S. capital investment abroad illustrates the tendency to discriminate against private interests, since the balance-of-payments problem is obviously more the result of military and foreign aid, which amounted to $4.4 billion in 1961.

(*b*) *The unemployment problem.*—The argument that capital investment creates unemployment in the United States is without any rational basis. If a U.S. manufacturer has established a foreign subsidiary because he is otherwise unable to compete in the Common Market, preventing the manufacturer from making the investment will not create jobs in the United States. The establishment of the foreign plant is his only chance of competing successfully. On the other hand, the investment in the foreign manufacturing activity will probably increase employment in the United States since the foreign manufacturing activity relies to a large extent on support and cooperation with a related U.S. manufacturer. This is illustrated by the common practice of buying semifinished U.S. products for further manfacture and assembly in Europe.

Even if the U.S.-owned foreign plant exports a portion of its products to the United States, it would not help to solve the U.S. unemployment situation by penalizing this U.S.-owned operation, since foreign-owned competitors would simply inherit this share of the U.S. market. Obviously, the rate of U.S. imports from Western Europe is determined by the relative costs of manufacturing in the two countries and by other considerations, including tariff restrictions. Whether the foreign manufacturing plant is U.S.-owned is completely irrelevant, and penalizing U.S. ownership is the classic example of cutting off the nose to spite the face.

(*c*) *The problem of import competition.*—This subject must be approached on the general premise that most of the U.S. imports from Western Europe are manufactured by companies owned by Europeans. We cannot equate, therefore, U.S. investment in Western Europe with the general problem of import competition. The manufacturing efficiency of Canadian, Japanese, and European manufacturers is no longer dependent on U.S. capital and know-how, and thus even a complete prohibition against U.S. investment abroad would probably not help the import situation one iota. The answer to the import competition problem lies in U.S. wage and budgetary policies and, of course, in our trade policies. Putting U.S.-owned foreign corporations at a disadvantage vis-a-vis its foreign-owned competitors is an inappropriate and economically harmful approach to the problem.

NATIONAL COMMITTEE OF SECTION 608 OWNERS,
Washington, D.C., April 24, 1962.

Hon. HARRY FLOOD BYRD,
Chairman, Senate Finance Committee,
Senate Office Building,
Washington, D.C.

DEAR CHAIRMAN BYRD: Our trade association represents a large number of mortgagor-owners of apartment houses built under section 608 of the National Housing Act. These projects have had a stormy financial career due largely to competition from other FHA-financed projects, despite an original FHA determination of economic feasibility.

About the only way to save investment real estate of this kind with its very high cash to loan ratio growing out of the 90 percent insured mortgage is through depreciation. Obviously, any change in the treatment of depreciation will seriously affect the valuation of these properties and the investment of the life savings of many older persons who acquire properties of this kind for income purposes during their retirement years.

As depreciation is exhausted, there is a continuing turnover of the properties. If the tax bill follows the Treasury Department proposal to impose ordinary income tax treatment on gain from the sale of buildings to the extent of depreciation taken before sale, instead of at the capital gain rate, as is now the case, serious injury will be done to innocent investors and business activity will be slowed down.

We strongly recommend that H.R. 10650 not be changed in this respect.

Very truly yours,

CARL L. SHIPLEY, *General Counsel.*

TEXACO, INC.,
New York, N.Y., May 1, 1962.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance of the Senate,
Senate Office Building, Washington, D.C.

MY DEAR SENATOR BYRD: The provisions of H.R. 10650 having to do with taxation of foreign income greatly concern me as a U.S. citizen and as chairman and chief executive officer of Texaco. The proposals, in my opinion, do not serve the best interests of our country and should not be enacted.

My conclusion as to the effect of the provisions is based upon extensive experience in foreign operations. Texaco entered the foreign field with the organization on September 29, 1905, of a subsidiary with a terminal in Antwerp, Belgium. Foreign operations have expanded continuously until today Texaco, directly or through subsidiary or affiliated companies, conducts business in all of the free world. My own experience with Texaco, in addition to executive responsibilities, has included many years of service in foreign countries.

If our country is to remain strong, to continue in a position to resist aggression, and to assist the new and emerging nations, it must encourage foreign investment and foreign trade. Such has been the announced policy of our Government. However, far from implementing such a policy, the proposed tax provisions would hamper and discourage direct private investment abroad. They would hurt our critical balance-of-payments situation; they would impose additional taxes on our foreign earnings, and make us less able to meet the severe competition from foreign sources, including the Soviet Union; they would impose additional taxes on our U.S. citizen employees in foreign countries and make it harder to obtain the competent technical and managerial personnel we so critically need. The provisions affecting shipping would, we are convinced, effectively drive a large segment of the foreign-flag tanker fleet from friendly countries, where it is available to the United States in event of national emergency, to complete foreign control.

We know of no reason why legislation having the foregoing most serious consequences, among others, need be enacted. If the legislation is designed to correct abuses, it goes far wide of the mark. I am, in fact, informed that present law, with its extensive reporting requirements and powers for allocating income among related companies, if implemented with an adequate audit program, should enable correction of any abuses. I am advised further that the proposed legislation, changing as it does taxation principles in effect for nearly half a century to entirely new and questionable concepts, is in large measure unworkable from an administrative standpoint.

For the foregoing reasons, and for those elaborated upon in more detail in the attached statement, I respectfully urge you to examine carefully and to reject the proposals for taxation of foreign income in H.R. 10650.

Very sincerely yours,

AUGUSTUS C. LONG.

STATEMENT OF TEXACO, INC.

Texaco believes that the provisions for taxation of foreign income contained in sections 5, 6, 11, 12, 13, 16, 20, and 21 of H.R. 10650, the revenue bill of 1962, are detrimental to the best interests of the United States and should not be enacted. Reasons for this conclusion are as follows:

1. THE BILL DISCOURAGES DIRECT PRIVATE INVESTMENT ABROAD

Private investment abroad cannot be maintained and increased if it is to be penalized by oppressive taxation. The pending bill, if enacted, would unquestionably increase the burden of taxation on foreign income, and therefore have the effect of discouraging private investment abroad.

The burden of taxation would be increased by taxing both distributed and undistributed earnings of foreign corporations controlled by American shareholders. As to distributed earnings, the bill (sec. 11—the so-called gross-up provision) would require U.S. corporate shareholders receiving dividends from foreign corporations to add to their taxable income the amount of foreign taxes paid by the foreign corporations. Attempted justification for the proposal is that it closes a loophole and will equalize the tax burden on income between foreign branches of U.S. corporations and foreign subsidiaries. The present method of taxing dividends from foreign corporations has been in our law for 40 years, and does not in any sense constitute a loophole. The proposed method would not result in equalizing the tax burden between foreign branches of U.S. corporations and foreign subsidiaries, because of utilization of offsetting losses and numerous provisions having to do with computation of income, which are available to U.S. corporations. The proposal would have the sole effect of increasing tax on distributed income of companies incorporated in foreign countries; such corporations often are used by American business not by choice, but because of requirements of the foreign countries.

The bill (sec. 13) also would tax undistributed earnings of foreign corporations controlled by U.S. shareholders by, in effect, ignoring the separate corporate entities and taxing U.S. shareholders currently on their share of the the undistributed earnings of such foreign corporations. The bill would not allow the U.S. shareholders to offset as deductions losses of the same or other controlled foreign corporations. The bill disregards the corporate entity when it is for the purpose of reaching profits, but respects it when losses are involved.

The bill, therefore, increases the tax burden on both distributed and undistributed earnings of foreign corporations, and inevitably would have the result of discouraging direct private investment abroad.

2. THE BILL IS INCONSISTENT WITH THE ADMINISTRATION'S POLICY

The stated objectives of the trade expansion bill of 1962, H.R. 9900, are to stimulate the economic growth of the United States by expanding exports of U.S. manufactured goods, strengthen economic and political relations with the European Economic Community and with other foreign countries, assist in the social and economic progress of less developed countries, and counter the growing threat of Communist economic penetration. These objectives are consistent with the foreign economic policy of the previous postwar administrations, both Democratic and Republican, to encourage American business to expand its international commerce and foreign investment.

The foreign provisions of the revenue bill of 1962, H.R. 10650, are not consistent with the aforementioned objectives, and, if enacted, would cause a retrenchment in American private foreign investment. Specifically, the controlled foreign corporation provisions of the bill by discouraging investment in industrialized areas would impose a policy of economic isolation upon American business in its operations with our free world allies. Many U.S. business firms are seeking to establish basic long-range positions within the European Economic Community. If those positions are not established within the near future, American business runs a real risk of losing out in the world's fastest growing market.

It would be anomalous for the United States to handicap its private enterprise at a time when many governments are providing programs to encourage their private enterprise to enter markets such as that afforded by the Common Market. It is inevitable that manufactured goods of all kinds will move across national boundaries in increasing volume as trade barriers are reduced. International trade requires international investment, and this investment must not be penalized.

Also, the checking of Communist economic expansion in the free world cannot be achieved if American controlled foreign enterprise is crippled by tax legislation purportedly designed to correct some ill-defined tax abuses.

3. THE BILL WOULD ADVERSELY AFFECT THE U.S. BALANCE-OF-PAYMENTS SITUATION

The Secretary of the Treasury has estimated that the U.S. balance-of-payments deficit would be greatly improved by enactment of the bill, apparently through restricting foreign investments in developed countries. The principal evidence submitted is three tables which are based upon questionable assumptions and relate only to manufacturing investments in Western Europe and Canada (tables A–5, A–6, and A–7 of exhibit III attached to the statement of the Honorable Douglas Dillon, Secretary of the Treasury, before the Committee on Finance on H.R. 10650, Apr. 2, 1962). Those tables purport to show that investments made in developed countries will not repay their balance-of-payments costs for at least 10 to 15 years. The fact, however, is that in each year since 1950 remittances to the United States for dividends, interest, and royalties have, of themselves, exceeded the capital outflow for all direct investments abroad, with the surplus amounting to about $9.5 billion from 1950 through 1961.

In addition, foreign direct investments generate substantial exports from the United States to American-controlled companies abroad. Most of the goods imported into the United States from foreign plants of these companies, on the other hand, cannot be attributed to U.S. investments abroad, since in all probability they would have been imported in any event.

Furthermore, investments in industrial countries should not be considered in isolation from investments made in less developed areas. By discouraging investments in processing plants and marketing facilities in the large and rapidly growing areas of Western Europe and Japan, the raw material exports of less-developed countries, and hence the income earned by American investors to develop such exports, will be affected adversely.

The deficit in the U.S. balance of payments is admittedly a serious problem and cannot be allowed to continue at the levels of recent years. But it should be recognized that our balance-of-payments difficulties are the result of Government expenditures abroad and failure of our allies to assume a larger share of the aid and defense burdens. The solution to the problem should not take the form of penalizing American foreign investments which provide substantial inflow of funds to the United States. Our own experience in Texaco shows how large this contribution can be. In the last 2 years this company has contributed a net inflow of well over $200 million to the U.S. balance of payments. This figure includes Texaco's share in foreign operations of affiliated companies and takes into account, in accordance with the Department of Commerce's balance-of-payment procedure, all of the company's transactions with foreigners, including imports and capital movements as reflected in intercompany accounts.

4. THE BILL JEOPARDIZES NATIONAL DEFENSE

The impact of the bill on American-controlled foreign-flag shipping would seriously jeopardize national defense.

Many foreign shipping companies are controlled by U.S. individuals who find it necessary to borrow substantial sums to finance ship construction. Creditor agreements not infrequently prohibit the payment of dividends during the mortgage payout period. Nevertheless, under the bill, U.S. shareholders would be subject to U.S. tax at the sharply graduated individual rates on their proportionate share of undistributed earnings of the foreign shipping companies, even though no cash could be made available to meet the tax obligation.

Under these circumstances, individual shareholders would be compelled at least to sell a controlling interest to foreigners in order to avoid being taxed as shareholders of a U.S.-controlled foreign corporation. The national interest would suffer, since sales of the shares would mean loss of effective U.S. Government control over vital tonnage that would be essential in time of national emergency.

5. THE BILL IMPAIRS THE ABILITY OF AMERICAN BUSINESS TO COMPETE ABROAD

The foreign income provisions of the bill are based upon the misconception that U.S.-controlled foreign corporations are primarily in competition with domestic export corporations. The ability of U.S. exports to compete abroad is not affected by American foreign investments. Such ability depends upon keeping domestic costs and quality competitive with foreign-produced products. In fact, the principal competitors of U.S.-controlled foreign corporations doing business abroad are foreign-controlled producers, manufacturers, and marketers.

As long as U.S.-controlled and foreign-controlled foreign corporations are subject to the same rates of taxation, both are on an equal footing. However, if, as proposed, American enterprise operating abroad is to be burdened with additional U.S. tax on its earnings, whether distributed or not, the position of competitive equality is lost—with the foreigner the winner.

6. THE BILL WOULD DISCOURAGE EMPLOYMENT OF AMERICAN MANAGEMENT PERSONNEL ABROAD

The bill would make it more difficult for American enterprises to attract and hold skilled U.S. personnel abroad by placing arbitrary ceiling on the nontaxable income of U.S. citizens living and working in foreign countries. Earnings up to $20,000 a year would be exempt from U.S. tax during the first 3 years of foreign residence, and thereafter up to $35,000 would be tax free.

Normally, Americans sent abroad by U.S. business firms are either of the managerial or skilled technical category. Both categories are in great demand in all foreign areas—particularly in the newly developing countries. They are usually in the higher salary levels and frequently go abroad at considerable sacrifice to themselves and their families.

Providing technical assistance and managerial skills to underdeveloped countries has been a basic feature of U.S. foreign policy for almost two decades. The presence of American experts employed by private enterprise in those countries has proved to be one of the most effective means of providing those skills. Exemption of foreign-earned income by U.S. citizens resident and employed abroad has been an effective inducement in carrying out that feature of our foreign policy. It would be a serious mistake to remove that inducement at the very time that the Communist bloc is making available in the newly developing countries experts who are seeking to alienate those countries from the free world.

If abuses compel limitations upon tax-exempt earnings of U.S. citizens abroad, the exempted amounts should be higher than the $20,000 to $35,000 limits provided in the bill.

7. THE BILL RAISES CONSTITUTIONAL ISSUES AND CONFLICTS WITH U.S. INTERNATIONAL COMMITMENTS

The bill raises serious constitutional questions because it would tax unrealized earnings of U.S. shareholders in foreign corporations. It has been a basic doctrine of our tax laws that unrealized appreciation of property is not income. In *Eisner* v. *Macomber* (252 U.S. 189 (1920)) the Supreme Court held that income is "not a gain *accruing to* capital * * * but a gain * * * *received* or *drawn* by the recipient [the taxpayer] for his *separate* use, benefit and disposal * * *. Nothing else answers the description." [Original emphasis.] That unrealized appreciation is not taxable income was reaffirmed by the Supreme Court in *Commissioner* v. *Glenshaw Glass Co.* (348 U.S. 426 (1955)).

Lacking authority to impose tax directly on the foreign corporation, the bill resorts to the expedient of levying tax on the shareholder measured by the undistributed earnings of the foreign corporation. Constitutionally, therefore, the bill is of doubtful validity.

Furthermore, the authority granted in the bill to the President to determine whether or not a country is "less developed" may be an unwarranted delegation of power over taxation and foreign commerce, since no criteria are furnished to guide its exercise.

The bill also is in conflict with treaty commitments of the United States.

The United States has been a leader in developing a system of income tax treaties designed to provide fairness and certainty to taxpayers of signatory nations. The bill (sec. 21) would amount to a unilateral repudiation by the United States of its treaty obligations, and would be inconsistent with the general U.S. position that urges foreign countries to honor their treaties and other contractual obligations, including those affecting foreign property rights.

8. THE BILL IS NOT NEEDED TO CORRECT ANY ABUSES THAT MAY EXIST

Those who organize their economic and business activities in a manner designed to evade U.S. taxes should be subject to appropriate action. However, it does not follow that legitimate American business operating abroad through foreign corporation should be penalized.

The Internal Revenue Code presently contains provisions which are adequate to correct any improper diversion of income to foreign corporations. Section 482, Internal Revenue Code, authorizes the allocation of income among related entities "in order to prevent evasion of taxes." Recently enacted legislation requires taxpayers to furnish extensive information with respect to foreign operations. Proper utilization of these and other data available to the Internal Revenue Service, if appropriately supplemented by an adequate audit program, should permit the correction of any abuses involving the use of U.S.-controlled foreign corporations. Abuses existing only because of nonenforcement of existing law should not be made the basis for unsound and administratively impractical legislation of the type proposed in the bill.

INVESTMENT BANKERS ASSOCIATION OF AMERICA,
Washington, D.C., May 1, 1962.

Hon. HARRY F. BYRD,
U.S. Senate, Washington, D.C.

DEAR SENATOR BYRD: The Investment Bankers Association of America would like to comment on two aspects of H.R. 10650, and we would appreciate your making this letter and its enclosure a part of the record of the current hearings which your committee is holding on this bill.

DIVIDEND CREDIT AND EXCLUSION

Although H.R. 10650 does not deal with the present provisions of the law having to do with the 4-percent dividend credit and $50 exclusion, we are aware that Secretary Dillion has recommended to your committee that H.R. 10650 be so changed as to repeal these provisions of the law.

In considering this recommendation of the Secretary, we commend to the consideration of your committee again the enclosed copy of a statement by Walter Maynard, then chairman of our Federal taxation committee, which was made before the House Ways and Means Committee on May 11, 1961. This statement still reflects our views on this proposal, and we earnestly solicit your support.

SECTION 19 OF H.R. 10650

First, let me make it clear that we do not here wish to take a position on the principle of withholding interest and dividend income, and we should like to make it equally clear that we are, of course, sympathetic with all practicable efforts to collect the maximum amount of taxes due the Government under the law at all levels of Government. In our view, however, the present provisions of section 19 do not provide a practicable and workable system for the withholding of dividend and interest income. The difficulties which the various segments of our industry anticipate with the administration of this proposal, should it be enacted into law as contained in H.R. 10650, have been amply presented and documented in the statements already made to or filed with your committee by Mr. Carmin C. Saccardi, representing the Association of Stock Exchange Firms, Mr. Edwin S. Cohen, representing the Investment Company Institute, and Mr. Keith Funston, president of the New York Stock Exchange and others. We shall not, therefore, endeavor to repeat or even summarize that testimony here, but we should like to go on record as heartily endorsing their description of the technical and mechanical difficulties which would be caused by this proposal in its present form.

Sincerely yours,

CURTIS H. BINGHAM, *President.*

STATEMENT OF WALTER MAYNARD, CHAIRMAN, FEDERAL TAXATION COMMITTEE, INVESTMENT BANKERS ASSOCIATION OF AMERICA, RE DIVIDEND CREDIT AND EXCLUSION

My name is Walter Maynard. I am a partner in Shearson, Hammill & Co. (14 Wall Street, New York), and I am here on behalf of the Investment Bankers Association of America.

The Investment Bankers Association is made up of some 800 firms, located in all sectors of the United States. These firms, in addition to their main offices, have about 1,900 registered branch offices. The members of this association conduct a large proportion of all the securities business in the United States. A very large part of this business represents the security transactions of this country's 15 million shareowners.

Of the present total of about 15 million shareowners, it is estimated that about 11 million have annual family income under $10,000. These are the people who are providing a steadily increasing share of the equity capital needed by our growing country, and these are the people who are most hurt by double taxation. The justification for increasing a basic discrimination against them at this time by eliminating the $50 exclusion and the 4-percent dividend credit, as proposed, is hard to see.

The investor in corporate stocks is penalized today, despite the small measure of relief granted by the Revenue Act of 1954, by a substantial measure of double taxation, in that earnings of corporations are taxed twice; once when earned by the corporation and again when received in the form of dividends by the stockholder.

The present situation is that for the ordinary investor the tax system is not neutral. A man who invests directly, say $10,000, in a business or apartment house, earns 6 percent on this investment, and is in a 30-percent income tax bracket, retains $420 of his $600 income. If, however, he invests in a corporation which earns $600 for his share, there remains after the 52-percent corporate tax $288. If half of this sum is assumed to be paid to the stockholder in dividends, and he pays personal tax at a 30-percent rate, there remains to him from the dividend $101.80, in addition to which there is $144 retained for his share by the corporation. The effect of the $50 exclusion and the 4-percent credit is that there remains to him directly or indirectly, after taxes and credits, $292.04. This is $127.96 less than if he owned the property or business directly. This $127.96, which is equivalent to an additional tax of 30 percent, may be regarded as overtaxation, or unfair taxation.

In our modern economy, most citizens cannot make direct investments, and they therefore must turn to securities. Moreover, American business could not obtain the equity capital needful for growth if it were not for the willingness of the American people to save, and to invest a part of these savings in dividend-paying common and preferred stocks. Fair treatment of small stock buyers should therefore logically be an important element of national policy.

In placing the provision for the $50 exclusion and the 4-percent credit in the 1954 act, the Congress rightly took the position held until 1936 that double taxation of corporate income was a basic injustice, and a modest step was taken to correct it. The fact that now a loss of revenue may result from a change in another sector of the tax law does not seem to be an adequate reason for accentuating an existing bad situation; rather, it would seem not too soon to consider further means of dealing with the problem of overtaxation as a measure of equitable tax reform. Certainly the proposal to drop the credit and exclusion cannot be called reform even if the present mode of relief, like other possible methods, is not perfect. Incidentally, in considering the situation that existed in 1936 when relief from double taxation was first omitted, the salient circumstance is that the lowest rate of personal tax was 4 percent and the corporate rate was 15 percent.

It has been said that the existing scheme is especially favorable to upper bracket taxpayers. Upper bracket taxpayers get exactly the same relief—$50 plus 4 percent—as do lower bracket taxpayers. The effect of the credit, even in the case of high-bracket taxpayers receiving a high proportion of income in the form of dividends, is merely to reduce slightly the steepness of the progression in the income tax scale. In the case of low-bracket taxpayers, however, the degree of relief in relation to dividend income is greater because the $50 exclusion constitutes a higher proportion of dividend income.

It has been said that the dividend credit and the exclusion have failed to encourage capital formation through equity investment. The record does not indicate that this is so. The present estimated total of 15 million shareowners contrasts with 7.3 million shareowners in 1954. It is true that many factors in addition to the dividend credit and exclusion have played a part in accelerating the rate of increase in shareownership, but it is evident that to eliminate the credit and the exclusion would tend to lessen the appeal of stocks in contrast with other forms of investment and therefore act to discourage financing by means of sales of equity securities. Upper bracket taxpayers especially might well be led to an increasing preference for tax-free bonds.

A matter that might be considered at this point is the fact that all buyers of dividend-paying securities since 1954 have bought them under circumstances of a yield increment reflecting the credit and exclusion. To reduce or eliminate the credit and exclusion now would work a hardship on these buyers, especially in the case of yield-type securities such as preferreds and guaranteed stocks. If the credit or exclusion were to be eliminated it would seem only fair to make the elimination applicable only to securities issued in the future, and/or to holders of securities who acquired them prior to 1954.

The question of remedying the basic injustice of double taxation should also be viewed in a somewhat broader context. To begin with, international considerations must bulk continuously larger in all our economic decisions, and our economic competition must be effective at every level, including our ability to mobilize equity capital. Other major industrial nations in which relatively high income taxes are relied on for a substantial proportion of government revenues provide in one manner or another for a very substantial degree of relief from the double taxation of corporate earnings. Canada utilizes a method of relief similar to ours, but the credit since 1953 has been 20 percent instead of our meager 4 percent. England uses a grossing-up system considerably more complex than ours that provides a larger degree of relief than does ours. Other countries granting such relief include West Germany, Japan, and France. There are 28 countries in all which treat dividends more liberally than the United States.

An even more important consideration is that our whole Federal revenue system is basically keyed to the income tax, and the successful working of this system depends upon a high degree of compliance on the part of taxpayers. This compliance is to a considerable extent voluntary, and in order to assure taxpayer cooperation, taxpayers must be convinced that, generally speaking, the income tax system is a fair one. Double taxation of dividends is a glaring unfairness in our income tax structure, of which an increasing number of taxpayers are becoming aware as shareownership grows.

The foregoing considerations would seem to make it certain that any rational and equitable program of tax reform contemplated for the future must include a provision for a measure of relief from double taxation. It would therefore seem unwise to drop at this time as a matter of opportunism a small measure of relief which will have to be restored at a later date as a matter of basic justice.

NATIONAL ELECTRICAL CONTRACTORS ASSOCIATION, INC.,
Washington, D.C., May 3, 1962.

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

MY DEAR SENATOR BYRD: It is our understanding that your committee has invited interested parties to comment, by testimony or statement, on the provisions of the tax bill (H.R. 10650) now being considered by the committee. Accordingly, we are submitting this brief statement on section 3 of H.R. 10650 and request that the statement be incorporated in the printed record of the hearings.

The National Electrical Contractors Association is the nationally recognized representative of the electrical contracting industry, which includes more than 15,000 small business concerns primarily engaged in the business of making on-the-site electrical installations. On the average, they individually employ fewer than 10 workmen. These concerns are located in every community of the United States and are engaged in building projects which range from small homes to such complex installations as atomic energy plants and missile facilities. On the local and State level, the industry is represented by 122 chapters of this association.

This association and its individual chapters and members are directly and adversely affected by existing Treasury regulations concerning deductibility for income tax purposes of business or trade expenses incurred with respect to legislative matters. These regulations specifically disallow certain deductions incurred by business concerns and trade associations in presenting their views and opinions to State, and the Federal, legislative branches of government, although such expenses have been and are considered legally deductible if incurred in making appearances before executive, administrative, and judicial officials concerning administrative and judicial matters. The prohibition against deductibility of legislative expenses is obviously unjustifiably discriminatory.

The present regulations also penalize the business concern and trade association for exercising a basic American right—freedom of speech. Such regulations penalize a business or association by taxing their words concerning legislative matters, even though such matters may involve the very survival of the business or association. This taxation naturally discourages business concerns and organizations from presenting information to legislative members and the public as to the impact of existing or proposed legislation on their organization or business. Hence, it tends to prevent proper evaluation of legislation. Accordingly, the existing regulations are not only inequitable to the business concern or trade association, but are also contrary to the interest of the general public.

Section 3 of H.R. 10650 is a commendable attempt to rectify this undesirable situation. This association, its members and chapters appreciate this legislative effort. However, we do not believe that the present language of section 3 will serve as an effective remedy to the problem. To support our opinion, and for the purpose of brevity, we endorse the statements submitted to your committee by the U.S. Chamber of Commerce and the National Association of Manufacturers, concerning clarification of that language.

In lieu of the present language of section 3, we strongly urge the committee to adopt the language of S. 467, as introduced by Senator Hartke, or H.R. 640, as introduced by Representative Boggs.

Very truly yours,

ROBERT L. HIGGINS,
Assistant Executive Vice President.

GOODWILL INDUSTRIES OF CHICAGO AND COOK COUNTY, INC.,
Chicago, Ill., May 1, 1962.

Hon. HARRY F. BYRD,
Chairman, Senate Finance Committee,
Senate Office Building,
Washington, D.C.

DEAR SENATOR BYRD: H.R. 10650, the revenue bill of 1962, contains provisions that will jeopardize the work of many charitable organizations, including Goodwill Industries. As you undoubtedly know, our primary purpose is to provide vocational rehabilitation services: training, employment, and opportunities for personal growth as an interim step in the rehabilitation process for the handicapped, disabled, and disadvantaged who cannot readily be absorbed in the competitive labor market or during such time as employment opportunities for them in the competitive labor market do not exist.

Last year contributions of depreciated capital assets from business and industry to Goodwill Industries of Chicago amounted to approximately 13,276 man-hours of evaluation, training and employment to the handicapped in our workshops. This represents a savings of thousands of dollars to the taxpayer because many of the people we employ are taken off the welfare relief rolls. Further, these same people return much earned income to the Government in payment of income taxes.

Obsolete, salvage and surplus inventory items; stocks and securities; buildings and art objects donated to charitable organizations and causes will continue to have the advantage of a tax deduction at fair market value, even if H.R. 10650 becomes law. However, with the Senate passage of section 14 (d) and (e) of H.R. 10650, in its present form, this tax advantage will be withheld from donations of depreciated capital assets. About 50 percent of our present industrial donations are of this kind—depreciated capital assets. We believe this to be very discriminatory to both donor and donee.

I speak for the officers, members of the board of directors and staff of Goodwill Industries as well as its many beneficiaries, requesting that you give very serious consideration to the above stated objection to section (d) and (e) of H.R. 10650, the revenue bill of 1962.

Sincerely yours,

WILLIAM RAGOLIO, *Executive Director.*

THE ASSOCIATED GENERAL CONTRACTORS OF AMERICA, INC.,
Washington, D.C., April 30, 1962.

Subject: Revenue bill of 1962 (H.R. 10650).

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

MY DEAR SENATOR BYRD: The Associated General Contractors of America, Inc., on behalf of the more than 7,200 construction firms composing its membership, appreciates this opportunity to express to the Finance Committee its opinion upon the following provisions of the pending revenue bill of 1962 (H.R. 10650).

CREDIT FOR INVESTMENT (SEC. 2)

General contractors throughout the United States are experiencing great difficulty in earning and retaining adequate funds to purchase necessary new equipment. In this highly competitive industry, it is essential that the contractor have modern, efficient equipment to reduce costs and to permit his winning of contract awards as the low bidder. But high taxes and labor costs, coupled with narrowing profit margins in the construction industry, impose a hardship upon the general contractors in acquiring the essential reserves for equipment replacement.

While the proposed tax credit is intended to spur investment in new equipment, we believe that it would be of little benefit to the general contractors. The credit is complex and uncertain. It is discriminatory in amount, especially as to equipment with useful lives of less than 8 years, which includes much of that subjected to the hard out-of-doors usage of the construction industry. Also the tax credit as now proposed completely excludes expenditures for buildings, which constitute one of the largest construction markets.

We submit that the needs of the general contractors, and industry generally, require congressional action liberalizing depreciation allowances. Congress should authorize more favorable annual deductions than those now permitted under outmoded internal revenue schedules. Also, it should classify depreciable property into broad categories of useful lives to minimize the ever-recurring depreciation controversies which are so burdensome for both the taxpayer and the Government.

Basic revision of the present unrealistic depreciation rates and policies would offer material incentive and assistance to general contractors in replacing obsolete construction equipment, with resultant benefits to them and to the public through maximum efficiency and minimum costs for construction.

LEGISLATIVE ACTIVITIES (SEC. 3)

We approve the purposes of this proposed section in allowing deductions for expenses connected with appearance before legislative bodies and with communication of legislative information between taxpayers and organizations in which they are members. In our opinion, section 3 would aid freedom of speech and the right of petition, and would encourage the dissemination of knowledge on legislative matters.

GAIN FROM DISPOSITIONS (SEC. 14)

With the price increases of recent years substantially raising the costs of new equipment, the capital gain treatment permitted on the sale of their depreciable used equipment has been of some limited assistance to general contractors in retaining necessary funds for replacement purchases. Gain on such dispositions should not be subjected to tax as ordinary income unless and until Congress has granted adequate realistic depreciation reform.

Determination of salvage value of equipment is a perplexing problem for general contractors, as they often cannot foresee the weather, soil, and other conditions under which their equipment will be operated and which will bear heavily upon its useful life in their business. Accordingly, we favor the proposed revision which would permit a reduction of the amount necessarily taken into account as salvage value by 10 percent or less of the basis of such property. Thereunder, it is our understanding that a salvage value of 10 percent or less of the cost of an item of equipment (with a useful life of 3 or more years, acquired after the date of enactment of the revenue bill of 1962) could be reduced to zero and ignored for depreciation purposes; or, if a salvage value of more than 10 percent of cost seemed required on another item of equipment, that the Internal Revenue Service could not adjust the taxpayer's determination within the 10-percent privilege. This proposed revision is a step in the right direction to avoid needless controversy.

We request that this statement be included in the printed hearings.

Respectfully submitted.

TRAVIS BROWN, *Counsel.*

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PHILADELPHIA 7, PA.

PLEASE REPLY TO.

Philadelphia Bar Association

ROOMS 600-603 CITY HALL

Philadelphia 7, Pa.

Committee on Taxation

May 1, 1962

Gentlemen:

Re: H. R. 10650
Revenue Bill of 1962

The Committee on Taxation of the Philadelphia Bar Association submits herewith its comments and recommendations with respect to H. R. 10650 - The Revenue Act of 1962.

<u>Bill Section 2(b)</u>
Section 47(b)

<u>Question of Undue Limitation of Scope of Exception</u>

"(b) SECTION NOT TO APPLY IN CERTAIN CASES. Subsection (a) shall not apply to -

(1) a transfer by reason of death, or

(2) a transaction to which section 38(a) applies. * * *"

<u>COMMENT</u>: PROPOSED CODE SECTION 47 applies to many involuntary as well as voluntary dispositions of property. The Committee believes this is unduly harsh since involuntary transfers are beyond the control of the taxpayer and do not appear to be a source of tax avoidance. This is particularly true in insolvency situations where the creditors of the bankrupt would be penalized to the extent prior tax credits had to be repaid.

<u>SUGGESTION</u>: Add to Section 47(b) the following:

"(3) the compulsory or involuntary conversion of property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof),

(4) transfers of property in a receivership, foreclosure, or similar proceeding or in a proceeding under Chapter X of the Bankruptcy Act (52 Stat. 883-905; 11 U.S.C., Chapter 10 or the corresponding provisions of prior law, or

(5) cessation of a trust beneficiary's interest upon the expiration of the trust term in accordance with the provisions of the instrument creating the trust."

<u>Bill Section 2(b)</u> <u>Question of Ambiguity</u>
Proposed Code Section 48(a)(1)(B)(ii)

"(ii) consititutes a research or storage facility used in connection with any of the activities referred to in clause (i)."

<u>COMMENT</u>: The quoted language is subject to the interpretation that property which is a part of but does not itself constitute a complete research or storage facility will not qualify as "Section 38 property". The Committee believes this is unintended.

SUGGESTION: Section 48(a)(1)(B)(ii) should be changed to read as follows:

"(ii) constitutes or forms an integral part of a research or storage facility used in connection with any of the activities referred to in clause (i)."

<u>Bill Section 2(b)</u> <u>Question of Unwarranted Limitation of Exception</u>
Proposed Code Section 48(d)

"(d) CERTAIN LEASED PROPERTY. - A person (other than a person referred to in section 46(d) engaged in the business of leasing may * * *."

COMMENT: This provision is designed to give the benefit of the credit to the party generating the demand for the investment. Accordingly, the Committee believes there is no reason to deny the election to a lessor who makes an occasional lease of property but is not "in the business of leasing property."

SUGGESTION: Proposed Section 48(d) should be changed to read as follows:

"(d) CERTAIN LEASED PROPERTY. - A person (other than a person referred to in section 46(d) who has leased property to another may * * *."

Bill Section 14 — Question of Application of Section
Proposed Section 1245(a)(3)

"(3) SECTION 1245 PROPERTY. - For purposes of this section, the term 'section 1245 property' means any property (other than livestock) which is or has been property of a character subject to the allowance for depreciation provided in section 167 and is either

(A) personal property, or

(B) other property (not including a building or its structural components) * * *."

COMMENT: This proposed Code provision is intended to give partial effect to the President's recommendation that the profit from the sale of depreciable property which is the result of depreciation allowances in excess of actual decline in the value of an asset should be taxed as ordinary income rather than as capital gain. The present bill would apply this principle to personal property but not to a building or its structural components. The committee report states, as the reason for this exclusion, that application of the rule to buildings presents problems where there is an appreciable rise in the value of real property attributable to a general price level rise over a long period of time.

This Committee believes that statutory recognition of this basic principle would produce such widespread complications throughout the Code that its introduction into the law would be warranted only if it had a marked effect on the revenue. This would not, in the Committee's opinion, be the case if the principle is to be applied only to depreciable property other than buildings. The so-called loophole of which the President has complained may exist in the real estate area. With regard to other depreciable property, it is believed to be inconsequential. Few taxpayers realized substantial profits upon the sale of used machinery and equipment. In the exceptional situations, such as taxpayers in the automobile leasing business, the possibility of converting ordinary income into capital gain by excessive depreciation allowances has been eliminated through judicial decisions which have held the regular and continuous disposition of used assets to be in itself a business producing ordinary income to the taxpayer.

SUGGESTION: The Committee recommends that either the parenthetical phrase "(not including a building or its structural components)" be deleted (so that real property is subject to the provisions of the section) or the section be deleted in its entirety.

Bill Section 14
Proposed Code Section 1245(b) and (d)

Question of Unwarranted Application of Section

COMMENT: By reason of Section 1245(d) the provisions of Section 1245 are applicable to gain realized on a sale by a corporation which would otherwise not be recognized under the provisions of Section 337 (which deals with a situation where a corporation sells assets after adopting a plan of complete liquidation and completes the liquidation within a 12 month period). If enacted, the provisions will again place a premium on the form a transaction takes since on the sale of shares of stock of a corporation only a single capital gain will be involved while on the sale of a depreciable assets ordinary income will be recognized by the corporation (to the extent of the gain reflecting the depreciation deductions) and a capital gain on the liquidation of the corporation. It was to provide similar treatment in both cases and eliminate the premium on the form of the transaction that Section 337 was enacted. The Committee believes the frustration of the purpose of Section 337 is unnecessary and unwise.

SUGGESTION: **Add to Section 1245(b) the following additional** provisions:

"(7) - Section 337 TRANSACTIONS. - Subsection (a) shall not apply in the case of transactions described in section 337(a)."

Bill Section 14(b)
Proposed Code Section 167(e)

Question of Unintended Limitation of Election

"(e) CHANGE IN METHOD. -

* * * *

"(2) CHANGE WITH RESPECT TO SECTION 1245 PROPERTY. - A taxpayer may, within such period after the date of the enactment of the Revenue Act of 1962 and in such manner as the Secretary or his delegate shall by regulations prescribe, elect to change his method of depreciation in respect of section 1245 property (as defined in section 1245(a)(3) from any declining balance or the sum of the years-digits method to the straight line method. An election may be made under this paragraph notwithstanding any provision to the contrary in an agreement under subsection (d)."

COMMENT: This Section adds to Section 167(e) a new provision which would permit a taxpayer to elect to change his method of depreciation Section 1245 property from any declining balance or sum of the years-digits method to the straight line. The Committee believes the same election should be available to a taxpayer using a method of depreciation described in Section 167(b)(4) ("any other consistent method productive of an annual allowance which * * * *").

SUGGESTION: "(2) CHANGE WITH RESPECT TO SECTION 1245 PROPERTY. - A taxpayer may, within such period after the date of the enactment of the Revenue Act of 1962 and in such manner as the Secretary or his delegate shall by regulations prescribe, elect to change his method of depreciation in respect of section 1245 property (as defined in section 1245(a)(3) from any declining balance or sum of the years-digits method or any method of depreciation described in section 167(b)(4) to the straight line method. An election may be made under this paragraph notwithstanding any provision to the contrary in an agreement under subsection (d)."

Bill Section 3
Section 162(e)

Question of Effective Date.

SEC. 3. APPEARANCES, ETC., WITH RESPECT TO LEGISLATION.

"(a) IN GENERAL. - Section 162 (relating to trade or business expenses) is amended by redesignating subsection (e) and subsection (f) and by inserting after subsection (d) the following new subsection:

* * * * *

(b) EFFECTIVE DATE. The amendments made by this section shall apply to taxable years beginning after December 31, 1962."

* * * * *

COMMENT: A potential problem is presented in the case of fiscal year taxpayers by reason of the relation of the effective date of the bill to taxable years of the taxpayers rather than the date when the expense was paid or incurred. For example, dues paid in January, 1963 to an organization that appears before a congressional committee on behalf of its members might be at least partially nondeductible in the case of a fiscal year taxpayer, but deductible by a calendar year taxpayer. Similarly, if two taxpayers retained an attorney to appear before a congressional committee and the attorney was paid in January, 1963, one might find the payment deductible and the other might find the payment nondeductible.

SUGGESTION: It is suggested that Section 3(b) be changed to read:

"(b) EFFECTIVE DATE. - The amendments made by this section shall apply to expenses paid or incurred after December 31, 1962."

Bill Section 4
[Section 274]

General Comments

"SEC. 274. DISALLOWANCE OF CERTAIN ENTERTAINMENT, ETC., EXPENSES"

GENERAL COMMENT RELATING TO SEC. 4 On the premise that Congress will adopt a proposal based on Section 4 of the House Bill, the Committee is making a number of specific suggestions. These suggestions might not be appropriate if the basic test in Section 274(a) is changed.

This Committee feels that Section 4 of the House Bill is an improvement on the Bill suggested by the Treasury and the Discussion Draft released by the Ways and Means Committee last year. Furthermore, it is our conclusion that the basic language in Section 274(a) is susceptible of clarification through amendments in the statute and examples in the Committee Report so that it will be reasonably certain in meaning. This will minimize difficulties for the Treasury in administration as well as allowing the taxpayers to know the tax consequences of contemplated acts.

FURTHER COMMENTS: The Section must be considered as it will appear in the Code. In this perspective the caption appears to be misleading as well as inconsistent with other Sections in Part IX (Items not deductible). The Section also relates to a number of other Sections of the Code to which cross references would be appropriate.

SUGGESTION: The title of proposed Section 274 should be changed to

"CERTAIN EXPENSES FOR TRAVELING, GIFTS AND ENTERTAINMENT."

Cross references to Section 274 should be made in the following Sections:

Section 162	(trade or business expenses)
Section 167	(depreciation)
Section 179	(additional first-year depreciation allowance for small business)

Section 262	(personal, living, and family expenses)
Section 1221	(capital asset defined)
Section 1231	(property used in the trade or business and involuntary conversions)
Section 6001	(notice or regulations requiring records, statements, and special returns).

<u>Bill Section 4(a)</u>
[Section 274(a)]

<u>Question of Clarification</u>

"(a) ENTERTAINMENT, AMUSEMENT, OR RECREATION. -

"(1) IN GENERAL. - No deduction otherwise allowable under this chapter shall be allowed for any item -"

"(A) ACTIVITY. - With respect to an activity which is of a type generally considered to constitute entertainment, amusement, or recreation, unless the taxpayer established that the item was directly related to the active conduct of the taxpayer's trade or business, or - -."

<u>COMMENT</u>: The test proposed is without precedent, or at least the Committee Report points to no precedent. The Section is one that will be applicable to large numbers of taxpayers and will in most instances involve relatively small amounts. If the statute is vague, the agents can impose arbitrary tests on the taxpayers, because the agent realizes that the amount involved will not justify litigation and the agent is also unclear on the meaning. If Congress thinks that legislation is necessary, it should do as much as possible to define the scope of the new rules. This would prevent any unfair imposition on the taxpayers as well as minimizing the volume of litigation the new Section will cause.

This Committee has no suggestion to make as to amendments in Section 274(a). The alternative statutory tests suggested present the same problem as to clarity. However, the Committee Report could be amplified so that the application of the statute to the more common types of expenses could be determined. This would substantially lessen the uncertainty that the Ways and Means Committee Report does not dispel.

<u>SUGGESTION</u>: The Committee Report does not explain what is meant by either "direct" or "active" except that something more is required than "a general expectation of deriving some income at some indefinite future time from the making of the entertainment type expenditure - - -". (p. 29). This implies that if the taxpayer can relate the expenditure to a reasonable expectation of realizing income at a specific future time, the expense would be deductible. The needed clarification could be secured by inserting the following examples in the Committee Report:

"Example 1. Bank A has a box at the baseball park. An officer of a correspondent bank goes to a game with an officer of the taxpayer bank one evening while he is in Philadelphia to discuss business with the bank. The extension of hospitality to the visitor may reasonably be expected to be reflected in a more cordial (and more lasting) business relationship. It is important to the taxpayer that some of its officers personally know the officers of the correspondent banks and it is important that the visitors feel that Philadelphia is a pleasant city to visit. Otherwise, he might prefer a New York bank.

The bank can deduct the expense of the entertainment. However, if the guest banker was from the Philadelphia suburbs and was a personal friend of the officer who was the host, the expense would not be deductible.

"Example 2. An officer of a distributor invites officers of customers to play golf. The host is not a salesman - the distributor has salesmen who call on its customers - and the usual guest is not a buyer. Rather, he will typically be the boss of the buyer. The golf game gives the host a chance to find out if the customer is getting the service it should (perhaps the salesman has not been punctual for appointments or has been calling without appointments, etc.) and also to informally learn about new or potential product needs. The golf game would seem to be directly related to the active conduct of the taxpayer's business and deductible under the proposed bill.

The taxpayer can deduct the expense of the entertainment. However, if the golfing companions were executives of customers but had nothing to do with purchasing or product development, the expense would not be deductible.

"Example 3. A Taxpayer-accountant entertains officers of corporations who are potential clients. If the gathering is sufficiently small so that the host and guests can carry on an extended conversation, the guests will hopefully be impressed by the host as a person of tact and charm and will think of him the next time they need accounting services. This entertainment would seem to be directly related to the active conduct of the business since an integral part of the business is to secure new clients to replace the ones no longer requiring the taxpayer's services. Thus, the entertainment is the active conduct of this portion of the business if the guests would be influential in the selection of accountants for their employers.

The taxpayer can deduct the expense of the entertainment. However, if the guests were close friends of the accountant who were well aware of his personal attributes, the expense would not be deductible.

"Example 4. Taxpayer is a 77 year old consulting engineer. He knows that several of his clients are concerned that due to his age, he no longer has the vitality to visit the jobs, climb the hills and generally be available in emergencies. During each year, he invites the appropriate individuals to play golf, and he plays the full 18 holes. He walks the whole round although he carefully sees that carts are available for his guests. Business isn't discussed, but the clients leave knowing that the taxpayer is still physically able to serve them.

The taxpayer can deduct the expense. However, if the engineer played with substantially the same foursome each week, the expense would not be deductible."

The result in all of these examples is open to doubt under the House Bill and will remain unclear unless the Committee Report supplies additional guidance concerning Congressional intent. In the case of businesses selling services rather than products, the desirability of the service can sometimes be best reflected by indirect means, as in the examples. While it could be argued that the deductible expenses are properly limited in all the examples to instances when the bankers talk banking, the distributor extolls his product, the accountant talks about the capabilities of his firm and the engineer talks about bridges, Section 274(a) is not that narrow. In each instance, the activity was a sensible means of carrying on the taxpayer's business.

If the expenses in any of these examples are not intended to be deductible under the House Bill, it would seem desirable to point out why they are not. It may be noted that in all four cases, the entertainment had a purpose other than good will.

Bill Section 4(a)(1)
[Section 274(d)(1)]

Question of Scope of Exception

Sec. 274(d)(1) provides as follows:

"(1) BUSINESS MEALS. Expenses for food and beverages furnished to any individual under circumstances which (taking into account the surroundings in which furnished, the taxpayer's trade, business, or income-producing activity and the relationship to such trade, business, or activity of the persons to whom the food and beverages are furnished) are of a type generally considered to be conducive to a business discussion."

COMMENT: The reference in the proposed statute is to food and beverages. The language is somewhat similar to that in Section 162(a)(2) which refers to "meals and lodging." Throughout the Committee Report, the references are to "food and beverage" in conjunction and there are no references to food alone or to beverages alone.

Under Section 162, the Service has contended that a taxpayer is not entitled to deduction for his meals while away from home unless he also incurs an expense for lodging. This position has recently been rejected by the Eighth Circuit in Hanson v. Commissioner, 62-1, U.S.T.C. §9195, but the Service is apparently adhering to its position. Based on this interpretation of Section 162, the Service might contend that a meal without a beverage does not come within the exception or (more likely) that a beverage without a meal does not come within the exception. Since the atmosphere conducive to business discussions can exist whether the parties limit their nourishment to solid or liquid form, it would appear that the congressional intent is that the exception applies whether the expense is exclusively for food or exclusively for beverages.

SUGGESTION: Subsection 274(d)(1) should be amended by adding after "and": "/or".

The Committee Report should appropriately state that this amendment should not be construed as approving or disapproving of the result in Hanson v. Commissioner, supra.

Bill Section 4(a)(1) [Section 274(d)(3)] — Question of Scope of Exception

"(3) EXPENSES TREATED AS COMPENSATION. Expenses for goods, services, and facilities, to the extent that the expenses are treated by the taxpayer, with respect to the recipient of the entertainment, amusement, or recreation as compensation to an employee on the taxpayer's return of tax under this chapter and as wages to such employee for purposes of chapter 24 (relating to withholding of income tax at source on wages)."

COMMENTS: In order to qualify under this exception, the employer must promptly decide that the value of the entertainment, amusement or recreation constitutes income to the employee and withhold from his wages on this assumption. For example, in Rudolph v. Commissioner, 291 F.2d 841 (5th Cir. 1961), presently pending in the Supreme Court, the employer would have been required to decide that the value of the trip constituted income to the employee and to withhold or else the employer would not have come within the exception. On the other hand, in John E. Cavanaugh, 36 T. C. No. 32, the employer did not withhold on amounts used to pay living expenses of the employee and the Tax Court held that the amount did not constitute income to the employee.

The House Bill would impose upon the employer the obligation of either guessing right in an area that is remarkably unclear or in the alternative unfairly imposing a burden on the employee. Assume for example that the expense is later determined to be compensation to the employee. The employer would be denied the deduction and the employee would be taxed on the income so that the Treasury would collect a double tax. If the law was clear this penalty might be justified but the Supreme Court now has before it a case relating to convention expenses (Rudolph v. Commissioner, 291 F. 2d 841). One tax on the entertainment expense would generally seem to be all the Treasury is entitled to. Of course, if the expenditure constitutes a dividend, or unreasonable compensation, this would be a double tax.

SUGGESTION: Change Section 274(d)(3) to read as follows:

> "(3) EXPENSES TREATED AS COMPENSATION. - Expenses for goods, services, and facilities, to the extent that the expenses are compensation to the recipient of the entertainment, amusement, or recreation."

Bill Section 4(a)(1)
[Section 274(d)(6)

Question of Necessity for Exception to Section 274(a)

> "(6) EMPLOYEE AND STOCKHOLDER BUSINESS MEETINGS. - Expenses directly related to business meetings of employees or stockholders."

COMMENT: This exception was taken from the earlier draft of the Bill in which there was a disallowance of all entertainment expenditures unless "directly related to the production of income and not merely for good will."

A luncheon served at a stockholders meeting would not have been directly related to the production of income and therefore this exception was necessary. However, Section 274 of the House Bill merely disallows entertainment expenses "unless the taxpayer establishes that the item was directly related to the active conduct of the taxpayer's trade or business." A business meeting of employees or stockholders is by its very nature directly related to the business and, therefore, not within the scope of Section 274.

If the meeting is not within the scope of Section 274, the exception is meaningless. However, it is a rule of statutory construction that all parts of a statute have meaning. Therefore, the Courts would be tempted to unnecessarily broaden the scope of Section 274(a) to give the exception some meaning.

There may be some type of meeting that (1) is a business meeting, but (2) is not directly related to the active conduct of the business and that the superior resources of the Treasury and Congressional staff have uncovered meetings of a type that would come within the exception. However, the Committee Report does not give an example of such a meeting.

SUGGESTION: The exception relating to employee and stockholder business meetings should be re-examined to determine whether any employee or stockholder business meetings come within scope of Section 274(a). It is suggested that (1) if there is a continuing need for the exception, this fact should be illustrated by an appropriate example in the Committee Report or; (2) if the exception is superfluous, it should be deleted and it should be stated in the Committee Report that it was deleted because business meetings of employees and stockholders would not come within the scope of Section 274.

Bill Section 4(a)(1)
[Section 274(d)(7)

Question of Necessity and Scope of Exception to Section 274(a).

"(7) MEETINGS OF BUSINESS LEAGUES, ETC. - Expenses directly related and necessary to attendance at a business meeting or convention of any organization described in section 501(c)(6), (relating to business leagues, chambers of commerce, real estate boards, and boards of trade) and exempt from taxation under section 501(a)."

<u>COMMENT</u>: This exception is subject to two criticisms. First, it is at least doubtful whether expenses directly related to attendance at a meeting of a business league would be deductible under Section 162 unless the meeting was directly related to the taxpayer's business. See Regs. Sec. 1.162-2(d). The Courts have regularly disallowed expenses of conventions when the taxpayer could not demonstrate the relationship to the business. See <u>Alexander P. Reed</u>, 35 T.C. 199(1960).

However, if it is decided that some meetings of business leagues come within the scope of 274, the restriction to organizations described in Section 501(c)(6) seems quite limited. Some organizations fail to qualify under Sec. 501(c)(6) because a portion of their net earnings inures to the benefit of the members. In addition, many business organizations have never secured rulings that they come within Section 501(c)(6) because they have no taxable income. The expenses related to attendance at a business meeting of a business league would seem to qualify for equal tax treatment whether or not the business league conducts an activity that earns a profit that inures to the benefit of its members.

<u>SUGGESTION</u>: Section 274(d)(7) should be re-examined to determine whether business meetings of business leagues come within the scope of Section 274(a). If it is determined that any meetings of business leagues come within the scope of Section 274(a), an example of a type of such meeting should be inserted in the Committee Report. If the exception contained in Section 274(d)(7) is superfluous, it should be eliminated and the reason for the elimination stated in the Committee Report.

<u>FURTHER SUGGESTION</u>: If it is determined that the exception is applicable to some meetings, it is suggested that the exception be changed to read as follows:

> "Expenses directly related and necessary to attendance at a business meeting or convention of any business league, Chamber of Commerce, real estate board or Board of Trade."

Bill Section 4(a)(1)
Section 274(d)(9)

Question of Necessity for Exception to Section 274(a)

"(9) ENTERTAINMENT SOLD TO CUSTOMERS. Expenses for goods or services (including the use of facilities) which are sold by the taxpayer in a bona fide transaction for an adequate and full consideration in money or money's worth."

COMMENT: This exception would appear to be clearly unnecessary under the House Bill and should be eliminated. The reason for the elimination of meaningless provisions was discussed in regard to Section 274(d)(6).

SUGGESTION: Delete Section 274(d)(9) and state in the Committee Report that it was deleted because such expenses were not within the scope of Section 274.

Bill Section 5(d)
[Amendment of I.R.C. §902(a)]

Question of Unwarranted Extension of "Loophole-Closing" Provision

"(d) CREDIT FOR FOREIGN TAXES. Section 902(a) (relating to credit for foreign taxes) is amended by adding at the end thereof the following new sentence: 'For purposes of this sub-section and sub-section (b), the amount of any distribution in property other than money shall be the amount determined by applying §301(b)(1)(B).'"

COMMENT: The stated purpose of Section 5 of the Bill is to require inclusion as a dividend of the fair market value of appreciated property distributed by a foreign corporation to a domestic corporation, and not merely the adjusted basis of the property. This is of course a laudable object as the adjusted basis rule can be justified only for distributions between domestic corporations (House Report, page 26). However, in the case of distributions from foreign corporations, an inequality of tax treatment results from taxing an American corporate shareholder on the full amount of any cash dividend but only on the adjusted basis to the distributor foreign corporation of any appreciated property.

If the American corporate shareholder is to include in its gross income the fair market value of the property, it would seem equitable to treat the entire fair market value as being the amount of the dividend for purposes of computing the foreign tax credit as well. However, this sub-section of the Bill requires that the amount of the dividend for purposes of the foreign tax credit be considered to be only its adjusted basis or fair market value, whichever is lower. This has the result of diminishing the foreign tax credit available to the American corporate distributee as compared with the amount which would be available had cash been distributed. Since the amount of the tax in the first instance is now the same under the Bill, it would seem that the amount of foreign tax which could be claimed as a credit should also be the same.

Some technical justification for this sub-section of the Bill may be found in sub-section 902(a), in which the denominator of the fraction used to compute the amount of foreign tax attributable to the distribution is the "accumulated profits" of the foreign corporation, which presumably do not include the unrealized appreciation in the property being distributed. However, this objection could be met by requiring addition of the unrealized depreciation to the accumulated profits figure used in the denominator.

There is nothing in the House Committee Report explaining why this position was taken with respect to the foreign tax credit.

SUGGESTION: The Committee suggests that the above quoted language be changed to read:

> "(d) CREDIT FOR FOREIGN TAXES. Section 902(a) (relating to credit for foreign taxes) is amended by adding at the end thereof the following new sentence: 'For purposes of this section and sub-section (b) the amount of any distribution in property other than money shall be the amount determined by applying §301(b)(1)(C), and the excess of the fair market value of such property over its adjusted basis, if any, shall be considered as part of the accumulated profits of such foreign corporation.'"

Bill Section 6(a) [I.R.C. §482(b)(1)] — Question of Effectiveness of Bill

"(1) IN GENERAL. In applying subsection (a) to sales of tangible property within a group of organizations -

"(A) owned or controlled directly or indirectly by the same interests, and

"(B) at least one of which is a domestic organization and at least one of which is a foreign organization,

the Secretary or his delegate may allocate the taxable income of the group arising from such sales in the manner set forth in paragraph (2). This subsection shall not apply with respect to any sale of tangible property for which the taxpayer can establish an arm's length price (within the meaning of paragraph (4))."

COMMENT: In the light of the introductory clause to Section 482 of the 1954 Code, subparagraph (A) would seem to be unnecessary since the requirements that the organizations be owned or controlled by the same interests already appears in the statute.

FURTHER COMMENT: It is questionable whether, literally construed, this subsection will have the intended effect. It refers to the taxable income of the group arising from sales of tangible property within the group. Of course, in the case of the typical tax haven export subsidiary the income diverted from the United States parent to the foreign export subsidiary is realized not from a sale within the group, but rather from the sale by a member of the group to an outsider. Thus, if the American parent sells to the foreign export subsidiary at cost, there is no income from a sale within the group. The only income is realized through the subsequent sale by the foreign subsidiary to an outsider; but this income, not being derived from a sale within the group, would technically not be subject to §482(b), although this is the very type of situation which this subsection is intended to control, as indicated in the pertinent reports. As a matter of fact, the technical explanation in the House Report specifically refers to income from the ultimate sale to an outsider as being within the scope of this subsection. H.R. Rep. No. 1447, supra, A39.

SUGGESTION: The Committee recommends that this paragraph be changed to read as follows:

"IN GENERAL. In applying subsection (a) to sales of tangible property by any member of a group where there have been prior transfers of such property between at least one member of the group which is a domestic organization and at least one member of the group which is a foreign organization, the Secretary or his delegate may allocate the taxable income of the group arising from such sales in the manner set forth in paragraph (2). This subsection shall not apply with respect to any sale of tangible property for which the taxpayer can establish an arm's length price (within the meaning of paragraph (4))."

Bill Section 6(a)
[I.R.C. §482(b)(3)]

Question of Fairness of Allocation Formula

"(3) SPECIAL RULES. In applying the method of allocation referred to in paragraph (2)(A), the following rules shall be applied:

"(A) ADJUSTED BASIS OF ASSETS. - The values to be assigned to the assets referred to in paragraph (2)(A)(i) is [sic] their adjusted basis in the hands of the taxpayer or, if such basis is not available in the case of a foreign organization, then their book values, adjusted to approximate their adjusted basis.

"(B) INCLUDIBLE ASSETS. - The assets referred to in paragraph (2)(A)(i) include real property and tangible personal property (whether owned or leased by a member of the group), but do not include inventory and stock in trade."

COMMENT: The use of adjusted bases in connection with the application of the formula provided under subparagraph (2)(A), above, rather than current fair market values is theoretically indefensible. Adjusted basis should be deemed only prima facie evidence of fair market value for this purpose.

Moreover, the limitation of the assets included in the formula to real property and tangible personal property, so as to exclude any consideration of good will, patents, know-how, or similar assets, is unwarranted. For instance, if a foreign sales organization has at considerable expense acquired local trade names or good will in order to expand its sales, such expenditure presumably should be, but apparently is not, taken into account in the application of the formula.

SUGGESTION: The Committee recommends that this paragraph be redrafted so as to make fair market value of all assets other than receivables and inventory determinative; and to provide that adjusted basis shall be prima facie evidence of fair market value.

Bill Section 6(a)
[I.R.C. §482(b)(4)

Question of Vagueness

"(4) ARM'S LENGTH PRICE DEFINED. For purposes of this subsection, the term 'arm's length price' means

"(A) the price at which tangible property similar or comparable to the property referred to in paragraph (1) generally is or can be sold in transactions in the same areas involving unrelated persons and made under similar conditions of sale; and

"(B) if subparagraph (A) does not apply, the price at which tangible property similar or comparable to the property referred to in paragraph (1) is sold in the same or other areas under similar circumstances and in transactions involving unrelated persons, with adjustment for material differences in quantity, marketing, conditions (including customs duties and transportation costs), and other relevant factors.

Subparagraph (B) shall apply only if the adjustment referred to therein is properly determinable."

COMMENT: The Committee believes that the phrase "properly determinable" is unduly vague. Neither the statute nor committee reports contain any criteria for proper determination. Moreover, the taxpayer has the burden of proof.

SUGGESTION: The last sentence of this subsection should be stricken.

Bill Section 6(a) Question of Vagueness
[I.R.C. §482(b)(5)

"(5) SALES COMMISSIONS. The Secretary or his delegate shall by regulation prescribe rules for the allocation of commissions arising from sales of tangible property within a group of organizations described in paragraph (1). Such rules shall be consistent with the principles specified in the other paragraphs of this subsection."

COMMENT: This paragraph leaves too much unsaid. While authorizing the Commissioner to prescribe suitable rules for commission income, it requires these rules to be consistent with the principles of this subsection, without any indication as to how such consistency is to be achieved.

SUGGESTION: The Committee believes that the basic principles of the subsection should be spelled out in the statute (elaborated and exemplified in the legislative history).

Bill Section 6(a) [I.R.C. §482(b)(6) — Question of Effectiveness of Bill

"(6) GROSSLY INADEQUATE ASSETS, ETC., OUTSIDE UNITED STATES. - In allocating taxable income under this subsection, no amount shall be allocated to a foreign organization whose assets, personnel, and office and other facilities which are not attributable to the United States are grossly inadequate for its activities outside the United States."

COMMENT: As under paragraph (1), a literal interpretation of the statutory language used in paragraph (6) would apparently fail to reach the most egregious offenders sought to be caught. The subsection, in effect, directs that no income shall be allocated to a foreign subsidiary whose assets abroad are grossly inadequate for its activities abroad. This paragraph is designed to frustrate tax avoidance through so-called "paper" or "sham" companies. However, the most extreme form of "paper" company may not have any appreciable activities outside the United States, and hence its foreign assets are not likely to be grossly inadequate for its foreign activities. If so, this subsection would literally be in-applicable.

SUGGESTION: The Committee sees no need for this paragraph and recommends that it be stricken.

Bill Section 9 — Distributions by Foreign Trusts

GENERAL COMMENT: The Committee believes that at any time the trustee of a foreign trust should be permitted to make an irrevocable election to be treated as a domestic trust by filing all past due federal income tax returns which would have been required of a domestic trust and by consenting to the future applicability of the Internal Revenue Code to the trust.

Bill Section 9(a)
[I.R.C. §643(d)]

Question of Clarification

"(d) FOREIGN TRUSTS CREATED BY UNITED STATES PERSONS. - For purposes of this part, the term 'foreign trust created by a United States person' means a foreign trust (as defined in section 7701 (a)(31) to which money or property has been transferred directly or indirectly by a United States person (as defined in section 7701(a)(30)), or under the will of a decedent who at the date of his death was a United States citizen or resident."

COMMENT: A trust created with a foreign trustee by a nonresident alien to which a United States citizen has added an amount, however small, would be treated as a foreign trust created by a United States person. Thus, if a beneficiary in this country of a trust created by a nonresident alien should permit the trustees to use income for a purpose for which a charge would be borne by principal, in order to avoid selling trust securities, the entire trust would become a foreign trust created by a United States person. Perhaps that result would not be so serious had the statute been in force at the time of the addition of the property to a foreign trust created by someone else. However, it is most unfair if applied to trusts to which additions already have been made. In fairness to beneficiaries, a foreign trust should be considered created by a United States citizen or resident only to the extent that such citizen or resident has transferred property to the trust.

SUGGESTION: "(d) FOREIGN TRUSTS CREATED BY UNITED STATES PERSONS. - For purposes of this part, the term 'foreign trust created by a United States person' means a foreign trust (as defined in section 7701 (a)(31) to the extent that money or property has been transferred directly or indirectly by a United States person (as defined in section 7701 (a)(30)), or under the will of a decedent who at the date of his death was a United States citizen or resident."

Bill Section 9(b)
[I.R.C. §665(c)]

Question of Undue Burden on Beneficiaries

"(c) ACCUMULATION DISTRIBUTION OF CERTAIN FOREIGN TRUSTS. - For purposes of this subpart, in the case of a foreign trust created by a United States person, the term 'accumulation distribution' for any taxable year of the trust means the amount by which the amounts specified in paragraph (2) of section 661(a) for such taxable year exceed distributable net income, reduced by the amounts specified in paragraph (1) of section 661(a). For purposes of this subsection, the amount specified in paragraph (2) of section 661(a) shall be determined without regard to section 666. Any amount paid to a United States person which is from a payor who is not a United States person and which is derived directly or indirectly from a foreign trust created by a United States person shall be deemed in the year of payment to have been directly paid by the foreign trust."

COMMENT: Unless the beneficiary is able to furnish full information about the "operations and accounts" of the trust for each of the accumulation years, the full amount of the distribution will be taxed to him as income for the year of distribution. Although the "short cut" method of computing tax would make it unnecessary for the beneficiary to preserve his own records for more than two years prior to the taxable year, nevertheless, if the beneficiary is to have the benefit of the optional methods of computing his tax, the trust must preserve its records for each year of the accumulation period, however long, and those records must be made available to the beneficiary. There would be many instances in which the records either were not preserved or were not made available to the beneficiary. There should be some period, such as ten years, beyond which the throwback rules would not operate, as the Committee believes that most of the tax avoidance in this area has been through the use of ten-year trusts.

SUGGESTION: The Committee suggests that the "accumulation distribution" be limited to that portion of the distribution accumulated during the ten preceding taxable years of the trust, and that the beneficiary be required to produce records for no longer period.

Bill Section 11(b) [I.R.C. &78] Question of Inconsistency

"SEC. 78. DIVIDENDS RECEIVED FROM FOREIGN CORPORATIONS BY DOMESTIC CORPORATIONS CHOOSING FOREIGN TAX CREDIT. If a domestic corporation chooses to have the benefits of subpart A of part III of subchapter N (relating to foreign tax credit) for any taxable year, an amount equal to the taxes deemed to be paid by such corporation under section 902 (relating to credit for corporate stockholder in foreign corporation) or under section 957(a) (relating to taxes paid by foreign corporation) for such taxable year shall be treated for purposes of this title (other than section 245) as a dividend received by such domestic corporation from the foreign corporation."

COMMENT: The Committee is unable to understand why the amount of the "gross-up" should not be considered as a dividend for all purposes, including section 245.

SUGGESTION: The parenthetical phrase "(other than section 245)" should be deleted.

<u>Bill Section 12</u>
[Paragraph (1) of
I.R.C. Section 911(c)]

<u>Question of Clarification</u>

"(c) SPECIAL RULES. - For purposes of computing the amount excludable under subsection (a), the following rules shall apply:

"(1) LIMITATIONS ON AMOUNT OF EXCLUSION. - The amount excluded from the gross income of an individual under subsection (a) for any taxable year shall not exceed an amount which shall be computed on a daily basis at an annual rate of ...."

<u>COMMENT</u>: The statute does not state to what "daily basis" refers. The comparable provision in the present law, Section 911(a)(2), which deals with only the 18-month rule, refers to the "number of days in the part of the taxable year within the 18-month period" in pro rating the excludable income. Presumably, "daily basis" was intended to have the same result with respect to the 18-month rule. However, in the absence of the specific language in present Section 911(a)(2), "daily basis" could be taken to refer to only the number of days of physical presence during the 18-month period.

<u>RECOMMENDATION</u>: The Committee Report should make it clear that the term "daily basis" does not change the present method of pro rating income under the 18-month rule.

Bill Section 13(a) **Question of Unintended Omission**
[I.R.C. §951(c)]

"(c) COORDINATION WITH ELECTION OF A FOREIGN INVESTMENT COMPANY TO DISTRIBUTE INCOME. - A United States person who, for his taxable year, is a qualified shareholder (within the meaning of section 1247(c) of a foreign investment company with respect to which an election under section 1247 is in effect shall not be required to include in gross income, for such taxable year, subpart F income of such company."

COMMENT: Section 1247 permits a foreign investment company to elect to distribute 90 per cent or more of its ordinary income currently and to advise its shareholders of their pro rata share of their capital gain of the company, and thereby the shareholders are relieved from the requirement of §1246 of including their pro rata share of the earnings and profits of such a corporation in their gross income upon disposition of their stock. If such a corporation happens also to be a controlled foreign corporation within subpart F, the Committee believes that no portion of its income or increase in earnings invested in non-qualified property should be included in the gross income of its U. S. shareholders. Section 951(c) as drafted would excuse a U. S. shareholder only from the requirement of including his pro rata share of the subpart F income of the company, but apparently would not excuse him from reporting his pro rata share of the increase in earnings invested in non-qualified property.

SUGGESTION: The Committee suggests that proposed §951(c) be changed to read as follows:

"(c) COORDINATION WITH ELECTION OF A FOREIGN INVESTMENT COMPANY TO DISTRIBUTE INCOME. A United States person who, for his taxable year, is a qualified shareholder (within the meaning of section 1247(c) of a foreign investment company with respect to which an election under section 1247 is in effect shall not be required to include in gross income, for such taxable year, his pro rata share of the subpart F income of such company or of the company's increase in earnings invested in non-qualified property for such year."

<u>Bill Section 13(a)</u>
[I.R.C. §952(e)(2)

<u>Question of Taxation of Income Having no Relation to the United States</u>

"(e) FOREIGN BASE COMPANY INCOME. -

. . .

"(2) CERTAIN SALES INCOME INCLUDED. - The term 'foreign base company income' includes foreign base company sales income if, for the taxable year, such income is equal to at least 20 percent of the gross income of the foreign corporation (not including for this purpose other foreign base company income under this subsection). For purposes of this paragraph, the term 'foreign base company sales income' means income (whether in the form of profits, commissions, fees or otherwise) 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, where -

"(A) the property which is purchased is manufactured, produced, grown, or extracted outside the country under the laws of which the controlled foreign corporation is created or organized, and

"(B) the property is sold for use, consumption, or disposition outside such foreign country. . . ."

<u>COMMENT</u>: This paragraph would include in "foreign base company income", which is in turn an ingredient of subpart F income, income derived by an entity such as a Swiss trading corporation which purchases goods of a foreign manufacturing subsidiary of a U. S. corporation and sells them to outsiders, or vice versa. Income of this nature bears no relation to the United States and is not passive in character and should not be lumped with dividends, interest, rents and other forms of passive income, and with income from U. S. patents, etc., which are taken into account in determining subpart F net income. The Committee is of the opinion that only if such

property is manufactured or produced in the United States, or if it is manufactured or produced outside the United States but sold to persons within the United States, should the trading income be includible in subpart F income.

FURTHER COMMENT: The Committee believes that the place of incorporation of a controlled foreign corporation should have no bearing upon the inclusion of trading income in subpart F income; the only legitimate concern of the United States should be whether income is diverted from the United States by the use of foreign trading corporations.

SUGGESTION: The Committee suggests that this paragraph be changed to read as follows:

"(e) FOREIGN BASE COMPANY INCOME. -

. . .

"(2) CERTAIN SALES INCOME INCLUDED. - The term 'foreign base company income' includes foreign base company sales income if, for the taxable year, such income is equal to at least 20 percent of the gross income of the foreign corporation (not including for this purpose other foreign base company income under this subsection). For purposes of this paragraph, the term 'foreign base company sales income' means income (whether in the form of profits, commissions, fees or otherwise) 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, where -

"(A) the property which is purchased is manufactured, produced, grown or extracted within the United States, and

"(B) the property is sold for use, consumption, or disposition outside the United States, or

"(C) the property which is purchased is manufactured, produced, grown or extracted outside the United States, and

"(D) the property is sold for use, consumption, or disposition within the United States."

Bill Section 13(a)
[I.R.C. §953(b)(2)(C)]

Question of Relevancy of Place of Incorporation

"(b) NONQUALIFIED PROPERTY DEFINED. -

. . .

"(2) QUALIFIED PROPERTY. The term 'qualified property' means -

"(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 and in which it together with four or fewer United States persons, owns, directly or indirectly, more than 50 percent of the voting stock (unless under the laws of a less developed country such percentage of ownership is not permitted, in which case such lesser percentage as is permitted); but this subparagraph shall apply only if -

"(i) substantially all of the property of such other controlled foreign corporation is ordinary and necessary for active conduct of a trade or business engaged in by it almost wholly within a less developed country or countries, and

"(ii) such other controlled foreign corporation is created or organized under the laws of one of such countries in which it is so engaged. . . ."

COMMENT: The Committee is again of the opinion that the place of incorporation of a controlled foreign corporation should be irrelevant in determining whether an investment in its stock by its immediate parent should be considered as "qualified property."

SUGGESTION: The Committee suggests that subparagraph (ii) be deleted and the reference to (i) eliminated.

Bill Section 13(a)
[I.R.C. §953(b)(3)(A)

Scope of Restriction

"(3) QUALIFIED TRADE OR BUSINESS. -

"(A) A trade or business is a qualified trade or business if such trade or business (or substantially the same trade or business) -

"(i) is carried on by the controlled foreign corporation outside the United States and has been so carried on by such corporation, while controlled by substantially the same United States persons since December 31, 1962, or during the 5-year period ending with the close of the preceding taxable year, or

"(ii) is carried on by the controlled foreign corporation almost wholly within a less developed country or countries . . . ."

COMMENT: This subparagraph, as acknowledged by the House Committee Report, is intended to prevent the use of earnings which have not been subject to U. S. tax to diversify the business of the controlled foreign corporation (Technical Explanation, p. A98). It also precludes an investment in a completely new trade or business from being "qualified property" as such business would not have been controlled by substantially the same U. S. persons since December 31, 1962 or during the 5-year period ending with the close of the preceding taxable year. Furthermore, in the event of a change of ownership, apparently an investment in that trade or business could not be considered as qualified property until a 5-year period had elapsed.

The Committee does not believe that restrictions on the diversification of active trades or businesses of controlled foreign corporations should be imposed except where the source of the funds is "foreign base company income" within §952(e). Furthermore, in the event of change of ownership of an otherwise qualified trade or business, there would seem to be no reason why the new owners should not be permitted to invest earnings in that business without subjecting such earnings to United States tax.

SUGGESTION: The Committee suggests that this paragraph be changed to read as follows:

"(3) QUALIFIED TRADE OR BUSINESS. A trade or business is a qualified trade or business if such trade or business is carried on by the controlled foreign corporation outside the United States."

Bill Section 15(a)(1)
[I.R.C. §1246(a)(1) Question of Clarification

"(1) GENERAL RULE. - In the case of a sale or exchange after December 31, 1962, of stock in a foreign corporation which was a foreign investment company . . . ."

COMMENT: The Committee presumes that the use of the phrase "sale or exchange" was intended to include a liquidation (complete or partial) and a redemption of stock of the issuing foreign investment company. However, there is nothing in the Bill itself or in the House Report which expressly says so, and the only reference to liquidations and redemptions at all is in Section 15(b) of the Bill which would add certain provisions to §312 of the Code having to do with the adjustments in earnings and profits to be made upon such events.

SUGGESTION: The Committee suggests that the language of the Bill not be amended but that a statement be inserted in the legislative history to the effect that "sale or exchange" is intended to include complete and partial liquidations and redemptions, particularly since the normal method of disposal of stock in an investment company is by a redemption.

Bill Section 15(a)(1)
[I.R.C. §1246(a)(3) Question of Burden of Proof

"(3) TAXPAYER TO ESTABLISH EARNINGS AND PROFITS. - Unless the taxpayer establishes the amount of the accumulated earnings and profits of the foreign investment company and the ratable share thereof for the period during which the taxpayer held such stock, all the gain from the sale or exchange of stock in such company shall be considered as gain from the sale or exchange of the property which is not a capital asset."

COMMENT: The Committee believes that it is undesirable to emphasize the taxpayer's burden of proof in this manner. In all cases (except where the statute expressly provides otherwise) determinations of the Commissioner are presumptively correct. Accordingly, there is no reason to repeat or underscore the taxpayer's burden of proof in the manner done by this sub-section, particularly as the burden here is not prove any fact of which the taxpayer has or should have personal knowledge, but rather a fact within the control of a foreign corporation over which his influence may be negligible.

The Committee believes that the burden of proof of establishing the taxpayer's ratable share of the earnings and profits of a foreign investment company should shift to the Commissioner in cases where the company has furnished a statement to the taxpayer of its earnings and profits prepared in accordance with generally accepted accounting principles consistently applied.

SUGGESTION: Paragraph (3) should be deleted as written and in its place there should be a paragraph shifting the burden of proof to the Commissioner under the conditions specified above and providing that such statements regularly furnished to the shareholders are presumptively correct.

Bill Section 15(a)(1)
[I.R.C. §1246(a)(1)

Question of Undue Complexity and Burden on Taxpayers

"(1) GENERAL RULE. - In the case of a sale or exchange after December 31, 1962 of stock in a foreign corporation which was a foreign investment company ... at any time during the period during which the taxpayer held such stock ...."

COMMENT: The Committee believes that requiring the treatment of gain on the sale or exchange as ordinary income to the extent of earnings and profits is too harsh a penalty to prescribe where a corporation may have been a foreign investment company at one time but has since engaged predominantly in other businesses. Furthermore, this language may lead the Internal Revenue Service to require every person selling stock in a foreign corporation to establish that at no time during the taxpayer's holding period was it a foreign investment company. If Congress is concerned about avoidance of this requirement via a liquidation at a time when a foreign corporation has ceased to be a foreign investment company and has engaged temporarily in some other business to avoid this Section, it seems to the Committee that a solution would be to limit the Section to the disposal of stock in a foreign corporation where that corporation qualified as a foreign investment company at the time of the sale or exchange or within a period of one year prior to the sale or exchange.

This provision of the Bill is particularly offensive when read in conjunction with §1246(b)(2) in which a foreign corporation can qualify as a foreign investment company, even though unregistered with the SEC, if it is engaged in the business of an investment company at a time when more than 50 per cent in voting power or value of its stock is owned by United States persons.

SUGGESTION: The Committee suggests that subparagraph (1) be amended to read as follows:

"(1) GENERAL RULE. ... which was a foreign investment company . . . at any time within a period of one year prior to the sale or exchange, ..."

Bill Section 15(a)
[I.R.C. §1246(e)(1)

Question of Clarification

"(e) RULES RELATING TO STOCK ACQUIRED FROM A DECEDENT. -

"(1) BASIS. - In the case of stock of a foreign investment company acquired by bequest, devise or inheritance (or by the decedent's estate) from a decedent dying after December 31, 1962, the basis determined under section 1014 shall be reduced (but not below the adjusted basis of such stock in the hands of the decedent immediately before his death) by the amount of the decedent's ratable share of the accumulated earnings and profits of such company. Any stock so acquired shall be treated as stock described in subsection (c)/"

COMMENT: If the alternate valuation date is used for estate tax purposes, the Committee Report (Technical Explanation, p. A119) states that earnings and profits accumulated up to the alternate valuation date are to be included within this basis reduction provision. The use of the phrase "decedent's ratable share of the accumulated earnings and profits" would not seem to support this interpretation.

SUGGESTION: The Committee suggests that the phrase "decedent's ratable share of the accumulated earnings and profits" be replaced by "the share of the accumulated earnings and profits of such company attributable to such stock, computed as of the date of the decedent's death, or in the case of valuation of the gross estate under section 2032, as of the date provided in that section."

Bill Section 15(a)(1) [I.R.C. §1247(a)(1) — Question of Limitation of Election to Distribute Income to Shareholders

"(a) ELECTION BY FOREIGN INVESTMENT COMPANY.

"(1) IN GENERAL. If a foreign investment company which is described in section 1246(b)(1) elects (in the manner provided in regulations prescribed by the Secretary or his delegate) on or before December 31, 1962, with respect to each taxable year beginning after December 31, 1962, to

"(A) distribute to its shareholders 90 percent or more of what its taxable income would be if it were a domestic corporation;

"(B) designate in a written notice mailed to its shareholders at any time before the expiration of 30 days after the close of its taxable year the pro rata amount of the excess (determined as if such corporation were a domestic corporation) of the net long-term capital gains over the net short-term capital losses; and the portion thereof which is being distributed; and

"(C) provide such information as the Secretary or his delegate deems necessary to carry out the purposes of this section,

then section 1246 shall not apply with respect to the qualified shareholders of such company during any taxable year to which such election applies."

COMMENT: The Committee is at a loss to understand why foreign investment companies which qualify as such after December 31, 1962 should not be eligible to elect under this section so that their shareholders will be taxed in a manner analogous to shareholders of a domestic regulated investment company.

SUGGESTION: The Committee suggests that the following language be inserted after the phrase "on or before December 31, 1962": "or on or before the last day of the first taxable year in which it becomes a foreign investment company."

Bill Section 16(a)
[I.R.C. §1248]

Question of Necessity of this Section

COMMENT: In the future the earnings and profits of a controlled foreign corporation will be taxed currently to United States persons owning 10 per cent or more of its stock as provided in Section 13 of the Bill, i.e. to the extent of (1) income accumulated in excess of the needs of an active business operation and (2) passive income, which is not invested in less developed countries. In most cases of liquidations or redemptions, the applicable rates of foreign tax are such as to make the additional United States tax upon the declaration of a dividend (after application of the foreign tax credit) less than 25 per cent. In such cases §1248 would presumably be unnecessary as less tax would be payable by declaring a dividend of all of the accumulated earnings and profits prior to liquidation.

In situations where the income of a foreign corporation will not be taxed to U.S. shareholders under Section 13, the Committee does not believe that the revenue loss or the effect on the balance of payments is such as to warrant the addition of this Section to the Code.

SUGGESTION: The Committee suggests that Section 16 of the Bill be deleted in its entirety.

Bill Section 16(a)
[I.R.C. §1248(a)(b)]

Question of Retroactivity

"(a) REDEMPTIONS AND LIQUIDATIONS. - If a foreign corporation redeems its stock . . . or cancels its stock in a complete or partial liquidation . . . the gain of a United States person 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 accumulated after February 28, 1913.

"(b) SALES AND OTHER EXCHANGES. - If a United States person . . . sells or exchanges stock in a foreign corporation, then the gain recognized . . . shall be considered as gain from the sale or exchange of 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."

COMMENT: In the event that this Section remains in the Bill, the Committee is opposed to taxing the gain on disposition of shares of a foreign corporation as a dividend or as non-capital gain to the extent that such gain is attributable to earnings and profits accumulated before December 31, 1962. No other provision of the Bill pertaining to foreign corporations is made retroactive to this extent. The only other provision dealing with sales or exchanges of stock of foreign corporations (Section 15, dealing with foreign investment companies), taxes as ordinary gain only earnings and profits accumulated after December 31, 1962.

SUGGESTION: The Committee suggests that the last clause of §1248(a) and (b) be changed to read:

"(a) . . . to the extent of such person's proportionate share of the earnings and profits of the foreign corporation accumulated after December 31, 1962."

"(b) . . . to the extent of such person's proportionate share of the earnings and profits of the foreign corporation accumulated after December 31, 1962, and during the period the stock sold or exchanged was held by such person."

Bill Section 16(a)
[I.R.C. §1248(c)(1) and (2)

Question of Excessively Broad Applicability of Bill

"(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.

"(2) 10-PERCENT OWNERSHIP. - Subsections (a) and (b) shall apply only to a United States person who can be considered by applying the rules of constructive ownership of section 955(b), as being the owner, directly or indirectly, of 10 percent or more of the total combined voting power of all classes of stock entitled to vote of the foreign corporation at the time of the sale or exchange, or at any time during the 5-year period ending on the date of the sale or exchange."

COMMENT: In the event that this section remains in the Bill, the Committee is opposed to taxation of the gain on disposition of stock in a foreign corporation as ordinary gain or as a dividend merely because that corporation was a controlled foreign corporation at some time within the 5-year period preceding the disposition and merely because the person disposing of the stock was the owner (directly or indirectly) of 10 per cent of the voting stock of the foreign corporation at some time within that period. The Committee Report (Technical Explanation, p. A125) makes it clear that the status of 10 per cent or more ownership of voting stock and of the corporation being a "controlled foreign corporation" need not be contemporaneous. Accordingly, merely because more than 50 per cent of the voting stock of a foreign corporation was owned by United States persons on one day of a taxable year not more than five years before the date of disposition(see proposed Section 954(a)), the status of the corporation is in effect "contaminated" and any United States person who thereafter becomes the owner of 10 per cent or more of the stock is unable to dispose of stock without suffering ordinary income consequences except in the event of his death (to the extent the disposition is a redemption qualifying under §303).

If this Section must remain in the Bill at all, the Committee recommends that at the very least the person disposing of the stock be one who was a 10 per cent or more shareholder of the corporation at the time when it qualified as a "controlled foreign corporation" and that the time at which the corporation must have been a controlled foreign corporation be not more than two years prior to the date of disposition of the stock.

SUGGESTION: The Committee suggests that proposed §1248(c)(1) and (2) be changed to read as follows:

"(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 2-year period ending on the date of the sale or exchange."

"(2) 10-PERCENT OWNERSHIP. - Subsections (a) and (b) shall apply only to a United States person who can be considered by applying the rules of constructive ownership of section 955(b), as being the owner, directly or indirectly, on the date of the sale or exchange and also on at least one day during the 2-year period ending on the date of the sale or exchange on which the foreign corporation was a controlled foreign corporation, of 10 per cent or more of the total combined voting power of all classes of stock entitled to vote of the foreign corporation."

Bill Section 16(a) [I.R.C. §1248(d)] — Question of Undue Emphasis on Taxpayer's Burden of Proof; Application of Foreign Tax Credit

"(d) TAXPAYER TO ESTABLISH EARNINGS AND PROFITS. Unless the taxpayer establishes the amount of the earnings and profits of the foreign corporation to be taken into account under subsections (a) and (b), all gain from the sale or exchange shall be considered a dividend under subsection (a), or as gain from the sale or exchange of property which is not a capital asset under subsection (b), whichever applies."

COMMENT: The Committee believes that it is undesirable to emphasize the taxpayer's burden of proof in this manner, as any determination of the Commissioner generally is presumed to be correct. Since the fact of earnings and profits is one not necessarily within the control of the taxpayer, particularly if the corporation is no longer a "controlled foreign corporation" on the date of the sale or exchange and the taxpayer is no longer a significant shareholder, at the very least the taxpayer's normal burden of proof situation should not be aggravated by repeating it in the statute.

Furthermore, if the entire amount of gain on any sale or exchange is treated as earnings and profits because of the taxpayer's failure to meet his burden of proof, in the case of redemptions and liquidations it should be made clear that the entire gain will be considered as a distribution for purposes of the foreign tax credit as well.

SUGGESTION: The Committee suggests that subsection (d) be eliminated. If it is permitted to remain, the Committee recommends that the House Committee Report on the Bill contain the following statement at the end of the last paragraph on page A126:

"If under this subsection the taxpayer's entire gain is treated as a dividend under subsection (a), the earnings and profits of the foreign corporation are to be reduced by the entire amount of the gain and the taxpayer will be entitled to compute its foreign tax credit under §902, if applicable, as though the entire gain were a distribution of earnings and profits."

Bill Section 16(c) Question of Effective Date

"(c) EFFECTIVE DATE. - The amendments made by this section shall apply with respect to sales or exchanges occurring after the date of the enactment of this Act."

<u>COMMENT</u>: If the retroactive features of this Bill are permitted to remain, the Committee believes that it is only fair that some "grace period" be allowed for the disposal of stock in controlled foreign corporations by sale, liquidation or otherwise, free of the effect of this Section.

<u>SUGGESTION</u>: The Committee suggests that Section 16(c) be changed so as to make the Bill applicable to sales or exchanges occurring after December 31, 1962.

<u>Bill Section 20(b)</u> <u>Question of Inconsistency</u>
[I.R.C. §6046(a)]

"(a) REQUIREMENT OF RETURN. - A return complying with the requirements of subsection (b) shall be made by -

"(1) each United States citizen or resident who is an officer or director of a foreign corporation on January 1, 1963, or who becomes such an officer or director at any time after such date.

"(2) each United States person who on January 1, 1963, owns 5 percent or more in value of the stock of a foreign corporation, or who, at any time after such date

"(A) acquires stock which, when added to any stock owned on January 1, 1963, has a value equal to 5 percent or more of the value of the stock of a foreign corporation, or

"(B) acquires an additional 5 percent or more in value of the stock of a foreign corporation, and

"(3) each person who at any time after January 1, 1963, becomes a United States person while owning 5 percent or more in value of the stock of a foreign corporation."

<u>COMMENT</u>: The Committee does not understand why the acquisition of 5 per cent of the stock of a foreign corporation, or the acquisition of an additional 5 per cent, should be an event requiring the filing of an information

return under §6046 when at the same time only 10 per cent or more shareholders of controlled foreign corporations are to be taxed upon certain categories of its income under Subpart F of Part III of Subchapter N, only transactions with such shareholders are to be disclosed in the return to be filed pursuant to §6038, and only those who were 10 per cent or more shareholders of controlled foreign corporations are to be subject to ordinary income taxation on the disposition of stock of a controlled foreign corporation under §1248.

<u>SUGGESTION</u>: The Committee suggests that §6046(a) be changed to substitute "10 per cent" for "5 per cent" wherever the latter appears in that subsection.

<u>Bill Section 20(b)</u> <u>Question of Multiplicity of Returns</u>
[I.R.C. §6046]

<u>COMMENT</u>: There is no provision in §6046 directing the Secretary or his delegate to provide by regulations for the filing of only one return where more than one person is required to file a return with respect to the same foreign corporation at the same time. In view of the fact that a civil penalty of $1,000 is to be imposed for failure to file a return under § 6046 without reasonable cause, the statute should contain a direction to the Secretary or his delegate to prescribe by regulations that one return disclosing all relevant data filed by one person will be sufficient to excuse others required to file a return at the same time from so doing.

<u>Bill Section 20(b)</u> <u>Question of Inconsistency</u>
[I.R.C. §6046(c)

"(c) OWNERSHIP OF STOCK. - For purposes of subsection (a)(2) and (3), stock owned directly or indirectly by a person (including, in the case of an individual, stock owned by members of his family) shall be taken into account. For purposes of the preceding sentence, the family of an individual shall be considered as including only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants."

COMMENT: The Committee does not understand why a different set of attribution rules is prescribed for purposes of §6046. To reduce undue complexity, the rules contained in §318 should apply here as they do elsewhere throughout the Bill.

SUGGESTION: The Committee suggests that subsection (c) be changed to read as follows:

"(c) OWNERSHIP OF STOCK. For purposes of subsection (a)(2) and (3), the rules prescribed by §318(a) for determining ownership of stock shall apply."

Bill Section 19
[Proposed Chapter 25]

Question of Advisability of Provision

COMMENTS: The Committee has considerable misgivings about the soundness of the basic policy of tax withholding in this area. If the withholding system devised is simple enough so as not to burden unduly the Payor, it will almost necessarily result in massive over-withholding and in consequent hardship to countless small taxpayers. This will be particularly unfair since there will be substantial over-withholding in areas where there has been little abuse (trusts administered by corporate trust companies for example). In this connection we incorporate by reference and support the testimony at the hearings on H. R. 10650 of the representatives of the American Bar Association. If, on the other hand, provision is made to ease the burden on Payees, as has been done to a limited (but insufficient) extent in H. R. 10650, through exemption certificates, interim refunds and other devices, the system becomes unduly burdensome to Payors and very complicated from the standpoint of all concerned, including the Treasury Department.

The Committee is aware of the estimated substantial revenue loss resulting from the failure of some taxpayers to report all of their interest and to a lesser extent their dividends. However, the Committee invites attention to testimony submitted to Congress by Stanley S. Surrey and Joseph A. Pechman (See Volume I Tax Revision Compendium on Broadening the Tax Base submitted to the Committee on Ways and Means, Nov. 16, 1959) which shows that revenue loss in this area ranks no higher than 4th and 5th respectively in the list of areas of unreported income and gaps in the tax base. From that testimony, these areas are estimated as follows:

Entreprenurial (proprietorship, partnership, etc.) income	-	6.086	Billion
Farmers	-	5.8	"
Exempt Pension Plans	-	5.7	"
Interest	-	2.837	"
Dividends	-	.94	"

While the Committee agrees that continued efforts should be made to improve compliance in the reporting of interest and dividends because the amount involved is substantial and in the interest of fairness to complying taxpayers, the Committee believes that withholding of tax on interest and dividends is so burdensome that it should be adopted only as a last resort. The Committee believes that automatic data processing will, within a reasonable time, provide a satisfactory answer if supplemented by a reduction in the minimum amount reportable on information returns and by an increased collection effort. (In this connection, it should be borne in mind that notices to delinquent taxpayers can be machine produced through automatic data processing rapidly and in wholesale quantities). Moreover, the full effect of the recent prosecutions and educational campaign of the Treasury has not been felt. Accordingly, it is believed that taxpayer compliance which has been steadily increasing (with a consequent drop in the revenue loss) will increase even more rapidly in the not too distant future in the face of these developments.

<u>SUGGESTION</u>: The Committee recommends that the enactment of withholding provisions should be delayed until the Internal Revenue Service can appraise the effect of automatic data processing and the recent information campaign. After such a delay, the need for such provisions can be reconsidered in the light of the situation at that time.

MAY 1, 1962.

Re appearances with respect to legislation; section 3 of H.R. 10650.

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

DEAR SENATOR BYRD: The American Life Convention and the Life Insurance Association of America are two associations with a combined membership of 308 life insurance companies having in force approximately 94 percent of the legal reserve life insurance written in the United States and Canada.

Our two associations support the provisions of section 3 of H.R. 10650, permitting the deduction of ordinary and necessary business expenses in direct connection with appearances before legislative bodies and in communication with the members thereof.

This amendment to the Internal Revenue Code is supported both in logic and in equity. The present denial of a deduction for the expense of appearances before legislative bodies, both State and Federal, is inconsistent with the long-standing allowance of expenses which are ordinary and necessary in the conduct of a trade or business. The exception was carved out not by legislation but by administrative actions of the Treasury and court decisions for reasons which may have been valid at one time but have no applicability today.

The denial of the deduction can be justified only on one of two grounds, that such expenses cannot be ordinary and necessary in the conduct of a trade or business or that the presentation of views before legislative bodies is against public policy. Neither precept is tenable. Legislation today affects the most intimate details of many businesses and participation in the formation of this legislation is essential in many cases to the very existence of these businesses. As to the question of public policy, it could hardly be said that the exercise of rights guaranteed by the Constitution is against public policy.

The orderly processes of Government require the submission of views by those affected by legislation, and the denial of a deduction for ordinary and necessary expenses in the presentation of these views inhibits the free flow of information. Even such presentations which are clearly in the proponent's self-interest are necessary to the legislative process. As stated by the Supreme Court, "Indeed, it is quite probably people with just such a hope of personal advantage who provide much of the information upon which governments must act." (*Eastern Railroad Presidents Conference* v. *Noerr Motor Freight, Inc.*)

Section 3 of the bill is also needed as a matter of sound tax policy to overcome the many ambiguities and uncertainties that exist under the current law. Present regulations (sec. 1.162–15(c)) deny the deduction for "expenditures for lobbying purposes, for the promotion or defeat of legislation," etc., or for the portion of dues attributable to such activities on the part of an organization to which the taxpayer belongs, if these activities are "substantial." There are no workable definitions of the terms "substantial," "promotion or defeat of legislation," "lobbying," and the like. And it has become quite doubtful that satisfactory definitions can be developed. Taxpayers have great difficulty in determining which of their expenses fall within the exception. Problems arising before departments of Government often overlap legislative planning. Purely informational activity, the expense of which is deductible if necessary in the taxpayer's business, may be hard to distinguish from the "promotion or defeat" of legislation.

In the case of our own two associations, activity related to legislation frequently has little to do with its promotion or defeat, but is primarily for the purpose of providing technical assistance within the special competence of life insurance experts. Often our views with respect to legislative matters are submitted in response to the request of legislative committees or administrative agencies. When we do take a position on legislation, it is usually in the form of an appearance at a public hearing, it is always merely incidental to the broader business purposes of our organizations, and there can never be any question as to sponsorship. We think it clear that organizations thus established to represent the total interests of a business should be free from doubt as to their status and should be uninhibited when called upon to express the position of the business on legislative matters.

The proposed legislation contained in section 3 of the bill is quite modest in form. It is limited to appearances or the submission of statements to legislative bodies or their members and the communication of information within organizations to which the taxpayer belongs. As stated in the House report (p. 18), it would not permit the deduction of entertainment expenses in connection with the promotion or defeat of legislation or the organization of grassroots campaigns intended to influence legislation. Some of these expenses thus disallowed are ordinary and necessary and we believe that further consideration should be given to them. In any event, the present provision does not appear open to any conceivable abuse.

It may well be that a broader provision would be justified. Certainly the limited provisions of section 3 of the bill are necessary both to business and to Government. In view of this, we urge their favorable consideration by the committee.

Yours very truly,

AMERICAN LIFE CONVENTION,
GLENDON E. JOHNSON,
General Counsel.
LIFE INSURANCE ASSOCIATION OF AMERICA
EUGENE M. THORÉ,
Vice President and General Counsel.

COMMITTEE ON THE JUDICIARY,
Washington, D.C., April 27, 1962.

HON. HARRY FLOOD BYRD,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: The Antitrust Subcommittee of the Committee on the Judiciary, of which I am chairman, is currently engaged in a study of the concentration of ownership in communications media. The subcommittee is particularly concerned with the alarming trend toward newspaper consolidations in recent years with an attendant shrinkage in the variety of news and opinion available to the public in our democracy. For treatment in depth of current news, there is simply no substitute for the daily newspaper.

From the subcommittee's study to date, it is already clear that the loss of advertising revenues has been an important contributing cause of the many newspaper failures and consolidations in recent years.

I am concerned, therefore, over any legislation which would discriminate against newspapers as an advertising outlet.

Section 3 of the tax bill, H.R. 10650, would permit a tax deduction as a business expense for lobbying but would exclude any deduction for paid advertisements in newspapers urging or opposing legislation. Under the circumstances, I suggest that if there is to be a tax deduction for business expenses connected with legislation, section 3 should be amended to extend such a deduction to newspaper advertising as well as lobbying.

Sincerely yours,

EMANUEL CELLER, *Chairman.*

PUGET SOUND PLYWOOD, INC.,
Tacoma, Wash., April 30, 1962.

HON. HARRY F. BYRD,
Senate Finance Committee,
U.S. Senate, Washington, D.C.

DEAR SIR: With the Senate Finance Committee in deep study of new tax legislation it is my desire to inform you of a problem confronting our organization.

We are organized and operate as a true cooperative association, in the manufacture of plywood and other wood products. There being 285 members in the organization, and all have paid in an equal sum of money for the purchase of working shares in the company. Skilled labor as well as unskilled labor are paid the same wage rate, as this system of pay was agreed to at the formation of the organization.

Our bylaws provide for an advance for labor at the end of each month and at the end of each quarter 75 percent of the income less operating cost is paid to each member in accordance to the number of hours worked, in comparison to the total hours of mill operation. This could be 160 hours per month, or it could be 176 hours depending on market demands. The amount paid represents a patronage refund, and the value is based on total sales. At the end of each year the totals for the year are computed and the remaining balance of 25 percent is paid to all members in accordance to their participation.

H.R. 10650, as now being considered by the Senate Finance Committee, section 1388 "Definitions; special rules"; the term "patronage dividend" should be broadened to include services rendered by members of the cooperative association as this language was included at section 1392 of H.R. 7875 of the 86th Congress.

Individual members of this organization who have contributed their time and money, have worked hard for their own economic betterment, are getting tired of having the cloud of uncertainty hanging over their heads, with reference to taxes through no fault of their own. This is a business form of organization with democratic ownership and control, working together as a group, receiving benefits in proportion to participation. The motive is to grant the maximum income to those who produce for a lawful organization. There should be no limit to one's earning power, so long as he does not exploit others in the procedure.

Trusting you will give this your utmost consideration, I beg to remain,

Sincerely yours,

A. G. Idso,
Chairman of the Board.

General Principles and Problems of Cooperatives

(By Archie G. Idso, Puget Sound Plywood, Inc., Tacoma, Wash.)

In behalf of the members of Puget Sound Plywood, Inc., a brief résumé might be in order to inform what a cooperative is and how it works. A cooperative association is an organization designed to carry on lawful business for the benefit of its members. Such organization may or may not be incorporated but it differs from other business organizations because of three basic principles. These govern all true and complete cooperatives: (1) The cooperative association belongs to its members rather than outside interests and creditors; (2) these members exercise democratic ownership and control of the organization; and (3) the allocation or distribution of earnings belong to its members and is distributed on patronage and not on ownership basis.

A cooperative may take many forms and serve many functions—processing, marketing, purchasing, to name a few. It matters not what type organization we have—the degree of what one might call completeness of cooperative control depends largely upon the degree of adherence to this principle.

A cooperative association is unique. It is an organization of neighbors working together with their own hands, their own tools, their own minds, for economic freedom, security, self-reliance, and self-respecting true Americans, doing together what none could do alone. An examination of the legal requirements and prevailing organizational practices of cooperative associations will, however, reflect certain underlying factors which set them apart from private organizations.

Another important difference between a cooperative association and a corporation can also be noted: An association operations for the benefit of its members who produce or patronize its business (give support) and not for those stockholders who have investments in the organization. Cooperatives always pay what they can while proprietary businesses pay what they must. In a cooperative association the members bear all risks.

In reference to Puget Sound Plywood, Inc., it was the desire of its members to improve working conditions, by free and uninterrupted flow of collective action, by avoiding work stoppage and other common labor troubles. They have banded together so they may help each other, without exploiting others.

PUGET SOUND PLYWOOD, INC., ORGANIZATION AND OPERATION

The free enterprise system here is America has brought this Nation to a position of preeminence among other nations in a comparatively short period of time. It was the belief of a group of responsible citizens of this immediate area that an enterprise established under the cooperative system provided in the association laws of the State of Washington would be a fitting contribution toward our Nation's growth and economy, with the firm belief that the Federal Government guarantees opportunity, and being a free nation people accept the responsibility for their own welfare.

The result of a series of meetings by interested persons was the formation of what is now Puget Sound Plywood, Inc., organized under the Cooperative Association Act of the State of Washington, which is chapter 19 of the Session Laws of 1913, and is codified in the Revised Code of Washington as chapter 23.56. People do not purchase stock in Puget Sound Plywood, Inc., as an investment but as a membership fee in a cooperative association so they may be assured of steady employment at wages in excess of those paid to employees in proprietary corporations.

The first shareholders' or potential shareholders' meeting was held May 18, 1941. Before the building was completed, and months before operations were to begin, the membership voted to pay $1.50 per hour for straight-time hours and pay overtime rate for work over 8 hours in one day and over 40 hours during the same workweek. This was necessary in order to obtain personnel to operate the machines when operations began. This being a cooperative organization all wages were at the same rate per hour for the skilled as well as unskilled labor. All workers were required to own equal shares of stock, and the rate of pay was well above the prevailing scale except that of other cooperative mills.

During the "wee" years of operation, it was incumbent upon this company to be governed by the regulations of the Wage Stabilization Board and other wartime agencies until terminated. Our wage rate was reviewed by the Wage Stabilization Board, and the wage rate was considered fair and equitable even though it was a higher rate than the prevailing scale.

Following the close of the war and termination of the Wage Stabilization Board, being a cooperative enterprise, organized for the pecuniary benefit of its members, taking into consideration the market outlook, cost of living, and other results of inflation, pursuant to the powers granted within the bylaws of the organization, acting with prudence and zeal, the board of nine directors chose to increase the wage rate so the members of the Puget Sound Plywood, Inc., could be in better position to meet their obligations.

The fieldmen of the Audit Division of the Internal Revenue Service, in making their routine audits, made inquiry in reference to our system during the early years of operation, but never called into question the authority of the board of directors to regulate the affairs of the company, even if they appeared to be unusual. Changes of personnel within the Revenue Bureau, we now find some will accept while others will frown on the same subject. This creates a difficult task for a taxpayer to solve. Of the huge number of employees within the Internal Revenue Service, it would be a mistake for a taxpayer to believe they all possess infallible judgment. Through all the years of operation no attempt was ever made to hide the fact that Puget Sound Plywood, Inc., was anything other than a cooperative enterprise engaged in the manufacture of plywood and other wood products not in the exempt class, but in a technical sense the corporation is but an instrumentality for the collective operation of the members, without profit to itself. Rates of pay were fixed in advance by the board of directors for services rendered. Services of the association are furnished or made available primarily for the use of the members.

This is a small business; the money distributed in the form of wages has stayed in the area to bolster the economy of other enterprises. By purchases of the necessities of life such as new homes, appliances, automobiles, etc., the excess over business was subject to tax at corporate rate. Taxes were computed at proper time and paid as required by the code.

Our system of distribution has gained recognition by the local banks as a very fine contribution toward local economy.

Sometime during 1952 our tax return was examined by the Revenue Bureau for the year 1951 and a substantial amount paid as wages was disallowed by this procedure. We found ourselves trapped by our own Government, while it was the firm belief of the board of directors that they had full control of the affairs of Puget Sound Plywood, Inc., and among the affairs was setting wage rate for the members. The year 1953—a year in question—total compensation paid was $2,202,518 and of this amount $1,060,579 was disallowed. This has the same effect as establishing a maximum wage—that Congress has never attempted to do. None of the total compensation was lost by the Government; it went to 285 families and was subject to personal tax. The power of the agent to substitute his judgment for the judgment of the board of directors where elements of dividends or gifts are not involved, to determine compensation for service rendered, is a regrettable practice and one that is not justified under correct interpretation of the statutes.

With the disallowance of the basic rate of $3.50 per hour set by the board of directors, and as the cooperative theory was deeply entrenched within the organization, it was decided at a general meeting of the members to alter our system of compensation. To avoid further conflict with the Internal Revenue Bureau provisions were set forth to allow an advance for labor each month and margins of the association are computed each fiscal year and periods thereof in accordance with sound principles of accounting. Such margins are determined four times each year. As soon as practical after the last day of March, June, and September in each year, three-fourths of the margins in the preceding quarter are refunded to the members as soon as practical after the 31st of December of each year; all margins not refunded during the fiscal year are refunded to the members. Each member is entitled to receive refunds of margins as provided above in proporation to the number of hours worked by him, in comparison to the total hours of mill operation.

The board of directors is empowered to determine whether the refund of margins shall be all cash, or part cash and balance in certificate of indebtedness, for the purpose of establishing or adding to a reasonable reserve for adding to or replacing worn equipment. Certificates of indebtedness bear 4 percent interest and are due and payable at the end of 5 years.

During the spring months of 1961 a ruling of the Revenue Bureau was issued to the effect that patronage based on man-hours worked for a cooperative association are not true patronage dividends, notwithstanding that a preexisting obligation was entered into by each member. The very heart of a cooperative association is the provision that the earnings of enterprise belong to those who produce it, and that the corporation is but an instrumentality. Unless legislative relief is forthcoming from this present Congress, a necessary and honorable enterprise will be destroyed by the very Government that was designed to give protection, and the livelihood of 285 families along with their investment will be taken away.

With Congress at the present time considering amendments to the 1954 Revenue Code, it is urgent that the Senate Finance Committee insert new language to broaden the law in part III, section 1388, at line 12, page 173, of the printed bill, as follows:

"(a) Patronage dividend" (line 16), "(1) on the basis of quantity or value of business done with or for such parton," should include "services rendered by" to make it workable in our operation, these provisions were included H.R. 7875, 86th Congress.

The profit motive—that is the lure of gain, the hope of reward—is the heart of the American plan and the base of the capitalistic system. By what logic can some insist that the rewards be restricted to some and not to all? It has been demonstrated from the beginning that operation by members of a cooperative enterprise is a modification of the wage system, which removes the laborer from his status as a simple earner of fixed wages, who has no further interest in the business beyond securing maximum regular wages, and converts him into the relationship of a partner, to the extent that profits realized by the company are a direct benefit of the producer. On what grounds can a legislative committee deny to that cooperative the reward, this being the result of the cooperative effort of a group of people working under one roof?

(Whereupon, at 12:20 p.m., the committee adjourned, to reconvene at 10 a.m., Wednesday, May 2, 1962.)

REVENUE ACT OF 1962

WEDNESDAY, MAY 2, 1962

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

The committee met, pursuant to recess, at 10:15 a.m., in room 2221, New Senate Office Building, Senator Harry Flood Byrd (chairman) presiding.

Present: Senators Byrd, Kerr, Douglas, Gore, Williams, Bennett, and Curtis.

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

The CHAIRMAN. The committee will come to order.

Senator CURTIS. Mr. Chairman, I have recently received a letter from an esteemed and distinguished member of the House Committee on Ways and Means, Congressman Jackson E. Betts of Ohio. Mr. Betts' communication pertains to the tax bill now before us and refers specifically to a discussion of the question of whether or not any of the pending proposals dealing with foreign income would be violative of any of the tax treaties now in effect to which the United States is a signatory. Mr. Betts' letter also transmitted a communication he had received from the Department of State on this subject. I believe that Mr. Betts' observations warrant the careful consideration of the membership of this committee, as well as the Members of the Senate in general, and I ask unanimous consent that his communication and the attachment thereto be included in the record at this point.

The CHAIRMAN. Without objection, the letter and attachment will be inserted in the record.

(The letter and attachment referred to follow:)

CONGRESS OF THE UNITED STATES,
HOUSE OF REPRESENTATIVES,
Washington, D.C., May 2, 1962.

Hon. CARL T. CURTIS,
U.S. Senate, Washington, D.C.

DEAR SENATOR CURTIS: I am writing to commend you for the very excellent series of commentaries you have recently made on current administration proposals to increase the tax burdens imposed on American free enterprise operations in world commerce. Your perceptive analysis of the contribution such commerce makes to the creation of American jobs, to improvement in our balance-of-payments position, and to the fulfillment of our commitments to our free world allies has done much to reveal the confusion and concern arising from the Treasury recommendations.

During the time the Committee on Ways and Means was considering these Treasury tax recommendations that were later included in H.R. 10650, I became concerned over the risks and dangers that could result from a precipitous and unwise shift in the ground rules covering the taxation of American business endeavors overseas. One of my concerns in this regard was derived from the assertion made by many informed persons to the effect that certain of the Treasury proposals would result in the United States unilaterally dishonoring its treaty obligations.

On February 23 I wrote to the Department of State asking that agency for a legal opinion as to the validity of the allegations that the tax proposals did involve treaty violations by the United States. I did not receive a responsive answer to my inquiry until April 11, 1962, which was after the House had concluded action on H.R. 10650. A copy of the State Department's reply is attached to this letter.

The expression by the State Department was in fact a conclusion by the Treasury Department that the Treasury proposals did not entail a violation of our treaty obligations. This Treasury conclusion, apparently subscribed to by the Department of State, seemed rather remarkable in view of the numerous times the Congress has received Executive communications asserting that an action involving tariff commitments should not be taken because of treaty obligations or other forms of international undertaking.

I was dissatisfied with the authoritative quality of the arguments in the State Department letter seeking to establish that the Treasury foreign income proposals were not violations of our treaty obligations. Accordingly, I have consulted with several authorities in the field of international law in an attempt to make a careful study of this matter. I have concluded that H.R. 10650 conflicts with many of our treaties as well as raises a host of other knotty problems involving relations with our allies abroad.

For example, proposed section 21 of the bill provides that section 7852(d) of the 1954 Internal Revenue Code shall not apply in respect of any amendments made by the bill. Section 7852(d) in turn provides that no provision of the Internal Revenue Code of 1954 shall apply in any case where its application would be contrary to the treaty obligations of the United States in effect on the date of its enactment. Section 21 thus represents a complete reversal of our tax policy with respect to treaty obligations. In 1954 we were careful to honor our treaty obligations. In 1962 we propose to tear up all existing tax treaties to the extent that they are contrary to our new tax policies.

Also, we have treaties with 19 countries establishing exemptions from tax or rates of tax of less than 20 percent on interest and dividends paid to nonresident aliens. The language in section 19(c)(1) of H.R. 10650 abrogates all of these treaties, and will require withholding at the general 20 percent rate regardless of whether or not section 21 remains in the bill. Of course the nonresident alien may be entitled to a refund, but there has been imposed upon him the delays, burdens, and complexities involved in filing the necessary claims for refund.

Far more serious conflicts, however, are those involved under section 11, the so-called gross-up provision. Dividends from foreign corporations are, of course, included in income and subjected to tax at the full rate. Recognizing the undesirability of double taxation, however, our tax laws have long provided a credit for foreign taxes imposed upon the foreign income.

To illustrate, a U.S. parent corporation receiving a dividend of $100 from a foreign subsidiary computes a tentative U.S. tax of $52 and then applies a credit to the extent of the effective rate of foreign income tax paid by the foreign subsidiary. If the effective rate of the foreign income tax was 40 percent, for example, the U.S. parent would deduct a credit of $40 and pay an additional U.S. tax of $12.

Under proposed section 11, however, the U.S. taxpayer is required to gross-up the dividend to $16 by adding to income the related foreign tax of $66. His dividend income is therefore deemed to be $166 even though only $100 is ever received in the United States. The tentative U.S. tax on this is $86. Deducting a credit of $66 (40 percent of the grossed-up dividend), the U.S. tax under proposed section 21 is $20 instead of $12.

Section 11 of H.R. 10650 thus obviously changes very considerably the computation of the foreign tax credit. By increasing the U.S. income tax on foreign dividends, the gross-up provision reduces substantially the effect of the foreign tax credit. The question then arises, Does this conflict with any of our treaty obligations? I have concluded that the answer is clearly "Yes."

The Norwegian Treaty has been cited to me as a good example. Article XIV states:

"(1) It is agreed that double taxation shall be avoided in the following manner:

"(a) The United States in determining its taxes specified in article I of this convention in the case of its citizens, residents, or corporations may, regardless of any other provision of this convention, 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 this convention had not come into effect * * *."

This "reservation clause," reserving to the United States certain rights with respect to its own citizens, residents, or corporations, is followed immediately, however, by the following "limitation clause" making it perfectly clear that the foreign tax credit provisions are not to be altered without renegotiation of the treaty. This limitation clause states:

"* * * 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."

The Norwegian Treaty is only one of 13 treaties containing such a specific provision for the allowance of the foreign tax credit in its present form. Eleven of these treaties are with economically developed countries so that if the courts were to decide in the future that these treaties are to be honored, the anomalous result is that the gross-up provision would apply primarily to the less-developed countries, thus discriminating against those emerging countries. Of these 13 treaties, 7 were effective before the enactment of the 1954 code. If the new bill is not to contain section 21, section 7852(d) of existing law would clearly and expressly preclude any change in their provisions. As to the six post-1954 treaties the spirit of section 7852(d), if not its letter, would certainly require that they also be unaffected by the bill.

The Treasury arguments contained in the aforementioned State Department letter can be summarized as follows:

(1) The "limitation clause" in the treaties quoted above is not intended to require the application of section 131 in its exact form, but permits any "reasonable" amendment. This interpretation seems to read into the limitation clause both intent and language that simply are not there.

(2) Gross up does not involve section 131. This argument apparently assumes that the full credit under section 131 is being given, the only change being that the taxpayer's income is increased by the foreign tax of the payor corporation. In support of this argument reference is made to the "reservation clause."

There are several answers to this argument. In the first place, there are five treaties in which there is no reservation clause. Any distinction in the application of the gross-up provision based on the presence or absence of a "reservation clause" would be whimsical indeed. Secondly, this kind of reasoning is pure semantics. Lipservice is given to section 131, but only upon the condition of including in the taxpayers' income part of the income of the foreign subsidiary, a separate entity, with a net increase in tax burden. This argument is not only superficial, therefore, but if taken at face value, points up another serious issue; namely, the constitutionality of the taxpayer being forced to include in his income a part of the income of a separate taxable entity. One taxpayer may not be taxed upon the income of another. Furthermore, the reservation clause, itself, only permits inclusion in the basis upon which taxes are imposed "items of income taxable under the revenue laws of the United States."

(3) Finally, the Treasury argues that gross up involves a "favorable change" on the ground that the credit is increased, apparently relying on the fact that most of the treaties contain a "no restriction provision." Article XX of the Norwegian Tax Convention is an example:

"(2) The provision of the present convention shall not be construed to restrict in any manner any exemption, deduction, credit, or other allowance now or hereafter accorded by the laws of one of the contracting states in the determination of the tax imposed by such state."

This provision clearly does not grant any power to a contracting party to make the provisions of the treaty more onerous. It merely says that a contracting party shall not be restricted in according any allowance it wishes; i.e., in being more liberal. And any argument that the Treasury is being more liberal by allowing a higher credit under gross up is entirely specious. The higher credit is only obtained at the cost of unconstitutionally including income in the base of the tax, with a substantial net increase in tax burden.

In conclusion, section 11 clearly abrogates many of our treaties. The arguments to the contrary are not persuasive. But even if there were some technical basis for the Treasury position, we should honor the spirit of the treaties. As my colleague from Michigan, the Honorable George Meader said before the House during the debate on H.R. 10650:

"Before the eyes of world opinion the U.S. Government has held itself out as a champion of morality in world affairs. We have repeatedly called the Government of Communist Russia to task as a treaty violator. How can we continue to take this firm moral position if we ourselves disregard treaty obligations when it suits our purpose to do so?"

Mr. Meader's point would seem to be reason enough for eliminating the gross up provision from the bill. If more persuasion is needed, however, the practical results of any other course should be considered. If section 11 is enacted, and these 13 treaties abrogated, we must be prepared for similar treatment at the hands of other nations around the world. I am informed that most continental countries, for example, are particularly sensitive about modification of international treaties by internal laws, for they consider the former sacrosanct. Retaliation may be expected, therefore, and may not be limited to tax treaty obligations, but may involve also our important treaties of friendship, commerce, and navigation.

The present financial strength of many of our allies is in great part due to the efforts of American business, but they are now competing with us on even terms, or better. The time has come when they might well welcome an excuse to adopt our proposed approach and unilaterally abrogate treaties now preventing discrimination against our business abroad. The result would be to hamper our efforts to expand our foreign sales that are vital if we are to reduce our current deficit in balance of payments.

As a matter of morality we should not abrogate these treaties. As a matter of practically I submit that we cannot afford to do so. But if the decision is made to abrogate them, then it should be done forthrightly and not indirectly. It is unseemly for us to say we are going to honor our treaties if in fact we intend to dishonor them.

Sincerely yours,

JACKSON E. BETTS, *Member of Congress.*

DEPARTMENT OF STATE,
Washington, April 11, 1962.

Hon. JACKSON E. BETTS,
House of Representatives.

DEAR CONGRESSMAN BETTS: Reference is made to your letter of February 23, 1962, with which you enclosed a memorandum prepared by the International Telephone & Telegraph Corp. concerning the "gross up" proposal in the draft tax legislation. You inquired whether the statement on page 1 of memorandum that "gross up" would violate the provisions of 13 treaties entered into by the United States for the avoidance of double taxation on income is accurate.

You were informed by letter dated March 6, 1962, that the Treasury Department is the appropriate agency of the Government to determine the effect of "gross up" on the tax treaties and that a substantive answer to your inquiry would be made after consultation with the Treasury Department.

This Department has received from the Treasury Department a letter dated March 29, 1962, in which the following statements are made in regard to the above matter:

"The statement in the memorandum of the International Telephone & Telegraph Corp. to the effect that 'gross up' would violate the provisions of 13 income tax treaties is not accurate in the view of the Treasury Department. The statement is probably based on an argument raised elsewhere that the violation would occur because of the agreement of the United States in certain of its treaties that the foreign tax credit as in effect on a particular date will be applied to taxes paid to the other signatory country. Aside from the fact that these provisions do not require the continuance of the exact credit provisions in effect on such dates but only require that a reasonable and effective foreign tax credit be accorded in good faith under our tax law, this argument is not relevant to the 'gross up' provisions of H.R. 10650. The United States does not limit in its income tax treaties its right to determine the tax base of U.S. citizens, residents, and domestic corporations. In fact, in most treaties, the United States expressly reserves to itself the right to determine the basis upon which U.S. tax may be imposed. The 'gross up' provision relates to the amount of income to be included in gross income of U.S. shareholders with respect to distributions from foreign corporations. The 'grossing up' of this income is therefore within this retained right and cannot be considered to be in violation of any of the treaties. The changes in the credit provisions themselves as a result of H.R. 10650 are to increase the amount of foreign taxes which may be credited with respect to dividend distributions and this, being a favorable change, cannot be considered as violating the obligation of the United States with respect to the allowance of a foreign tax credit. Let me assure you that this matter was given the most careful consideration and review by the Treasury Department prior to its recommendation of the 'gross up.' "

If I can be of further assistance to you, please do not hesitate to call on me.

Sincerely yours,

FREDERICK G. DUTTON, *Assistant Secretary.*

The CHAIRMAN. The first witness is Mr. Norman A. Lang of the United States Gypsum Co.

Mr. Lang, take a seat, sir, and proceed.

STATEMENT OF NORMAN A. LANG, ASSISTANT SECRETARY, UNITED STATES GYPSUM CO.

Mr. LANG. Mr. Chairman, my name is Norman A. Lang. I am assistant secretary and head of the tax department of United States Gypsum Co.

I have with me, Mr. Chairman, Mr. David Dickinson, of company counsel.

Our company objects to the passage of sections 11 and 13 of the bill which have to do with taxation of income of foreign subsidiaries. Our principal business is the mining of gypsum and the manufacture of the mineral into gypsum plasters, wallboard, and building blocks for use in construction and other gypsum products for industrial use. We operate gypsum mines and plants in some 20 locations throughout the country.

Our principal foreign subsidiary is a Canadian company which also mines gypsum and manufactures it into various gypsum products for sale in Canada.

I. BASIC OBJECTIONS

Our basic objection to these provisions of the tax bill is that they are largely economic in character rather than revenue producing. These provisions are designed to encourage investment in some foreign countries which the President determines from time to time to be "less developed." And, at the same time, it discourages investment in developed countries because it would tax the profits of the foreign subsidiary at a higher total rate than the local competitor has to pay. The bill, of course, does not say we should not invest in factories in foreign countries that are developed, but it places our foreign subsidiaries in those countries at a competitive disadvantage. It is easy to say: "What is the difference between a dollar earned in the United States and a dollar earned by a foreign subsidiary? Why should not both of these dollars be taxed in the United States at the same total rate?" The plain answer is that the dollar earned in the United States is earned in competition with companies that are subject to the same tax rates, whereas the dollar earned by the foreign subsidiary is earned in competition with foreign competitors which pay only the taxes of that country.

II. THE REASONS GIVEN FOR THESE SECTIONS ARE UNSOUND

The provisions of sections 11 and 13 of this bill are not directed to any basic fault in our tax structure. The various reasons given for these provisions are basically unsound and I mention three.

(*a*) *Tax havens*

It has been said that their purpose is to eliminate tax havens, as though every foreign subsidiary were organized and operating to take advantage of lower taxes in some foreign country.

But there must be thousands of foreign subsidiaries conducting legitimate businesses in many foreign countries, with large capital investments, which were not created and are not operated for tax considerations. The reason they were created was to take advantage of a market for the kind of products they manufacture and to make money and return the profits to the parent company. Yet, this tax bill affects those companies as well as the companies organized and utilized primarily for tax advantages.

Our Canadian Gypsum Co. has been mining gypsum and making gypsum products in Canada since 1927. It is certainly not a company formed or operated to take advantage of the tax laws. Nobody could call Canada a tax haven, yet the bill operates on Canadian subsidiaries as well as others. The tax haven reason for the bill is not justifiable. If there is real abuse, that should be specially treated and the bill should be limited to that area.

(*b*) *Equalization with foreign branches*

The proponents of the bill have said that the legislation is necessary to equalize the tax treatment of foreign subsidiaries with foreign branches, but that reason is also unsound. It ignores U.S. tax advantages of foreign branch operations. These advantages are so substantial that foreign subsidiaries may well operate at a tax disadvantage. For example: The Internal Revenue Code allows as offsets against branch income: percentage depletion, intangible drilling and development costs, foreign exchange losses on local currency working capital, net operating losses and the myriad of other deductions available to domestic corporations. None of these tax advantages is available to foreign subsidiaries. If equalization is truly the administration's aim, then U.S. tax deductions currently available to branch operations should be extended in full to foreign subsidiaries.

(*c*) *Tax neutrality*

This committee was told at the start of these hearings that the bill was necessary to achieve tax neutrality, and that was explained to mean that income earned abroad should be subject to the same tax rate as income earned in this country. But this is very questionable, because the foreign dollar of income which this bill would tax is not the same dollar of income that the domestic corporation or the foreign branch might report for tax purposes. The income of the foreign subsidiary has not been accorded the same tax deductions that domestic or foreign branch income has been afforded. For example: Our Canadian subsidiary is not accorded depletion in Canada on as favorable a basis as we are accorded depletion in the United States. If we could operate our Canadian mines as branches, we would be entitled to the U.S. rate of depletion and the Canadian dollar of profit might then be comparable to a domestic dollar of profit. But, because we sell our products to the Canadian public, we have to operate as a Canadian company. Therefore, the tax neutrality argument is wrong because it attempts to compare different kinds of profit dollars.

III. OUR FOREIGN SUBSIDIARIES WOULD OPERATE AT A DISADVANTAGE

This bill, if enacted, would place our legitimate foreign factories at a distinct disadvantage with our foreign competitors and not stimulate any export trade. For years, this country has encouraged business to invest in plants abroad and has accorded foreign subsidiaries an equal tax basis with the foreign-owned plant. Thus, our foreign subsidiaries pay the same taxes that our foreign-owned competitors pay and we have the same opportunity to use the balance of the profits for enlargement, modernization, and diversification. These foreign income provisions would undoubtedly discourage the ownership and operation of foreign subsidiaries by U.S. companies which have contributed substantially to our economy.

Furthermore, if there is any idea that taxing subsidiary income whether or not distributed as a dividend would stimulate exports, I can assure you that it would not result in the export of a single ton of plaster or a single foot of wallboard, because those materials are not exportable. The cost of exporting them is ordinarily prohibitive.

IV. THE PROPOSED LAW IS PRACTICALLY INOPERABLE

The provisions of the bill as drafted are not only confusing but extremely uncertain. The bill would give the Treasury Department such power over the operation of a foreign subsidiary that no company could be certain how it could operate and what its tax bill would ultimately be. Let me give you some examples:

Certain foreign income is not to be included in gross income if reinvested in the foreign company's existing trade or business. This is to be decided administratively by someone in the Treasury Department. What is an existing trade or business and how far can a company diversify and still be in the same trade or business? One of our competitors in Canada manufactures and sells gypsum products and also makes brick, and it might be desirable to go into the brick business ourselves as a competitive step. Is this the same trade or business because the product is used in construction? Would any material used in construction be the same trade or business? Or are we to be limited to another gypsum plant? The concept of the term "same trade or business" could differ with different people, at different times. It could differ with different revenue agents, and even with the same man at different times.

Another example is: Money that is ordinary and necessary to the active conduct of the foreign subsidiary's trade or business need not be included in the parent's gross income. How much of our Canadian profits could be kept as working capital to meet payrolls, extend credit, and give long-term stability to the enterprise? Some revenue agent will make these determinations. Will they be the same from year to year? Will they be the same for my company as for my competitor? Where are the standards that are to be applied? And how can a revenue agent in this country determine what proper working capital of a Canadian enterprise should be?

Another example: How is earned income of the foreign subsidiary to be determined—by our laws or by the laws of the foreign country, or by a combination?

Another example: Certain income of the foreign subsidiary need not be included in gross income if invested in a "less developed" country, to be determined by the President. Obviously, we cannot make a decision to invest in a "less developed" country until the President has chosen the "less developed" country. What is a "less developed country"? The bill gives no standards. What is to prevent a country being declared "less developed" one year and taken off the list the next year, and leave my company with a half developed enterprise?

These are but a few examples of the way in which this bill turns over to administrative decision questions for which the bill provides no standards, so it becomes a great guessing game, and a very dangerous guessing game. The bill creates power in men—where it should provide standards.

The bill in its present form will develop a mountain of litigation, and the administrative costs to the Treasury will be staggering. Even if it is admitted that taxing the income of a foreign subsidiary before it is declared out as a dividend is necessary and economically sound, the incredible complexity of these foreign tax provisions is enough, standing by itself, to warrant its rejection.

V. DOUBLE TAXATION ON ROYALTIES

Imputing income by way of fees for royalties can very definitely subject a company to double taxation. The imputed royalty will undoubtedly not be deductible under foreign jurisdictions, but undoubtedly will be taxable in the United States. In addition, the provisions in the bill can also result in imputing income where an adequate purchase price already has been paid by the foreign company. Again, the present code section 482 contains adequate machinery for preventing abuses in this area.

VI. IT OVERTURNS 50 YEARS OF PRECEDENT

This bill is completely contrary to a fundamental principle of our tax law that a corporation's income is taxed to its shareholders only when actually distributed to them as dividends. The corporate identity has always been recognized for tax purposes, the only exception being in the clear abuse situation which produced the foreign personal holding company provisions. Sections 11 and 13 of the bill overturn a rule of 50 years standing and treat bona fide foreign operating subsidiaries and their shareholders as one and the same for tax purposes. Both sections would require a shareholder to report as his income, amounts which he had not received and which he may never receive. Is that fair? There is no reason whatsoever for such a radical and sweeping change in our basic tax philosophy.

Only 2 years ago the House of Representatives passed H.R. 5, which would have liberalized the present rules for taxing foreign income. Has there been such a pronounced change in the situation since that time as to warrant a drastic and wholesale reversal of the policy which prompted H.R. 5?

In my opinion, this bill represents a departure so great from prior concepts of a fair distribution of the costs of Government that it requires a great deal more time and debate than this bill has had. This is particularly true with an administration promising a rather sweeping revision of the tax laws later this year. May it not be asked properly then, why the pressure to put through this bill at this time only a few months ahead of an announced broad revision of the tax laws? The bill does not accomplish certainty of tax liability, rather, and seemingly by design, it seeks to place judgment decisions in many areas of business operations increasingly into the hands of Government officials to be exercised in accordance with the foreign policy of the moment. This bill should be defeated; and if the Congress feels it necessary to reconsider the foreign income tax provisions at another time, this can better be done next year as part of the overall review of the tax law. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, Mr. Lang.

Senator Kerr.

Senator KERR. Mr. Lang, I heard a good deal of your statement and I think I got the tenor of it.

So far as my participation in the deliberations on this bill is concerned, I would be better off arriving at a conclusion to substantiate the position that I might take if I could hear more constructive discussion of how to accomplish certain purposes without creating inequities maybe as bad or worse than those now existing than by a statement which concludes that this bill should be defeated, and if Congress feels it necessary to reconsider the foreign income tax provisions at another time, this can be done better next year as a part of the overall review of the tax law.

It would seem to me there is a good deal of evidence before those affected that Congress feels certainly an urge and may be moving on the basis of some degree of intelligence, which is not altogether impossible, and they might have arrived at the conclusion that there is a situation that amounts to something approaching a necessity to reconsider or to consider the foreign income tax provisions.

You certainly have a very bad situation when an American industry can create a foreign corporation and have it buy all of the equipment which the American industry is using in this country, and then in this country lease from its own foreign subsidiary the equipment it is going to use over here in carrying on its business, and pay a rental to a foreign subsidiary which siphons off all of the profit on the transaction in this country, with the result that it makes a very substantial profit, but it is vested in a foreign-owned subsidiary, and none of it left here for taxation, and yet have an Internal Revenue Code that does not subject that profit thus siphoned off into a foreign subsidiary to taxation here.

Now, it also would seem to me that taxpayers, realizing that a situation exists where American insurance companies, if they so desire, can create their own foreign subsidiary and make reinsurance contracts with them whereby all the profit on the underwriting of the business is paid out to its own foreign subsidiary in the form of reinsurance premiums, and build up a very substantial nontaxed amount of money in a foreign-owned subsidiary on business which it does in this country and with reference to which no tax is paid here.

Now, I do not know much, but I know that a tax structure that permits those two things, which I happen to know are going on, creates a situation that would indicate a need for some adjustment, and your comment reminds me a little bit of the fellow who had acute appendicitis, but there was not anybody there but a veterinerian, and he said rather than have him mess with him he would wait until next fall when his physician got home, and his wife took charge of the situation and said she would rather he would die even with a crude operator trying to help him than die waiting for one who would not be there in time to do anything about it. [Laughter.]

I would like to hear some testimony on how existing abuses can be corrected rather than generalities, saying that this should not be done because you are going to be considering it next year anyhow, and why not just wait until then to do it.

Mr. LANG. Senator, I appreciate your concern very much. It is a concern that we all have.

I also feel very certain that there are abuses in this area. I think we all recognize that there are abuses.

I also feel there are very many more situations, very many more, that are in the area of legitimate business activities.

We have got to be careful what we do to the whole situation.

Senator KERR. I agree with that. I am just as anxious that we do not completely disregard it because some of the things suggested are not well founded.

Mr. LANG. Well, fine, I think we are in accord.

I think the other thing I am saying here is that I believe these meetings and these appearances that you are having, and the Ways and Means Committee has had, with the public are very purposeful and very good to try to get the objections first so that when the new bill, the work on the proposed new general revision comes up, the men can have the benefit of these hearings and these observations at that time.

Senator KERR. When the new bill comes up, if it does, suggestions are going to be made with reference to the whole realm of Federal taxation.

Mr. LANG. I appreciate that, Senator. But I would think in this particular area the question would be pretty well in hand and narrowed down to a point that it can give more substantial results, more substantial effective working position.

Senator KERR. You think after the House heard the evidence last year and we hear it this year, in the interim if we will hear evidence on all other phases of the tax law, that we will be so phenomenal in our mental capacity that we can recall the discussions of last year and this year, and consider them and implement them with reference to the matters covered by section 13 in a general tax bill, we will be in better position than we could to do it now?

Mr. LANG. Senator, I am just chiefly concerned as an ordinary individual and citizen——

Senator KERR. Let me tell you a little secret. That is all there are on this committee. It is just a group of ordinary citizens, see?

Mr. LANG. Yes. I am interested in having certainty in our tax laws rather than large areas of judgment by Government revenue agents, because this just provokes an enormous amount of controversy and litigation.

Senator KERR. Let us say that I agree with you, for the sake of the argument.

Mr. LANG. Yes.

Senator KERR. I still say that so far as I am concerned—and I am only one out of a lot of members up here—that I could do better in arriving at my own conclusions with statements, (1) recognizing that abuses exist under present law; (2) we have a very serious economic problem in an unfavorable balance of payments of gold which, unless arrested, is going to take this country off of what is even now more or less of a myth of redeeming foreign-owned dollars with gold, and having constructive suggestions here as to how abuses could be eliminated, how equity could be done, and how measures could be provided that would start moving us into the direction of retaining international solvency insofar as the balance of payments is concerned.

I want to tell you that if the present adverse situation with reference to the balance of payments of gold is continued, neither your investments nor anybody else's abroad are going to have anywhere near the same valuation that they have got today.

The soundness of your foreign investments has to be tied to the continued value of the dollar in international trade and commerce, and the value of that dollar, either with or without justification, is based largely upon the continuing ability of this country to make it redeemable in gold, and they can do that only if conditions are changed from what they are now.

You are talking about how your foreign operations are taxed. I am saying to you that unless that problem is solved, the way your foreign operations are taxed is going to be a matter of no moment or concern.

Mr. LANG. Senator, if I may add, I think we all share your concern about the stability of the U.S. dollar. I believe many of us in business feel that a contribution is being made to this very problem by these foreign subsidiaries, the ones that are acting in good faith. I am eliminating, obviously, those that are not operating in strict accord with the provisions of the existing code.

But these corporations, by taking advantage of worldwide business opportunities, are developing a type of earning and prosperity——

Senator KERR. Sure, they are; but they are doing it with American dollars at the rate of $3.5 billion a year, the value of which is based upon the assumption that they are redeemable in gold which, if we were required to make good on we could not meet.

Mr. LANG. But, Senator, that is a risk the business managements have assumed when they made these investments.

Senator KERR. I understand the business managements have assumed that. But Government has a responsibility in that regard.

Mr. LANG. To encourage anything that helps in this area as, I believe, these foreign subsidiaries do.

Senator KERR. I think the primary thing the Government has in that regard is just like the primary responsibility of a bank. A bank wants to maintain an environment in which it can make a profit. But the first thing a bank has got to do is to keep itself in position where it can meet the demands of its depositors for withdrawal, and when it permits its depositors to determine its policy for their individual benefit to the extent that it gets itself to where it could not be solvent under all operating conditions, it not only endangers itself but everything that its depositors have in it, and the Government is in that posture now, and it is there with reference to your dollars abroad or anybody else's dollars abroad.

Mr. LANG. And, Senator, don't you believe that business is in this same posture that you have described; namely, if managements cannot see a profitable continuation of their operations, they are most certainly going to take some steps to modify them, change them or, perhaps, eliminate them altogether?

Senator KERR. Yes, yes.

Mr. LANG. This is what you and I do not want to see happen.

Senator KERR. I would like to see them able to maintain their profitable operations abroad.

Mr. LANG. So would I.

Senator KERR. I am opposed to the principle of taxing income until you get it.

Mr. LANG. Thank you, Senator.

Senator KERR. But I will tell you this, that more important than either one of them is the ability of this Government to maintain itself, the integrity of its balance-of-payments operation.

Mr. LANG. No question about it.

Senator KERR. And when we get to where we cannot do that, and that is sufficiently recognized, I will tell you your foreign investments are liquidated.

Mr. LANG. Senator Kerr, let us not tie that situation up entirely with this foreign subsidiary problem because there are many other factors, of course, that are in the picture.

Senator KERR. You cannot separate them.

Mr. LANG. It is a factor, but there are many factors.

Senator KERR. You cannot separate them, any more than you can separate the operations of the depositor of a bank with the fiscal integrity and responsibility of that bank.

Mr. LANG. Well, in that area I would like to suggest then that these foreign subsidiaries, if they were without profit to these companies, they would not exist.

Senator KERR. I understand.

Mr. LANG. I think this is an area——

Senator KERR. But they are profitable so long as that dollar is stable, and if their operations have to be less profitable in order to restore solvency here, which requirement do you think should have priority?

Mr. LANG. Well, again, I come back to the separability of these things which, I think, is in that. There are other factors on the expenditure level as well as the subsidiaries which are involved in this matter of solvency.

Senator KERR. I have no further questions.

Mr. LANG. Thank you.

The CHAIRMAN. Senator Douglas.

Senator DOUGLAS. No, thank you.

The CHAIRMAN. Thank you very much, Mr. Lang.

Mr. LANG. Thank you, Mr. Chairman.

The next witness is Mr. Tyrone Gillespie of the Dow Chemical Co.

Take a seat, sir. You may proceed.

STATEMENT OF TYRONE GILLESPIE, ASSISTANT TO THE PRESIDENT, THE DOW CHEMICAL CO.

Mr. GILLESPIE. Mr. Chairman, my name is Tyrone Gillespie. I am assistant to the president of the Dow Chemical Co. of Midland, Mich.

Mr. Chairman, we would readily admit that there are desirable objectives and philosophies supporting parts of H.R. 10650, but we are of the opinion that this bill, and the suggestions of the Treasury, as a package would not be good legislation and do not meet the stated objective of the administration to stimulate the economy. Some parts of the bill would be harmful to our economy, and even some of the good objectives are wrapped up in cumbersome procedure which overcomplicate an already complex tax structure so seriously as to create injustice rather than benefit. This is our impression of the entire bill.

However, today we shall address ourselves only to the provisions of H.R. 10650 relating to changes in the proposed taxation of income earned outside of the United States, and the suggestions of the Secretary of the Treasury made before this committee on April 2 of this year.

We are impressed with the comment by the Senator from Tennessee, Mr. Gore, a member of this committee, and I shall quote from his remarks as they appeared in the Congressional Record on March 20:

> * * * The present session of the U.S. Congress may well be remembered by what it does or fails to do with respect to two very important measures which are now before the Congress. These measures are the tax reform bill and the trade expansion bill.
>
> These two measures are inextricably interwoven. Provisions of both bear on the same problems. * * *
>
> Ideally, the two measures should be considered in one single package. But we have become so accustomed to legislating piecemeal that we must, I suppose, continue this fragmentary procedure. Even so, the same legislative committees in both the upper and lower House have jurisdiction over both measures. * * *

We endorse this proposal and we hope this committee may give consideration to accepting the course advocated by Senator Gore to consider jointly the tax and trade expansion bills; or alternatively, that the provisions in H.R. 10650 pertaining to the taxation of foreign source income be included in the trade expansion bill rather than in the bill now under consideration. Either procedure would enable this committee to more readily see the complementary character of the two bills as they relate to international trade.

Senator KERR. May I interrupt, Mr. Chairman?

The CHAIRMAN. Yes.

Senator KERR. Do you endorse Senator Gore's position on both bills?

Mr. GILLESPIE. We endorse his position that the two be joined, so that the complementary character of the two bills and how they would operate together can be seen.

Senator KERR. Do you suppose it is conceivable that the members of this committee are unable to do that?

Mr. GILLESPIE. I do not know, sir. I would agree that the committee could certainly do that.

Senator KERR. I just wanted to know in view of the fact that you were endorsing the statement of the Senator from Tennessee, for whom I probably have as high a regard or maybe higher than you do, if you endorse his position on both bills.

Mr. GILLESPIE. No, sir; we do not endorse his position on the bills.

Senator KERR. All right.

Mr. GILLESPIE. We endorse his proposal that the bills be joined.

Senator KERR. You mean that the committee consider them in their relation to each other.

Mr. GILLESPIE. Yes, sir.

Senator KERR. Well, I want to give you assurance that so far as the Senator from Oklahoma is concerned it would be impossible for him to retain consciousness and not do that. [Laughter.]

Mr. GILLESPIE. Very good, Senator. Now, if we understand the arguments by the Treasury in support of changes in the taxation of foreign income, these fall in five principal categories:

(1) To achieve neutrality or equality of taxation between foreign subsidiaries of U.S. companies and domestic companies;

(2) To reduce the unfavorable balance of payments and the resulting outflow of gold;

(3) To stimulate investments in the United States;

(4) To increase U.S. exports; and

(5) To create more employment in the United States.

Senator Curtis, also a member of this committee, has, in well-reasoned and well-documented statements, issued a somber warning of the damage and dislocation inherent in these proposals to American business, and to our foreign relations. We have read his statements with care and we are persuaded that his warnings give cause for concern for the welfare of our country's foreign business and diplomatic relationships should this measure be enacted. We have heard this sentiment echoed many times by citizens and business leaders in recent days.

The Secretary of the Treasury has stated that the administration's primary purpose concerning the taxation of foreign income is not the raising of revenue. We recognize that this is not the first time that tax laws have been used for other than fiscal purposes; however I am sure that some of you gentlemen would agree that such use has inherent dangers, not the least of which is that the primary purpose of proposed legislation does not receive study by the appropriate congressional committee or committees. A serious precedent is created which throws unfair burdens on the committees responsible for revenue and taxation while other committees with particular responsibility are bypassed. This will eventually undermine time-tested congressional procedure.

That this bill is not designed as a revenue measure is confirmed by the Treasury estimates that when the provisions for the taxation of foreign source income under H.R. 10650 are fully effective, the gain in revenue would only be $145 million and with the additional provisions suggested by the Treasury, the increase in revenue is estimated at $310 million. The Treasury estimates do not include the adverse effects on the taxable income of domestic firms that would result from the loss of both domestic and foreign business generated oversea by foreign subsidiaries. It is most probable that these losses will more than offset the estimated increased revenues.

If, therefore, the recommendations will have the serious deterrent effect on American business abroad as has been predicted unanimously by the business witnesses before the House Ways and Means Committee and Senate Finance Committee, and will in fact be harmful to our foreign relations, the proposed changes can only be justified if they overwhelmingly serve the five purposes which we have outlined from the Secretary's testimony.

To assist this committee, we would like to analyze whether these purposes would be served, and attempt to estimate the results that would accrue if this legislation were passed. These predictions we would derive by extrapolations from our own experience.

It is our judgment that H.R. 10650 and the Treasury recommendations will not achieve the objectives which are argued for them.

The first proposition of the administration is that H.R. 10650 achieves neutrality of taxation. The administration has concentrated its attention on measures to produce neutrality of taxation between foreign subsidiaries of U.S. companies and domestic companies. This view does not take into account that tax neutrality has two separate and distinct aspects.

One aspect of neutrality is to assure American firms the opportunity to compete with foreign competitors without imposing upon them an added tax burden that will increase their costs and hamper their activities in the marketplaces of the world. The other aspect of tax neutrality is to assure that when earnings become realized income and repatriated to the United States, they then will bear the same tax burden as earnings derived from activities conducted solely in this country. Under our present tax system, which applies the tax when profit is reduced to possession or is beneficially received by the stockholders, there is achieved a rough neutrality from both standpoints. H.R. 10650 destroys both types of neutrality.

Taxation of a foreign subsidiary of a U.S. company can never be neutral with U.S. companies because the United States has no jurisdiction to tax the foreign subsidiary and must instead tax the stockholders who are incorporated in, or citizens of, the United States. This is the concept of H.R. 10650.

This will have the effect of enforced consolidation of accounting, overlooking separate legal entities, and net worth increases of subsidiaries must be embodied in the profit and loss statement of the parent. There will be great differences between such consolidation and the consequences of reporting of profit and loss on domestic corporations. Some of these are—

1. There can be no provision for a carryback or carryforward of losses;
2. There can be no provision for exchange losses and expropriation or inconvertibility;

3. There can be no equal treatment of allowances and incentives;
4. There can be no equal treatment for interest and royalties;
5. There can be no consistency of definition of taxable income;
6. There can be no provision for recognition of valid intercompany transactions;
7. There can be no recognition of capital gains and losses;
8. There can be no recognition of requirements imposed by local laws;
9. There will be no recognition that consolidation may be impractical, impossible, or undesirable from a business standpoint and consolidation is forced in order to levy a tax.

The above are some of the reasons why taxation of a U.S. stockholder on earnings imputed to a foreign corporation cannot achieve neutrality.

In effect, the philosophy of H.R. 10650 alters our concept of taxing realized income and applies an often rejected concept of taxing increases in net worth. A similar analogy would be to apply tax to an increase of paper value of stock before the stock is sold, which has never been done in the United States. Another comparison would be the taxation of an individual stockholder on the increase of net worth in the companies in which he holds stock. This concept is contrary to several decisions of the Supreme Court of the United States, which has held over the years that income consists not in an increase in the value of an investment, but rather from exchangeable value proceeding from the property, severed from the capital and received actually or constructively by the taxpayer.

We would call the committee's attention to the disturbing provision of the pending measure found in section 16 (p. 161 of H.R. 10650) which states that under certain conditions—

> the gain of a U.S. person 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.

This is taxation of net worth retroactively for 49 years at current tax rates on earnings accumulated during periods which the tax rates were either nonexistent or substantially lower. This one provision combines to very serious and unjust changes in concept. The first is unlimited retroactivity in taxation and the second is the application of penalty rates on prior accumulations.

This is a section which has only recently come to our attention. It is impossible to know at this time what other inequities may lurk within this complex and voluminous bill. For this reason we urge that the Congress incorporate the foreign income provisions, which at the conclusion of these hearings may be deemed important to correct inequities, into the foreign trade bill and the balance of the provisions into an overall tax reform bill which the administration has already announced it will submit to the Congress at a later date rather than enact them now as patchwork legislation.

If the foreign income concepts are enacted into law, our company and all other companies similarly situated will be faced with the severe problem of trying to determine whether the accounting principles and methods of our foreign subsidiaries are compatible with those in the United States, and whether in those cases where we have less than 100 percent ownership, it would be possible to do so in fairness, or at all, without full concurrence of other stockholders. In any case, it would be necessary to maintain two sets of records, one to comply with foreign law and one with U.S. law, and there is a question as to where such records should be kept.

In order to comply with U.S. law, much of the information will have to be estimated because data are not available under foreign accounting systems, and certainly companies will have a built-in and continuing argument with the Treasury Department as to whether their estimates are proper or improper. We are certain that the committee is cognizant of the vast enforcement costs which will be entailed for worldwide policing most of which will gain little revenue so we will not elaborate on this point.

Another question which gives us concern is our company's position if we disclose certain data and economic information of a company in a foreign country in which we are part owner, where the laws of the country prohibit such disclosure. Does this U.S. law force us to commit economic espionage and thereby render us liable under the laws of our host country?

These are but some of the problems that we foresee in trying to comply with the provisions of the law as set forth in H.R. 10650. There would undoubtedly be more if we were to gain further familiarity with it.

The next question is whether or not H.R. 10650 aids in the balance of payments and gold flow problem.

Certainly, if attractive investment opportunity exists abroad, the investment will be made. If it is not made by a subsidiary of a U.S. company with retained foreign earnings, it will be made by a U.S. company with earnings or capital exported from the United States; or if this is prevented, it will be made by a foreign competitor. In any of these three instances, it does not aid in the solution of the balance-of-payments problem, and insofar as the requirement is filled by a foreign competitor, our balance of payments is injured; and if filled by export of capital from the United States, the capital formation to support industry in this country is thereby lessened.

There is, of course, a partial answer, and that is foreign exchange control. Senator Gore, a member of this committee, has stated on March 20 that it might be necessary to institute exchange controls to restore our balance-of-payments position. He said, and I quote:

> Today we need some reasonable regulation—not the prohibition—of capital flows among countries, and I see no objection to our Government exercising reasonable control over the flow of funds into and out of the country. Indeed, in my view, this is necessary.

If foreign exchange control is instituted, the criteria to determine which transactions are in our interests and which should be prohibited, an important aspect of our oversea economic policy will be delegated to the control of appointed officials rather than to free enterprise economy. The United States has been for years the leader in advocating free convertibility.

In the light of much testimony both before this committee and before the House Ways and Means Committee, it was demonstrated again and again that U.S. companies have returned more funds than they have sent abroad, and our experience would confirm this testimony.

It must be emphasized that the administration's proposals were offered to improve our balance-of-payments position. Nevertheless, the Secretary of the Treasury concedes that after a period of time, these provisions will have an adverse effect on our balance-of-payments position.

Since 1953 the funds remitted to the United States by Dow's foreign operations have been approximately 10 times the outflow of capital funds. The inflow includes receipts for goods produced in this country that could not have been marketed without the assistance of our oversea operations as well as payments to us for goods, services, and similar transactions. Each year the inflow has been growing. We have not imported any products produced by foreign subsidiaries into the United States. We should point out that in many cases our foreign participation represents a contribution of Dow know-how, and in those cases there has been no occasion to transfer dollar exchange to a foreign country.

If the raising of revenue is not the major objective, and if the committee were to agree with our view that the purposes of neutrality of taxation and improvement of balance of payments are not served, let us look at the other three purposes:

Stimulation of U.S. investment; improvement of U.S. exports, and creation of more employment in the United States.

There has been much discussion about the stimulation of U.S. investment. We would simply say that it appears that adequate funds can be made available in the United States by domestic companies for new and profitable investment projects. However, these funds will be reduced by the amount U.S. companies must pay in taxes on unrealized foreign net worth. The problem with which we as a company are faced, along with many other companies in this country, is the underutilization of present capacity. The solution is not the provision of more capital to invest in plants where we have adequate capacity but rather to find more new and profitable investment opportunities. Increases in taxes, labor, higher costs of raw materials, and increasing competition from both domestic and foreign-owned companies have narrowed profit margins and reduced operating levels. Taxation of net worth of foreign subsidiaries cannot create new investment opportunities in the United States nor make modernization attractive economically. Thus the only argument which can be made is that by taxing U.S. foreign subsidiaries that American companies will try to replace them with exports or sell them to foreign interests. If the latter course should be followed the jobs, know-how, and markets will be lost as an asset to our country.

The position of the Treasury has been that if our foreign investment were reduced, our exports and employment in the United States would thereby materially improve. Dow's experience would not support this concept. In our company, more than 3,000 people and more than $70 million in investment in the United States are directly employed in support of our foreign activities. Should foreign investment become unprofitable due to Government intervention, our judgment is that 60 percent or more of the domestic people and facilities supporting foreign sales might be idled. These losses would reduce the taxable income in the United States and would more than offset the gains from the enforced consolidation of unremitted foreign earnings by reduction in domestic profits. We are positive that taxation on the proposed basis will not increase our ability to compete in world markets, which is the only way that additional exports can be attained.

Based on the above reasoning, it is our opinion that the provisions relating to foreign income of H.R. 10650 and the Treasury recommendations ancillary thereto will serve no purpose other than to give aid and comfort to Russia, who is seeking to penetrate foreign countries through the economic route. We are aware from articles which have appeared in various trade publications that the Soviet Union is seeking to establish subsidiaries within the European Economic Community. These subsidiaries are in furtherance of the Soviet objective of levying economic warfare against the West. The Russians do not object to "dumping prices" and must be regarded as fierce and major competitors in the business world. Any Soviet competitor located within the European Economic Community must be met by U.S. firms on a worldwide basis and the U.S. firms should not be forced to meet them with one hand tied behind their back.

Another special interest who would approve of this tax measure are the foreign competitors of U.S. business who will be eager to fill the vacuum caused by withdrawal of U.S. investment abroad.

We urge this committee to postpone consideration of the taxation of foreign source income as proposed in H.R. 10650 and supplemental suggestions by the Treasury Department until they can be considered in conjunction with the administration's Trade Expansion Act as suggested by Senator Gore.

The CHAIRMAN. Thank you very much, Mr. Gillespie.

Senator Kerr.

Senator KERR. Mr. Gillespie——

Mr. GILLESPIE. Yes, sir.

Senator KERR (continuing). In your statement you indicate that the Russians are dumping products in the European Economic Community and other places as their means of waging economic warfare, and that such dumping creates fierce competition for American companies competing there.

Mr. GILLESPIE. Yes, sir.

Senator KERR. Is that the thesis of that paragraph?

Mr. GILLESPIE. Yes, sir; that is part of it, sir.

I might also add I have an article here which, if there would be no objection, it is very short, I would like to insert in the record, which is an article from the Herald-Tribune of December 21, 1961, discussing how the Soviets are planning on putting in a big refinery in Bavaria, using Arabian oil, which would be severe competition to our American industry, in both the chemical and the oil industry, and if there would be no objection, I would like to insert that.

Senator KERR. Is there any objection, Mr. Chairman?

The CHAIRMAN. No objection.

(The document referred to follows:)

[From the New York Herald Tribune, Dec. 21, 1961]

SOVIETS PLAN BIG REFINERY IN BAVARIA

(By Gaston Coblentz, a staff correspondent)

BONN.—The Soviet Union is reported to have made contact with West German interests with a view to constructing a mammoth Russian oil refinery in Bavaria, southwestern state of the Bonn Republic.

The Soviet move is aimed at establishing the first major Russian-controlled industrial installation in Western Europe and simultaneously, at buttressing Moscow's mounting influence in the international oil market.

According to the forthcoming issue of the business journal German International of Bonn, the contacts have been initiated for the Soviet Union by the Banque Commerciale pour l' Europe du Nord, of Paris, and the Garant Versicherung A. G., of Vienna.

They are reported to have been discussing the project with prominent West German financiers and industrialists. The plan is said to envisage a refinery with a capacity of 6.5 million tons a year. This would make it the largest refinery in West Germany, larger than those operated by the major Western oil companies.

In selecting Bavaria as the location for the proposed refinery, the Russians are said to have been influenced in part by the state's relative proximity to the western terminals of the huge oil pipeline now under construction from the interior of the Soviet Union to the western fringe of Eastern Europe.

German International reported that the Soviet plan calls for the refinery to be 51 percent Russian-owned, the remaining 49 percent to be held by West German interests that are being invited to participate in the venture.

Senator KERR. Let us get back to my question, and the premise for it was, as I understood from you, that the dumping of products by the Soviet Union in the European Economic Community creates fierce competition for American businesses there.

Mr. GILLESPIE. Yes, sir.

Senator KERR. Do you think that any measure of this Congress can enable American companies there to successfully compete against dumping?

Mr. GILLESPIE. Yes, sir. I feel that we are in a position at the present time to give dumping some contest by virtue of building within the European Economic Community and building a steady market so that we have customers that depend on us, and as they depend on us, they will be less likely to buy product which is dumped on the market because they are more interested in the steady source of supplies than the dumped supplies.

So I think that the steady normal business approach that the companies from the United States have taken abroad will help in this problem.

Senator KERR. Well, now, you and I think we know something about the oil business, don't we?

Mr. GILLESPIE. I would not say I do, sir, but I will readily admit that you do.

Senator KERR. Well, I will readily admit that I do, and I am going to assume for the purposes of this discussion that you do, and if you did not, your outfit would not have you here.

How do you think American oil producers can meet the competition of the Russians in those areas where they just state as their purpose and follow along with actions of proving it, they are going to undersell American oil producers a dollar a barrel?

Mr. GILLESPIE. Well, I do not know that they are except that I would assume that in a large measure the American oil companies are using probably the same source of supply for the European market that the Russians may be using, in other words, the Arab oil.

Senator KERR. The Russians are using their own oil. They have vast oil reserves, and they are developing them as fast as they want to, and their supply far exceeds their own requirements, and the Government owns them.

If they start out, as they have in a number of other fields of enterprise, as a means of economic warfare, to engage in the practice of dumping to the extent that they do and for the period of time that they do and in the area in which they do it, I do not know any private enterprise that can continue to compete with them.

Mr. GILLESPIE. Well, you certainly would know about that, sir; and I would——

Senator KERR. Did you ever see a price war on gasoline?

Mr. GILLESPIE. We seem to have them recurrently in Detroit. This is a little distance away, but we do see them.

However, I would say this, Senator Kerr, could I ask you a question?

Senator KERR. Can you tell me what would happen to any oil company that continued to charge 31 cents a gallon for gasoline across from a filling station that is selling equally efficient and usable gasoline at 21 cents a gallon?

Mr. GILLESPIE. There is no question about it, the economics would control it.

Senator KERR. I have seen that tried, and it is amazing how few people drive in and pay 31 cents for gasoline one one corner when they can go across the street and get it for 21 cents. It is just amazing how few of them do it.

I have never seen a company yet that is able to keep a distributor more than 24 to 48 hours or any longer than he could hold him with a pair of handcuffs, if he could get them on him, to where he would continue to buy gasoline from one producer that made it necessary for him to charge 10 cents a gallon more than the fellow across the street.

When insanity enters into an economic picture, and that is what I call it, and, of course, with Russia it is not insanity, it is planned economic warfare——

Mr. GILLESPIE. No question about it, sir.

Senator KERR. And I would say this to you, if the killing of this bill would enable American competitors to meet the competition of the Russians in their economic warfare of dumping at the time and the place and for the period of time that they were dumping it, I would be among those to help try to kill it. But I think a fellow has his head buried in the sand if he thinks that it may be that European distributors are different from those in the United States. They might develop a sense of loyalty and a respect for a continuing source of supply that they would for an extended period of time pay you or any other American producer 40 percent or 50 percent or 30 percent more than they could get it somewhere else just in order to be able to get it a year from now.

But I do not know many in this country that would, if they could, and fewer that could if they would. They just would not be there.

Mr. GILLESPIE. Well, I bow to your superior knowledge of this certainly, Senator Kerr.

Senator KERR. You know as much about human nature as I do.

Mr. GILLESPIE. The question that would run in my mind, and the point that seems to be indicated here, is that in addition to their own oil the Russians would like to be buying oil from the Arab countries as a matter of foreign policy.

Senator KERR. That gives me some comfort because I thought their designs on it did not include paying for it.

Mr. GILLESPIE. Well, they intend to buy some from the Arab countries apparently, and I think to that extent Americans could compete as long as they were able to buy and sell in the European market.

But I agree that on their own oil you would have no defense.

Senator KERR. Or on the other if, as a matter of economic warfare, they decided to dump it on a basis that they are going to undersell the other fellow who is putting it there.

Mr. GILLESPIE. You could not do anything about that either.

Senator KERR. We haven't been able to keep the Japanese refineries using America's oil with Russia saying "we will sell it to you at 80 cents a barrel less when you fix their price."

I notice that we have not been able to do that in spite of the things we are doing for Japan.

Mr. GILLESPIE. Well, certainly the point——

Senator KERR. That is a very understandable manifestation of human nature to me.

Mr. GILLESPIE. That is true. The fact is they are trying to penetrate the Common Market and, apparently, are making some moves they have never made before in this direction.

Senator KERR. On page 5 of your statement you say that the other aspect of tax neutrality is to assure that when earnings become realized income and are repatriated to the United States they will bear the same tax burden as earnings derived from activities conducted solely in this country.

I presume you limit that to dividends or other similar returns?

Mr. GILLESPIE. Any kind of returns that would be beyond the net worth stage where it was being paid back to the parent.

Senator KERR. What kind of returns are there except those that come by dividends or liquidation?

Mr. GILLESPIE. I would assume that royalties and remittances of that nature, would be returns. But in any case, where the money is no longer in the possession of the subsidiary and comes back to the parent, it should bear the same burden of taxation as would be applied to a domestic company.

Senator KERR. Well, if your statement is addressed to the situation of the stockholder or an owner receiving income from an investment, I want to tell you that I agree with you, and that is the reason why I was asking you if that is what you did mean when you said that when earnings become realized income they will bear the same tax burden as earnings derived from activity conducted solely in this country.

You are talking about the return to the investor in whatever form he may get it?

Mr. GILLESPIE. That is right; yes, sir.

Senator KERR. In your statement, you say:

If attractive investment opportunity exists abroad, the investment will be made. If it is not made by a subsidiary of a U.S. company with retained foreign earnings, it will be made by a U.S. company with earnings or capital exported from the United States; or if this is prevented, it will be made by a foreign competitor. In any of these three instances, it does not aid in the solution of the balance-of-payments problem.

You are associated with a very great company that I have watched through the years and seen it grow from a position where it was not nearly the size it is now to its present rather substantial and expanded and enlarged position.

I wonder if it was ever confronted with an opportunity that it thought was a profitable opportunity or an opportunity for a very profitable investment, and was forced to decline making it because it did not have the funds available or felt that its fiscal situation was such that it would not be wise to make the effort necessary or meet the conditions that would be required to borrow capital that it did not have to make it?

Mr. GILLESPIE. Not if the opportunity were in the area in which we usually work, sir.

Senator KERR. Then you would have been——

Mr. GILLESPIE. In the past few years.

Senator KERR. Then you have been a very fortunate company. The one with which I have been associated has had to turn down far more opportunities for profitable investment than it has made because it did not have access to, it did not have the capital to make it, nor access to it in a manner that it thought would be consistent with fiscal safety and responsibility.

If your company has always been able to take advantage of every profitable opportunity that it saw or that came to it, I am surprised that it does not own the United States. [Laughter.]

Mr. GILLESPIE. Well, I put the limitation on it, sir, that we limit it to those in our fields of capability, we do not try to diversify too far and get beyond the fields of our capability, and the opportunities——

Senator KERR. You mean your technical or financial capabilities?

Mr. GILLESPIE. Our technical capability. Our fields of capability technically have so far offered all the opportunities we would like to have, and we are able to take care of those that do come.

Senator KERR. Well, you are still expanding your foreign operations, are you not?

Mr. GILLESPIE. Yes. Our foreign operations are expanding.

Senator KERR. How did it happen that you did not just happen to do them all at once?

Mr. GILLESPIE. Well, we did not have the technical capability to do them all at once.

Senator KERR. I see. You have always had the financial capability?

Mr. GILLESPIE. We have had the financial capability to take care of the needs of our technical capibility. [Laughter.]

Senator KERR. I believe I would a lot rather have the technical capability to take care of the financial capability than to have the technical capability that had to be supported by my financial capability. I believe it would be a more constructive foundation for growth. [Laughter.]

Then, your company is not an example of what I believe to be the general situation. I think there is a vast abundance of opportunity for profitable investment abroad and, for that mater, in this country. But in the discussion of the balance of payments, in my judgment, there is no relation between the two because we operate in this country with a system of managed currency, managed credit, that has enabled us to achieve the distinction, whether it is favorable or unfavorable, of having as of December 31, 1961, a total public and private debt of $1,070 billion of which some $30 billion is in the form of currency.

We are able to do that domestically because we create our own medium of exchange and operate on a system of managed credit which, while it has a mythical relationship to gold, for all practical purposes is totally disassociated from gold.

So with a total amount of monetary gold of about $16.5 billion against which there are some $19 billion in valid foreign claims now, aside from the legal requirement that we have got to have about $12 billion in gold to back up our own currency and our own Federal Reserve deposits, we have built an economy that, as of this moment, is sustained by and is sustaining total public and private debt of $1,070 billion.

But in our foreign investments, when we turn one of these dollars loose and it gets into the hands of a central bank, it becomes a claim against gold, and you say that the United States has for years been the leader in advocating free convertibility, I presume you mean convertibility of dollars for gold?

Mr. GILLESPIE. Convertivility of exchange between all countries, not blocking currency.

Senator KERR. Well, one of the elements of it relates to converting dollars to gold.

Mr. GILLESPIE. Yes, sir.

Senator KERR. Now, with the limited supply of gold that we have, does it not occur to you that there has to be some limitation on the dollars that we permit to get into the posture of being convertible into gold?

Mr. GILLESPIE. I am certain, sir, there will have to be a limit somewhere of the expenditure that goes abroad.

We share your concern, we recognize the balance of payments problem as being a very severe problem in this country.

The point that I think we are trying to make here is that companies going abroad are paying their own way and, at least in our own company, and we have seen substantiating testimony of others, that they are paying their own way, and they are returning money to this country to aid in the balance of payments, and I think that is the point.

The other point that could be made, I think, is that where a company knows that an opportunity exists abroad, and the funds that are now being retained—and incidentally 50 percent of the earnings of most companies are coming back to this country in the form of dividends, the balance after foreign tax is retained for capital and expansion and some of it for overhead—we have a lot of it, $14 million of our funds are just tied up just taking care of our credit—

that when this investment is to be made it does not make much difference as far as the balance of payments is concerned if the United States taxes the other 50 percent and forces the money home and then the company must take the money from here and put it back in again; it is just back and forth unless you insert exchange control in between and say, "Well, you can't send it back."

Senator KERR. Do you favor that?

Mr. GILLESPIE. I do not favor it; no, sir. But I think that is——

Senator KERR. Do you agree with the quotation you gave there from the Senator from Tennessee?

Mr. GILLESPIE. I would agree that the Senator from Tennessee may be right that that may be a time when we will have to come to that. I do not think he is happy nor would anyone be happy to come to it, but that may be the situation to which the country will have to succumb if we follow the present course.

Senator KERR. I will say this to you, if we do nothing about it, we will be forced to it. It would occur to me that those who feel as I do, and as I believe you feel that we should operate our business in such a way that we will not be confronted with that necessity, had better take such measures as are required ahead of time so that we will not be confronted with that necessity.

Mr. GILLESPIE. I think that is absolutely right, sir.

Senator KERR. And, therefore, it would seem to me that any committee considering this bill would have to do so in light of the effect it would have or should have on the balance-of-payments problem.

Mr. GILLESPIE. I agree with you, sir. The point, I think——

Senator KERR. Then I do not see how you could make the statement that regardless of the amount of money invested by U.S. companies in foreign operations that that might not precipitate just the situation which the Senator from Tennessee says he now favors and which you said you might get to where you would, but that you would like to avoid.

Mr. GILLESPIE. The only point, I think, sir, is this: that our own experience and, I think, the experiences of many other companies that have testified, is that their expenditures abroad have been replaced many times on the flow back. I can give you the figures——

Senator KERR. You mean returned. I am familiar with those statistics. But the point I am trying to make and apparently with no degree of success, is that regardless of how good an investment might be, unless you can make it on the basis of your current available capital, there comes a time when you cannot make it. I would say that if that is not recognized by American business in view of the fact that American business uses that little gadget or thing we call the dollar with reference to which Uncle Sam says that he will maintain free convertibility of it into gold, and in view of the limited amount of gold he has got with which to convert it, Uncle Sam had better take whatever measures are necessary to fix it so that neither he nor his subjects can get him into a position where he cannot honor that commitment.

Mr. GILLESPIE. Senator Kerr——

Senator KERR. You know in any company that I know anything about they have budgetary controls.

Now, the only great financial institution with which I have any substantial relationship that does not have it is the Federal Government, and you belong to the group that, in my judgment, thinks that it should.

I never saw a company that could operate under a situation where each department could make any commitment it wanted to for the company regardless of whether or not the sum total of those made by the various departments might exceed the ability of the company to meet them.

Mr. GILLESPIE. Senator Kerr, I'm trying to find disagreement with you, and I cannot. I agree with you completely on what you are saying, sir.

Senator KERR. The way I apply it to this situation is in this manner: American subjects in their foreign operations are using dollars which they own but with reference to which this Government says it will maintain the principle of convertibility.

Now, in some way or other I say that either those who are using that medium of exchange have got to do so on a basis that they will not put Uncle Sam in the position of where he cannot maintain convertibility or else Uncle Sam has got to do what is necessary, and I would hope he would do it ahead of time, so as to avoid getting into the posture visualized by the Senator from Tennessee, to where our subjects, and that includes both your company and the one I am associated with——

Mr. GILLESPIE. I would agree, sir.

Senator KERR (continuing). Keep that operating on a basis that our country will not be put in the posture of having either to repudiate, restrict, or delay indefinitely convertibility.

Mr. GILLESPIE. I feel this way, sir: I would agree with you completely. I think you are absolutely right. But I think the evidence would seem to us, at least in our own case, and in others——

Senator KERR. But we cannot pass a law for the Dow Chemical Co.

Mr. GILLESPIE. This is true. But I think that most companies are similarly situated. We have put in $31 million abroad and we have returned from this $438 million, and this is a great return in dollars for a permanent investment abroad.

We have actually spent $186 million of cash outflow, but we brought in $448 million, and this is not harmful to the balance of payments.

Senator KERR. No, no; it is not. It is marvelous.

But it just so happens that in the overall picture in 1960 we were $3.8 billion short and that took more than we had; and in 1961 we were $2.5 billion short, any part of which we did not have.

So it seems to me that there comes a time when the overall economic community, operating with American dollars, either by their own action or by action brought about by somebody else, must recognize the fact that we have got to catch up, that we have got to restore a situation in which the inflow, as a total, not on an individual basis, exceeds the outflow because when the well runs dry, everybody dependent on it goes without water, although one fellow might have a rain barrel somewhere, and be bringing back two bucketfuls for every bucket he takes out.

Mr. GILLESPIE. The question, of course, is business the villain. Are they the ones that are carrying the money away; isn't that the point?

Senator GORE. Would you state that again.

Senator KERR. Well, I cannot disassociate—I do not have the capacity to settle all problems at once. I always found out that if I had a lot of bundles to tie up I had better tie them up one at a time. If I tried to tie them all up at once I would not get them tied.

Mr. GILLESPIE. The statistics I have seen, and I do not recall them offhand, do not indicate that business is the cause of the large outflow, that they are actually returning more dollars than they are sending out.

Senator KERR. Business is not the only concern of the Government, and business is not totally disinterested in the operation of Government——

Mr. GILLESPIE. No, sir.

Senator KERR (continuing). That maintains a national defense program, a part of which is maintaining troops overseas, with the resultant loss or adverse effect on the balance of payments.

Business is not totally disinterested in that.

Mr. GILLESPIE. Business is very much interested in it, sir. If business is causing the——

Senator KERR. Businessmen are among the tourists who spend a billion and a half American dollars abroad every year, which become claims against our gold.

Mr. GILLESPIE. Yes.

Senator KERR. I do not know any way to disassociate business from the entire body politic or social order, and say that we will legislate for them in a manner totally unrelated to the entire economic and political structure, which is made impossible and which sustains it.

Mr. GILLESPIE. I think there is no quarrel with that, and I do not think that business would claim that it should have any special preference.

But the question on the overall balance would be what is taking money away without returning at least its equivalent or more in helping the balance of payments and, in the overall, I think that the statistics show that the money spent abroad by business in its foreign investments is returning more money than goes out, which is helpful to our balance of payments.

Senator KERR. It is now.

Mr. GILLESPIE. Yes, sir.

Senator KERR. But there have been $50 to $60 billion of it spent over there which has not been returned.

Sure, the billion and a half now going out is less than the amount business is bringing back, but the $2 billion that business has overseas that they are annually spending, plus the billion and a half dollars they are spending from here is $3.5 billion, and that is more than business is now bringing back, totally disassociated from the net $50 billion that has been sent over and not brought back.

Mr. GILLESPIE. Well, I do not think business is going abroad unless it brings back profit, sir, and this is the whole idea of going abroad.

Senator KERR. I doubt if you and I are going to agree on that.

I have no further comment.

The CHAIRMAN. Senator Douglas.

Senator DOUGLAS. Mr. Gillespie, in your statement you declare that the provisions of the bill cannot be designed as a revenue measure because the gain would only be $145 million if we passed the House provisions or $310 million a year if we adopted the recommendations of the Treasury.

Now, my perspective may be restricted, but I had always thought that $145 million, to say nothing of $310 million a year was a considerable figure.

Mr. GILLESPIE. I would agree, Senator Douglas. This is a considerable amount of money. It is inconsiderable in the total revenue of the Government, but it is a considerable amount of money to any of us, I am sure.

We follow along though by pointing out that the Treasury estimates do not include the adverse effects on the taxable income of domestic firms that would result in the loss of both domestic and foreign business generated overseas by foreign subsidiaries. It is most probable that these losses will more than offset the estimated increased revenue.

Senator DOUGLAS. Yes. But those losses, if they occur, will occur in the future, whereas the gain in revenue will be in the present, isn't that true? And it is the present, with its unfavorable balance of payments, which is of primary concern.

Mr. GILLESPIE. This is true. The question is how far in the future. Is it an immediate or long-distance problem?

Senator DOUGLAS. Yes, I understand.

Now, you speak of this tax as being an added burden that will increase their costs and hamper their activities in the marketplaces of the world.

Now, this is not a tax on costs. This is a tax on reinvested profits of subsidiaries of American corporations abroad.

Therefore, it does not fall on costs or on margins. It is on surpluses.

It would be a tax only after profits are made, and after operating expenses and interest on bonds and other fixed charges are met, but it will include not merely dividends or payments distributed to the parent company, but reinvested profits abroad.

So I would grant that this would reduce the amount to be reinvested in the future, I grant that. I think this has to be taken into consideration. But I do not see how you can say it would immediately increase costs because these are not costs, these are surpluses.

Mr. GILLESPIE. Well, we classify taxes as costs. It can have an effect in two or three ways, Senator Douglas.

Certainly one of the things would be the restriction of the amount of funds for expansion. But I think that, more importantly from the competitive point of view, is that the foreign competitor who does not pay this tax will have more money in his till, and he can do one or two things with it:

He can either pay more to his stockholders, which gives him an advantage in raising capital because he pays a higher return; and the other thing he can do is cut his price, and this is where we would be hurt, if he cuts his price with the surplus he has, he could drive us out and obtain a monopoly position.

Senator DOUGLAS. Well, I think it is probable that the imposition of this tax would reduce the rate of growth of American subsidiaries abroad, and it would mean that the United States in the future would get a smaller share of the world market then it otherwise would. But that is in the future, and we have got an immediately pressing problem, and the issue is whether this purpose is so overwhelming and controlling that it should cause investment abroad to be treated more favorably than investment at home, because at home, as we have pointed out under cross-examination, the corporate tax is on the earnings after operating costs and fixed charges, and so forth, have been met, and prior to the distribution of dividends; that is, at home it falls on reinvested corporate earnings and not merely on cash distributions to owners.

But abroad it is only on cash distributions to the parent company at home, and the query is whether there is such an overriding purpose in the future that you should favor investment abroad as compared with investment at home. That is the issue, but I do not think that we can say this increases immediate costs.

Mr. GILLESPIE. When you put the word "immediate" in, I guess I would have to agree with you, sir.

Senator DOUGLAS. In the short run.

Now, there was a peculiar statement of yours which I hope could be cleared up lest anyone in the press or public misinterpret it:

> Based on the above reasoning, it is our opinion that the provisions relating to foreign income of H.R. 10650 and the Treasury recommendations ancillary thereto will serve no purpose other than to give aid and comfort to Russia, who is seeking to penetrate foreign countries through the economic route.

Now, this is subject to misinterpretation. You say it is the purpose of the framers of this bill to give aid and comfort to Russia?

Mr. GILLESPIE. Certainly not, sir.

Senator DOUGLAS. I think that needs to be corrected.

Mr. GILLESPIE. If there is a possibility of misinterpretation, it should be corrected.

Senator DOUGLAS. You say it serves no purpose other than that. It might have—you can argue that it might have—that effect. But I hope you do not say that it is the purpose of the Treasury and the administration to help Russia.

Mr. GILLESPIE. Certainly there is no intent of that at all. You would have to agree with all of our reasoning in advance, and then you could arrive at this result.

Senator DOUGLAS. I am glad you answered that. There are a lot of people trying to make these very charges, and it is well to get them disavowed at this time.

Mr. GILLESPIE. This is certainly only a matter of disagreement in philosophy, and it certainly would have no implication that there is any lack of good faith on anyone's part.

Senator DOUGLAS. I am very glad to get that. That is all.

The CHAIRMAN. Senator Bennett.

Senator BENNETT. I came in after your statement had been read——

Mr. GILLESPIE. Yes, sir.

Senator BENNETT (continuing). So I can only ask questions with respect to the colloquy which has taken place between you and my colleagues.

There are two areas that have interested me.

We now have a position where the outflow of dollars is greater than the inflow currently of returns from our investment.

Do you know at what point in time the situation turned around and what was approximately the year up to which we said we had a dollar gap, and we were doing everything we could to make it possible for our friends abroad to earn dollars?

Mr. GILLESPIE. No, sir; I could not answer that question.

Senator BENNETT. Well, from the best information I can get it was probably about 5 years ago and it would be interesting to know how much of this American investment abroad at which our friends now look with some suspicion, was incurred during that time when we were very anxious to make it possible for our friends to earn dollars and close what they called the dollar gap? It has turned around in the last 4 or 5 years, and certainly in the last year we have been concerned about it. This is something that might be interesting.

The other comment and question I would like to ask you refers to the questions Senator Douglas has just asked you.

In response to a question from him you said that there were two purposes that were served by the retention of profits abroad: One was to increase the income to the stockholders, and thus attract new capital into an enterprise; and the other was to expand the enterprise from retained earnings.

I think there is a third, and I think this is pertinent to our present discussion. In this particular tax bill in another section it is being recommended that we give investment tax credit to an American concern in order to persuade it to modernize its machinery for the ostensible purpose of reducing costs.

Don't you think that some of the withheld or of the retained investment abroad will be used to increase the productive capacity of your units by modernizing machinery and thus make yourself more competitive more or less immediately?

Mr. GILLESPIE. Yes, sir; this is a possibility.

I think that the three points that we make are: one thing that can be done, of course, is to pay greater dividends; the second is to expand, and you might include in that to modernize; the third is to have the money with which to compete. You may have to lower your prices.

Another thing we have found in our own experience is that we have been on 30-day credit terms in the United States, and we go abroad we have to meet competitors that give 240-day credit terms, so we have got millions of dollars tied up just in inventory to meet competition, and this is another way that these funds are to be used, and this is the thing that we are facing, and this is why we say that we need this to compete.

I do not think we get much more return from abroad than we do from the U.S. investments, by and large, but we do have problems of competition that are severe.

Senator BENNETT. That is all, Mr. Chairman.

The CHAIRMAN. Senator Gore.

Senator GORE. I have enjoyed your testimony, particularly the erudition of the colloquy between you and Senator Kerr. I thank you for quoting me although you did not do so with entire approbation.

The speech from which you quoted was the fourth in a series that I made trying to examine the problems to which you have referred and about which you have testified.

Many people seem to rush to the conclusion that the way to solve our balance of payments is to increase exports. Exports per se are not necessarily good. Exports are good if we obtain an advantage in returned goods and services.

The more of the fruits of the talents and the labor and the resources of our country that our own people utilize, the higher the standard of living we have. I think you would agree with that general statement.

Mr. GILLESPIE. Yes; I agree with that completely, Senator.

Senator GORE. One of the things I tried to demonstrate in the address from which you quoted, and I appreciate your reading it, and feel complimented that you did, was that the imbalance-of-payments problem was not likely to be solved alone by an increase in exports. Yet this is, as Senator Kerr has stated, one of our very pressing problems.

So long as our problem is entirely domestic we can wrestle with it and roll with the punches. But it becomes a matter of urgency when it involves our position in the world economy. I think you would agree with that.

Mr. GILLESPIE. I would agree with that, sir.

Senator GORE. One other conclusion which many people, at least some of the witnesses appearing before this committee, seem to raise, is that if the rate of U.S. business investment abroad is slowed, then the inflow of funds will slow.

As a matter of fact, the inflow of funds is from investment already made.

What we need now is an increase in the inflow. What I have proposed would, I think, check the outflow and increase the inflow.

This, it seems to me, would constitute a significant contribution toward the solution of our imbalance of payments. That alone will not be sufficient unless that and the trade bill and other measures are sufficient, and then we may very well find the necessity of some regulation of the outflow of capital.

You have not regarded this as a demon, as some people have. Actually we are the only sophisticated economy in the world which has not exercised or does not now exercise such regulation.

It may become a matter of urgency within 3 years, I hope not. I really do not wish to take the time of the committee to examine you further because Senator Douglas and Senator Bennett and Senator Kerr have done so, and you have contributed well.

I did want to make those general remarks and to express gratification that you have taken the time to read the addresses I made in the Senate.

Mr. GILLESPIE. Thank you, Senator.

I would say this, that I know of no one in the country who goes into the matter more thoroughly and persistently than you do. I think that you would gather from our statement that we do not agree with your conclusions, but we certainly recognize that you have examined the facts.

Senator GORE. Thank you, sir. That is all, Mr. Chairman.

The CHAIRMAN. Thank you very much, Mr. Gillespie. You have made a fine contribution.

Mr. GILLESPIE. Thank you, gentlemen.

The CHAIRMAN. The next witness is Mr. Thomas Mellon Evans, the H. K. Porter Co., Inc.

Take a seat, sir, and proceed.

STATEMENT OF THOMAS M. EVANS, CHAIRMAN, H. K. PORTER CO., INC.

Mr. Evans. I am Thomas M. Evans, chairman of the H. K. Porter Co., Inc., and chairman of the Crane Co.

I would like to testify on only one phase of the tax bill concerning foreign operations, and that is the effect particularly on smaller companies with foreign subsidiaries or those planning to establish them.

It seems to me the proposed bill discriminates against smaller companies, and those getting started with foreign operations. It is important that all companies develop more foreign operations, and the smaller companies should, if anything, be aided rather than hurt in such development.

To explain what I mean, I think if you look at the very largest companies you will find that many have had extensive operations abroad for many years and they are now drawing back practically all of the earnings, so the proposed tax would not affect them. Naturally, the eventual ability to draw back earnings is the only reason for businesses to establish foreign operations.

During the past few weeks, the question has come up at the annual meetings of several of these large corporations, and I know that at some of them the chairman stated that the proposed tax would have little or no effect on them, since they took back all of the earnings. However, smaller companies establishing foreign operations need to leave the earnings abroad until the foreign operations are well established and well financed. In effect, to put a tax on earnings left abroad would penalize the smaller companies trying to develop foreign operations.

Also, it seems to me it would invite some of the foreign countries to add taxes to American subsidiaries and thus make it more difficult for these subsidiaries to compete abroad. If a tax rate of 52 percent is to be imposed on the earnings of U.S. companies, wherever located, the country of location will naturally incline to have the benefit of it. Therefore, it can be expected that foreign countries will increase taxes on U.S. businesses to an equal amount. Inasmuch as the established company is already repatriating substantially all its earnings, this prospective increase in foreign tax rate will have little if any effect on it. However, the smaller company, needing to accumulate earnings for future expansion, will be faced with the same increase which to it will be an impediment to securing its place in the market.

Finally, discriminatory imposition of the U.S. tax rate, by increasing the cost of doing business, will seriously hamper the ability of the new company to compete with local foreign companies not subject to the same tax rate. The larger, established company has already built its business at competitive tax rates, and in effect has thus been conditioned to paying U.S. taxes off the top. Thus the proposed law would seem to be designed to encourage the expansion of large established business both by relieving it from U.S. rates except on earnings repatriated and by effectively prohibiting the entry of new U.S. enterprise.

I would like to add one statement after listening to the testimony this morning.

I realize that foreign exchange, the foreign exchange situation, is a serious one, but I know from operations we have abroad in England and in France, for example, to take dividends out of any large capital you have to get governmental approval.

It seems to me—and the budget was mentioned, the budget this morning—to know what is coming is the problem. I know a year and a half ago when the automobile companies took a large sum of money to invest, buy out the minority in the company, it came at a time of crisis in the exchange markets.

I feel in the same system England and France used—and they have had a good many exchange crises, more than we have had—the licensing of larger exports of capital, say, over $1 million by somebodv like the Federal Reserve, might be the answer.

Coming down this morning I read in the paper of two public issues of foreign funds, one for $100 million in Canada and one for $20 million in Denmark. That is $120 million in 1 day going out, in effect, and that is not helping our business. It is people coming here because our interest rates are what they are. The Canadian rate was—to borrow that money in Canada would probably cost 5¾ percent.

I presume the Denmark issue was for the same reason put out here because and for the same reason that our rates are lower.

It seems to me that that approach would assist the foreign exchange problem and be more in keeping with what England and France and some of the other countries do.

The CHAIRMAN. Senator Douglas.

Senator DOUGLAS. No questions.

The CHAIRMAN. Senator Williams.

Senator WILLIAMS. No questions.

The CHAIRMAN. Senator Gore.

Senator GORE. Thank you for your contribution. You have made a helpful suggestion.

The CHAIRMAN. Senator Bennett.

Senator BENNETT. No.

The CHAIRMAN. Thank you very much, Mr. Evans.

The next witness is the Honorable Kenneth C. Royall, Pharmaceutical Manufacturers Association.

I use the word "honorable" because he has held a high position in our Government.

STATEMENT OF KENNETH C. ROYALL, PHARMACEUTICAL MANUFACTURERS ASSOCIATION

Mr. ROYALL. Mr. Chairman and members of the committee, it is a pleasure to be here. It brings to my mind the many days when I was here serving in a department of the Government.

I appear—I am a member, incidentally, of a law firm, Royall, Koegel & Rogers in New York, and I am appearing on behalf of the Pharmaceutical Manufacturers Association in opposition to certain sections of the Revenue Act of 1962.

I have filed an amplified statement which is longer than the notes I am now using for presentation here.

The CHAIRMAN. Do you want your statement printed in the record?

Mr. ROYALL. Yes; I do want this, if it is consistent with the policy of the committee.

The CHAIRMAN. Without objection, it will follow your oral presentation.

Mr. ROYALL. The particular provisions of the act to which I address myself are sections 6, 11, and 13.

These provisions would tax an American corporation on the undistributed income of its foreign subsidiary in addition to the present tax on the distributed income.

It would even tax an American parent corporation for unrealized annual appreciation in its investments in a foreign subsidiary.

The new law goes even further. It would tax the American parent corporation on income and earnings that even the subsidiary itself had never had, for under the dividend gross-up provision the parent would have to pay a tax on the tax which the subsidiary paid to a foreign government.

Also, in the case of the subsidiary's use of a U.S. patent, there would be a tax on the "gross rental," and those words are in quotes, that is, the subsidiary is deemed to have paid even if the subsidiary operated at a loss.

It is our considered opinion that these provisions are clearly unconstitutional, and certainly there cannot be a doubt in anyone's mind that they would provoke protracted litigation with resulting business uncertainty and confusion.

First and foremost today I want to suggest that they are unwise and unjust. In the recent words of a distinguished member of this very committee, the proposed provisions, and I quote—

> would establish a monstrous precedent by ignoring corporate entities and taxing shareholders directly for the earnings rather than the dividends and they would make it almost impossible for American enterprises to do business abroad.

This statement would surely be true as to the members of our association.

Senator GORE. Whom are you quoting?

Mr. ROYALL. Senator Kerr in a magazine article.

The proposed provisions will, to a large extent, we say, dry up the foreign operations of our members. The reasons are simple.

As a practical matter, foreign law and foreign competition require our individual members to conduct their foreign activities through foreign subsidiaries, for the health codes and the economic development programs of many foreign countries require, in our industry, that the final manufacturing and packaging process be done in the country where the product will be sold; and even in the area where legal restrictions do not apply, foreign custom and prejudice require it.

Today, without this new law, as much of the manufacturing process as is possible or practical occurs in the United States. But under the proposed legislation there would be less manufacturing in the United States than now exists.

If we did not have substantial subsidiaries in foreign countries, the market of our American products would be greatly reduced; as to some important products it would disappear entirely.

We realize that the Treasury has testified that foreign markets for American products will not dry up by reason of these provisions. Indeed, it claims that the competitiveness of those products abroad will substantially increase because the investment credit will provide a subsidy.

We say in the case of the pharmaceutical industry this is completely incorrect.

The pharmaceutical industry does not require heavy capital investment in depreciable assets. So no investment credit could possibly provide a subsidy that would even begin to counterweigh the impact of these proposed foreign investment provisions.

The Treasury has also said that these provisions would increase employment in the United States. As to our industry it will sharply reduce employment in the United States.

In the first place, our operations abroad are necessary to meet the local requirements to which I have referred. They could not be performed in the United States for the reasons, the statutory and customs reasons, accepted rules applied.

The basic manufacturing for our export is already done in the United States by American labor. So in no event could these changes help American labor. On the contrary, these proposed provisions will reduce or destroy the foreign markets of our industry. Therefore, basic manufacture in the United States which now supplies our foreign subsidiaries will recede or, perhaps, disappear; and, therefore, the effect of this law as far as our industry is concerned is to reduce employment in the United States.

Now, as to the balance of payments, even the Treasury now says that this legislation may, over a long range, adversely affect our balance of payments. That is quite an admission. But we go further. This balance of payments will be immediately and seriously worsened in our industry.

A survey of 10 of the larger members of our association, 1956 through 1960, shows total inflow here from the foreign subsidiaries exceeded the total outflow by $540 million, or a ratio of 7 to 1, nearly 8 to 1.

Official Government statistics show that over the same period the average annual exports of all medicinal and pharmaceutical products, $273 million, imports only $18 million.

This amount of inflow will be no longer available if this legislation is enacted, for there will be a greatly reduced foreign market; and, therefore, the balance of payments will be adversely affected.

Now, there has been a lot of talk about runaway industry. As far as the pharmaceutical industry is concerned, that is not a tax runaway industry. There has been no flight to foreign countries of manufacturers of products for U.S. consumption.

Over the period of 1956 through 1960, total imports of foreign subsidiaries and branches of the 10 association members for resale in the United States totaled only $1.3 million, only one-half of 1 percent of the annual foreign sales of $250 million.

Next the proponents of these provisions claim that it will produce tax neutrality; that is, equal American tax on American business wherever located. These provisions will not have that result. On the contrary, they will generally penalize and discriminate against foreign investment by U.S. corporations. If an American parent has both an American and a foreign subsidiary under existing law, the money actually paid over by the subsidiary to the American corporation is taxable. In the case of a foreign subsidiary, these proposed provisions will have the effect of also taxing the parent corporation on the income and earnings which are not paid out. This is anything else but equality.

As to losses, the proposed provisions would result in another unjust discrimination for if the proposed act is passed a foreign subsidiary's losses cannot be used to offset other taxable income. It is very possible for the parent to be taxed on income of the subsidiary, which never will be paid because of subsequent losses by the subsidiary.

Behind these provisions is the erroneous concept that American business investors can take advantage of a loophole by making foreign investments and accumulating income.

We say, and establish by any evidence needed, that the income and earnings of the foreign subsidiaries of our association members not reinvested into business abroad are repatriated and taxed here. Any other course would be unthinkable in any publicly owned corporation.

As to section 11, the gross-up, the Treasury does not follow up with this analysis. It does not take into account that this provision would give a foreign government every reason to increase its tax to 52 percent on American-controlled subsidiaries. This is a phase of it that, so far as we know, has not been covered in other discussions, but it is an interesting one to show the bad effects that these provisions can have without any counterbalancing good effects.

The foreign government knows if it increases its taxes the gross-up provision will produce nothing for the U.S. Government, and the foreign government would get more money at the cost of the United States. They could gage their taxes at 52 percent, and if they did, and this provision was effective, the United States would get not 1 cent of taxes under this provision, and yet we would have the various ill-effects which have been described.

In other words, the foreign governments would get their 52 percent on the undistributed income, the United States would get nothing, and no benefit could possibly inure to the foreign subsidiaries or to the parent corporation. What kind of tax law is that? Where is the Treasury Department's neutrality?

We next come to the patent provision affecting section 13 of the act. This taxes the imputed income derived by the foreign subsidiary of a U.S. patent. This provision applies only to a U.S. patent, pointedly refers to only U.S. patents, and under this provision the only recourse of the American companies would be to transfer abroad the research activity now being conducted in the United States. That is the only way they could meet it. The products could then be patented under foreign law and then purchased by the American parent corporation for sale in the United States. There would be no impropriety, no violation of law or no departure from commonsense if that course were followed. The tax would then disappear, and why go through the absurdity of imposing it, and in doing so cause other injury to this particular industry?

Here is what the injury could be, the consequence of such a course would be harmful in several ways: For example, $151 million was spent here by American industry on research in drugs and medicine in 1959, spent in America. If the legislation were adopted much, if not most, of this money would be spent overseas. American research workers would either lose their jobs entirely or they would have to go overseas where the research is being conducted.

The manufacture of foreign patented drugs would take place overseas by the subsidiary and then sold to the American parent corporation. Production jobs here would again decline. Thus, both the balance of payments and employment, not to mention revenue, would be adversely affected.

All these novel provisions were obviously composed in haste. In 1960 Congress, in the Internal Revenue Code, required returns of certain information by American parent companies with a view to determining what was proper legislation. That was in 1960. The first returns have just come in. There has been no time to analyze them.

The purpose of those returns, the purpose of that information, was to make an intelligent study of the needs arising in this very field. Yet before those returns could have even been digested, this broad legislation is now proposed as sort of a bird-shot blast.

Is this the kind of legislation we need in an important matter like the taxation of undistributed funds?

Another serious problem arises in the administration of the act. The formulas for the allocation of income between an American parent corporation and a foreign subsidiary, the bookkeeping requirements, the administrative problems, which many have said are almost insurmountable, if not entirely so, tax reporting, tax collecting, getting information which is difficult to get from abroad, would be most burdensome and most expensive.

The Treasury estimates that these provisions will produce $115 million. Even if this estimate is predicated on the assumption that these provisions will not reduce worldwide demand for American products and will not decrease American employment, the fact is, as we have pointed out, they will dry up the foreign market and will decrease employment.

On top of that, they will reduce sources of income, and the taxes from those sources.

Mr. Chairman, we submit that, on behalf of an important segment of American industry, that the Treasury's assumptions are palpably wrong, and we strongly urge the deletion completely of sections 6, 11, and 13.

The CHAIRMAN. Senator Curtis.

Senator CURTIS. One question: Do you know any business, individual, or institution or group that is supporting these sections?

Mr. ROYALL. I do not, sir. I would not want that to indicate that I have talked with all elements of business.

Senator CURTIS. It has not been called to your attention?

Mr. ROYALL. No, no, it has not. We have directed this to our industry, because it is something that we can give the figures on and talk about the facts and know they are right.

We did that because it seemed to us that it was the proper approach for each person to give the exact situation as to his industry.

I believe you will find, in line with your question, that somewhat similar results to the ones I have described, which I do not think can be gainsaid in any way, I think you will find that somewhat similar results will result in many, if not most, of the industries, and I have known none that thought that it would be helpful to this country in any way.

Senator CURTIS. That is all, Mr. Chairman.

The CHAIRMAN. Thank you very much, Mr. Royall. You have made an impressive statement. We are always glad to have you before the committee.

(Mr. Royall's prepared statement follows:)

TESTIMONY OF KENNETH C. ROYALL FOR PHARMACEUTICAL MANUFACTURERS ASSOCIATION ON H.R. 10650

I am Kenneth C. Royall of the law firm of Royall, Koegel & Rogers, of New York, N.Y. I am appearing on behalf of the Pharmaceutical Manufacturers Association in opposition to certain sections of the Revenue Act of 1962.

The Pharmaceutical Manufacturers Association is composed of about 140 corporations engaged in the manufacture and sale of ethical pharmaceutical and prescription drug products. These corporations account for a very substantial portion of the total industry.

The particular provisions of the act to which I address myself are Sections 6, 11, and 13. These provisions would tax to an American parent corporation the income and the earnings not distributed to or received by the American corporation, in addition to the distributions it receives and which are presently taxable. In fact, under the proposed provisions tax would have to be paid in some cases on imputed income and earnings; that is, income not even earned by the foreign subsidiary.

We believe that these provisions, if enacted, would pose grave problems of constitutionality. It is a fundamental principle of our tax laws that the unrealized appreciation of property is not income. The Supreme Court in the leading case of *Eisner* v. *Macomber*[1] held as long ago as 1920 that income is "not a gain *accruing to* capital * * * but a gain * * * *received* or *drawn* by the recipient (the taxpayer) for his *separate* use, benefit, and disposal * * *. Nothing else answers the description." (Original emphasis.) The principle that unrealized appreciation is not constitutionally taxable income was reaffirmed by the Supreme Court as recently as 1955.[2]

The provisions which we have referred to would tax an American parent corporation on the unrealized annual appreciation in the value of its investment in a foreign subsidiary. They go further than that: They would tax to the American parent corporation income and earnings the foreign subsidiary never had. Thus, under the dividend "gross up" provision (sec. 11 of the act) the parent is taxed on the tax the subsidiary paid a foreign government and in the case of the subsidiary's use of a U.S. patent (sec. 13 of the act) is taxable on a "gross rental" the subsidiary is deemed to have paid, even if the subsidiary operated at a loss.

It is our considered opinion that these provisions are clearly unconstitutional. There can certainly be no doubt that they would evoke protracted litigation, with resulting business uncertainty and confusion.

Aside from the issue of unconstitutionality we contend that the proposals are unwise and unjust. In the recent words of a distinguished member of this committee, the proposed provisions "would make it almost impossible for American enterprises to do business abroad. This proposal not only runs counter to our foreign economic policy, but would also establish a monstrous precedent * * * [by] ignoring corporate entities and taxing shareholders directly for the earnings of a business * * * rather than taxing the dividends they receive."

Next, we would predict that if these provisions are enacted it will become virtually impossible for members of the Pharmaceutical Manufacturers Association to do business abroad. The Treasury Department has taken the opposite view. It has said that under these provisions American industry can continue to do business abroad because, as it states, the present demand for the products of foreign subsidiaries will continue as a demand for the exports from American industry.[3]

This assumption, we assert, is in error, certainly with respect to our particular industry. The proposed provisions will to a large extent "dry up" the foreign operations of the association's members.

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[1] *Eisner* v. *Macomber*, 252 U.S. 189, 207 (1920).
[2] *Commissioner* v. *Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955).
[3] Hearings before Senate Committee on Finance on H.R. 10650, pt. I, 100, 192 (Apr. 2, 1962).

The reasons are simple. Foreign law and foreign competition require our individual members to conduct their foreign activities through foreign subsidiaries. The health codes and economic development programs of many foreign countries require that the final manufacturing and packaging processes occur in the country where the product will be sold.

Even where there are no legal restrictions, foreign custom and prejudice require these processes to occur in the country where the product will be sold. For example, it is common knowledge that a French doctor will not prescribe for his patients a drug designated as American if a similar French drug is available. Nevertheless, as much of the manufacturing process as is possible or practical now occurs in the United States. But there is a limit to how far we can go. Without a substantial subsidiary in a foreign country and without foreign packaging, the market for our American products would be greatly reduced or—as to some important product—would disappear.

The Treasury Department has testified before the committee that foreign markets for American products will not "dry up" by reason of these provisions. Indeed, it claims that the competitiveness of those products abroad will "substantially increase" because the investment credit will provide a subsidy to offset the costs of American manufacture for export.[4]

In the case of the pharmaceutical industry this is completely incorrect. Even if the investment credit may have this offsetting effect on some commodities—which we do not admit, it does not, we suggest, apply across the board. Indubitably, it does not apply to pharmaceuticals. For the pharmaceutical industry does not require heavy capital investment in depreciable assets, and any investment credit could not provide a subsidy that would even begin to counterweigh the impact of these foreign investment provisions.

The Treasury Department has also testified that these provisions will increase employment in the United States.[5] We say just the opposite as to this industry, where it will sharply reduce domestic employment.

On the one hand, operations abroad are in large part necessary to meet local requirements and could not be done in the United States. Thus, in no event—new law or not—would American labor be affected. The basic manufacturing for our exports is already done in the United States by American labor to the maximum extent possible.

On the other hand, these proposed provisions will reduce or destroy the foreign markets of our industry. The logical and inevitable result is that basic manufacture in the United States which supplies our foreign subsidiaries will recede or disappear. Therefore, employment here will be reduced.

As to the balance of payments, even Secretary Dillon has testified that these provisions may over the long range adversely affect our balance of payments.[6] We go further. We say that the extremely favorable balance of payments between association members and their foreign subsidiaries will be immediately and seriously worsened.

A survey of 10 of the members of the association, which included several of the larger members, over the year 1956–60 shows that the total inflow from these subsidiaries to the United States was $618,600,000 and the total outflow was only $78,500,000. Total inflow exceeded total outflow by $540,100,000, or by a ratio of 7.9 to 1. Official Government statistics show that over the same period the average annual exports of all medicinal and pharmaceutical products were $273 million and the average annual imports were only $16 million.[7] These amounts of inflow will be no longer available if this legislation is enacted, because there will be no foreign market.

The organization and operation of the pharmaceutical industry abroad is not a tax "runaway industry." There has been no flight of manufacturers of products for U.S. consumption to foreign countries where, by reason of taxes and other circumstances, products can be manufactured and imported into the United States more cheaply than they could be manufactured and sold here. The survey I just referred to showed that over the period 1956–60 total imports from foreign subsidiaries and branches of the 10 association members for resale in the United States totaled only $1,300,000, or only 0.01 percent of total worldwide sales of pharmaceutical products of about $1,300 million over that period,

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[4] Ibid., p. 80.
[5] Ibid., p. 100.
[6] Ibid., p. 198.
[7] U.S. Bureau of the Census, Statistical Abstract of the United States, 1961, tables 1204–1205, pp. 881, 884.

only 0.5 percent of total foreign sales of $250 million over that period, and only 1.6 percent of the total outflow of $78,500,000.

Proponents of these provisions claim that it will produce tax neutrality, i.e., equal American tax on American business wherever located. The Treasury Department has described this concept as "one of the most fundamental of the guiding principles in American income taxation," [8] and it has said:

"Applied to corporations, this principle must be interpreted to mean that the income of any branch or subsidiary of an American corporation operating overseas should as far as possible be subject to the same corporate income tax rates as the income of any branch or subsidiary operating at home." [9]

Of course, these provisions will not have any such result. On the contrary, they will generally penalize and discriminate against foreign investment by U.S. corporations.

If a parent corporation has both an American and a foreign subsidiary, under existing law only the money actually paid over by the subsidiaries to the parent corporation is taxable to the parent corporation. However, these proposed provisions have the effect of taxing the parent corporation on the income and earnings of a foreign subsidiary whether or not they are paid out. In other words, as to the income and earnings of a foreign subsidiary, it will be treated as though it were a branch of the American parent corporation.

However, this is not true as to losses. As to them, the proposed provisions would result in unjust discrimination. Under present law, if the foreign subsidiary were a branch instead of a subsidiary, not only would its income and earnings be taxable to the parent corporation, as this act would have it, but also its losses would be available to the parent corporation to offset other taxable income. But if the proposed act is passed, there is no provision at all for the utilization of a foreign subsidiary's losses by the American parent corporation to offset other taxable income. It is very possible for the parent corporation to be taxed on income or earnings of the subsidiary which were not paid to it in the year of taxation and which will never be paid to it because of subsequent losses by the subsidiary.

Behind the principle of tax neutrality is apparently the concept that American investors have taken or can take advantage of a loophole by making foreign investments and accumulating earnings which will be exempt from U.S. tax. Our figures show that the foreign operations of members of this association have never taken advantage, and can never be expected to take advantage, of any such loophole, if in fact there is one. The income and earnings of the foreign subsidiaries of association members are either reinvested in the business or repatriated to the U.S. parent corporation, where they become subject to U.S. tax. Any other course would be unthinkable in any publicly owned corporation, with its many stockholders.

We next come to the gross-up provision (sec. 11 of the act). This imposes on the American parent corporation a tax based not only on the dividends it received but also on the foreign tax paid by its subsidiary on the amount of the dividend.

The Treasury Department does not follow through on this. It does not take into account that a foreign government has every reason, under the proposed provision, to increase its tax to 52 percent on American-controlled subsidiaries, while continuing its lower tax rate on other corporations. For it knows that if it does so, the gross-up provision will produce nothing for the U.S. Government, and the foreign government would get more money at the cost of the United States. That is, the foreign government would get 52 percent and the United States nothing—all with no benefit to the foreign subsidiary or to its American parent corporation. What kind of tax law is this? It would increase our competitive disadvantages and would be a far cry from the Treasury Department's definition of neutrality I have already quoted.

All these provisions were obviously composed in haste.

In 1960, the Congress added section 6038 to the Internal Revenue Code.[10] This provision requires returns of certain information by American companies with respect to their controlled foreign subsidiaries. It became effective only with annual accounting periods beginning after December 31, 1960. In other words, the first returns have just come in. The obvious purpose of this legislation was to provide information necessary to any intelligent study of the need for any

[8] Ibid., p. 177.
[9] Loc. cit.
[10] Public Law 86–780.

legislation, as well as provide information to facilitate the selection of cases for audit.[11] Yet now, before the first information returns can even be digested, not only is legislation proposed but a shotgun approach is taken.

We next come to the provisions affecting patents in terms of the members of our association. We refer to the provision (sec. 13 of the act) taxing the actual or imputed income derived from the use by a foreign subsidiary of a U.S. patent. Under these provisions the earnings of such a subsidiary from the use of the patent by others is taxable to the parent corporation. In addition, an imputed gross rental for the subsidiary's own use of the patent is taxable to the parent corporation. This provision applies only to a "U.S. patent" and that term means a patent either created in the United States or acquired by the subsidiary from any U.S. person controlling or affiliated with the subsidiary. If the research presently being conducted by association members in the United States were transferred abroad and products patented under foreign laws were purchased by the American parent corporation for sale in the United States, the tax imposed by this and related provisions would be avoided.

In addition to the tax features, the consequences of such a course would be staggering; $151 million was spent by industry on research in drugs and medicines in 1959.[12] If the proposed provisions were adopted, this money would be spent overseas. American research workers would either lose their jobs or follow the research overseas.

Also, in order effectively to avoid the thrust of these provisions, the manufacture of foreign patented drugs would be made overseas by the subsidiary and sold to the American parent corporation. Production jobs here would decline. Thus, both the balance of payments and employment, not to mention revenue, would be adversely affected.

Another very serious problem would arise in connection with the administration of the proposed provisions. The provision amending section 482 of the code would provide formulas for allocation of income, etc., between an American parent corporation and a foreign subsidiary. We can conclude only that this provision was also hastily drafted because the formulas are unworkable, the bookkeeping requirements are immense, and the administrative problems are insurmountable. The expense of tax reporting and tax collecting would be exceedingly large.

Finally, the Treasury Department's own estimate is that these provisions will produce at the most $115 million additional revenue annually, or slightly more than 1 percent of the current budget. Even this estimate is predicated on the assumptions that these provisions will not reduce worldwide demand for the products of American industry and that they will increase American employment. However, as we have demonstrated in the case of the Pharmaceutical Manufacturers Association, these provisions will dry up foreign markets and decrease employment. So, at least with regard to this important segment of American industry, the Treasury Department's assumptions are palpably wrong.

In conclusion, we strongly urge the deletion of these provisions from the act.

The CHAIRMAN. The committee will now recess until 2:30 this afternoon.

(Whereupon, at 12:20 p.m., the committee recessed, to reconvene at 2:30 p.m. this same day.)

AFTERNOON SESSION

Senator GORE (presiding). The committee will come to order.

The first witness is Mr. F. W. Salditt. The committee is pleased to hear you, Mr. Salditt.

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[11] Hearings, op. cit., p. 229.

[12] U.S. Bureau of the Census, op. cit., table 725, p. 535.

STATEMENT OF FREDERICK SALDITT, VICE PRESIDENT IN CHARGE OF INTERNATIONAL OPERATIONS, HARNISCHFEGER CORP., ACCOMPANIED BY ALVIN H. WEISS, TAX MANAGER

Mr. SALDITT. Thank you, Mr. Chairman.

Mr. Chairman, my name is Frederick Salditt. I am vice president in charge of international operations and a member of the board of directors of Harnischfeger Corp., of Milwaukee, Wis.

My company is a manufacturer primarily of heavy construction and mining and industrial machinery and equipment. We have been in business since 1884. In addition to three factories in Milwaukee, we have plants in Michigan, California, and Illinois, and employ some 5,000 people in the United States.

We have been an active exporter of our products for the past 45 years. In addition to being an exporter, we have substantial oversea manufacturing operations, many of which involve foreign investment in a number of countries throughout the world, some of which I suppose would be classified as developed and some underdeveloped.

In developing our oversea manufacturing operations, we have used and continue to use the principle of deferral of U.S. taxes on the income of some of our foreign subsidiaries, due to the requirement for reinvestment overseas for continued expansion. It is this very principle of tax deferral which has been such a stimulus to legitimate business expansion overseas that now would be blocked and prohibited by pending tax legislation.

We thus have a vital interest in H.R. 10650, particularly in the provisions regarding the tax treatment of the income of foreign subsidiaries and we welcome this opportunity to appear before this committee to register our strong protest against this part of the bill and to suggest most strongly that this part of the bill be stricken completely so as not to hamstring and make more costly foreign operations of U.S. industry, which actually might use a helping hand in order to stay even with foreign competition, but most certainly does not need a punch in the nose.

Having reviewed some of the testimony before the House Ways and Means Committee last year, and some of that currently before your own committee, it seems to me that there is ample irrefutable evidence presented by reputable, experienced, and knowledgeable sources in banking, industry, and commerce, which would compel the elimination of any consideration of the tax treatment of foreign income such as is proposed.

Nevertheless, this year the bill seemed to fly out of the House Ways and Means Committee, pass through the House without extensive debate, and is presently under consideration by your committee.

For the life of me, I cannot understand how all of the testimony presented could have been ignored if there is a sincere interest and understanding on the part of our administration and Congress in furthering our foreign trade, increasing our exports, and improving our balance-of-payments situation. I think one of the reasons where some of the previous testimony has failed and where possibly some of the testimony of the administration, such as that of Mr. Dillon before your own committee, has been misinterpreted is due to the fact that the statistics used and referred to do not really reflect how these very same statistics really came into being in the first place. They came into being because someone made a sale in a competitive market. This sale is not a routine accomplishment. I know you gentlemen recognize that it takes organization, good teamwork and a lot of hard work and expense, and in our business on the export side as an important part of the team or organization it takes an oversea manufacturing operation that can produce at competitive costs.

There does not seem to be a full appreciation as to how really intertwined are the many factors of foreign trade as a whole, both exports and oversea investment. Most of all how little consideration is given to the real controlling force in foreign trade (or domestic trade for that matter); namely, that of competition. This is paramount and all controlling.

We, meaning ourselves, and all U.S. industry, must be able to deliver our products to the foreign purchaser competitive as to quality, price, terms, and service. Our real foreign competitors (by this I don't mean oversea subsidiaries or licensees of U.S. companies) are a very formidable group and are becoming more so.

Generally they have various official means of assistance at their disposal encouraging exports, and in no case that I know of do they actually have roadblocks and hurdles thrown in their path to make exporting more difficult. We and other U.S. companies have had to go into oversea manufacturing to remain competitive and to hold markets which we would otherwise lose completely. Our oversea manufacturing and investments have helped maintain and increase our exports from this country. In our business these two things are inseparable.

The utilization of tax deferral methods has helped provide the wherewithal to do this and to keep our overall costs, both overseas and, indirectly, in this country, in line so that we can maintain our position and fend with our competition with some measure of success.

Anything which discourages this kind of foreign investment by taking away one of the many tools which industry needs in this fight just as surely makes for less rather than more U.S. exports. We have enough problems just staying competitive, and if we are not competitive you may be sure that we will not export at all in the not too distant future.

I think the experience of our company and the industry of which it is a part provides a pretty good example as to how exports become entwined with and dependent upon more extensive foreign operations, which in turn must be kept fully competitive with foreign companies who are doing business in the same markets in this country and all over the world.

In our business, our real growth market is really made up of the world's underdeveloped and not too highly industrialized countries since we build and sell the kind of equipment that digs ore, builds roads and bridges, handles materials, and in general does many of those things needed to develop a country and/or modernize an industrialized country. The big opportunity for expansion in our industry is overseas. This means exports. The opportunities overseas are far greater than those existing domestically, since we have developed to a high degree our transportation systems, our mining operations, and have built in this country most of our needed industrial capacity.

To sell our products overseas, we must have a strong distribution system and a strong and active oversea force of our own to obtain and hold independent distributors and assist them. This is costly. We must give them something to sell, which means a complete line of products in which they can do business every day.

In the areas in which our products are manufactured, each foreign manufacturing operation was created in order to give these distributors a steady source of products which could be sold at prices competitive with other locally made products. Because we have been able to offer some products of this type, we have been able to develop a strong oversea distribution system. Because we have a strong oversea distribution system, these distributors have been able to sell, in addition to our products manufactured overseas, a substantial volume of our products manufactured in the United States; that is, exports. As a matter of fact, only in this way would we have sold these goods for export. We would have lost these markets completely without oversea investment and manufacture.

In developing our organization in this way, which active development commenced some 10 years ago, we have had to take advantage of every U.S. and foreign local favorable tax and other provisions in order to remain competitive. We have had to accumulate earnings from technical service fees and/or dividends and/or, in part, sales commissions outside of our shores to have such funds available to reinvest in the same or other oversea areas, to allow us indirectly to price our U.S. exported products in keeping with foreign competition and to allow us to grant payment terms on a deferred basis as forced to do by foreign competition. These things are an all-important part of a whole picture. They are very much interrelated.

We are stronger today overseas and domestically because of this, and this overall position has been gained at least in the last few years in a period during which our industry has been experiencing severe difficulties domestically.

We are a better U.S. taxpayer and better exporter because of these mediums and we are a substantial oversea manufacturer and investor abroad as well. As a matter of fact, prior to our active participation in oversea investment and manufacture, the exports of our U.S. products lagged slightly behind the exports for our entire industry.

With the advent of our active oversea manufacturing program, which involved the use of foreign subsidiaries' reinvested profits, et cetera, our exports of U.S. produced goods have steadily, increased. They have substantially surpassed the average for our industry, which has generally been on a steady to downward trend. This means that we have been able to maintain rather steady domestic employment and even increase it in some of our plants during a most difficult and competitive period.

As a matter of fact, during the years 1958 and 1959, we probably would not even have been a domestic taxpayer at all had it not been for our foreign operations and exports, and we most certainly would have employed fewer people in the States of Wisconsin and Michigan.

We do not need roadblocks thrown in the way of our industry and business, which is exactly what the present tax bill would do. If anything, we need tax legislation which gives U.S. industry competitive equality with its foreign competitors.

If enacted, the present foreign tax legislation will certainly discourage foreign investment and make overall foreign operations most costly. This, in turn, as sure as you are sitting here, will cause a decline in U.S. exports and place us at a serious competitive disadvantage for the future.

This is the exact opposite of what we should be trying to do at this time, and I am sure that your committee, which is knowledgeable in such practical matters of business and finance, will not pass this bill to vote unless there are drastic revisions made in the foreign section of the bill, or better yet, unless this section be deleted completely.

Thank you.

Senator GORE. How long has your business been engaged in oversea investment?

Mr. SALDITT. We have been engaged in active exports since 1916, and in oversea investment since approximately 1952.

Senator GORE. 1952. Where was your first oversea investment?

Mr. SALDITT. Our first oversea investment in the nature of a license agreement—I revise this statement, we were first engaged in oversea investment in the middle thirties through the medium of a license agreement which was first completed at that time, and, subsequently, in accelerated form since the year 1952.

Senator GORE. Would you identify the countries in which you have foreign subsidiaries?

Mr. SALDITT. And/or license agreements?

Senator GORE. Yes.

Mr. SALDITT. I have here before me a pamphlet which describes our company, its products, and also its foreign operations.

Senator GORE. Would you have any extra ones?

Mr. SALDITT. Yes.

Senator GORE. Would you supply Senator Curtis and me with one?

Mr. SALDITT. We have foreign affiliates in Brazil, two in Germany, two in Japan, one in Chile, one in Australia, one in Canada, one in India—I think I mentioned Germany. We are about to conclude arrangements in Mexico and, unless political and economic reasons prevent doing so, in Argentina.

Senator GORE. I notice your pamphlet refers to foreign affiliates. Are these subsidiary corporations?

Mr. SALDITT. These are partially straight license arrangements, Mr. Chairman, and some of them are arrangements which include equity on our part. They are not subsidiary companies. In none of them do we have a controlling interest.

Senator GORE. Do you have an oversea trading corporation?

Mr. SALDITT. Yes. We are organized under a Panamanian company known as Harnischfeger International Corp.

Senator GORE. What part of your oversea sales are handled through your Panama subsidiary?

Mr. SALDITT. A substantial part.

Senator GORE. Percentagewise would it be in the order of 80 percent?

Mr. SALDITT. I would not be in position to give the exact percentage.

Senator GORE. I was not asking for exact.

Mr. SALDITT. Yes. I could not answer—well, it is more than 50 percent of our oversea sales which are handled by Harnischfeger International Corp., yes. That is our exports I am speaking of as well as sales made by these affiliated companies; and in this connection I might say that a few of our oversea affiliates do depend on the worldwide organization of Harnischfeger International Corp. through sales offices and distributors to sell their equipment, that is their Harnischfeger-produced equipment under license in the world market for which Harnischfeger International Corp., of course, receives a fee.

Senator GORE. And this is located in Panama?

Mr. SALDITT. That is a corporation organized under the laws of Panama.

Senator GORE. Does your company's Panama subsidiary handle exports to Europe?

Mr. SALDITT. From the United States?

Senator GORE. Yes.

Mr. SALDITT. They are acting, of course, inasmuch as Harnischfeger International Corp. has the worldwide distributing system and all of the distributors of Harnischfeger are Harnischfeger International Corp. distributors, they are the ones who are handling our exports in oversea markets.

We, however, of course, produce machines and sell them to these markets.

Senator GORE. Is your Panama subsidiary a wholly owned subsidiary

Mr. SALDITT. It is a wholly owned subsidiary of Harnischfeger Corp.

Senator GORE. So it is entirely your creature.

Mr. SALDITT. It is. Creature, you say?

Senator GORE. Yes. Well, it is an instrument of your own making. Although Panama is many thousands of miles removed from Europe, nevertheless exports are funneled through the Panama subsidiary.

Mr. SALDITT. We do not deny that.

Senator GORE. And you unabashedly say you do this as a means of tax avoidance in order——

Mr. SALDITT. Not tax avoidance. We are doing this in order to have the advantage of tax deferral, which we consider to be legally possible.

Senator GORE. Please understand I do not use "avoidance" in the same sense as "evasion." To use your own words, you are using your Panama contraption as a means of obtaining deferral of payment of taxes which you would otherwise owe to the U.S. Government.

Mr. SALDITT. May I restate our position?

Senator GORE. The only word I used that you did not use was "contraption." You do not like that?

Mr. SALDITT. No, no, excuse me, Mr. Chairman. From what page in my prepared statement are you quoting here?

Senator GORE. I think I can find it very presently.

Mr. SALDITT. Page 4 in my prepared statement, I believe, says that the utilization of tax deferral methods has helped provide the wherewithal to do this, and I spoke of maintaining and increasing the exports from this country.

Senator GORE. Well, rather than to try to find your quote, let us see exactly what you do.

Mr. SALDITT. That is my quote.

Senator GORE. Let us see exactly what you do do.

You manufacture in the United States and you export to many countries in the world. Most of that export trade is handled through your Panama subsidiary; is that correct?

Mr. SALDITT. They provide the organization to accomplish our exports, yes.

Senator GORE. Well, is the money from the sale, say, to Germany or Egypt or wherever you sell—

Mr. SALDITT. Is paid to the United States. Our entire exports are paid for in the United States. We are merely engaging Harnischfeger International Corp. to do the selling job.

Senator GORE. What kind of fee do you pay to your subsidiary in Panama?

Mr. SALDITT. I would not be in position to answer that. It is somewhat out of my—

Senator GORE. Is there someone in the back who can answer that? Do you have someone with you who can?

Mr. SALDITT. Yes.

Mr. WEISS. I am Alvin H. Weiss, tax manager at Harnischfeger Corp.

The foreign subsidiary which has its headquarters in Venezuela, receives a reasonable sales commission for sales actually consummated by them, also on sales of products manufactured by its licensees, they also sell those products and maintain distributors.

Senator GORE. You said Venezuela. I understood we were talking about Panama.

Mr. WEISS. It is merely incorporated in Panama. We happen to have the administrative offices in Venezuela.

Senator GORE. You say a reasonable fee. Will you be specific?

Mr. WEISS. Well, it varies with the different products, and I might say we have been audited on that particular aspect, and with some minor adjustments they felt it has been a reasonable figure for the services actually rendered by the foreign subsidiary.

Senator GORE. What have been the profit accumulations in the—I do not know now whether to call it the Panamanian or Venezuelan subsidiary; Panamanian, I take it, is correct?

Mr. WEISS. That is right.

Senator GORE. What have been the profit accumulations there?

Mr. SALDITT. Mr. Chairman, as far as answering or being able to answer that question is concerned, I would have to, first of all, mention the amount of business that has been accomplished and, particularly from the export point of view, during the period of time that we have been able to operate in that manner.

As far as profit accumulation is concerned it is, of course, my job as the vice president for international operations to see to it that the profit obtained is a maximum and that the profit reinvested in our foreign operations is such as to maintain and further improve our worldwide ability to export from the United States, and where we cannot export to produce our product abroad so that we, at least, have the advantage of an income from manufacturing operations abroad, whether under license, straight license, or equity participation which profits, eventually, of course, will be returned to the United States.

Senator GORE. Please understand I am not accusing you of violating the law, of doing anything wrong. You have taken advantage of a provision in the law, a loophole in the tax law to, as you say, obtain deferral of taxes due the U.S. Government.

Mr. SALDITT. We have used the deferral features of the prevailing law for the purpose of accomplishing something abroad which would have been impossible to do without it.

Senator GORE. Well, of course, as far as that is concerned, if you had not been required to pay taxes at home you could have accomplished things which have been impossible because you did have to pay taxes.

Mr. SALDITT. Well, I do not quite agree with that, Mr. Chairman.

Senator GORE. You really cannot argue with that.

Mr. SALDITT. Well, I should think——

Senator GORE. That is true of all of us, I understand.

Mr. SALDITT. I would like to refer you, however, to a very significant statement I made along those lines in my prepared statement where I speak about the industry of which we are a part having had a rather difficult time to increase its exports during the last 10 years and where, in turn, our company, through the medium of, if you please, available means of tax deferral, and the courage that we have had to go abroad and to establish through Harnischfeger International Corp. a very extensive foreign sales organization of our own people or, I should say, Harnischfeger International's people, thereby maintaining and building up a very strong distributing organization throughout the world, have been vastly increasing our exports from the United States.

I would like to mention exactly what it has meant in actual figures. if you care to have them.

We began enlarging our oversea manufacturing operations between the years 1952 and 1954. These foreign manufacturing operations since then resulted in increasingly greater sales volume and earnings. Most importantly, however, they directly contributed to a substantial increase in Harnischfeger Corp. domestically produced exports.

Taking the entitre American power crane and shovel industry exports between the years 1947 and 1951 at an average of 100 and likewise taking Harnischfeger Corp. exports during the same period at an average of 100, we find that in 1954 the industry exported at 110 and Harnischfeger exported at 102; that in 1957 the industry exported at 198 and Harnischfeger Crop. exported at 270; that in 1960 the industry exported at 118 and Harnischfeger Corp. exported at 210.

The industry figures are computed from the Census Report FT 410, U.S. Department of Commerce, export classifications 72000, 72002, 72004, and 72006. It is estimated that during the year 1961 the industry exported at 135 with Harnischfeger Corp. exports actually amounting to 246.

Senator GORE. I would like the actual figures on your profit accumulation in your Panamanian subsidiary first.

Mr. SALDITT. Well, in order to have a profit we have to sell first. In order to sell first we have to meet foreign competition. That is the end result, of course.

Senator GORE. This committee is not going to force anyone to give an answer. We have means of doing so, but certainly those means has not been used in these hearings. If you do not wish to answer the question——

Mr. SALDITT. I do not have the figures with me, to be quite honest. I cannot give you even the approximate figures.

Senator GORE. You are vice president of——

Mr. SALDITT. Of international operations, yes.

Senator GORE. What are the current assets, what is the current net value of your Panamanian subsidiary?

Mr. SALDITT. I am not in a position to give this figure, but I shall be glad to supply it.

Senator GORE. How long has it been established?

Mr. WEISS. Harnischfeger International was established about 1953.

Senator GORE. With what investment?

Mr. WEISS. I believe the original investment was approximately $100,000.

Senator GORE. Well, do you know what its current book value is?

Mr. WEISS. I do not know that I am at liberty, for competitive reasons—we do not like to give this type of information for the record. I hope you understand that.

Senator GORE. The vice president just said he would submit it for the record, and I thought if you had it in your own mind it would be more useful if we had it now.

Mr. WEISS. Because we have worked this thing out on the basis of index numbers which, I believe, Mr. Salditt has presented to you to give you a picture of our foreign operations since we have gone into foreign manufacturing and licensing; and you can easily compute relatively what it has done.

Senator GORE. Well, I am interested in exports, but I am also interested in the amount of profit you have earned on which you have avoided paying any U.S. taxes.

Mr. SALDITT. Let me enlarge on this somewhat, Mr. Chairman.

Senator GORE. You have appeared here and you have said unabashedly that you have utilized this deferral privilege, and I am not saying you have done wrong in doing so; but I believe it would be pertinent to these hearings for the committee to know to what extent you have avoided paying taxes by use of this device.

Mr. SALDITT. Fine. I will answer your question in this manner, Mr. Chairman: We have—I can tell you what we have remitted to the United States in taxable income.

Senator GORE. I would like to have that. But that would only be of real value if and when we know how much you have not remitted.

Mr. SALDITT. We have remitted to the extent, as it was at all possible to do, and at the same time maintain and build up on the strength of our foreign organization which, in turn, has increased our export into phenomenal figures from this country, and if it is, if you please, the intention of covering our balance-of-payments situation, if it is the intention of aiding in the flight of gold, if it is the intenton of utilizing Amercan production facilities to the greatest possible extent in order to maintain employment and accomplish the other purposes, I am prepared to tell you to what extent we have been able to do that, with the aid and assistance also of keeping some of our earned profits abroad for—not keeping them there, but investing them into organization, into a buildup of organization, without which all of these things would have been impossible—if that should be of interest, I certainly would like to get it into the record as to what has been accomplished along those lines.

Senator GORE. That is of interest. But I would like to take this opportunity to say that insofar as I am concerned, the overriding objective is equality and fairness in the treatment of taxpayers.

I want to see measures enacted which will contribute to the solution of our imbalance of payments. But the overriding objective I have is to close the loopholes of favoritism in the tax law, one of which you have unabashedly said you are taking advantage of, and I wanted to know, first, to what extent your company has benefited by tax deferral.

Now, if you do not—there is really no need, sir, in discussing the matter further. I do not want to be combative, and I am sure you do not.

If you prefer not to tell the committee this, if you will say so, we will go to something else. If you wish to tell the committee, then I invite you to do so.

Mr. SALDITT. I do not have it, Mr. Chairman.

Senator GORE. Do you wish the committee to have it?

Mr. SALDITT. If you request such information I should like to have it referred to the committee under circumstances however, that would not reveal this figure publicly, for competitive reasons. However, it can be made available to the committee, of course.

Senator GORE. If that is your wish I shall not pursue this particular matter further.

Mr. WEISS. Excuse me, do I understand that you would like that information for executive committee considerations?

Senator GORE. No; I do not make that request. If the chairman of the committee wishes something for use in executive session I would rather defer to him in that matter.

Mr. WEISS. We will be very happy to supply that under those circumstances, I am sure.

Senator GORE. I understand. I am not chairman of this committee. The chairman asked me to serve this afternoon while he is making a speech on the floor of the Senate.

What is the total value of your foreign subsidiary branch and affiliated holdings?

Mr. SALDITT. You mean the holdings that we have, the equity that we possess, in our foreign affiliated—in the companies?

Senator GORE. The total amount, the book value or equity, the total equity, the total book value, the total assets of the foreign holdings—property, portfolio, affiliates, branches, subsidiaries of the parent corporation.

Mr. SALDITT. It is a matter of public record, and I am quoting from the October 31, 1961, annual report of Harnischfeger Corp.

Investment in affiliated and partly owned foreign companies at cost and assigned value, $1,006,376.

Senator GORE. How much?

Mr. SALDITT. $1,006,376; and may I add that none of this money concerns U.S. dollars sent abroad. All of this is in the nature of capitalizing know-how, plus the sale of some used machine tools which were virtually useless and had no value in the United States, but represented some value abroad, and were capitalized, and form part of this equity. This equity is capitalized know-how, experience, knowledge.

Senator GORE. I am not sure I understand.

Do I understand correctly that you say you have made no dollar——

Mr. SALDITT. Contributions from the United States.

Senator GORE. To any of your affiliates?

Mr. SALDITT. No, sir.

What we have done is to capitalize our know-how or, at least, partially our know-how.

In addition to that we receive a service fee, and then have used dollars that we have earned abroad through this initial capitalization of know-how to reinvest in the course of time in order to increase our equity in these operations, and so we have finally accumulated a total of somewhat over $1 million.

Senator GORE. $1 million?

Mr. SALDITT. Somewhat over $1 million, in equities abroad.

Senator GORE. And all of this has come from earnings abroad on which you have paid no taxes to the U.S. Government?

Mr. SALDITT. No. We have capitalized our know-how.

For instance, in the case of Brazil we received in a jointly formed company a certain equity in return for its rights to manufacture, for the rights to manufacture that we extended to these people and in return for the continuing servicing of that joint operation with our technical information and know-how. For that we received an equity in that company, which equity, in turn, has been capitalized, and is thereby represented in this $1 million-plus position in our balance sheet.

Senator GORE. Does this $1 million-plus include your investment in your Panamanian subsidiary?

Mr. SALDITT. Does it?

Mr. WEISS. Yes. To that extent there has been money put in, that initial investment in the formation of the corporation, capital stock.

Senator GORE. And this formation, the contribution to capital stock in your Panamanian subsidiary, is the only dollar outflow which your foreign investment has generated?

Mr. WEISS. That is correct.

Senator GORE. And all of the other is accumulation of the profits. Whether capitalization of know-how or whatever, you have accumulated assets which you estimate to be $1 million, slightly in excess of $1 million.

Is that the total extent of your foreign holdings?

Mr. WEISS. Yes.

Mr. SALDITT. That is the only asset—we have a consolidated balance sheet here—that is the only asset.

Senator GORE. Do you have a foreign manufacturing subsidiary?

Mr. SALDITT. We have no foreign manufacturing subsidiary. We have equity in foreign manufacturing operations, as I mentioned before.

Senator GORE. And that equity is involved in the $1 million?

Mr. SALDITT. That is correct.

Senator GORE. Then the profits from your foreign operations, from your answer here, could not loom or do not loom as large as I had anticipated they had been. That is why I asked you if you are sure this is the total of all your foreign holdings.

Mr. SALDITT. This is the total of our foreign equity holdings, yes; that is correct.

Senator GORE. Your foreign holdings of all kinds?

Mr. SALDITT. But we have an income through, of course, licensing arrangements, service fees, and so forth, which has amounted in the course of time to some substantial figures. But those incomes we have only partially reinvested in equities abroad, and that is the reason I said before that it was dollars we earned abroad, which, in turn, have partially been reinvested abroad.

Senator GORE. Then the total worth of your Panamanian subsidiary is considerably less than $1 million.

Mr. SALDITT. I would not be able to say that at all.

Senator GORE. I did not understand.

Mr. SALDITT. We could not very well—I do not think this is entirely correct, and I believe the figure should be supplied to you in order to settle this issue—I have not the figure, I do not have this figure available.

Senator GORE. I am only deducing when I asked you for your total foreign holdings in all countries——

Mr. SALDITT. These are the equity holdings that we possess, Mr. Chairman, and that is all there is. That is somewhat over $1 million.

Senator GORE. Well, then, if the total is only $1 million, then it seems reasonable to deduce that your Panamanian subsidiary is worth less than $1 million.

Mr. SALDITT. That is not so.

Senator GORE. Maybe I am confused on terms. When I asked you your total holdings, your total assets, your total cash, your total capital value, your total real values, everything of value which the parent company owns in any form, subsidiary, branch, portfolio, real, tangible or intangible, what is the total? Is it still $1 million?

Mr. SALDITT. I am not in position to answer that at this moment.

Mr. WEISS. Perhaps there is some confusion here. This figure represents equity ownerships in partly owned companies, manufacturing.

Senator GORE. Now you are an accountant. Is there any way that I can ask for your total foreign assets, which I have not asked?

Mr. WEISS. That is the information which I asked you whether you wanted us to supply for executive committee meeting.

Senator GORE. Then the $1 million figure is not the answer.

Mr. WEISS. No; it is a substantially larger figure than that. In fact, we have returned a lot more than that per year as income to the United States.

Senator GORE. I do not know much about your company, but I thought I knew enough to know that I was not getting the right answer. Maybe you did not understand what I was seeking.

Mr. SALDITT. My understanding of your question was, Mr. Chairman, what equity ownership do we have in foreign manufacturing companies. That is the way I understood your question.

Senator GORE. I asked you repeatedly for the total assets, and I ask you now, What are the total assets, the total holdings, in whatever form?

Senator CURTIS. May I inquire of something, Mr. Chairman?

Senator GORE. Yes.

Senator CURTIS. Are you talking about assets that are not within the jurisdiction of the United States?

Mr. SALDITT. That is correct.

Senator CURTIS. And have those assets ever been in the jurisdiction of the United States?

Senator GORE. I will say to my friend from Nebraska the whole question has been about assets without the United States. That was the whole burden of my question. That is what the witness has been testifying about. That is the subject before the committee. We are not talking about the value of the assets of his company in the United States.

Mr. SALDITT. Of course, I came here to testify on the remarkable performance from the U.S. point of view of our company in building up a major exporting operation for Harnischfeger Corp., U.S.A., and came here to testify as to how we accomplished that.

Senator GORE. Yes.

Mr. SALDITT. And how, to a very large extent, it was possible to accomplish it by having available for a period of time certainly, until now, the full dollars that we earned abroad, without having to cut this dollar in half or less than half for the purposes of making an investment abroad that became necessary in order to accomplish the purposes in which we are all interested.

Senator GORE. You so testified. Then I asked you the simple question, and I have asked you in numerous less simple ways, To what extent have you avoided U.S. taxes by the use of this deferral device?

Mr. SALDITT. We have deferred, with the exception of the last 4 years when we were able to refer back to the United States and to the shareholders of our company, all of whom are Americans and are as much interested in receiving their share of the profits as, I am sure, the U.S. Government is interested in receiving its share of the profits in the form of taxes, in the following amounts:

Starting in 1958, 890,000; 1959, $979,000; 1960, $1,029,000; in 1961, $1,180,000, in the form of taxable income remitted to the United States, none of which would have been available unless we had operated abroad as we did.

Senator GORE. You have given us the amount that has been repatriated. Are you prepared to tell the committee your total profits which have not been repatriated?

Mr. SALDITT. We are prepared to refer that to the committee, but not in public testimony.

Senator GORE. Senator Williams.

Senator WILLIAMS. No questions.

Senator GORE. Senator Curtis.

Senator CURTIS. This income from which dividends were paid into the United States was all earned outside the United States, was from income earned outside the United States and its jurisdiction?

Mr. SALDITT. From income earned outside of the United States; that is correct.

Mr. WEISS. That is correct.

Senator CURTIS. Do I understand your position in reference to the figures in regard to assets and income that you regard as of value, as possible value, to competitors, you are willing to give whatever the committee asks in executive session?

Mr. SALDITT. That is correct. I am also prepared to give in the form of index figures and not actual values the things that have been accomplished in the form of actual business done; that is, in this case I am speaking of our export business and what it meant in the nature of employment in a sharply declining market, domestic market, under which the entire industry in the last 6 years——

Senator CURTIS. How much have you added to employment by reason of your foreign operations? How much have you added to employment by reason of having these foreign operations, I mean domestic employment?

Mr. SALDITT. In the thirties 1 man out of 10 in our organization was employed by virtue of foreign operations.

Senator CURTIS. In the United States?

Mr. SALDITT. In the United States.

In the years 1951–54, one out of six men was employed in the United States, and not only workingmen but staff also.

In the manufacture of equipment for export——

Senator CURTIS. Do I understand this right, of every six people working in the United States, one of them had his job by reason of your foreign operations?

Mr. SALDITT. By reason of our foreign operations, by reason of our exports, if you please.

Senator CURTIS. Exports.

Mr. SALDITT. That was in the early 1950's by reason of exports.

Then this figure gradually rose with 1 man out of 4 today in our operations in our plants in the United States, deriving his livelihood from our export operations, 1 out of 4, an increase from 1 out of 10 to 1 out of 4, and the chances are that this will further increase if the operations so far this year, since the beginning of our fiscal year this year, are any indication at all as to the steadily rising exports that we have enjoyed by virtue of the operations that we have been conducting so effectively in foreign countries.

Senator CURTIS. That is all, Mr. Chairman.

Senator GORE. Well, you are in the unusual position of petitioning this committee to continue in the law a special tax provision from which you have benefited vastly, but you demonstrate your unwillingness to tell the committee to what extent you have benefited.

Mr. SALDITT. We are perfectly willing, Mr. Chairman, to supply the information, but we feel, first of all—first of all, I do not have it with me. Therefore, I cannot give the exact figure; and, secondly, it is, and we shall supply this information as quickly as we can obtain it and make it available to you.

Senator GORE. Thank you very much.

Mr. SALDITT. Of course.

Senator GORE. Would you tell me quickly now in what other countries besides Panama you have a foreign corporate subsidiary?

Mr. SALDITT. As far as the parent company is concerned, we have one in Canada, have we not?

Mr. WEISS. Yes.

Senator GORE. Do you have another?

Mr. SADLITT. No.

Senator GORE. That is all.

Mr. SALDITT. The Panamanian subsidiary, however, has its own subsidiaries in Germany and in Japan. In other words, these are granddaughters of the parent company.

Senator GORE. So whatever money is made by the subsidiary in Germany, et cetera, goes to the Panamanian subsidiary.

Mr. SAIDITT. And Panama refers to us, and that is done purely for purposes of reducing to the minimum the tax exposure in the countries in which we are operating.

Senator GORE. Yes; and including this one.

Mr. SALDITT. It is done, however——

Senator GORE. I understand it. [Laughter.]

Mr. SADLITT. Mr. Chairman, for purposes of retaining, if you please, a maximum return to the U.S. Government when the times comes that we shall pay our taxes, and that time is being forcefully reduced by the insistence of our stockholders.

Senator GORE. I think we understand each other perfectly.

Mr. SALDITT. I hope you understand.

Senator GORE. I think we understand this perfectly. You want this privilege continued, and I want to strike it out.

Thank you very much.

The next witness is Mr. Robert H. Tucker.

The committee is pleased to have you, Mr. Tucker.

STATEMENT OF ROBERT H. TUCKER, SECRETARY, MINNESOTA MINING & MANUFACTURING CO.; ACCOMPANIED BY RICHARD W. BRUST, MANAGER, TAX DEPARTMENT; AND EUGENE F. KINDLER, ASSISTANT TREASURER IN CHARGE OF INTERNATIONAL DIVISION

Mr. TUCKER. Thank you very much.

Mr. Chairman, I first would like to introduce the two seconds I have along with me. On my left is Mr. Richard Brust who is the manager of our tax department; on my right is Mr. Eugene Kindler, who is the assistant treasurer in charge of our international division.

Senator GORE. We are glad to have you gentlemen.

Mr. TUCKER. The primary thrust of our remarks today will be directed to our own individual foreign operations and the affect of this new tax proposal on those operations.

My name is Robert H. Tucker, I reside in St. Paul, Minn., and am secretary of Minnesota Mining & Manufacturing Co.

American industry is confused today as to what the policy of the U.S. Government really is with respect to foreign trade. In the past we had our point 4 program which was an attempt to share technology. U.S. industry feels it has been a partner with the U.S. Government in raising the technological and living standards of other countries through our private investment programs. It has been U.S. foreign trade policy to increase exports. We have our Alliance for Progress. These all seem to be directed toward increasing our foreign trade and raising the standards of living of other countries with the cooperation of U.S. industry, and yet a tax bill has been designed which will tend to reduce the amount of U.S. exports.

As a representative of a company engaged in foreign trade for many years, it is my firm belief that many sections of this bill relating to foreign activities will have a practical effect which will run directly counter to what I have understood to be the U.S. Government's foreign trade policy. It is historic that governments, in an attempt to increase their export activity, have not penalized their global industry with taxation, such as represented by this bill, but have generally given tax relief and in many instances subsidies to build up their export markets and foreign trade.

In 3M's experience the strongest reason in recent years for expanding domestic plant facilities has been the growth of our foreign business. If American industry does not develop its products and markets on a worldwide basis, it is to be expected that this void will be filled and the products and markets will be developed by the industry of foreign countries, and U.S. industry will lose its foreign markets, and Government in the long range would lose its source of foreign exchange.. U.S. industry certainly is not asking for subsidies or for tax aid, but it does feel that it should be allowed to progress as it has in the past under rules that have long been established.

Let us consider the allocation of income between related foreign and domestic corporations. We feel that section 482 of the present law has sufficient teeth to correct pricing situations designed for purpose of avoidance of U.S. taxes. It has been our company policy to supply goods made in the United States where costs are reasonably close even though we have many sources of potential supply around the world. Our pricing has been designed on what we consider sound business and economic principles relating to our business.

Application by the Government of an arbitrary formula, as permitted by section 6 of this bill, would likely result in our case, because of the availability of multiple sources of supply, in an export loss of U.S.-made goods of up to $20 million annually. U.S. industry must be competitive in the marketplace even with its own foreign subsidiaries and up to now, in our experience, United States has been our best economic source of supply. This bill displaces management judgment in this critical area of pricing and could result in the export of U.S. jobs.

On the subject of controlled foreign corporations (sec. 13 of the bill), the proposed basis for taxing certain income of foreign corporations is extraterritorial—it assumes income for taxation purposes which has not been received. This would destroy the legal concepts which have been developed over the years. The taxation of a parent on income earned by its subsidiaries is repugnant to the basic legal concept of the corporate entity and to say the least its constitutionality is opened to serious question.

In the case of *Watson* v. *Commissioner of Internal Revenue* 124 Fed. 2d 437 (2d Circuit 1942), it was stated:

> From the beginning the revenue acts have recognized a corporation and its shareholders as separate taxpayers.

Even sections 531 and 532 (sec. 102 of the 1939 code) imposing the penalty tax on corporations for improper accumulation of surplus is a tax against the corporation, and not upon its shareholders. There certainly would be a strong tendency for foreign governments to follow suit and apply extraterritorially their tax laws which would result in years of conflict in international taxation. This would also have the effect of putting U.S. companies at a competitive disadvantage with foreign companies in international trade, who in most instances are receiving substantial tax and subsidy benefits from their countries.

The enactment of this proposed legislation could result in one of the outstanding errors in foreign taxation and foreign trade of this era. We certainly would hope that it would not, but we fear it would put the U.S. industry at such a disadvantage that future proposals before this body might entail ways of increasing U.S. exports through subsidization of U.S. industry. We would not want to subscribe to this any more than we would subscribe to the investment credit which is proposed to be furnished to American industry by this same bill.

The bill encourages foreign research in place of domestic research by imputing income of a controlled foreign corporation to the U.S. parent corporation where such income is derived from patents substantially developed in the United States.

With respect to treaties, the Government has spent years developing agreements governing international taxation. By section 21 of this bill the U.S. Government unilaterally would invalidate the provisions of these treaties and would disturb our present amiable relationships with other countries. It should be noted in his statement at the opening of the hearings before this committee, the Secretary of the Treasury recommended elimination of section 21, with which we agree.

Finally, I call your attention to the letter of March 28, 1962, from the President of the United States to the President of the Senate and the Speaker of the House of Representatives, in which he spoke of "our varied efforts to penetrate foreign markets more deeply." Our experience has been that the establishment of a manufacturing subsidiary in a foreign country permits market penetration in depth in the economy of that country. This is in contrast to the rather superficial penetration accomplished solely by exports from the United States.

Parenthetically, we at 3M like to feel that our expansion has increased the standard of living of people in these foreign countries.

It has been the experience of 3M Co. that the more successful the foreign manufacturing subsidiary becomes, the greater and greater do our U.S. exports into that country likewise become, through shipments of raw materials, and also of finished goods manufactured in the United States. The claim that jobs are exported when a foreign subsidiary is established is not only untrue, but in fact, in our experience the contrary is true; namely, that new U.S. jobs are thus created.

In 1951, a handful of our people handled our total foreign business. Today, 1 out of every 10 employees in our domestic factories owe their jobs to the fact that we are exporting products to foreign countries. Our experience is that exports are increased by foreign manufacturing operations. Business begets business.

Thank you.

Senator GORE. The problem we are concerned with here is, on the one hand, equity and fairness in tax law, and on the other, the export of dollars.

Now, you say on the first page of your statement that this bill will tend to reduce the amount of U.S. exports.

Are you talking about exports of dollars or exports of goods?

Mr. TUCKER. Goods.

Senator GORE. What effect do you think it would tend to have on the export of dollars?

Mr. TUCKER. From our company's standpoint I would say—or could I put it this way, sir, that we gave before the House committee these figures which are now a year old. We have accumulated—this is as of 1960—$12 million investments in our various foreign subsidiaries, and we have produced $153 million in return to the United States.

For every $1 that has been invested abroad, $12 have been returned to the United States in our situation.

Senator GORE. Well, congratulations.

There are other companies from whose foreign investments the balance-of-payments problem has benefited.

Unfortunately, last year there was an investment in plant and equipment in U.S.-owned foreign enterprises of $4.5 billion. It would not be right to assume that your particular company is typical; in fact, it is highly untypical.

Was my understanding correct that your foreign assets are now $12 million?

Mr. TUCKER. That was as of 1960, I think.

Mr. KINDLER. That was the foreign investments from the States. That is not total foreign assets that have accumulated since then.

Senator GORE. Are you prepared to give the committee your total foreign assets?

Mr. KINDLER. Yes, sir. We do not have that figure available at the moment. The total assets of our foreign companies, without consideration of minority interests, would run in the area of about $40 million.

Senator GORE. So you have invested $12 million——

Mr. TUCKER. I think we should probably use $15 million, I think that is correct.

Mr. KINDLER. As of today. We are reporting as of 1960 on the $12 million; yes, sir.

Senator GORE. You invested $12 million, and you now have profit accumulations of approximately $40 million?

Mr. KINDLER. The $12 million and the $40 million are not comparable in this sense, that the $12 million is for our interest in our companies, and the $40 million is the total assets of our companies.

Senator GORE. I thought you were excluding—you included it?

Mr. KINDLER. No, sir; I did not.

Senator GORE. Could you give the committee your equity holdings, your total holdings, your total assets?

Mr. KINDLER. I do not have that available, but certainly we will supply it.

Senator GORE. Well, you know, this record gets thick, and I have great difficulty going back and reading something that somebody is going to supply.

Could you give me an estimate? I do not ask you to be exact.

Mr. KINDLER. Well, if I were estimating, I would say around $35 million, possibly.

Senator GORE. $35 million.

Mr. KINDLER. Yes.

Senator GORE. So you have profits of around $22 million?

Mr. KINDLER. Accumulated.

Senator GORE. In foreign earnings which have not been repatriated.

Mr. KINDLER. That is right.

Mr. TUCKER. Spread over 26 subsidiaries throughout the world.

Senator GORE. Over a relatively short period?

Mr. KINDLER. Yes, sir. We have been in business since 1951. This is 1962.

Senator CURTIS. You mean you have been in foreign business?

Mr. KINDLER. In foreign business.

Mr. TUCKER. We have been in the foreign business through a Webb-Pomerene Corp. through 1948 or 1949. We went on our own in 1951.

Senator GORE. Well, congratulations, you have had fine success.

So far as I am concerned, my only aim here is to require you and other people who engage successfully in international business to pay a tax on your earnings.

Mr. KINDLER. Yes, sir. You might have an interest in the average for the first quarter. We have the average tax, and I think Mr. Brust can quote that for you.

Mr. BRUST. For the quarter ending March 31, 1962, our effective rate of tax on a consolidated basis for domestic and foreign companies was in excess of 51 percent. The foreign portion of that effective rate for the foreign portion or the foreign companies was around 47 percent.

Senator GORE. Well then, you do not funnel yours through a tax haven.

Mr. KINDLER. Well, sir, when you speak of a tax haven, I think we would have to define it a little bit. Any of our merchandising transactions are not in the sense that the word has been used, no.

Senator GORE. You do not have a Panama subsidiary through which you export?

Mr. KINDLER. We do not have a Panama subsidiary; no, sir.

Senator GORE. Do you have a subsidiary in Panama?

Mr. KINDLER. No.

Senator GORE. Do you have one in Liechtenstein?

Mr. KINDLER. No, sir; we do not.

Senator GORE. Do you have one in the Bahamas?

Mr. KINDLER. No, sir.

Senator GORE. Do you have one in Bermuda?

Mr. KINDLER. No, sir.

Senator GORE. Do you have one in Switzerland?

Mr. KINDLER. We have one in Switzerland.

Senator GORE. What does it do?

Mr. KINDLER. The objective of that company is to insulate the parent company from the imposition of a foreign tax on a branch basis. The function is to serve as a headquarters for a sales organization in Europe which services our export area in Europe.

Senator GORE. Yes.

Well now, you said, you gave me a purpose and a function.

Mr. KINDLER. Yes, sir.

Senator GORE. The purpose was to insulate a branch from the transaction——

Mr. KINDLER. No merchandise transaction transpires with that company.

Mr. TUCKER. They buy and sell nothing.

Mr. KINDLER. They buy and sell nothing.

Senator GORE. How does it insulate a branch from taxation?

Mr. KINDLER. In a sense that all of the costs of that are the costs of the Swiss organization who bill us for those costs, but they can make contracts locally for the rental of headquarters and other facilities, as well as employing personnel.

Senator GORE. Now, with your consolidated statement which you have just given, the terms of this bill would have no serious effect upon you.

Mr. KINDLER. No, sir. In our area we do not think it will. But we still think there are many features of this bill——

Senator GORE. It might have considerable consequence on the company whose spokesman preceded you?

Mr. KINDLER. We feel it is going to have a serious effect on us also, but not in the particular area that you are speaking of.

Senator GORE. With your average foreign tax rates—did you say 47 percent?

Mr. BRUST. Forty-seven percent.

Senator GORE. Then there would be no serious consequences taxwise of this bill in your operations?

Mr. KINDLER. Well, in the sense in which you are speaking, that is perhaps true, for a merchandise transaction.

Senator GORE. Do you mean that it would?

Mr. KINDLER. Well, sir, as we mentioned—as Mr. Tucker mentioned in his presentation, when you get into this area of choices—on shipments that we make from the United States to our foreign companies, that is an area which disturbs us quite a bit. Section 482, we have felt, has effective teeth in it, if we were abusing the privilege, which we do not feel we are. And we feel it is necessary that management should have a prerogative of tracing its products in order to meet the situation that we meet internationally.

Senator GORE. You don't think this bill would prevent you from doing this?

Mr. KINDLER. Yes, if the allocation of foreign profits went into it, it very possibly would.

Senator GORE. You mean you want to set it at a loss in some countries?

Mr. KINDLER. Definitely not, Minnesota Mining is a profit-minded company.

Mr. TUCKER. We are afraid that that markup would get so great that we would become noncompetitive in the foreign country.

Mr. KINDLER. Say, you are putting in administrative hands other than foreign management the right to determine prices.

Senator GORE. Will you explain just how this bill would do this?

Mr. KINDLER. Well, sir, you are determining an allocation formula, you are giving a formula for the allocation of income between a foreign company and the U.S. company, and to that extent, if that formula, for instance, determined a price to be $1.20, and $1.20 put us out of the market, that would be an administrative decision made through the income tax law and not through management's prerogative in establishing prices, would it not?

Senator GORE. If such occurred, that would be administratively determined, and I would think that there would be sufficient flexibility that your fears are more fancied than real.

Mr. KINDLER. Well, sir, I think generally—I am sure Mr. Brust is more familiar than I am with this subject—but between States this formulation has been used for allocation of income. And that is one problem. But when you are going between countries, that is a completely different problem, and I hope there is not a confusion in that area.

Senator GORE. For one, I want to look into this point that you raised here.

Mr. KINDLER. I would appreciate it.

Senator GORE. Because, as I said earlier, taxwise, judging from your consolidated statement, there would be no serious consequences from the bill to you and no great increase in your annual tax liability. I want to return, if I may, to this sentence on the bottom of page 1 of your prepared statement. I asked you if you referred to export of dollars or goods, and you said goods. How would this reduce export of goods? I don't know how long you have been here, but for several days now people have been saying that this bill is going to reduce exports, and no one has told us how.

Mr. KINDLER. If I might try that, I think it will reduce exports—one is in the instance that I just mentioned, this taking from management its prerogative on the prices—on pricing. I think that is one possible way in which it might reduce exports. And another is the fact that in our experience we have had very strong and fast growth over this past 11 years, and during that period we have seen our exports to our subsidiaries increasing at a faster rate than our total international business has been increasing. For instance, if we go back to the early days of international operations of our company, our exports to our subsidiaries amounted to about 10 percent. Today they amount to about 13 percent of our annual sales of the division.

Senator GORE. Now, you said that if this bill is passed it may prevent this trend from continuing—or are you saying that it is going actually to reduce exports?

Mr. KINDLER. Actually, I think, No. 1, it would prevent it from continuing; that is one factor. And we have very strong fears that it may go so far as to make it impossible for us to have these particular sales to our subsidiary companies, which are the things that round out their product lines.

Senator GORE. How would it make it impossible?

Mr. KINDLER. Well, sir, we have quoted that—in this allocation of income that we were talking about a little earlier, if the Government administratively, if this bill were passed, allocated income to the United States, saying that our prices to our subsidiaries were not justified, if that position were taken, and income were allocated to the United States, that would put that income as being taxable in the United States, and we would have no alternative but to raise our prices, based on that administrative decision, to our subsidiaries, which might put them competitively out of the market. I think it is very serious.

Senator GORE. Do you mean by that that this law might prevent your selling to a foreign subsidiary at a loss to the U.S. corporation?

Mr. KINDLER. Sir, we don't sell at losses.

Senator GORE. Well, if you sell at no profit.

Mr. KINDLER. No, sir; we do not. In our transactions between ourselves and our subsidiaries we——

Senator GORE. You know, of course, that some people have resorted to that device.

Mr. KINDLER. Yes, sir. But we do not. We figure on 10 percent, and it has been running between 11 and 12 percent on all of our sales to our foreign companies.

Senator GORE. You don't seriously think that the U.S. Government would challenge as unreasonable the sale of a product from U.S. factory at an overall profit of 12 percent?

Mr. KINDLER. Well, sir, administratively I think it is very possible; yes. If an arbitrary allocation formula is put in, it would put in the administrative hands a tool which could force situations which might be completely uneconomical, but from a tax standpoint—and it is the tax people that are wielding this tool—from a tax standpoint, they would be wielding a tool which could be detrimental from the standpoint of export and balance of payments.

Senator CURTIS. May I ask you a brief question on that point?

Senator GORE. Surely.

Senator CURTIS. At what point in time did the Internal Revenue Service assert that power with respect to your sales?

Mr. KINDLER. At what point in time would they?

Senator CURTIS. Yes; before the sales were made, or a year or two after, or when?

Mr. KINDLER. Well, I would say normally it would be several weeks afterward.

Mr. TUCKER. That is the inherent danger; normally it would come subsequent to the transaction.

Senator GORE. Well, if over a period of years the U.S. corporation was operating on the nub, or in financial difficulty, and its Panamanian subsidiary was quite profitable, you would think somebody would be looking under the cover, wouldn't you?

Mr. KINDLER. Yes.

Mr. TUCKER. There is no question about it.

Senator GORE. Do you have any doubt but what that would be a proper thing for this Government to do?

Mr. TUCKER. I have no doubt.

Senator GORE. That is what this provision is intended for, as I understand it.

Mr. KINDLER. Very often the intention and the actual application are two different things, are they not, Senator?

Senator GORE. That is true.

Mr. TUCKER. We feel the virus in this thing, sir, is that in effect we are burning down the house to catch the mouse.

Senator GORE. But we are not burning the house down. This is an assumption to which you gentlemen have rushed, it seems to me.

I won't compliment you, but I feel like I am sitting down in my living room with you, and you are frank and open in discussing your operation. You told us that in your consolidated statement, your overall tax rate is 51 percent, the foreign segment of that being 47 percent. So the tax consequences of the bill could not be serious. And now, this administrative arbitrariness which you, shall I say, fear, is not as serious, I am constrained to believe, as you may envision it. Surely we can depend upon the U.S. Government to be reasonable in the administration of a law. Now, take it from me, as one who has been here—this is my 24th year—any bad administrator will do a bad job with a good law. We simply cannot pass a bill that is good enough to work out well and fairly if we are to presume we are going to have arbitrary and mean and poor and unwise administrators. A good administrator, on the other hand, can take a rather inadequate law and turn in a pretty good performance. Regardless of what administration has been in power, I think that by and large the Internal Revenue Service has been reasonable, I have found it that way, and I believe my constituents have found it that way. Have you found it differently?

Maybe I shouldn't ask you that.

Let the record show that there was some amusement.

Senator CURTIS. And the question was withdrawn.

Senator GORE. And that the question was withdrawn.

You gentlemen have raised an interesting point. Now, what you have said here really is not that this bill would reduce exports; you have expressed some apprehension that because of some arbitrary administration it might prevent your company from continuing to grow in its international operation.

Mr. KINDLER. From continuing to grow, right.

Senator GORE. So really you misspoke yourself when you said it would reduce exports.

Mr. KINDLER. We have a fear it would reduce exports.

Senator GORE. I think we have now determined what your fear is, it is really of an arbitrary administration of the allocation formula?

Mr. KINDLER. Yes—it is broader than that.

Seantor CURTIS. But that is confining the question to your company's operation?

Mr. TUCKER. This is confining, this particular question. We also think that because of the number of foreign subsidiaries that we have—if, for example, we are priced out of the market in our U.S. company exports, because of the price, we may divert those jobs, so to speak, into perhaps an English subsidiary or French subsidiary or some other subsidiary to fulfill that particular order into that particular country. Many of our subsidiaries do not manufacture, none of them, I guess, manufacture the full line of products. I think we have—there is one more thing I would like to add, and that is not to overlook the risk inherent in these foreign operations. We have, for example, in Argentina a situation that we are sweating out. We fortunately had little in Cuba. But the risk of the foreign operation is such that you must, I think, approach the taxing of the profit derived from that with one look at what the risk is and what the future risk is. You may pull in these taxes at one time and then find in the next 3 or 4 years that the subsidiary is faced with a political upheaval. And I think you must look at the overall situation as far as the risk is concerned to encourage foreign investment, otherwise those markets are going to be supplied by foreign countries rather than U.S. companies.

Senator CURTIS. A few moments ago the chairman cited a hypothetical case that you and the witness agreed was an abuse the Government should attend to, or it could probably be one. Could such a problem be reached by section 482 in existing law?

Mr. TUCKER. That is our position, that there are ample teeth in section 482 that it could take care of those situations.

Senator CURTIS. If all of the situations of this House bill relating to foreign income had been ineffective in the last 10 years, so far as your company is concerned, would it have lessened the exports from the United States?

Mr. TUCKER. If this bill had been in effect?

Senator CURTIS. If this bill had been in force for the last 10 years.

Mr. TUCKER. It is our sincere judgment that it would have done just that.

Senator CURTIS. Materially?

Mr. TUCKER. Materially.

Senator CURTIS. Last night I had laid before me a situation coming from my own State of Nebraska, a concern that has one operation outside of the United States—and incidentally, its business is selling grains, which are at a surplus in this country. They have in mind becoming part owner of a subsidiary in two other foreign countries. They have signed contracts with the local people who put up the better portion of the money, that both parties would leave their earnings in the foreign company for a period of 5 years. And this will be an outlet for grain, for feed, and for flour. If this bill becomes law they can't do that.

Mr. TUCKER. That is right.

Senator CURTIS. Those two companies will just not exist foreign.

Mr. TUCKER. It creates those situations; yes.

Senator CURTIS. I think you have given us a very fine statement here, and I want to thank you.

Senator GORE. I wanted to point out to you, on page 37 of the bill, with respect to the possible arbitrariness of the allocation formula, this provision—I am reading from lines 13 to 16 inclusive—this provision reads:

this subsection shall not apply with respect to any sale of tangible property for which the taxpayer can establish an arm's length price.

Now, I would like to ask the staff of the joint committee to explain the legal meaning of the arm's length term.

Mr. KINDLER. Senator, I was wondering if we could think of that in terms that you mentioned earlier where you felt that if we were marking this up with a 10-percent profit in it that it would satisfy the requirements of this bill. I believe that the arm's length that they are going to give you will not meet that same——

Senator GORE. Perhaps so. And if you have raised a problem here you may be sure that the committee will consider it.

Mr. WOODWORTH. The arm's length provision is defined a little further on page 39 of the bill, beginning on line 13. In general terms it specifies that if the person involved can show that someone else sells at a similar price, this would establish the fact that their price was at arm's length. Alternatively, if they can show after taking into account certain adjustments, indicating differences as to quantity or area of the sale or conditions of the sale, that someone else sells at a comparable price, this also would establish an arm's length price.

Senator GORE. Would you take a look at this language which has been cited here by Mr. Woodworth, and if you have suggestions for further changes, submit a memorandum for the committee?

Mr. KINDLER. All right, sir, we certainly will. But I think that that wording did not fit the definition that you and I were coming up with on this 10 percent.

(The memorandum referred to was subsequently submitted on May 10 and appears on p. 3879.)

Senator GORE. Thank you very much, gentlemen, for coming up. I think you have pinpointed a problem to which the committee will want to give attention.

The next witness is Mr. Robert E. Lewis, Perkin Elmer Corp.

STATEMENT OF ROBERT E. LEWIS, PRESIDENT, THE PERKIN-ELMER CORP., NORWALK, CONN.

Mr. LEWIS. Mr. Chairman and gentlemen of the committee, my name is Robert E. Lewis. I am president and chief executive officer of the Perkin-Elmer Corp., Norwalk, Conn.

I have prepared a statement which I would like to have inserted in the record.

Senator GORE. Without objection it will be made a part of the record following your oral testimony.

Mr. LEWIS. I would also like to take a brief time to orally summarize my company's views on the bill.

Let me state first that I make no case for so-called tax haven loopholes or nonoperating devices for avoiding taxes. And I say that notwithstanding the fact that we ourselves set up a holding company in Zug last fall, which has had no transactions. However, the administration proposal for changing the treatment of foreign earned income goes well beyond closing tax haven loopholes and achieving tax neutrality. Based on our experience, the proposed measures would be a handicap to oversea operations, where we have to compete on the basis of local conditions and tax structures. Perkin-Elmer is a relatively small company, but I think in many ways we are symbolic of many others. We came into being to provide a source in this country for precision optics, which were available only in Germany at that time. We are now engaged in providing optical and electronic optical systems for space and national security programs, and are in the position of leadership in the field of scientific instruments for chemical research and quality control. It is in this latter field that we operate internationally. Ten years ago our annual sales were under $5 million. Last year they approached $30 million, of which $4,300,000 was derived from oversea operations.

We have two fully integrated oversea subsidiaries, one in Germany and one in England, which handle engineering, manufacturing, and marketing. We also have marketing and sales corporations in Italy, France, Switzerland—which has no connection with the company that I have already mentioned—Sweden, Canada, and we have a mutually owned company in Japan with Hitachi for the interchange of technical information and know-how. All of our operations are on an arms-length basis. This has been the policy of our oversea operations. We are established overseas for a number of reasons. One is, we of course want to reach markets that would otherwise be unavailable. And I mention in this vein England, where the import restrictions make it almost impossible to come from the outside. We also want to be in a position of holding markets in which we have already had a position.

We also are very strong believers, and the point has been made by many others, that our oversea operations are strong sustainers of our domestic operations. And I will amplify on this slightly.

Also—and this is something that I have not heard mentioned to any measured degree—we have gone overseas because we want to have access to scientific abilities.

With regard to the balance of payments, since starting in 1954—I am talking about oversea operations—and despite starting costs and the initial costs of getting going, we have already brought back to the United States in royalties and dividends more than we have sent abroad. This is both in investments and advances. We have brought back a little over a million dollars, and we have sent over slightly less than a million dollars. During this period we have invested $14 million in our domestic operations. And as I have already pointed out, we have invested less than a million dollars in our oversea operations.

With regard to exports, our dollar volume has grown from $910,000 in 1950 to $2,800,000 last year. And this, percentagewise, is a constant percentage of 25 percent in relation to our domestic sales.

With regard to jobs, our domestic employment in 1955 was 525 people. Today we employ 1,800 in the United States and 1,200 overseas.

In our business we feel that the international operations support and strengthen our domestic operations by bringing back products and technologies which are put to work here to create jobs.

Senator GORE. That is a fine record. You understand, of course, that if the total record were comparable to your individual record, we would not have an imbalance-of-payments problem at all.

Mr. LEWIS. Senator, I am no statistician or expert, but I am under the impression that the statistics I have been reading bear out that year after year the inflow is greater than the outflow.

Senator GORE. The inflow there is not comparable, is not properly related, beause you have an inflow from the accumulation of investments since this country began, and you have an outflow on a 12-month basis.

Mr. LEWIS. In that connection, then, I should like to point out that a great amount of the outflow was done during the period when the administration was encouraging exactly that, when the trade balance was in the other direction, and it was our national policy to do just the opposite.

Senator GORE. And it is now in our national interest to change the direction of that flow.

Mr. LEWIS. Unless my statistics are incorrect, as I read them, the flow of money in from operations such as ours is greater than the current outflow.

Senator GORE. Well, such as yours?

Mr. LEWIS. I am talking about industry in general.

Senator GORE. Well, there is really no point in our engaging in this discussion, is there? You know what the overall picture is, and I am sure if you don't you will look it up.

Mr. LEWIS. If we had not established oversea operations we are certain that we would have lost some of our market to foreign companies in these other areas. It is our experience, and I speak particularly of our business, which is a highly sophisticated, technical business— that a company producing our type of product in one nation or area cannot remain competitive in other developed areas of the world. Import restrictions, national pride, and a variety of questions come to bear in that respect.

I would like to place emphasis on a subject which, in my opinion, deserves more attention: scientific and technical interchange. In a scientific sense, perhaps more than any other sense, this has become one world. Our business is highly scientific and is subject to rapid obsolescence because of the pace of international technology. Without direct access to foreign technology we would be at a very serious disadvantage.

In addition to the scientists who are employed in our oversea operations, we also employ about 40 leading scientists throughout the world as consultants to keep us continually abreast of technical progress in our field. And in that connection you may say, why do you need oversea operations to do this? They tie in very closely.

For example, our English company works very closely with several scientists from Oxford and also from Cambridge. The same is true of other areas. They can't work in a vacuum.

In a sophisticated business such as ours, foreign competition can only be successful in the U.S. market through technical superiority, not through lower costs. In order to forestall this we must be permitted to create and maintain vigorous operating subsidiaries in the developed areas of the world. These instruments cannot very well be made in undeveloped countries, because there is not the personnel or a local market.

To conclude my testimony, we have brought back more money than we have sent out. Our exports have been increased substantially. Our domestic employees have increased substantially. Our oversea operations help sustain our domestic operations. And we now have direct access to the world of technology which is the lifeblood to our business.

We earnestly recommend to the committee that in closing any tax haven or loopholes, an unnecessary handicap must not be placed on trade as far as international operations are concerned, they are of substantial benefit to our national economy, with a great emphasis on the balance of payments. I would rather see us handle the matter through currency control than make the false move, in my opinion, of handling it through a revenue bill.

Thank you.

Senator GORE. Thank you, sir.

(The prepared statement of Mr. Lewis follows:)

STATEMENT OF ROBERT E. LEWIS, PRESIDENT, THE PERKIN-ELMER CORP. BEFORE THE SENATE FINANCE COMMITTEE MAY 2, 1962

Mr. Chairman and gentlemen of the committee, my name is Robert E. Lewis. I am president and chief executive officer of the Perkin-Elmer Corp., Norwalk, Conn.

I appreciate this opportunity to present our view on H.R. 10650, in particular section 13 which deals with taxing foreign income.

My purpose in appearing here today is to explain how and why Perkin-Elmer has constituted its international business; how, in fact, these operations support our domestic growth; and, why legislation such as the proposed section 13 should not be brought to bear on such operations.

Let me say at the outset that we make no case for tax haven type operations, or for any contrived device to avoid tax responsibility. Section 13, however, in its broadness and ambiguity, could be applied or interpreted so as to unnecessarily burden or hamper legitimate international operating subsidiaries. This particular proposal would, indeed, seem to be in contradiction with the proposed foreign trade legislation which is aimed toward broadening and strengthening U.S. business potential around the globe.

Our concern is not only with section 13, as it now stands. Of more far-reaching consequence is the proposal of the Secretary of the Treasury that all income of American oversea subsidiaries be taxed as earned. Such a proposal requires careful analysis and thought for what will be seriously affected here is the ability of U.S. industry to compete and participate fully and freely in world trade.

Our company is quite small by most industrial standards. Most of its growth has taken place in the last decade. Ten years ago annual sales were under $5 million. Last year they approached $30 million, of which $4.3 million was derived from oversea subsidiaries.

We now operate with integrated manufacturing subsidiaries in West Germany and Great Britain. Last year, we established a jointly owned company in Japan. We maintain sales and service subsidiaries in Switzerland, Italy, France, Sweden, and Canada. In addition to these direct operations, we have available to us throughout the world about 40 scientific consultants, most of them men preeminent in their respective fields.

Before describing our international operations, I would like to summarize their result in regard to three key points—the balance of payments, the raising of additional tax revenue, and the exporting of jobs.

Perkin-Elmer began establishing international subsidiaries in late 1954. Since that time, despite startup and other initial expenses, we have actually brought back to the United States in the form of royalties and dividends slightly more ($1,008,171) than we have sent abroad in investment and advances ($966,468). The company has not, then, contributed to any balance-of-payments deficiency.

In regard to increased tax revenue, the proposed legislation would not add significantly to the taxes we are already paying. In all likelihood, administrative expenses and burden—on both ours and the Government's part—would offset some of this gain.

Thirdly, in regard to jobs, our international operations are intended to support and strengthen our domestic operations by bringing back to this country products and technologies which can be put to work here and which will create more jobs in this country. In the past year we have seen the first developments from our overseas companies which can be produced and marketed in the United States. Our domestic employment in 1950 was 250. In 1955, at the early stage of our move overseas, it was 525. Today, we employ 1,800 in the United States. Employment overseas is about 1,200.

Had we not established companies overseas, we feel convinced we would have placed our continued domestic growth in jeopardy. Other companies would have been established in these countries—either by nationals in those countries or by other companies. Hence, we would be facing far more severe competition abroad. We might also be facing more competition in domestic markets by foreign companies which would have been established in our stead.

Export sales have always been a significant factor in our business. Yet, they have not been diluted through our overseas manufacturing programs. They have actually maintained about the same percentage (25 percent) of our domestic instrument sales as they were before we went abroad. In dollar volume, our export orders have grown from $910,000 in 1954, to $1.8 million in 1958, to over $2.8 million last year.

In order that you may more fully understand our situation, let me review the company, and particularly, our philosophy as it relates to international operations.

The company was founded 25 years ago on the conviction that a source for precision optics and optical design could be developed in the United States to match or surpass the one or two European capabilities that then dominated this field. The success in meeting this objective is attested to by our present activities and capabilities in providing optical and electronic-optical systems for space and national security programs, and our leadership in the field of scientific instruments for chemical research and product quality control.

Our international operations are aimed more specifically at the latter category of product—scientific instruments. These instruments are generally highly complex systems, many with a relatively high unit cost which may range to $20,000 or over.

It has been our belief, and it has been substantiated by experience to date, that a company producing such products in one nation or area cannot remain competitive in other areas of the world. Several factors come into play. There are import restrictions in other countries, as well as national pride in the purchase of such instruments.

It also is true that, while the United States had a clearcut lead in this type of technical product through and after World War II, technologies in other parts of the world are fast approaching those of the United States. Industries on the Continent and in Japan are catching up with basic needs and have begun to spare some of their resources for the more advanced technologies. Moreover, U.S. industry is experiencing a shortage of skilled engineers and scientists due to the military and space exploration demands. The United States no longer has a monopoly on invention and creativity.

Therefore, if a company is to compete in this type of business, if it is to continue to grow in its own country, it must then be able to tap the technical resources of the free world on a firsthand basis. This is the basic objective of our international operations. A second objective is, by producing in certain areas, to have access to markets which would not be available to us if we did not produce in those countries.

Had Perkin-Elmer not made the decision to organize international companies, the domestic as well as the export business would now be in jeopardy from foreign competition. Our experience proves that this move has been a principal factor in the growth and stability of our domestic operations.

DEVELOPMENT OF PERKIN-ELMER'S OVERSEA OPERATIONS

The first international investment by Perkin-Elmer was through the purchase in the fall of 1954 of a small precision instrument company in Western Germany known as Bodenseewerk. The business was transformed into a prototype of its U.S. parent, with skilled instrument designers and production and sales specialists, to establish the potential for perfecting the next generation of commercially successful instruments. To initiate this process, several products of the parent company were licensed to Bodenseewerk for manufacture in Germany and for sale there and elsewhere. The step was none too soon, for German instrument-makers had already begun to move into the field.

The second major decision was taken in 1957 through the establishment in England of a second manufacturing subsidiary corporation. The objectives of the English subsidiary, Perkin-Elmer, Ltd., are similar to those of the German, with an added factor that foreign analytical instruments were virtually excluded from the British market due to import restrictions. Perkin-Elmer initially placed under license with that company an instrument which was then a new design and had the best potential for capturing a significant portion of the British market and rather quickly providing the vehicle for creation of an integrated instrument business.

The international licenses, incidentally, are regarded as arm's-length type of commercial transactions, with royalty rates up to 10 percent, depending upon the instrument involved. The parent company management wants no crutch for its subsidiaries; hard-hitting organizations meeting the test of competition in a free world are desired if we expect to advance our position in the industry.

Coincidentally with the acquisition and creation of European manufacturing subsidiaries, Perkin-Elmer sought to strengthen its international marketing organization. In the United States all instruments are sold and serviced by factory-trained specialists who are regular employees of the corporation. The complexity of the product line and the rate of new developments in the industry have made this necessary. However, until recent years, export markets were not large enough to justify such steps. In general, export sales in many countries of the free world are handled through an import agent or dealer who has been extended an exclusive franchise in his country. Perkin-Elmer has appointed about two dozen such agents. The agent solicits orders on a commission basis and periodically a Perkin-Elmer serviceman will visit his country to install and service instruments sold there and to train personnel or servicemen.

The volume of sales on the Continent had begun in 1950 to reach the level where a captive sales organization could be supported by the usual commission arrangement. Zurich was selected as the focal point because of its geographical location, good transportation facilities, and fine banking system. A wholly owned subsidiary corporation, Perkin-Elmer AG, was established in 1954 and staffed with Perkin-Elmer personnel as the prime sales and service center in Europe for Perkin-Elmer products. It also manages the European dealer organization in countries where Perkin-Elmer personnel are not available. Suboffices were later opened in Paris, Milan, Goeteborg, London, and Frankfurt. In each case these were incorporated as additional subsidiary companies as an administrative convenience in dealing with local laws and regulations. Here again, each sales office is operated on a straightforward commercial commission structure identical with that applicable to independent dealers, except the Zurich office, which receives an override to compensate for overall supervision and assistance, advertising, participation in trade shows, and the like.

As the third phase of integrating its international instrument business, last year Perkin-Elmer established a new company in Japan jointly with Hitachi, Ltd., to coordinate joint development, manufacturing, and sales programs. This project is in its early stages of development.

RESULTS OF PERKIN-ELMER'S OVERSEA INVESTMENTS

Oversea investments have enhanced Perkin-Elmer's domestic operations in the following respects:

1. The skills of foreign instrument designers are now available as part of the corporation's facilities. Had the West German and English subsidiaries not been built up as they have been, companies within those countries would have established similar businesses since there is no dominant patent position to protect Perkin-Elmer's position. Had similar businesses been established by other companies, their new instrument designs would not be available to the U.S. company as they now are.

2. Markets otherwise unavailable due to import restrictions have been tapped and the earnings derived therefrom are being plowed back into research and development aimed at advanced instrumentation designs which may be brought back to the United States for manufacture and sale.

3. Had uncontrolled foreign instrument companies sprung up in direct competition with Perkin-Elmer's particular products overseas, such companies would now be in a position to compete in the domestic market.

The foregoing factors have added to Perkin-Elmer's capacity to grow and invest and provide more jobs in the domestic operations. Both the German and English subsidiaries have already made important advances in the instruments under license, which in turn are being translated back to the parent company to keep its products out in front in the world market. Programs also are underway abroad to open up new product lines which have the potential of creating new businesses and new jobs here at home when the products are introduced here for manufacture.

The notion that oversea subsidiaries are taking something away from the U.S. economy and are providing a reservoir to escape U.S. taxation is not so in Perkin-Elmer's case. In the first place, the growth rate of the business is so high that earnings fall far short of current needs. In the last 5 fiscal years, from 1957 to 1961, capital invested in the business has more than quadrupled; 50 percent of the new funds came from equity financing, 30 percent from long-term debt, and only 20 percent from retained earnings. Second, the vast bulk of the new capital has gone into the domestic operation. Of the more than $15 million added to capital in the 5-year fiscal period from 1957 to 1961, less than $1 million has gone into oversea subsidiaries.

In the hope of removing primary reliance of oversea companies on the U.S. parent corporation for new capital requirements, and thereby alleviating some of the pressure for new funds which exists in the U.S. parent corporation, Perkin-Elmer established a holding company in Zug, Switzerland, last fall. It is planned to utilize the portfolio equity investments of the holding company as a basis for raising debt capital in the Swiss money market, to meet new capital requirements in excess of retained earnings of the foreign subsidiaries. The holding company was not founded as a tax shelter, since Perkin-Elmer's business has traditionally required more new capital in its business than earnings could provide. No patent rights or sales arrangements have been extended to the holding company.

PROBLEMS POSED BY SECTION 13 OF H.R. 10650

Through a background of Perkin-Elmer's scientific instrument business I have attempted to explain the reasoning for our management and the commercial practicalities in the development of an international operation. As we all know, market forces in the free world are changing very rapidly. Even our own Government, through the trade expansion bill now before Congress, proposes a broad, new basis for dealing with world trade problems and industrial expansion. The U.S. businessman today must be given an environment by our Government which places him in at least as good position of opportunity as exists for those foreign business people with whom he competes. By placing additional hurdles before him, compounding his administrative expenses and adding uncertainty and complexity to his tax obligations, as I feel section 13 does, Congress is not aiding the cause, however meritorious the objective of eliminating tax deferral may seem. That is why I urge leaving alone operational entities, which section 13 does not.

To be more specific, I have appended to my statement a series of questions related to the application of section 13 to Perkin-Elmer activities.

CONCLUSIONS

In the broad sweep of its definition, section 13 of H.R. 10650 will apply to intercompany licensing arrangements among Perkin-Elmer and its manufacturing subsidiaries abroad, and to the marketing structure which was established to replace independent import agents in certain countries where the economies were justified.

The countries in which Perkin-Elmer has subsidiaries have about the same rates of taxation as the United States. Therefore, with the foreign tax credit, the added revenues payable to the United States will not be significant.

In addition to the administration burden which this legislation would add, it would have a greater effect of adding uncertainty to our operations due to its broadness and the interpretations which might follow.

Our international operations, as they have been constituted, are straightforward operating companies. Our dealings and relationships with them are of the arm's-length type.

These operations have had a positive effect upon our domestic operations. We anticipate that the resulting benefits for the domestic operations, in terms of greater sales, more jobs and newer products, will become yet greater.

The present tax deferral approach to foreign earnings, we feel, is far the more equitable method of taxation in the case of legitimate international operations.

APPENDIX I

STATEMENT OF ROBERT E. LEWIS—QUESTIONS REGARDING H.R. 10650, SECTION 13

PROPOSED IRC SECTION 952(C) INCOME FROM U.S. PATENTS, COPYRIGHTS, AND EXCLUSIVE FORMULAS AND PROCESSES

1. Exploitation of "patents" rather than inventions is referred to in subparagraph (1). Does this mean that unpatented designs are exempt?

2. What does "substantially developed, created, or produced in the United States" mean? What if the basic invention had its origin abroad, was further developed in the United States and then licensed back? Would improvements over the years made by the foreign licensee which obsolete the original development or design remove the development from this category?

3. At the end of subparagraph (1)(A), should the "or" be "and"? Otherwise why should the U.S. parent corporation be required to take into its gross income royalties paid by its controlled foreign subsidiary under a license with an unrelated U.S. licensor?

4. Does subparagraph (2) merely deal with amortization of the acquisition costs of the patent rights? Otherwise the provision is inconsistent on the one hand in allowing deduction of "expenses incurred * * * in the receipt or pro-

duction of the income" and on the other excluding "any production, manufacturing, or similar expenses incurred in the use or other means of exploitation of such property or rights." Moreover, will "ordinary and necessary expenses" mean those so recognized in the foreign country or only those so recognized by U.S. practices? And what about operating losses of the subsidiary, are they deductible?

5. Is subparagraph (3) to apply only in absence of income derived under subparagraph (2) or may it create an additional and perhaps supplemental inclusion in gross income? Who is to make the determination and how is the U.S. taxpayer to establish "an arm's length transaction" where there is no other similar transaction to point to? Must the determination be made each year? What is the position of the U.S. taxpayer which charges a controlled foreign subsidiary a certain royalty which has been allowed by the foreign government as an expense in the tax return of the subsidiary and some years later on audit of the U.S. taxpayer's return a higher royalty is determined by the U.S. Government to be applicable?

PROPOSED IRC SECTION 952 (d) AND (e) NET FOREIGN BASE COMPANY INCOME

1. With respect to sales income includible under subparagraph (e)(2), would not it be proper to exclude operating functions such as Perkin-Elmer's Zurich sales company and confine the provision to "artificial arrangements between parent and subsidiary," as the President expressed in his tax message last year? At very least, should not consolidation be permitted so as to offset losses of one sales company against gains of another? Will not the concept of subparagraph (e)(2)(B) concerning sales of property for use outside of the subsidiary's country of incorporation, taken with the 20–80-percent rule of subparagraph (e)(6), require an inordinate amount of recordkeeping and encourage "artificial arrangements?"

2. Under subparagraph (e)(7), does the provision "deductions (including taxes) properly allocable to such income" mean deductions by foreign standards or by U.S. practices? May losses and starting-up expenses from prior years be carried forward?

PROPOSED IRC SECTION 951(a)(1)(B) EARNINGS INVESTED IN NON-QUALIFIED PROPERTY

1. In the definition of "qualified trade or business" appearing in proposed IRC section 953(b)(3)(A)(i), who is to decide and what criteria will apply in determining whether a trade or business is "substantially the same" as that carried on before? Will technological obsolescense and innovation introduced through the foreign company's own inventions be recognized as a natural outgrowth of the business which existed on December 31, 1962?

2. Similarly, will the expression of money or other property "ordinary and necessary for the active conduct of a qualified trade or business" appearing in proposed IRC section 953(b)(2)(A) be applied in a way which inhibits growth and diversification of a foreign subsidiary?

Senator GORE. The next witness is Mr. William G. vonBerg.

STATEMENT OF WILLIAM G. vonBERG, CORPORATE CONTROLLER, PFAUDLER PERMUTIT, INC., ROCHESTER, N.Y.

Mr. VONBERG. My name is William G. vonBerg and I am the corporate controller of Pfaudler Permutit, Inc., of Rochester, N.Y. My company is not representative of what is commonly termed "big business." Our sales volume reported for the year 1961 was $50,333,000, consisting of shipments by the company and its wholly owned subsidiaries, domestic and foreign. Worldwide product sales in 1961 totaled $62,499,000, which include the above amount plus shipments by partially owned affiliated companies whose figures have not been consolidated with those of the parent.

Our 1961 annual report disclosed that 52 percent of total consolidated earnings were contributed from foreign sources. This will indicate the extent of our interest in global operations. For this reason, I have elected to reserict my testimony today to those provisions of H.R. 10650 which are most directly related to foreign source income and which will have the most injurious effect upon American companies engaged in operations abroad.

First, a brief history of the company may be helpful in order to put my remarks in proper perspective.

Pfaudler Permutit, Inc., today is a specialized producer of glassed steel and alloy equipment for the process industries—such as chemical, pharmaceutical and beverage—as well as a designer and manufacturer of water conditioning equipment and the ion exchange resins used in conjunction therewith.

In addition to four U.S. plants, we operate plants in Germany, Great Britain, Canada, Mexico, and Japan. Also, we have representation in most of the industrialized countries of the free world.

Our predecessor, the Pfaudler Co., was organized in 1884 and incorporated in 1902. At that time it was a manufacturer of tanks for the brewery industry. In 1907, it embarked upon its first foreign manyventure by the establishment of a wholly owned subsidiary in Germany. In 1933, it teamed with a British concern, Henry Balfour & Co., Ltd., and organized jointly owned enterprise in Scotland to produce the Pfaudler line of equipment.

By the early 1940's the company had accomplished a substantial change in product emphasis and became a producer of specialized equipment for the process industries. In the mid-1950's, management came to the conclusioin that in order to survive increasingly competitive conditions within the United States, and also to benefit from the resurgence of the economies of the war-torn nations, it must expand. This was accomplished by the acquisition of a number of small companies whose product lines complemented our own, and most significantly by merging with the Permutit Co. in 1957, to form Pfaudler Permutit, Inc.

Our objective of expansion was fostered during this period by greater emphasis on research, both internally and by soliciting Government sponsored research in fields where we have existing competent technology. In 1960, we acquired AeroChem Research Laboratories, Inc., of Princeton, N.J., which was comprised of a group of scientists and engineers engaged in basic research in such fields as flame technology and solid fuel propellants, and which operated chiefly under contracts sponsored by agencies of the U.S. Government.

Expansion through geographical diversification also received special management consideration. During the early 1950's, the Germany subsidiary began to show signs of revival, and our British affiliate began to participate more actively in the world market place. We foresaw the rapid development which was beginning to take place in many areas of the globe, and made a policy decision to move into these areas as rapidly as our resources would permit.

In 1954, we joined with Kobe Steel Co. to form Shinko-Pfaudler Co., Ltd., of Kobe, Japan. For two-thirds ownership interest, Kobe Steel put up the capital. Our sole contribution was technical knowhow, for which we.received a one-third ownership together with a royalty arrangement which has subsequently proven to be very profitable, as will be shown later.

In 1956, we purchased 85 percent of the outstanding shares of a Mexican fabricating company, and the remaining 15 percent in 1959.

Also in 1959, we acquired a Canadian company engaged in the fabrication of metal products.

In 1962, we purchased Henry Balfour & Co., Ltd., of Scotland, joint owner with us of our previously mentioned Scottish affiliate, and thereby achieved 100 percent ownership of both companies.

In addition to these manufacturing companies, we have in the last several years set up sales companies in Australia, Brazil, and Switzerland to concentrate our marketing efforts on customers in those areas.

Why did we, as a relatively small company, devote so much time and attention to developing operations abroad? The maturity of our domestic market was resulting in declining profit margins, and the relative immaturity of foreign markets presented greater opportunity. We found, too, that there was a tremendous demand abroad for our glassed steel products. Many of our foreign customers were the subsidiaries of our domestic customers.

Why could we not serve these markets by export? First of all, our products are large and heavy. The physical size of these products renders distance a competitive disadvantage. Second, these products are specially engineered and custom built, and require servicing that could not, on a practical basis, be entirely accomplished from the United States. Third, our customers require technical assistance in planning their needs for equipment, which can best be supplied on a local basis.

It is keenly evident that if he had not established operating companies abroad, our business would surely have fallen to local competition. This competition includes not only suppliers of similar products, but competition from other materials of construction.

Another very important consideration is that we would have lost many of our oversea markets due to foreign tariff considerations if we had not set up foreign based operations. The following specific examples will speak more effectively than any generalizations.

Our purchase of a plant in Mexico was occasioned by the fact that the Mexican tariffs were increased to 50 percent on our products, thus essentially prohibiting our export from the United States.

In Canada, over years in the past, we have exported our product in significant volume. After the war, a British company set up operations in Canada which resulted in the duty on our products being increased to 22.5 percent. Henceforth, we lost the complete market for this class of equipment in Canada. Our purchase of a plant there enabled us to supply the Canadian market which we were prevented from doing on an export basis.

We are currently investigating the desirability of establishing a manufacturing plant in India, where U.S. taxpayers are spending millions in grants, loans, and Cooley funds. We now export in the neighborhood of $300,000 a year of our products to India. However, prospective purchasers of our equipment are now being referred to an Iron Curtain source for similar equipment by India's Department of Commerce and Industry because their trade agreement enables them to pay in local currency. Further, we have learned that both a German and a Hungarian company are negotiating for the establishment of a manufacturing facility in India and in the event these plans are carried out, the Indian market will be closed to us on an export basis.

We have been able to export to Australia from the United States for a number of years, paying a duty of 7½ percent on our product in contrast with the duty-free status of British competitors. If a company manufacturing our product began production in Australia, a duty of 55 percent would immediately be applied on our U.S. exports.

These are only a few of the typical situations the U.S. manufacturer must face and we believe that our U.S. interests are better protected by moving into these countries than merely allowing them to go by default to competitors.

It is a peculiar fact that in spite of our buildup of foreign manufacturing facilities, our export volume from plants in the United States did not suffer, but instead, showed a tendency to increase. The reasons are several. First of all, we supply frit, a compound used in the glassing operation, to our foreign plants. Second, special parts and components are supplied from our U.S. plants to our factories abroad. As the activity of our foreign plants increases, so do our exports of frit, parts, and components. Third, as oversea customers became accustomed to our equipment and familiar with its advantages, orders for equipment in sizes which could not be made by our foreign plants were transferred to the larger U.S. plants for manufacture.

Now, let me cite a few statistics in support of the data I have presented.

Below are figures on the amount of dollars we have invested abroad, and the amounts returned to us here in the United States:

Ten years (Jan. 1, 1952 to Dec. 31, 1961)

[In thousands]

	Amount invested abroad	Amount of income received in United States (before U.S. income taxes)
Western Europe	$40	$2,385
Far East	154	1,364
Western Hemisphere (outside United States)	1,088	450
Total	1,282	4,199

Since our investments in countries within the Western Hemisphere outside of the United States have been made more recently, these operations have not had the opportunity to progress to the point where our return is favorable. Moreover, our efforts south of the border are in undeveloped nations, and we anticipated that a longer time period would be required for their development.

I would like to add that the figures on income to the United States do not include that portion of the earnings of our foreign companies which have been reinvested there to build up a stronger position in their respective markets.

Having presented a brief history of Pfaudler Permutit and its efforts to expand on a global basis, let me next return to H.R. 10650 and the provisions of which have aroused our major concern. These are as follows:

Section 6. Allocation of income in the case of sales made to or from a foreign corporation: We feel that this provision of the bill is unworkable, inequitable, and would have injurious effects on our foreign operations which, on a net basis, contribute favorably to the U.S. balance of payments.

As previously explained, part of our exports to our subsidiaries is a material "frit" made according to a secret formula. In addition, we supply parts and components to our subsidiaries abroad. We think that we charge our subsidiaries a fair price, but now—if the bill passes—we could be challenged and part of the profits of the subsidiary charged back to the parent company and taxed on current U.S. rates on the grounds that the price is unreasonably low. Any such decision would be purely arbitrary and could not possibly be justified on sound economic grounds by anyone ignorant of the trade. Yet we would be put to the trouble and expense of defending a reasonable business judgment against such an arbitrary decision. Our foreign competitors have no such burden inflicted on them by their governments.

Even more alarming is the imputation of income to the foreign subsidiary to be taxed currently to the U.S. parent corporation arising from patents and secret processes, especially as—

> This category will also include income from sales derived by a controlled corporation from manufacturing items to the extent this income is attributable to the use of the above described items. Reductions in this income are to be made for expenses incurred in producing the income and for any costs incurred by the foreign corporation in acquiring the patent, etc. (House of Representatives Ways and Means Committee, RR62–14, Feb. 27, 1962).

Frankly, we feel that these provisions would create an administrative monstrosity. We do not see how we or anyone could accurately track down that part of the income of our foreign subsidiaries which arises from the use of patents or processes belonging to the parent U.S. corporation. We respectfully submit such an administrative burden and additional tax should not be inflicted on American business, particularly as none of our foreign competitors have to bear this tax or this burden.

Section 11. Domestic corporations receiving dividends from foreign corporations ("gross up" provision): The case for the "gross up" provisions is stated by the House of Representatives committee as being a matter of correcting a discrimination in favor of foreign operations against domestic operations (see committee report, p. 76). The same point is made by Secretary of the Treasury Dillon in his evidence to the Senate Finance Committee on April 2, 1962, stressing the importance of tax "neutrality."

Really, the "gross up" provision would not promote tax neutrality as alleged by the Secretary but would penalize one type of corporate income by taxing that part of the earnings of a foreign corporation which cannot possibly be repatriated because they represent taxes already paid to another country.

The simple mistake made by the committee and by the Secretary of the Treasury is to confuse two separate legal persons and two separate incomes and to treat them as though they were one income of one person. Furthermore, no mention is made nor is any attention given to that situation wherein the operations of a foreign subsidiary result in a loss. Losses of foreign branch operations are treated as a reduction of the income of the domestic parent. Does then this provision create tax "neutrality?"

If the tax credit, as it is computed under existing regulations, is not given, there is an invasion of the sovereignty of the foreign country. The United States would by a deliberate act of Congress be retarding the economic development of the foreign country. This might well result in counterdiscrimination by the foreign country against the United States.

Insofar as underdeveloped countries use tax incentives to attract U.S. investment, the change will destroy the tax incentive. The effect will be to slow down the economic development of the underdeveloped country and to increase the need for greater foreign aid. What will be saved on the one hand will be given away on the other—with the exception that we shall have lost an income-producing asset. The longrun effect on the balance of payments will be adverse.

We feel strongly that the "gross up" provision introduces inequity and discrimination and is not only inequitable but would have adverse effects on economic growth.

Section 13. Controlled foreign corporations: These provisions are directed against the abuse of so-called tax havens. If they were limited to correcting this abuse, we would strongly support them. Unfortunately, as drafted, the provisions go far beyond this laudable objective and severely penalize legitimate subsidiary operations in foreign countries. The result would be discriminatory and would substantially reduce the incentive of American industry abroad. Not only would it discourage new expansion, but would lead to curtailment of existing operations.

This provision is by far the most drastic in changing the concepts of U.S. taxation. In fact, its philosophy is alarmingly inconsistent with the free enterprise system. Let me illustrate:

1. This provision completely disregards corporate legal entities, legitimate in purpose, or otherwise.
2. It disregards existing tax treaties and conventions, which have taken years to negotiate.
3. It provides for a tax on imputed income. From whence does the U.S. corporation get the cash with which to pay this tax?
4. It provides unfair competition to foreign subsidiaries of U.S. corporations, in that no foreign government imposes such a burden on local competitive enterprises.
5. It places undue burdens resulting from difference in accounting practices employed by foreign versus U.S. companies. Which country's accounting practices will govern in the determination of income on which this tax is to be levied?
6. It imposes a tax on income of foreign corporations, but gives no recognition to losses incurred.
7. It creates a powerful incentive to the governments of foreign countries for raising taxes on the income of U.S. subsidiaries.

8. It would seriously curtail expansion abroad by a U.S. subsidiary due to the broad generalization in the definition of "reinvestment in substantially the same trade or business." Such discrimination is left entirely in the hands of the U.S. tax collector.

9. It provides that definition of a developed versus an undeveloped nation be by Executive directive. Uncertainty as to consistency of definition, or changing of the basis, will not encourage U.S. expansion abroad.

In summary, the far-reaching consequences of this particular provision go beyond the correction of abuses arising under existing law, to the extent of unduly penalizing foreign operations which could by no means be described as a sham.

Section 20. Information with respect to foreign entities: This provision is objectionable because of the additional administrative burdens which will be placed on already overworked small and medium sized companies. Very broad powers would be granted to the Treasury Department to demand additional information. This seems unnecessary in view of the full disclosure already required under present law. Also, because of the severe penalties which could be imposed by a failure to comply with the submission of information with respect to any foreign corporation, it would seem that any additional information required by this provision should at least be specified.

CONCLUSION

The initial objective of those advocating changes in tax legislation was the curtailment of abuses. If this were, in fact, the effect of this proposed legislation, I would be in its favor. However, H.R. 10650 is so broad in scope that the result is to penalize many in the hope of punishing a few.

It has been said that legislation is required to improve our unfavorable balance-of-payments position and to protect American workers against the exportation of their jobs.

By describing the results of my company's foreign operations, which I believe are illustrative of many U.S. companies' operations abroad, I have shown that the U.S. balance-of-payments position has been materially aided by American private investment abroad over a period of years.

By the addition of foreign income to domestic earnings, we have increased the stability of our company's earnings, which has helped us to maintain stability in employment. By increased earnings, we have been able to enlarge our research and development efforts, which have resulted in new or improved products. This, in turn, has had a favorable effect on employment. I do not believe that my company is unique in the influence its foreign operations have exerted on the total organization.

It has been stated that the enactment of H.R. 10650 would prevent unreasonable accumulation abroad of income earned from foreign sources. Again, using Pfaudler Permutit as an example, we are a U.S. company with almost 100-percent U.S. shareholders. How could our management, who are a professional management group the total of whose ownership is small, justify the unreasonable accumulation of its assets in a foreign country, or freezing its funds in a foreign currency. Our objective is to manage our company in a manner which is consistent with the best interests of our shareholders, our customers, and our employees. Can this be inconsistent with the best interests of our country?

My conclusion is that those provisions of H.R. 10650 which I have discussed do not accomplish their intended objective and therefore should not be enacted into law.

Many spokesmen for the present administration have stated that the United States must maintain its position in world trade, and that American industry must carry its share of the burden to combat communism and to spread the free enterprise system throughout the world.

This American industry has tried to do, in spite of the takeover by Castro of American private property in Cuba; the creeping "Mexicanization" south of the border; and the expropriation of American properties in Brazil. American industry has been and will continue to be willing to accept the risks of doing business abroad. I ask that the capriciousness of some foreign governments not be aided and abetted; and I urge that this proposed legislation not be enacted into law.

Senator GORE. Mr. vonBerg, I notice that your manufacturing operations are very generally located in what we call high-tax countries.

Mr. VONBERG. Yes, sir.

Senator GORE. The tax consequences would not be great on your operation, say, in Great Britain, France, or Germany, unless you had a third-country affiliate into which, in one way or another, your profits were funneled. If your parent company owns a subsidiary directly in England, and there is a twoway exchange, the tax consequences of this bill are nil.

Mr. VONBERG. That is correct, sir. In those countries where we have plants whose local tax rate is equal to or higher than our own, there would be no consequences.

Senator GORE. As I read your statement, I wondered why you were so apprehensive about the bill.

Mr. VONBERG. Well, our concern, sir, is that if this bill is enacted into law, there are countries abroad in which we are engaged or may engage whose tax rates are lower than our own, where we would be subjected to a penalty.

For example, in my statement I indicated that we were considering beginning an operation in India. We have negotiated on the basis of securing 100-percent ownership. We are willing to assume the total risk. We would like, therefore, to be the beneficiary of the total return. However, we could not secure permission from the Indian Government for a greater interest than 50 percent. This would define our ownership in this subsidiary if we do decide to go ahead as a controlled corporation. This means that any profits made by this Indian company in the future, whether or not they were repatriated to the United States, on any such profits the parent company would be subjected to the tax.

Senatore GORE. Those assets would be the property of the parent corporation.

Mr. VONBERG. The parent corporation would own 50 percent of the company, and therefore 50 percent of the assets.

Senator GORE. If the accumulation of assets——

Mr. VONBERG. My point is, sir, in starting a company from scratch, as we will be doing in India, the chances are relatively great that this will not be a profitable operation in its early years. In its later years, assuming it is successful, we hope it will be profitable.

But in order to build this company we will be required from a natural business standpoint to reinvest those profits in that business. We would hope that we would be able to expand the production lines of that particular business. But there are provisions of this bill which leave it very unclear as to what might be considered reinvestment in the same business. And we are uncertain as to the definition of that reinvestment, as to whether it will be tax free as to the U.S. tax, or whether it would not be considered a similar business and therefore subjected to U.S. tax.

Senator GORE. There is one other provision or lack of provision in the bill which you might well address concern to, and that is the lack of ability to carry forward or carry backward your losses.

Mr. VONBERG. Yes, sir; that is a concern.

Senator GORE. My inclination is to try to improve the bill in that regard. It certainly is not my desire as one member of the committee to do anything that is unfair, inequitable, to the American businessman in his operating abroad. I would like, however, to see all of them pay taxes on the profits they earn, not only in business, but earned income.

Well, you have presented a very good statement, and I thank you, sir.

The committee will be in recess until 10 tomorrow.

(By direction of the Chairman, the following is made a part of the record:)

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

REPORT ON FOREIGN INCOME PROVISIONS
OF
REVENUE BILL OF 1962, H.R. 10650

as adopted by the House of Representatives
on March 29, 1962

by

COMMITTEE ON INTERNATIONAL TAXATION

PETER MILLER, *Chairman*

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April 24, 1962

NEW YORK STATE BAR ASSOCIATION
TAX SECTION

Report on Foreign Income Provisions of Revenue Bill of 1962, H.R. 10650

as adopted by the House of Representatives on March 29, 1962

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Committee on International Taxation

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COMMITTEE ON INTERNATIONAL TAXATION

Honorable Harry F. Byrd
Chairman, Senate Finance Committee
The Senate
Washington, D.C.

April 24, 1962

Dear Senator Byrd:

The Committee on International Taxation of the Tax Section of the New York State Bar Association hereby submits its report on the Revenue Bill of 1962, H.R. 10650, as adopted by the House of Representatives on March 29, 1962. The Committee reviewed Sections 5, 6, 11, 13, 16 and 20 of the Bill which deal primarily with the taxation of income earned by foreign corporations owned by United States business enterprises.

Since the text of H.R. 10650 did not become available for study by the public until after its introduction in the House on March 12, 1962, our Committee has had only a relatively short period in which to analyze the Bill and to formulate comments for consideration by the Senate Finance Committee during the Hearings which commenced on April 2, 1962. Those comments therefore represent, not an exhaustive critique of the Bill, but merely those points which could be developed during this brief survey.

Our review was directed primarily to technical rather than to policy aspects. Nevertheless, this review has led us to conclude that in many respects the Bill does not establish neutrality or equality of tax treatment between foreign and domestic business ventures, as claimed by its proponents, but rather discriminates unduly against foreign ventures.

In a number of situations, particularly with respect to the proposed taxation of undistributed profits of certain "controlled foreign corporations", the Bill would operate in such an arbitrary and unreasonable manner as to raise serious doubts as to its validity, not only under the Sixteenth Amendment to the Constitution, but under the Fifth Amendment as well.

The following are examples of such situations:

1. The U. S. stockholder of a controlled foreign corporation would be taxed currently on part of its undistributed profits (measured by his share of its Subpart F income and his share of its increased investments in nonqualified property) without regard to the fact that payment of dividends may be prohibited by foreign law or that the currency of the foreign country may be blocked. Thus, the U. S. shareholder would be taxed on income which is unavailable to him and may be dissipated by future corporate losses, currency devaluation, confiscation or other factors over which he has no control. This may well constitute a deprivation of property without due process of law.

2. Undistributed profits would be taxed to a U. S. shareholder owning 10% of the stock in a foreign corporation if 45% of the stock were held by a few foreigners and the remaining 45% were widely held by numerous other U. S. shareholders completely unrelated to him. Since working control would be in the hands of the foreigners, he may be powerless both (1) to deter the corporation from generating Subpart F income or investing in nonqualified property and (2) to compel distribution of any of its earnings as dividends.

3. Where 50% of the voting stock of a foreign corporation, "A", is owned by a U. S. stockholder and the other 50% is owned by a foreign corporation, "B", the U. S. stockholder could be taxed on undistributed profits of "A" if a single share of voting stock of "B" is owned by a U. S. person, even though that person is wholly unrelated to the U. S. stockholder holding 50% of "A" 's stock. Moreover, the latter may have no way of finding out whether any U. S. person owns stock in "B", particularly if "B" has bearer shares outstanding. In addition, it would be necessary to obtain a daily record of stock ownership in order to deter-

mine the portion of the year during which the foreign corporation was a controlled foreign corporation.

4. U. S. stockholders would be required to include in income a part of the undistributed earnings of a controlled foreign corporation and to this extent would be taxed as if the corporation were a partnership. However, they would not be allowed deductions for losses of the corporation or losses of other foreign corporations controlled by the same U. S. shareholders and hence would not be on an equal footing with the members of a partnership. Since the Bill scrupulously respects the corporate entity where it serves to insulate losses rather than profits, it cannot be rationalized as applying partnership tax concepts to foreign corporations. Moreover, the U. S. shareholder would be taxed on the earnings of a foreign subsidiary of a controlled foreign corporation without regard to the fact that the intermediate foreign corporation has sustained losses in excess of the earnings of its subsidiary. In that case tax would be imposed even though the U. S. taxpayer's profit was not only unrealized but non-existent.

5. If sufficient stock of a foreign corporation engaged in genuine business operations abroad is held by a foreign trust for the benefit of a U. S. citizen or resident, the latter would be taxable on undistributed profits of the foreign corporation invested in European securities ("nonqualified property") even though (1) the trust was created many years ago by the Will of the beneficiary's father, (2) the trustee properly accumulates all of whatever income is received by the trust, and (3) the U. S. beneficiary has, in fact, no voice in the management of either the corporation or the trust. Here, rules for "constructive" ownership of stock would be used, not merely to determine the character of income in the hands of the "constructive" owner, but to impose tax on someone who never receives anything.

6. A controlled foreign corporation actively engaged in business in country X expands into country Y, designated

as "less developed", and for four years reinvests its earnings in new facilities in Y. If the President then withdraws the designation of Y as "less developed", the U. S. stockholders holding 10% or more of the stock would immediately be taxed on their share of the entire four-year accumulation of earnings invested in Y regardless of when they bought their stock or the fact that the company then lacks liquid assets for distributions as dividends to pay the taxes of its stockholders. It seems doubtful that the U. S. stockholders could be said to have realized income within the meaning of the Sixteenth Amendment. Moreover, the taxation of the corporation's earnings of prior years to the stockholders is so unreasonable that it may amount to a taking of property without due process of law. Finally, it is at least questionable whether Legislative power can or should be delegated by the Congress to the President without more definite standards to guide its exercise.*

Our Committee believes that the foregoing illustrations indicate the need for further consideration by the Congress of whether the foreign-source income provisions of the Bill would not operate so arbitrarily and unreasonably as to raise serious doubts as to its constitutionality.

Respectfully submitted,

Committee on International Taxation
PETER MILLER, *Chairman*

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* Except for the list of countries which Congress may be presumed to consider developed, no criteria are furnished for determining whether or not a country is "less developed". Furthermore, there is no requirement that a country be designated as "less developed" even though in fact it is, nor any requirement that such designation be withdrawn when in fact it is not. In the absence of specific statutory provisions, therefore, presidential action would presumably not be subject to judicial review.

Even if the present Bill could be justified as an adjunct to the President's powers in the fields of foreign policy and national defense, it is respectfully submitted that such a delegation of the Legislative powers of taxation and control of foreign commerce should not be made without more study of available alternatives than appears to have been given.

Sec. 5—Distributions in Kind.

Section 5 of the Bill is designed primarily to prevent a foreign corporation from distributing appreciated property to its U. S. corporate shareholder, so that the latter can sell the property and pay only a U. S. capital gains tax on the appreciation. Section 5 purports to be a companion provision to Section 16 of the Bill, which provides generally for taxation as ordinary income of gain on sale or liquidation of stock by 10% or larger U. S. stockholders in controlled foreign corporations (H. Rep. No. 1447 at page 27). Taken together, Sections 5 and 16 are intended to exact U. S. tax at ordinary rates upon any withdrawal of funds or property from the foreign corporation.

The purpose of this section of the Bill is to be achieved by amending Section 301 of the Code so as to tax the U. S. corporate shareholder on a dividend in kind from a foreign corporation at its current fair market value rather than at its lower tax basis in the hands of the distributing foreign corporation. A correlative amendment to Section 902(a) of the Code would require that foreign tax credit be determined by valuing the dividend property at the lesser of the fair value or the basis of the asset in the hands of the foreign corporation. No change, however, is made in the rule of Section 312(a) of the Code that earnings and profits of the distributing corporation shall be reduced only by the adjusted basis of the property distributed.

A. Ordinary Rates Should Apply Only to Tax Avoidance Cases.

H. Rep. No. 1447 states at page 27 that the present rule of taxing a dividend in kind from a foreign corporation at its adjusted basis results in the domestic shareholder receiving what amounts to a cash dividend at capital gains rates. This could occur, however, only where there is both (i) the distribution by a foreign corporation of an asset which has appreciated in value, and (ii) immediate sale of such asset by the U. S. corporation. Only when both conditions are present is the U. S. corporation in the same position as if it had received a cash dividend. In such a situation, the U. S. corporation pays ordinary income tax on the adjusted basis of the asset and capital gains tax on the portion of the sales proceeds in excess of the adjusted basis, i.e., on the gain realized from the sale of the asset.

Even under present law, the Commissioner should often be able to prevent this device under the step transaction doctrine as applied by the Supreme Court in the *Court Holding Company* decision, 324 U. S. 332 (1945). However, it is possible that present law may be inadequate to cover all situations of this sort, and that remedial legislation is appropriate to eliminate any tax avoidance. Nevertheless, the remedy proposed, i.e., taxing the receipt of the property as a dividend to the extent of its fair market value, may result in unfair application of the proposed rule to many situations which do not involve tax avoidance. Legitimate business reasons may require a foreign corporation to distribute assets to its U. S. corporate shareholder, e.g., so that those assets may henceforth be operated as a branch of the U. S. corporation.

The Bill, however, imposes tax at ordinary income tax rates on the unrealized appreciation of the assets distributed, even though the U. S. shareholder does not convert the appreciation into cash at capital gains rates, but continues to hold and use the appreciated property in its business. In effect, the proposal accelerates the payment of a tax on the appreciation in value prior to the realization of any cash, or its equivalent from the asset. Moreover, the unrealized appreciation may never be realized by the U. S. corporation.

Furthermore, this Section is inconsistent with Section 16 of the Bill dealing with liquidations and sales of stock of controlled foreign corporations although the House Committee Report states that the two sections are "companion" sections (H. Rep. No. 1447, at p. 27). Under proposed Section 1248, unrealized appreciation of capital assets held by a controlled foreign corporation may be realized through sale of the stock of the foreign corporation, and in such event the gain is taxed to the U. S. shareholder as a capital gain. However, under Section 5 of the Bill such unrealized appreciation is taxed not only before the gain is realized but is taxed at ordinary income tax rates.

If, as implied in H. Rep. No. 1447 at page 27, the principal purpose of Sections 5 and 16 is to prevent the conversion of ordinary income into capital gain, this end could be achieved in a more equitable manner. Accordingly, we recommend that existing law with respect to dividends in kind be continued, and that the law be amended to provide that any gain realized by a U. S. corporation on the sale or other taxable disposition of property received as a dividend in kind from another corporation should be taxed as ordinary income if the sale or disposition of such property takes place within a specified number of years after receipt of the dividend.

B. The Same Earnings Should Not Be Taxed Twice.

Section 5 is defective insofar as it would tax more than the total accumulated earnings of the foreign corporation where the tax avoidance intent described immediately above is not present.

Double taxation of the same earnings would result from the combined effect of the new rule and the existing Section 312(a)(3), which limits the reduction of the accumulated earnings of a corporation making a distribution in kind to the adjusted basis of the asset distributed, rather than its current market value.

For example, assume that a U. S. corporation has invested $100,000 in capital stock of a wholly-owned foreign corporation, the balance sheet of which is as follows:

Assets

Cash	$100,000
Operating Assets	100,000
Machinery (Fair market value $50,000)	10,000
Total	$210,000

Liabilities and Capital

Accounts Payable	$ 10,000
Capital Stock	100,000
Accumulated Earnings	100,000
Total	$210,000

Because certain machinery owned by the foreign subsidiary is needed in the U. S. business of its U. S. parent, the subsidiary distributes the machinery as a dividend to its parent. Thereafter, it distributes a cash dividend of $90,000.

Under the Bill, the distribution of the appreciated property will result in ordinary income to the U. S. parent in the amount of $50,000, on which a 52% U. S. tax, or $26,000, will be paid. However, the accumulated earnings of the foreign subsidiary will be reduced only by the adjusted basis of the appreciated property distributed, or $10,000, thus leaving $90,000 as the undistributed balance of accumulated earnings. When the subsidiary distributes a further cash dividend of $90,000, the entire amount of that dividend will also bear the full 52% U. S. tax, or $46,800.

Thus, $140,000 ($50,000 in property and $90,000 in cash) will be taxed to the U. S. corporation, even though the foreign corporation had only $100,000 of accumulated earnings. In effect, the $100,000 of earnings will bear total U. S. taxes of $72,800, representing an effective tax rate of almost 73%.

The same result would obtain if, instead of paying the second dividend, the foreign subsidiary were liquidated. In that event, the undistributed accumulated earnings of the foreign subsidiary would be taxed to the U. S. parent under Section 16 of the Bill at the full 52% rate as a dividend.

We recognize that the same result obtains under present law with respect to property distributions to noncorporate stockholders. However, in such a case, the property has passed out of corporate solution. On the other hand, in the case of a corporate stockholder of a foreign corporation, the property is still in corporate solution. Moreover, any appreciation taxed at ordinary income rates to the domestic corporation by reason of the new provision will again be taxed at ordinary income rates when distributed by the domestic corporation to its stockholders.

We suggest that the Bill be amended to provide that, if the fair market value of a dividend in kind from a foreign corporation is to be taxed to the U. S. corporate shareholder, then the earnings and profits of the foreign corporation should be reduced by such fair market value, thus preventing multiple taxation of the same earnings and profits.

C. Foreign Tax Credit Should Be Computed on Amount Taxed as Dividend.

Although the proposed amendment would tax the fair market value of a dividend in kind paid by a foreign corporation to a U. S. corporate shareholder, a companion amendment to Section 902(a) of the Code would require that the foreign tax credit applicable to such dividend be determined by valuing the dividend at the lesser of the fair market value or the adjusted basis of the asset in the hands of the distributing foreign corporation.

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This will result in maximizing the U. S. tax on the appreciated property received as a dividend, while minimizing the U. S. credit for any foreign taxes paid by the foreign corporation.

We recommend that, if the dividend in kind is to be taxed at fair market value, the foreign tax credit with respect to the distribution should likewise be computed with reference to such fair market value of the property distributed. We recognize that the unrealized appreciation in value has not itself borne any part of the subsidiary's foreign taxes, but if such appreciation is to be taxed by the United States as ordinary income when distribution occurs, we think it appropriate to allow credit at that time for the part of foreign taxes actually paid by the subsidiary which is proportionate to the amount taxed to the U. S. shareholder. This increase in the credit would, of course, reduce the credit allowable when subsequent distributions are made.

Sec. 6—Amendment of Section 482.

Section 6 of H. R. 10650 is intended to implement the authority of the Secretary of the Treasury to eliminate abuses in sales of products between a United States person and a foreign entity controlled by such United States person or controlled by the same interests which control the United States person. Section 6 of the Bill proposes a new Section 482(b), which would deal only with this type of situation.

Present Section 482 grants to the Secretary a blanket authority to

> "distribute, apportion or allocate gross income, deductions, credits or allowances between or among such organizations, trades or businesses if he determines that such distribution, apportion or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations, trades or businesses."

H. Rep. No. 1447 states at page 28 that the present Section 482 gives the Secretary the necessary authority to allocate income between a domestic parent and its foreign subsidiary but that, in practice, the difficulties in determining a fair price under this provision severely limit its usefulness, especially where there are thousands of different transactions between a domestic company and its foreign subsidiary.

The method employed in proposed Section 482(b) is to allocate the taxable income of the combined organizations based on the proportion of assets, compensation of employees, and selling expenses attributable to the United States and the foreign countries involved. Various limitations would permit the use of special factors and alternate formulae in certain cases.

We believe that the proposed amendment would add unnecessary complications and conflicting concepts to the already complex structure of the Internal Revenue Code.

A. Compliance Difficulties.

On the surface, a three-factor formula of allocation has much to commend it. It appears to be objective, equitable and similar to methods presently in force under many State corporate income tax laws. In operation, it may fail to fulfill these criteria.

The formula may work acceptably where a United States taxpayer manufactures only one product that it sells at an artificially low price to its controlled foreign subsidiary, which in turn sells the product at a large profit to third parties.

In practice, there are almost no taxpayers whose operations are so simple. The vast bulk of United States manufacturers are engaged in multi-product operations as are their subsidiaries, frequently with foreign "partners" owning significant interests in the subsidiary.

The multi-product manufacturer is rarely able to make an exact allocation or identification of costs to each of its products where, as often is the case, overhead costs are not readily susceptible of specific allocation to individual products.

In contrast with allocations found in most State franchise tax allocation formulae, allocations under Section 482 are not on a company-wide, across-the-board basis. Instead, it would be necessary to break down each product involved on a geographic basis. Indeed, each separate product might require an individual allocation of taxable income. This would result in staggering costs in terms of time, effort and expense.

If the Congress nevertheless finds that an allocation formula is required in this area, further study should be given to the methods and factors entering into the formula with a view to simplification. The following comments are designed to clarify the proposed statute and to prevent unnecessary and unreasonable burdens upon taxpayers.

B. Allocation Should be Limited to Gross Income from Sales.

Proposed Section 482(b)(1) would allocate "taxable income" of the group arising from sales of tangible property.

The concept of allocating "taxable income from such sales" would, we believe, create serious administrative difficulties, both for the Government and for taxpayers. The words "taxable income" are words of art peculiar to the United States Internal Revenue Code and relevant cases. Under the proposed statute, it would become necessary to audit the financial affairs of foreign entities in terms of United States tax concepts, accounting standards and currency. Such an audit would not be limited to the propriety of the sales prices charged, but would extend to the last detail of expenses and deductions of foreign corporations. This would require restatement of the financial accounts of the foreign corporations with (to them) alien tax, accounting and currency concepts.

These complexities could be reduced to some extent by authorizing the allocation of "gross income" rather than "taxable income" from such sales. Thus, the inquiry would appropriately be directed to the gross profit realized by the controlled group as an entity on sales to independent third parties. That the profit on the sale to independent third parties is the appropriate criterion seems clear, since the proposed amendment has no application where the sales price is an arms' length sales price, even though the sale is between related entities.

C. Need to Clarify Types of Sales Affected.

The proposed Section 482(b)(1) is ambiguous insofar as it might apply to sales *between* United States persons, simply because foreign entities are members of the controlled group. To make it clear that the Bill is to apply only to sales between a United States entity and a foreign entity, it is recommended that the proposed language in Section 482(b)(1) reading "In applying subsection (a) to sales of tangible property . . .", be changed to read "In applying subsection (a) to sales *between a United States person and a foreign person* of tangible property. . . ."

D. Allocation Should be to United States Persons.

We suggest that the phrase "the United States" in proposed Section 482(b)(2)(A) be changed to "a United States person".

This change is required to insure allocation of the gross profit to the entities (United States or foreign) rather than to the places where the factors for such entities may be located. In many cases the assets or other factors of the United States person may be located abroad rather than in the United States. Similarly, the assets of the controlled foreign entity may be located in the United States rather than abroad. In such cases, the proposed amendment would not operate as intended.

E. Special Risks Should be Amplified.

The last sentence of proposed Section 482(b)(2)(A) states that, in applying the three-factor allocation formula, the method of allocation "may also give consideration to other factors, including the special risks (if any) of the market in which the property is sold."

This provision implies that recognition is to be given to the peculiar economic, social and political risks present in foreign operations. However, the provision fails to take account of cases where the foreign operations comprise not merely selling, but also manufacturing, mining or other types of activities. The special risks of such operations may be much greater than those of a simple selling organization.

We therefore suggest that the last sentence of subparagraph (A) of Section 482(b)(2) be re-stated to provide that "Such method of allocation shall also give consideration to any other material factors." This suggestion would also eliminate any inference that it is solely within the discretion of the Secretary to consider other factors where appropriate.

F. Use of Tax Basis Rather Than Market Value.

The proposed Section 482(b)(3)(A) would use tax basis or book value of assets in computing the asset factor in the formula.

The fair market value of an asset is ordinarily better evidence of its current economic importance than its tax basis or book value, which is usually historical cost less accumulated depreciation. As a practical matter, however, it will often be extremely difficult to establish the current market value of an asset, such as a factory constructed and gradually improved by the taxpayer over a period of years. In such cases, the ready availability of tax basis or book value figures may outweigh their inadequacies as economic indicators.

We therefore suggest that the proposed Section 482(b)(3)(A) be amended to provide that tax basis or book value is to be used only in the absence of a satisfactory showing by the taxpayer of the fair market value of the asset. This would permit the use of fair market values whenever they can be established without undue difficulty, e.g., where comparable assets have recently been purchased in an arms' length transaction.

G. Elimination of Rule as to Grossly Inadequate Assets, Etc.

The proposed Section 482(b)(6) provides that no amount shall be allocated to a foreign organization whose assets, personnel, and office and other facilities which are not attributable to the United States are grossly inadequate for its activities outside the United States.

Our Committee sees no reason for this rule and suggests that it be eliminated. If, under the formula, an amount of income can be allocated to a foreign entity, it would seem inappropriate for the Secretary's representative to substitute his judgment for that of the Board of Directors of the corporation to determine the assets and personnel required to conduct the business.

H. Need for Judicial Review.

Proposed Section 482(b)(2)(B) provides that, in lieu of the three-factor formula, an alternative method of allocation shall be used if the taxpayer establishes "to the satisfaction of the Secretary or his delegate" that such method clearly reflects income. Proposed Section 482(b)(7) provides that if the taxpayer fails to furnish information sufficient for application of the formula, the Secretary or his delegate may estimate the taxable income and allocate it within the controlled group.

These provisions appear to delegate more authority to the Secretary or his delegate than is necessary. Our Committee recognizes that there may be cases of flagrant non-cooperation by taxpayers for which it is appropriate to endow the Secretary or his delegate with broad discretionary authority. However, the majority of taxpayers who attempt in good faith to furnish information or to establish an alternative method of allocation are entitled to some measure of protection that the Secretary's broad power will not be used arbitrarily or unreasonably.

Our Committee therefore recommends that the proposed Section 482(b) be amended to make it clear that any allocation made thereunder by the Secretary or his delegate is subject to judicial review to the same extent as any other determination affecting the amount of a taxpayer's income.

I. Need for Regulations with Prospective Effect.

The proposed Section 482(b)(2)(A) provides that allocation shall be made by the Secretary or his delegate by taking into consideration "that portion of the following factors which is attributable to the United States . . .". The subsection then refers to assets, compensation, and certain expenses "to the exent used" and "to the extent attributable" to the property sold by one affiliate to another.

Our Committee anticipates that serious difficulties will be encountered in attempting to determine the "extent" to which the various factors are "attributable" to the sales which are the subject of allocation. These practical difficulties are particularly likely to arise in the case of taxpayers with hundreds or thousands of different products. Some of these products may be manufactured and/or marketed solely in the United States, while others are manufactured and/or marketed solely abroad, and still others are manufactured and/or marketed partly in the United States and partly abroad. Such cases would involve a great number of possible factual combinations, depending upon the location of the various economic processes relating to each type of product.

It is therefore probable that the calculations under the proposed Section 482(b) will require many taxpayers to set up and maintain special new types of accounting records to provide a break-down, on a geographical basis, of the figures relating to each class of the company's products. This will involve very substantial expenditures of both time and expense since the records required under the new statute would be different from, and in addition to, those regularly maintained for the ordinary conduct of business.

The keeping of these special records will clearly be very burdensome for many taxpayers. Moreover, the burden can be borne only if taxpayers are informed by Regulations, promulgated by the commencement of the taxable year, as to precisely what additional records are to be made of data relating to that year. As a practical matter, such data must be collected contemporaneously because when the taxpayer's return is audited years later, such data could not be assembled from the taxpayer's regular business records.

Our Committee therefore recommends that the proposed Section 482(b) be amended to require that any allocation thereunder shall be in accordance with Regulations to be promulgated by the Secretary which are in effect on the first day of the taxable year for which the allocation is to be made.

The amendment should also provide that no allocation is to be required on the basis of data requiring the keeping of records other than records regularly maintained in the ordinary course of business, unless such special records were expressly required in Regulations in effect on the first day of the taxable year for which the allocation is to be made.

A precedent for requiring such Regulations is found in the existing Section 6038 of the Code relating to annual information returns concerning controlled foreign corporations. Section 6038(a)(3) provides:

> "No information shall be required to be furnished under this subsection with respect to any foreign corporation for any annual accounting period unless such information was required to be furnished under regulations in effect on the first day of such annual accounting period".

J. Allocation of Foreign Income Taxes.

The proposed Section 482(b)(8)(B) provides that where income is allocated from a foreign organization to a domestic organization, any foreign income taxes paid by the foreign organization with respect to such income shall be treated as paid by the domestic organization rather than by the foreign organization.

This provision is intended to give the domestic organization credit against its increased U. S. tax for any foreign income taxes paid with respect to the income allocated to the domestic organization. The provision may, however, also have the effect of reducing the credit allowable under the existing Section 902 with respect to dividends received by a U. S. corporation from a foreign corporation, since the amendment would reduce the amount treated as foreign income tax paid by the foreign corporation.

Although the Report of the Ways and Means Committee is explicit as to the Congressional purpose of allowing the U. S. taxpayer a credit for the foreign income taxes attributable to the income allocated to it under the new Section 482(b), the Report also states:

> "However, the income so reallocated for purposes of the overall or per country limit is not to be classified as foreign income." H. Rep. No. 1447 at p. 30.

The practical effect of this statement is to deny the benefit of a credit for the foreign taxes referable to the allocated income, except in the fortuitous circumstance that the United States taxpayer may happen to have other foreign-source income on which little or no foreign tax has been paid.

We therefore suggest that, if Congress intends to allow foreign tax credits in the majority of cases to which Section 482(b) would apply, the proposed statute should be amended to provide that, for purposes of the limitations under Section 904, income allocated to a United States taxpayer under Section 482(b) shall be deemed to have its source in the country under the laws of which the foreign entity (from which the income is allocated) is organized or incorporated. In addition, the statute should provide that all foreign taxes paid by the foreign entity with respect to the income so allocated shall be deemed to have been paid to the foreign country under the laws of which the foreign entity is organized or incorporated.

Moreover, the provision speaks only in terms of taxes paid. It should be made clear that rules currently in effect under Section 901(b)(1) for taxes accrued would also be applicable to transferred taxes.

K. Desirability of Defining "Control".

The proposed amendments of Section 482 do not contain any definition of the term "organizations . . . owned or controlled directly or indirectly by the same interests", as used in the new Section 482(b)(1).

Our Committee believes that where there is a substantial minority interest, such as an interest of 20% or more, transactions will normally be on an arms' length basis, since to do otherwise would be either to cheat or to enrich the minority owners.

We therefore recommend that the proposed amendments be modified so as to become inapplicable unless the identity of interest represents at least 80% of the value of the stock of each of the corporations. This will minimize administrative difficulties both for taxpayers and for the Treasury.

In the alternative, we recommend that there be added to the proposed Section 482(b)(4) a presumption that sales between corporations in which identical interests do not own as much as 80% are at an arms' length price.

L. Need for Amendment Increasing Basis of United States Taxpayer's Investment in Foreign Entity.

The proposed Section 482(b) appears to be technically defective insofar as it fails to provide expressly for an increase in the United States taxpayer's basis for its investment in a controlled foreign entity from which income is allocated to the United States taxpayer.

Assume that a domestic corporation sells its product for $60 to a wholly-owned foreign subsidiary, which resells to unrelated third parties for $100. Under Section 482(b) it is determined that $15 of the $40 profit of the foreign subsidiary should be allocated to the domestic corporation.

This allocation would mean that, in effect, the domestic corporation has (1) realized $15 of additional income by sale to the foreign subsidiary at a price of $75 and (2) transferred assets worth $15 to the subsidiary as a contribution to the capital of the subsidiary.

Our Committee therefore recommends that the proposed Section 482(b) be amended to make appropriate provision for increasing the tax basis of the domestic corporation for the stock of the foreign corporation in cases of this type. A comparable provision appears in the proposed Section 958(a) which states that the basis of a United States person's stock in a controlled foreign corporation shall be increased by the amount of the corporation's undistributed earnings included in the gross income of the United States person under the proposed Section 951(a). The presence of this provision in the new Section 958 makes it particularly desirable to include a similar provision in the new Section 482(b) to prevent any inference that a different rule was intended to apply under Section 482(b).

Sec. 11—Domestic Corporations Receiving Dividends from Foreign Corporations ("Grossing-Up").

Section 11 of H.R. 10650 would require a U. S. corporation claiming a foreign tax credit under Section 902 of the Code to include in its income, not only the dividend it receives from a foreign corporation, but also the foreign income taxes paid by the foreign corporation on the profits from which the dividend is derived.

This would be accomplished by adding to the Code a new Section 78 and a series of amendments to the present Section 902. The new Section 78 would provide that if a domestic corporation elects to take the foreign tax credit, it must report as an additional dividend the amount of the foreign income taxes paid by the foreign corporation which the domestic corporation is deemed to have paid for foreign tax credit purposes. The amendments to Section 902 would provide that the domestic corporation is deemed to have paid the full amount of the foreign corporation's foreign income taxes. The latter amendments would overrule

American Chicle Company v. *U. S.*, 316 U. S. 450 (1942), which now limits the credit to that portion of the foreign taxes which the after-tax profits of the foreign corporation bear to its pre-tax profits.

The stated purpose of the "grossing-up" amendments is to assure that, regardless of the level of the effective foreign tax rate, the combined U. S. and foreign taxes will always represent 52% of the pre-tax income of the foreign corporation. This is in contrast to present law under which the combined U. S. and foreign taxes *with respect to the dividend to the U. S. parent* always represent 52% of the *dividend.*

A. "Grossing-Up" Would Not Equalize Tax Burdens of Businesses at Home and Abroad.

The "grossing-up" amendments do not, in the form proposed, carry out their stated objective of equalizing tax burdens of U. S.-owned enterprises at home and abroad.

The amendments are inadequate to accomplish their purpose of tax equalization because they deal only with income taxes. They thus fail to take into account the fact that a major part of the tax burden borne by enterprises operating abroad consists of a variety of turnover and other non-income taxes, which have far greater importance under most foreign fiscal systems than under our own. Whereas the United States relies on income taxes rather than excise taxes for most of its national revenues, this relationship does not prevail in many foreign countries which, for a variety of reasons, derive a larger share of their total tax collections from non-income taxes.

Accordingly, equalization of tax burdens cannot be accomplished by changes in the U. S. tax credit which ignore the heavy excise taxes borne by U. S.-owned enterprises operating abroad that are not borne by U. S.-owned enterprises operating at home.

We therefore suggest that, if the Congress desires to equalize the tax burdens of U. S.-owned enterprises throughout the world, this requires that credit be given for a variety of foreign taxes which now fall outside the narrow scope of Section 903 of the Code allowing credit for foreign taxes paid "in lieu of" income taxes.

Pending this broader and more realistic approach to foreign taxes imposed "in lieu of" income taxes, we recommend that enactment of "grossing-up" be deferred on the ground that the present method of computing the foreign tax credit tends to compensate, albeit inexactly, for the failure of present law to recognize the greater relative importance of excise taxes under foreign fiscal systems.

B. "Grossing-Up" Amendments Should Not Apply to "Less Developed" Countries.

Application of the "grossing-up" amendments to dividends from corporations organized and conducting bona fide business operations in "less developed" countries appears inconsistent with several provisions of the proposed Subpart F which give effect to a policy of encouraging private investment in "less developed" countries.

For example, in defining undistributed "net foreign base company income" of a foreign corporation, which is taxable to a U. S. shareholder, the proposed Section 952(d) provides that the foreign base company income (consisting primarily of income from portfolio-type investments plus certain sales income) shall be reduced by "the increase in investment in qualified property in less developed countries for the taxable year." Thus, a U. S. shareholder is excused from current taxation of undistributed income, such as profits of a Swiss trading company considered to be a "tax haven" device, to the extent that such income is matched by an increase in investment in "less developed" countries.

The policy of encouraging investment in "less developed" countries is also given effect under the proposed Section 951 (a)(1)(B), which would tax a U. S. shareholder on his pro rata share of a foreign corporation's "increase in earnings invested in nonqualified property'' for the year. In implementing the new concept of ''investment of earnings in nonqualified property'', Section 952 (b)(2)(C) provides, in effect, that the U. S. shareholder will not be taxed on undistributed income of the foreign corporation to the extent that an equal amount is invested in stock of another corporation (i) engaging in the active conduct of a trade or business ''almost wholly within a 'less developed' country or countries'' and (ii) ''created or organized under the laws of one of such countries in which it is so engaged''.

Again, the proposed Section 953(b)(3)(A)(ii) provides special favorable treatment for a trade or business carried on ''almost wholly within a 'less developed' country or countries'' in defining a ''qualified trade or business'' in which earnings of a foreign corporation may be reinvested without causing them to be currently taxable to the U. S. shareholder. In such a case, the U. S. shareholder is excused from current taxation of the earnings reinvested in the trade or business even though that trade or business fails to qualify under the general rule requiring that the trade or business must have been carried on ''since December 31, 1962, or during the 5-year period ending with the close of the preceding taxable year''.

The foregoing provisions of the proposed Subpart F evidence a clear policy to encourage investment in ''less developed'' countries. Moreover, such encouragement takes the form of an exemption from undistributed profits taxation in cases which otherwise are considered to involve ''avoidance'' of U. S. taxes.

If tax ''avoidance'' is excused by investment in ''less developed'' countries, the policy of encouraging U. S. investment in ''less developed'' countries would, *a fortiori*, require that an exception be made under the proposed ''grossing-up'' amendments for dividends from legitimate business enterprises in ''less developed'' countries.

In support of such an exception, it should be noted that the ''less developed'' countries are the very same countries in which the "grossing-up" amendments would have their sharpest effect. That is because, with a few exceptions such as India, most of the "less developed" countries impose their income taxes at rates well below the U. S. rate of 52%. Moreover, in "less developed" countries the effective rate of tax is frequently reduced by a variety of provisions affording tax relief for new or expanding local enterprises, e.g., extra deductions for earnings reinvested in new plant or equipment.

In many cases, the benefit of the tax incentive program of the "less developed" country would be partly or completely offset by "grossing-up" the earnings later paid out as dividends to the U. S. shareholder. In effect, the United States would then collect taxes foregone by the "less developed" country, thus neutralizing the effectiveness of the local program of tax incentives for private enterprise.

Our Committee therefore recommends that, if the Congress wishes to encourage U. S. business investment in "less developed" countries, consideration should be given to excluding dividends on investments in those countries from operation of the proposed "grossing-up" amendments.

We also call attention to the fact that the "grossing-up" amendments cannot apply to dividends from subsidiaries incorporated in a number of advanced countries with which Income Tax Conventions are now in force, without either (i) renegotiation of these Conventions or (ii) enactment of Section 21 of the Bill to render existing Section 7852(d) of the Code inapplicable. The latter alternative appears tantamount to unilateral repudiation of the pertinent Conventions by the United States.

C. Characterization of Foreign Taxes as a "Dividend" Would Have Unnecessary Side-Effects.

Our Committee finds the "grossing-up" amendments defective in form because they would have numerous side-effects which probably are not intended by the Congress and which have no logical relationship to the stated purpose of the amendments.

These side-effects stem primarily from the fact that the amendments do not simply alter the computation of the foreign tax credit. Instead, they add to the Code a new Section 78 stating that the foreign taxes of the foreign corporation "shall be treated for purposes of this title (other than Section 245) as a dividend . . ." received by the U. S. corporate shareholder.

The most frequent side-effect of the proposed "grossing-up" amendments would be to reduce the U. S. tax where both dividends and low-taxed income are received from advanced countries in which the effective foreign rate exceeds the U. S. rate. This reduction in U. S. tax would result from the fact that inclusion of the amount of the foreign tax in the U. S. shareholder's taxable income would increase its pre-credit U. S. tax by only 52% of the amount so included, whereas the increase in its credit could be as much as 100% of such amount.

The credit limitation in Section 904 is, of course, intended to deny credit for foreign tax in excess of the U. S. tax. However, where the taxpayer receives from one country both dividends and other income, such as royalty income, bearing little or no foreign tax, the limitation is increased, so that "grossing-up" would result in larger credits than under present law. This side-effect of "grossing-up" would have growing practical importance as an increasing number of U. S. corporations elect the over-all limitation instead of the per-country limitation in order to average their credits for high and low foreign taxes. Thus, instead of discouraging investment in advanced countries, "grossing-up" might often encourage it.

By increasing the U. S. corporation's gross income, and then characterizing the increase as a "dividend", the new Section 78 would have many tax consequences in addition, and unrelated, to the intent of the "grossing-up" amendments. A few examples of these "side-effects" are:

1. Inclusion of the foreign corporation's foreign taxes in the U. S. corporation's income may move the latter from a 30% tax bracket into a 52% bracket.

2. The increase in the U. S. corporation's gross income will change the limitation on its charitable contributions under Section 170(b)(2) of the Code.

3. Since the increase in the U. S. corporation's gross income would presumably increase its earnings and profits, the effect of this increase may be to change the character of distributions made by the U. S. corporation to its shareholders, i.e., to convert distributions which would otherwise be non-taxable or taxable as capital gain into fully-taxable dividends.

4. The increase in the U. S. corporation's gross income would inter-act with the net operating loss carryback and carry-over provisions, thus changing taxable income for other years. This interplay can, in turn, have a variety of capricious effects. See article by Frederic G. Corneel entitled "Grossing-Up" in 38 *Taxes* 507 (July, 1960).

5. Treatment of the foreign corporation's foreign taxes as an additional "dividend" to the U. S. corporation may disqualify the latter as a Western Hemisphere Trade Corporation under Section 921 or an "electing small business corporation" under Section 1371 (Subchapter S).

6. Treatment of the foreign corporation's foreign taxes as an additional "dividend" to the U. S. corporation may cause the latter to become a Personal Holding Company subject to penalty tax under Section 541. Only partial relief from this result is afforded by the proposed amendment to Section 531(b)(1) which would allow deductions for the foreign taxes deemed paid in computing undistributed personal holding company income.

The foregoing are merely some of the anomalies which would result from the attempt to alter the foreign tax credit by treating taxes paid by the foreign subsidiary as additional "dividends" to the U. S. corporate shareholder.

It is therefore suggested that, if the Congress decides to adopt the "grossing-up" principle, this should be done directly by limiting the foreign tax credit, without increasing gross income for all purposes (most of them having nothing to do with the foreign tax credit) and without characterizing the increase as a "dividend".

Sec. 13—Controlled Foreign Corporations ("Subpart F").

Introductory Comments

Section 13 of the Bill would add to the Code new Sections 951 to 958, inclusive, which tax certain United States shareholders on undistributed income of "controlled foreign corporations".

Before discussing the specific provisions of Section 13, it is appropriate to make certain general comments relating to the overall operation of the proposal:

1. Assume that a U. S. citizen owns all of the stock of a foreign corporation that owns and operates an office building in Country X which has a 52% corporate income tax. Since all of the income is defined as Subpart F income, the net rental income would be currently taxable to the U. S. shareholder. However, if the corporation were domestic rather than foreign, its rental income would be not taxable to the U. S. shareholder. Since the foreign income tax is identical with the U. S. tax, it seems clear that the organization of the corporation in Country X was not motivated by tax considerations. Nevertheless, the U. S. shareholder would be subject to burdensome taxation without having engaged in tax avoidance or other conduct to warrant such treatment.

2. Assume that in 1963 a controlled foreign corporation earns $1,000 of Subpart F income in foreign currency. This income is currently taxable to the U. S. shareholders as ordinary income even though the foreign corporation may not be able to pay out such income as dividends. If by reason of a subsequent decline in the value of the foreign currency, the shareholder must ultimately liquidate the corporation or sell his stock at a loss, the loss would be

treated as a capital loss even though the income originally included in 1963 was taxed as ordinary income. Not even a capital loss would be allowed if the foreign corporation is an 80%-owned subsidiary which is liquidated under Section 332 of the Code.

The inequity is even greater if the income previously taxed to the U. S. shareholder is never received because the foreign country has confiscated the assets of the foreign corporation. Under these circumstances only a capital loss would usually be allowed, except under the limited circumstances under which an ordinary loss is allowed by Section 165(g)(3) of the Code.

3. Assume that a foreign business is conducted through a separate foreign corporation organized in each country in which business is done, e.g., to limit liabilities and secure other non-tax advantages of local incorporation. Here the proposed statute would tax the profits of one corporation without regard to the losses sustained in other corporations carrying on a different phase of the same business. In this respect the statute would, in essence, disregard the corporate entity to tax profits, while scrupulously respecting it to deny deductions for losses.

4. Assume that A is a 10% shareholder of a controlled foreign corporation. In the middle of the year the other U. S. shareholders sell their shares to foreigners so that at that point the foreign corporation ceases to be a controlled foreign corporation.

(a) A would be required to pay a tax with respect to undistributed Subpart F income even though such income was earned after the corporation ceased to be a controlled foreign corporation.

(b) In order to determine A's proportionate share of Subpart F income, he will have to obtain certain information from the corporation. Inasmuch as A will then be a minor shareholder, he may be in no position to compel the corporation to furnish him with that information. Indeed, the same result may follow even where the U. S. shareholder was a controlling shareholder during one year but is no longer a shareholder at all in a subsequent year when his tax return for the earlier year is audited.

"Subpart F income" is defined in proposed Section 952(a) as the sum of (1) income derived from insurance of U. S. risks; (2) income from U. S. patents, copyrights and exclusive formulas and processes; and (3) "net foreign base company income".

A. Insurance of U. S. Risks

Definition of Net Income From Insurance of U. S. Risks Should Be Reconsidered

Section 13 of the proposed Bill taxes to American shareholders the undistributed net income of a foreign corporation derived from insurance of United States risks. Under proposed Section 952(a)(2), this section is not applicable if the foreign corporation is engaged in business in the United States since the income from insurance of United States risks is considered to be from U. S. sources. See *Standard Marine Insurance Company, Ltd.*, 4 BTA 853 (1926)(Acq.).

However, the U. S. taxes imposed under the Bill on the U. S. shareholders on income from insurance of U. S. risks are higher than would be imposed if the foreign corporation were doing business in the United States or were a domestic corporation.

Foreign life insurance companies doing business in the United States and domestic life insurance companies are taxable under Section 802 on the sum of (a) investment income; (b) 50% of the amount by which gains from operations exceed investment income; and (c) amounts subtracted from policyholder's surplus account.

Under the Bill net income from foreign life insurance is defined as income from operations attributable to the U. S. risks, rather than the lesser amount which would be applicable if the foreign corporation were doing business in the United States. The Committee Report gives no reason for providing that the net income taxed to a U. S. shareholder is greater than the net income which would be taxed to the foreign life insurance company if it were doing business in the United States or were a domestic corporation.

For other insurance companies the Bill also defines net income to be the same as that for a foreign insurance company doing business in the United States, except that certain deductions are disallowed. The most important deduction which is disallowed to these foreign insurance companies under the Bill is the deduction for net operating loss carry-overs and carry-backs. The Committee Report gives no indication why such deductions are disallowed.

If there are no reasons of policy for the above differences in the computation of net income of such companies, consideration should be given to the elimination of the differences.

In View of Subpart F, Review Should Be Given to Role of 1% to 4% U. S. Tax on Premiums

Under present law a foreign insurance company insuring U. S. risks pays, under Section 4371 of the 1954 Code, a tax of from 1% to 4% on premiums on U. S. risks where the foreign insurance company is not engaged in business in the United States. This tax was first imposed on foreign insurance companies under the Revenue Act of 1918 as a tax in lieu of a United States income tax on the income arising from the writing of such insurance by foreign corporations. See I. T. 1358, I-C. B. 292 (1922).

The insurance of U. S. risks by foreign insurance companies appears to be the only situation envisioned by the Bill in which a major portion of the income of the foreign company is from U. S. sources. In view of this fact, consideration might be given to granting the U. S. shareholder credit for the U. S. taxes on the premiums.

B. Income from U. S. Patents

Subpart F income consists of three elements one of which is income from United States patents, copyrights, and exclusive formulae and processes. (See proposed Section 952(c)). The proposal is intended to tax to the United States shareholder of a foreign controlled corporation any income derived by such corporation from the license, sublicense, sale, exchange, use or other means of exploitation of the aforementioned property if it was substantially developed, created or produced in the United States or acquired from the United States person controlling the foreign corporation. (See proposed Sections 952(c)(1)(A) and (B)).

From such income may be deducted ordinary and necessary expenses incurred in the receipt or production of the income. (Section 952(c)(2)).

A separate subsection provides the criterion for the determination of income from the use or other means of exploitation of such property. (Section 952(c)(3)). Such income shall be deemed to be the amount of income which would be obtained in an arm's length transaction with an unrelated person for similar use or exploitation.

The House Report states that the foregoing provision is necessary because, if it were not for lower taxes abroad, the domestic company would retain the rights and directly license them for use by foreign corporations.

Imputed Income from Use of Property Rights

The present foreign personal holding company rules, incorporated by reference in proposed Section 952(e)(1), provide for the taxation of royalties, rents and similar income from the use of industrial property rights and also provide for the taxation of copyrights under limited circumstances. Thus *actual* income from the exploitation of industrial property rights taxed under proposed Section 952(c) would have been included under Section 952(e) but for its express exclusion by Section 952(e)(4).

In effect, therefore, the function of the new Section 952(c) is to include in income an imputed royalty where none has, in fact, been received. Historically, our tax system has not heretofore contained provisions relating to imputed income. In those systems in which income is imputed, some objective standard is used, e.g. Great Britain and Sweden impute rent using appraised value of the real estate owned. In this instance no such standard is available. Because of the nature of the rights involved, it will, in nearly every case, be impossible to find an "amount which would be obtained as a gross . . . payment in an arm's length transaction with an unrelated person for similar use . . . of the property or right."

The result will be that the Internal Revenue agent's opinion will be the standard on which the bargaining will begin. That opinion may often be based on virtually no knowledge of the development or use of the property involved. Moreover, the agent will have the clear vision of hindsight available to him, particularly in cases where a property right when granted was of little value, but at the time of examination has great value.

The preceding discussion concerns the basic assumption of the proposal, i.e. that a U. S. taxpayer would simply grant its foreign subsidiary a royalty-free right to use valuable property. What of the situation where the subsidiary gave consideration for such right? Does it matter what kind of consideration was given? Is one payment enough? Consider the following situations:

1. A U. S. parent sells (assigns) its German patent to its foreign subsidiary for $100,000. The same year it assigns its French patent to an unrelated company for $100,000. U. S. taxes were paid in both cases by the patentee. The foreign subsidiary exploits the patent with great success. Will a royalty be imputed to the U. S. parent? This is not clear under Section 952(c)(3).

The provision says the imputed amount is that amount which *would be obtained* in an arm's length transaction. By whom? If it means by the U. S. parent, no further amounts can be attributed since by hypothesis we have had an arm's length transaction. If it means by the foreign subsidiary in a sublicensing transaction, then the result is open to conjecture. The Technical Explanation of the Bill seems to support the first conclusion set forth above (see H. Rep. No. 1447, p. A94) and that appears sound. Nevertheless, this ambiguity should be resolved.

2. If the U. S. parent transfers industrial property rights to a foreign corporation in exchange for stock therein and has received a ruling under Section 367 that such transfer does not have tax avoidance as one of its principal purposes and a ruling that the transfer qualifies under Section 351 for nonrecognition of any gain, the effects of proposed Section 952(c) are not clear.

a. If the foreign transferee was wholly owned by the transferor, is the receipt of stock sufficient to satisfy the arm's length requirement—or indeed has anything of value been received? Whether value is deemed to be received or not, the taxpayer has received a ruling that tax avoidance was not involved in the transfer and the rationale for the new proposal was to prevent tax avoidance. It would seem to follow therefore that proposed Section 952(c) should not apply in such cases. However, that result cannot be predicted as the provision now stands.

b. If the property rights are transferred to a foreign corporation, "A," at the same time that an unrelated foreign corporation, "B," transfers cash or other property to "A," and if shares of the transferee "A" are issued in consideration of such rights and property, this is clearly an arm's length transaction and, assuming a ruling under Section 367 has been given, no tax avoidance is involved. The question again arises whether Section 952(c) is satisfied by the price paid to the transferor of the right or whether it requires imputed income based on how much the transferee "A" could get if he sublicensed the rights received. Under the latter interpretation, the Treasury would appear to collect tax where by existing law it would not be entitled to tax.

3. If the U. S. company licenses a patent on a royalty-free basis but reserves the right to receive any improvements thereon, will income be imputed and, if so, how?

The varieties of licensing transactions in which no continuing royalty is paid are limitless. How the proposal will affect these transactions is not clear.

Ambiguities Contained in Proposed Section 952(c)

There are other ambiguities contained in proposed Section 952(c) relating to the use of such terms as "exclusive formulas and processes", "substantially developed, created and produced", "owns and controls", "ordinary and necessary expenses".

It is not clear what the word "exclusive" means in proposed Section 952(c)(1). Because the term can be used in several ways, disputes as to its meaning will certainly ensue. For example, the word can read to mean "secret" and, if so, this raises problems of proof for the Treasury and the taxpayer as to whether the information contained in the formula or process is a matter of general knowledge within the industry. So read, non-secret processes and formulas would be outside the scope of the proposal even though valuable information may be disclosed therein. On the other hand, the word "exclusive" may refer to the means by which such formulas or processes are exploited. For example, if a U. S. company has given its foreign subsidiary an exclusive license in one country and an unrelated third party a nonexclusive license in another country, is the amount received from the latter license relevant in determining arm's length prices?

The words "substantially developed, created or produced" will almost certainly cause difficulties. See proposed Section 952(c)(1)(A). In cases involving research ventures carried on jointly both here and abroad, it will be virtually impossible to determine where the property was *substantially* created. The amount of effort expended may be susceptible to measurement, but the value of such effort is often so elusive a concept that it is measureless.

The use of the word "owns" in proposed Section 952(c)(1)(B) adds another word which is not defined anywhere in the proposal. If it means the same as "control", it should be removed as a redundancy. If it means something other than "control", it should be defined.

The provision relating to deductible expenses (Section 952(c)(2)) presents several problems. First, it is noted that the details concerning expenses which may be deducted from income thereunder are left for the Secretary or his delegate to prescribe in regulations. In this connection it may be significant that no regulations, rulings or revenue procedures have yet been published by the Treasury in the closely related area of what constitutes know-how under Section 351. A similar delay here would impose on the taxpayer the necessity of operating without any guidelines. Moreover, extensive controversy with the Treasury can be expected concerning what expenses are ordinary and necessary for the production of this type of income.

There are, moreover, substantial problems presented by costs attributable to research programs jointly financed or undertaken. If a U. S. firm conducts the entire research program and bills its foreign subsidiary on an annual basis for such program, will such expenses be available as deductions when and if a process or formula resulting from the research is made available to the foreign subsidiary on a royalty-free basis?

In discussing amortization as a deductible cost, H. Rep. No. 1447 at A93 picks the easy case of a limited life intangible as an example. However, nothing is said as to the problem presented by the impossibility of amortizing intangibles with no fixed life, e.g., formulas and processes.

Some Curious Results from Application of Proposal

The proposed Section 952(c) will have at least three other curious results which we believe were not intended by its draftsmen.

1. Assume that a subsidiary foreign corporation pays an unrelated U. S. enterprise for the development in the United States of a particular industrial property right. Proposed Section 952(c)(1)(A) read with Section 952 (c)(3) would require the U. S. parent of such corporation to include income in its U. S. tax return for the use of such property by its foreign subsidiary even though the U. S. parent had nothing to do with the creation of the property, simply because the property was substantially developed in the United States.

2. If an unrelated German company acquires a property right substantially developed in the United States and then licenses it to a foreign subsidiary of a U. S. company, income must be imputed to the U. S. company as the provision now stands. Whether a royalty different than that paid to the German company by the foreign subsidiary would be imputed is not clear, particularly if the proposal contemplates an annual review of royalty rates with changes therein to reflect the success of the business.

The result of the two examples set forth above suggest that the provision relating to rights "substantially developed, created, or produced in the United States" was meant to be read conjunctively with the next provision relating to the party from whom such rights are obtained. In other words, the "or" between Section 952(c)(1)(A) and Section 952(c)(1)(B) should be "and". In the final analysis, it would probably be best to eliminate subsection (A) and retain (B) alone.

3. The proposal requires the imputation of an income when a controlled foreign corporation uses a property right acquired from its parent. Undoubtedly the future licensor of such rights will consider carefully whether it is worthwhile to charge a royalty and run the risk that a foreign tax authority may deny the deduction for such royalty to the foreign corporation. He may decide that since there may be a dispute with the U. S. Treasury whether a royalty is charged or not, he might just as well forego imposing

a royalty and thus avoid a discussion with the foreign tax authorities.

Although the Committee Report is cast in terms of base company licensing operations, the provision as drafted will hit every controlled foreign corporation including those operating under patents and know-how of the United States company. To add administrative burdens to the shareholders of such companies—not simply of reporting such income but in determining what the income *should* be (both gross and net)—seems unnecessary in view of the purpose stated. If imputed income is not to be taxed, adequate protection to the Treasury is afforded by the existing Section 482.

For the reasons set forth herein, it is recommended that Section 952(c) be eliminated from the proposed statute.

C. Foreign Base Company Income

Rules for Inclusion of Net Foreign Base Company Income are Unclear

The third category of Subpart F income is "net foreign base company income," which is defined in proposed Section 952.

Proposed Section 952(a)(1)(C) provides that the net foreign base company income is to be included as Subpart F income only in the case of a controlled foreign corporation in which five or fewer U. S. persons own more than 50% of the voting power. It is not clear whether, for this purpose, the requisite stock ownership must exist at the end of the taxable year or whether it will suffice if the requisite ownership existed at any time during the taxable year. This provision should be contrasted with Section 951(a)(1) which operates where the foreign corporation is a controlled corporation on "any day of the taxable year".

"Subpart F income" does not include any item of gross income derived by a controlled foreign corporation from sources within the United States, if the foreign corporation is engaged in trade or business in the United States. (Proposed Section 952(a)(2).) This exclusion is needed in order to avoid a double tax on the U. S. income of resident foreign corporations. However, since a foreign corporation which is not engaged in trade or business in the United States would be subject to U. S. tax on its fixed or determinable income from U. S. sources, we recommend that proposed Section 952(a)(2) be expanded to cover all U. S.-source income of a foreign corporation which is subject to tax in the United States, whether or not such corporation is engaged in trade or business in the United States.

If this recommendation is not accepted, we would recommend in any event that the Bill be clarified to indicate whether a foreign corporation (in order to qualify for the exclusion of U. S.-source income from Subpart F income) must be engaged in trade or business in the United States throughout the entire taxable year, at any time in the taxable year, or at the end of the taxable year.

The amount of Subpart F income of a controlled foreign corporation which is currently taxable is limited to "the earnings and profits of such corporation for such year". (Proposed Section 952(a)(3).) The statute is silent as to whether in computing earnings and profits, the actual accounting principles used by the foreign corporation are to be used or whether U. S. tax principles are to prevail. Assuming that U. S. tax concepts would govern, it is unclear, for example, as to whether U. S. tax benefits, the availability of which are conditioned upon an election by the taxpayer, would be available. Instances of such tax benefits are elective methods of depreciation (such as double declining balance and sum-of-the-years-digits), expensing of intangible drilling costs, etc. If they are available, would the U. S. shareholder or the foreign corporation be entitled to make the election? If the election is to be available to the shareholders, could each shareholder make his own separate election?

Foreign Base Company Income Defined

Foreign base company income is basically personal holding company income plus certain sales income, less the increase in investment in qualified property in "less developed" countries.

In general, the sales income which is included in foreign base company income is income derived through purchase from, or sale to, a related person if the property which is purchased is manufactured outside the country under the laws of which the controlled foreign corporation is created *and* the property is sold for use, consumption or disposition outside such foreign country.

Undue Emphasis Upon Place of Incorporation

By making "base company sales income" depend upon purchase or sale outside of the country of incorporation, the seemingly insignificant fact of legal incorporation is given controlling significance. This would tend to compel U. S. firms to incorporate in the country in which they do business, even though for valid business reasons they would prefer to incorporate elsewhere, just as many domestic corporations incorporate in Delaware while doing business in other States. It also would tend to encourage proliferation of such corporations by according more favorable tax consequences to enterprises which incorporate in several different countries.

Definition of Related Person is Unclear

Proposed Section 952(e)(2) would include only sales income which is derived from transactions involving a related person. This concept is defined as a person who "directly or indirectly owns or controls, or is owned or controlled by, or is under common ownership or control with, the controlled foreign corporation". Neither ownership nor control is defined in this context.

Commission Income Apparently Not Subpart F Income

Sales income which is includable in Subpart F income is generally all types of income, including "commissions", 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".

It is unclear whether this definition would cover a situation where a foreign base company receives a commission for arranging a sale from a related company to an unrelated company. In that case there has been no purchase from a related person. Since that type of commission is very common, it is extremely doubtful that Congress intended to exclude it from taxation.

Statutory Definition of Manufacture would be Desirable

The words "manufactured", "produced", "grown" or "extracted" are highly ambiguous. According to H. Rep. 1447 at p. A94, this provision does not cover income from sale of a product where the foreign corporation purchases parts or materials which it "substantially" transforms or incorporates into the final product.

A concept controlling such important tax consequences should be defined in the statute itself and not in a Committee Report. Moreover, the word "substantially" does not adequately clarify the term.

This provision might constitute an incentive to increase manufacturing activities abroad, with adverse effects upon both the U. S. balance of payments and domestic employment.

Destination of Merchandise Sold is an Unfair Test

"Base company sales income" does not include income from the sale of property which is sold for *use* inside the country in which the controlled foreign corporation is organized.

On its face this provision would place on the U. S. shareholder the duty to determine what an unrelated purchaser intends to do with the merchandise bought from the controlled foreign corporation. The Committee Report attempts to alleviate this by assuming that property is to be retained for use, consumption or distribution within the country of incorporation if it is sold to a person operating within that country, unless there is a basis for contrary belief. Aside from the fact that there is no assurance that the statute will be interpreted in the light of the Committee Report, this assumption falls short of the mark in solving the problem.

For example, in view of the Rome Treaty, it is anticipated that many companies will distribute merchandise throughout the European Common Market. Such a company may purchase large quantities of goods for resale to such of its customers as may place orders. Under these circumstances, the selling company may well have adequate basis for belief that some merchandise is sold for disposition outside of the country of incorporation. However, at the time of sale, neither the seller nor the buyer would be in a position to know how much of the merchandise will be sold outside the country of incorporation. This provision is unique in the Federal income tax law in that tax liability will be based on information which may be unknown or unknowable at the time the transaction is consummated.

Rental Income from Operations Should Not be Subpart F Income

Subsection (e) would include rents in "foreign base company sales income" without regard to whether such rents constitute more than 50% of gross income. This is a departure from existing Section 543(a)(7), which includes rents in personal holding company income only where they constitute less than 50% of gross income.

We suggest that an effort should be made to distinguish operating rental income, e.g. income arising from the conduct of a rental business, from passive rental income.

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While the latter, e.g. rental derived from a net lease, is admittedly in the same category as dividends or royalties, rentals derived from operation of an office building, a hotel, an automobile rental agency and certain types of ship charters should not be accorded any different treatment from that accorded to income from any other operating business.

A possible solution to this problem is to distinguish operating rental income from passive income by applying a standard comparable to that set forth in Section 543(a)(8)(B) of the Code, which provides that mineral, oil and gas royalties are not considered to be personal holding company income if the deductions allowable under Section 162 (relating to trade or business expenses) constitute 15% or more of such gross income.

Deductions to be Taken Into Account are Difficult

Proposed Section 952(e)(7) provides that "foreign base company income" for the taxable year shall be reduced so as to take into account the deductions properly allocable to such income.

The statute is silent as to whether the deductions are to be determined in accordance with U. S. tax concepts or with foreign accounting concepts. Other difficult administrative and accounting problems will arise in allocating the amount of allowable deductions where the corporation's sales income constitutes Subpart F income only in part. Furthermore, it may be difficult to determine how deductions such as administrative overhead and general operating expenses are to be allocated to Subpart F income.

Exclusion of Income of Foreign Banks

Section 952(e)(5) of H. R. 10650 provides in part:

> "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)".

Section 552(b) of the Code applies to a certain kind of bank, described as follows:

> "a corporation organized and doing business under the banking and credit laws of a foreign country".

The use of this definition of a foreign bank excludes foreign banks created and lawfully doing business in jurisdictions having no banking or credit laws. There are several such jurisdictions, e.g., Liberia.

There appears to be no reason why the income of a bank which is lawfully organized under the laws of the jurisdiction in which it is operating should be included merely because such jurisdiction has no banking law.

It would seem desirable that there be an amendment of Section 952(e)(5) to include foreign corporations lawfully engaged in the banking business in a foreign country.

D. Investment of Earnings in Non-qualified Property

The major purpose of proposed Section 953 is to set forth in detail the circumstances under which United States persons are required to include in gross income, under proposed Section 951(a)(1)(B), their pro rata share of a controlled foreign corporation's "increase in earnings invested in non-qualified property". To this end the section provides a formula for measuring such "increase" (Section 953(a)) and also defines "qualified" and "non-qualified" property (Sections 953(b)(1) and (2)), "qualified trade or business" (Section 953(b)(3)), and "less developed country" (Section 953(b)(5)). Some of these definitions are also relevant in determining taxability under proposed Section 951(a)(1)(A) (relating to taxation of Subpart F income).

A controlled foreign corporation's "increase in earnings invested in non-qualified property" is defined generally as the amount of non-qualified property held by the corporation at the end of the taxable year less the amount held at the end of the preceding taxable year (proposed

Section 953(a)), but in no event to exceed current and accumulated earnings and profits. "Non-qualified" property is defined as all property other than qualified property, and "qualified property" is defined as "money or other property which is located outside of the United States and is ordinary and necessary for the active conduct of a qualified trade or business" carried on by the controlled foreign corporation. (proposed Section 953(b)(2).)

The Phrase "Ordinary and Necessary" Requires Clarification

The reliance of proposed Section 953(b)(2) upon the concept of assets which are "ordinary and necessary" to the business raises a serious problem of interpretation. It is not clear whether the phrase covers reasonably "anticipated" needs of the business or only immediate needs. In this connection it should be noted that a special statutory amendment was required in respect to the accumulated earnings tax to make sure that corporations were able to reserve assets for reasonably anticipated future needs. Prior to the amendment courts had held to the contrary notwithstanding the obvious need of a corporation to plan its business life over a period longer than a single year. A failure to clarify proposed Section 953(b)(2) in this regard may very well destroy the ability of controlled corporations to compete with local businesses or to reserve sufficient assets to replace obsolete plant and equipment at current higher prices.

Definition of "Qualified Property" Places Undue Emphasis on Last Day of Taxable Year

Under proposed Section 953(a), the increase in amounts invested in non-qualified property is determined by comparing such amounts at the close of the current taxable year with similar amounts at the close of the preceding taxable year. (proposed Section 953(a)(2).) This rule, which takes a single day in each of two years as the measure, together with the further requirement that "qualified property'' must be ''located outside the United States'', may create unintended results.

For example, property, such as a vessel or airplane or equipment undergoing repair, would become non-qualified property if it happened to be in the United States on the last day of the taxable year. In any event, the physical location of property at an accidental point of time (while perhaps relevant for property tax purposes) would not appear to be significant for income tax purposes. Consideration should be given to redefining ''qualified property'' so as to include all assets, wherever located, which are ordinary and necessary to the conduct of the controlled foreign corporation's business outside the United States.

Reduction of Basis of ''Non-Qualified Property'' by Liabilities Creates Difficult Problems

Under proposed Section 953(a)(3), ''non-qualified property'' is valued at its adjusted basis, ''reduced by any liability to which the property is subject.'' The reduction of adjusted basis by ''any liability to which the property is subject'' raises difficult interpretative problems.

For example, all property of a corporation is subject to all its liabilities since an unsecured creditor may satisfy his claim by levying against any of the debtor's property. Under this view, non-qualified property must be reduced by some apportioned share of general liabilities (with no statutory guide for such apportionment), and unintended results can easily follow. A foreign corporation may diminish its investment in ''non-qualified property'' deliberately by incurring unsecured obligations to purchase qualified property and secured obligations in respect of non-qualified property. On the other hand, if the corporation's unsecured obligations have diminished at the end of the year for wholly independent business reasons, it then would find that its holdings of ''non-qualified property'' would be automatically increased to the extent that a share of such unsecured obligations was allocated to ''non-qualified property.''

It is not clear how proposed Section 953(a)(3) can be modified to correct this defect. Liabilities considered cannot be limited to those which constitute a lien on property without creating other problems, such as the treatment of after-acquired property which becomes subject to the lien. Subjecting after-acquired property to the lien would have the effect of reducing the portion of the lien attributable to the older assets and thus produce an unintended "increase" in the amount of such older assets.

The reduction of adjusted basis by liabilities (however liabilities are determined) may also create unintended results because of the fact that depreciation deductions are based upon adjusted basis without reference to liabilities. For example, a controlled corporation may have purchased depreciable "non-qualified property" at a cost of $10,000 plus assumption of a $90,000 liability for a total price of $100,000. Since the asset is depreciable on the basis of a $100,000 cost, at any given point of time the depreciation allowable may have reduced adjusted basis below the debt. In such cases, an unintended *decrease* in investment in non-qualified property will result. For example, if annual depreciation is $20,000, the adjusted basis of the asset at the end of the first year will become $80,000. If there has been no reduction of the $90,000 debt, the amount attributable to "non-qualified property" has been reduced by $10,000 (adjusted basis of $80,000 less the $90,000 of indebtedness to which the property is subject).

Concept of "Qualified Trade or Business" May Discourage Expansion and Discriminate against Smaller Businesses

To be "qualified", property must be necessary for the active conduct of a "qualified trade or business". (proposed Section 953(b)(2).) A "qualified trade or business" is one (a) carried on by the controlled foreign corporation almost wholly within a less developed country or countries, or (b) carried on elsewhere (outside the United States) since December 31, 1962 (while "controlled by substantially the same United States persons"), or (c) carried on during a 5-year period ending with the close of the preceding taxable year.

It would appear that the extremely limited definition of "qualified trade or business" fails to carry out the intended purpose. The reason for permitting reinvestment of "untaxed" profits in qualified businesses is to avoid putting American-owned businesses "at a disadvantage with other firms located in the same areas not subject to U. S. tax". (Comm. Rept. p. 58).

However, the principal problems stem from the fact that the reinvestment privilege, as noted above, is limited to businesses which were conducted on December 31, 1962, or which have been conducted for a continuous period of 5 years. The stated reason for so restricting the privilege is "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" (Comm. Rept. p. A98).

Trade or Business Concept

A preliminary difficulty arises in determining whether any given investment is made in the same or substantially the same business or in a separate business. The Committee Report appears to rely upon the "nature of the product line" (p. A98) to make the determination. However, there is no indication of whether the "nature of the product line" is to be the only criterion or whether the manufacture of each individual product is to be considered a separate business or whether a related group of products is to be considered a separate business. There is similarly no guidance as to *how much* change in the constitution of a product or product line must take place before a "different" business is created or whether the production of a new product attributable to discovery or technological innovation in the industry will be deemed a separate business.

Similar problems are encountered today under existing tax provisions which use the "trade or business" concept in dealing with divisive reorganizations (Section 355) and partial liquidations (Section 346). Litigation has already been generated by the use of this concept in Section 382(a) to determine whether net operating loss carryovers are deductible by a corporation after a material change in the ownership of its stock. *Goodwyn Crockery Co.*, 37 T. C. ___, No. 28 (Nov. 29, 1961), on appeal to CA 6th. This does not speak well for the future of the proposed Section 953.

Five-Year Seasoning Period

The 5-year "seasoning" period may also cause difficulties by operating to discriminate against smaller or younger companies and in favor of large or established companies. The large corporation with established credit standing may very well be able to borrow for the full seasoning period substantially all sums needed to expand into a new line of business. The combination of start-up expenses, interest payments and depreciation deductions would normally reduce taxable income to a minimum during the seasoning period after which, the business having "qualified", earnings could be used to pay off the original indebtedness and expand the business. Smaller or younger companies would normally be unable to obtain adequate credit to accomplish the same ends.

Furthermore, the 5-year rule does not carry out its stated objective. The intent was 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 (Comm. Rept. p. 64). However, the indiscriminate application of the 5-year rule, as required by the Bill, operates just as much where the initial investment is large as where it is small, and just as much where the continuing capital requirements are intensive as where they are slight.

Same Business Requirement

The Committee Report notes that one of its guiding policies is to avoid weakening the competitive power of U. S. owned businesses abroad. In this regard it should be noted that the "same business" requirement of proposed Section 953(b) is in direct conflict with such policy since the requirement must operate to eliminate competitive diversification. For example, a U. S. owned corporation operating in a foreign country with a 30% tax rate could only diversify with 48¢ dollars while its local competitor could do so with 70¢ dollars. If the U. S. owners cannot supply the additional 22¢ from other sources, the business must fall behind and may ultimately fail.

Drafting Change Required to Insure that Investment in 80% Subsidiary is Qualified Property

Proposed Section 953(b)(3)(B) provides that a controlled foreign corporation may consider as its "qualified trade or business" the qualified trade or business of an 80% owned subsidiary corporation. However, the statutory language is ambiguous in that it permits the parent corporation to invest in the same qualified business as that of its subsidiary but may not permit the parent to invest in stock of the subsidiary. Since this was not the intent (Comm. Rept. p. A98), the provision should be revised to permit direct investment in a qualified subsidiary.

The provision should also be revised to permit a qualified trade or business to be conducted by the foreign parent or the subsidiary or both and to permit shifting of the qualified trade or business from one corporate entity to the other. Under the proposed Bill a shift of a qualified trade or business from the parent to a subsidiary may destroy its characterization as "qualified" and may require a new 5-year seasoning period. It does not appear that any sound purpose is served by making important tax consequences follow solely from the form of corporate organization without reference to substance. Similarly, a shift of a qualified business from a subsidiary to a parent may not be accomplished tax free. The distribution of assets from the subsidiary to the parent will be taxed to the U. S. person as Subpart F income, i.e. as a dividend or as gain in respect of the subsidiary's stock, if the subsidiary is liquidated. In either case, the "dividend" or "gain" is deemed to be Subpart F income under proposed Section 952(e)(1). Although this result might be avoided in the case of liquidations of 80% owned subsidiaries if the U. S. shareholder or the intermediate foreign corporation could obtain an advance ruling from the Commissioner of Internal Revenue under Section 367 of the existing Code, such rulings are extremely difficult to obtain and require considerable time and expense. Therefore, even this limited escape is not satisfactory. The proposed Bill should be revised to prevent what appears to be the imposition of an unintended hardship.

Investment of Income in "Less Developed" Countries

Under proposed Section 953, "qualified property" includes property ordinary and necessary for the conduct of an active trade or business in one or more "less developed" countries (proposed Section 953(b)(3)(A)(ii)) and also includes stock in another controlled corporation (in which the first corporation and four or fewer United States persons own more than 50% of its stock) if substantially all of the property of the second corporation is ordinary and necessary for the active conduct of a trade or business within one or more "less developed" countries. (Proposed Section 953(b)(2)(C).)

To encourage investment in "less developed" countries (Comm. Rept. p. 58), not only is investment in such countries considered "qualified" for purposes of proposed Section 951(a)(1)(B) (relating to increases in investment in non-qualified property) but also, under proposed Sections 952(d)(2) and 952(f), the amount of "foreign base company income" (one of the chief elements in computing Subpart F income taxed to U. S. persons under proposed Section 951(a)(1)(A)), is reduced by investment in "qualified property in less developed countries''. However, as the provisions are now written, investment in ''less developed'' countries may actually be discouraged because of the risk of legislative fiat and the inflexibility of the proposed law.

Under proposed Section 953(b)(5), a ''less developed'' country is defined as a foreign country (other than those specifically excluded) with respect to which there is in effect an Executive Order so designating such country. Investment in a country thus designated carries with it the risk that the designation will be removed when the country is no longer less developed or when, for extraneous reasons wholly within the discretion of the Executive Department, e.g. a Communist take-over, the country is removed from the list. Should this occur, property held in such country or stock owned in a subsidiary doing business in such country may automatically become ''non-qualified property'', with the result that the entire amount invested could become an ''increase'' in earnings invested in non-qualified property subject to tax in a single year under proposed Section 951(a)(1)(B).

To avoid this problem, property held in a ''less developed'' country or stock held in a corporation operating in such country should continue to be ''qualified property'' if the investment was made or stock acquired when such country was designated as a ''less developed'' country.

In regard to investment in ''less developed'' countries, a further problem arises if the controlled corporation also happens to be a foreign personal holding company. Under these circumstances, investment in ''less developed'' countries will reduce Subpart F income but will not reduce undistributed foreign personal holding company income, with the result that the U. S. persons will be taxed whether or not the investment in ''less developed'' countries is made. If the policy of encouraging investment in ''less developed'' countries is deemed paramount, a technical change should be made in existing law to exclude from undistributed foreign personal holding company income amounts invested in "less developed" countries in accordance with proposed Section 952(f).

E. Definition of Controlled Foreign Corporation

Section 954 defines "controlled foreign corporation."

The general rule is set forth in Section 954(a), which defines "controlled foreign corporation," for purposes of Subpart F, to mean any foreign corporation of which more than 50% of the total combined voting power of all classes of stock entitled to vote is owned directly or indirectly by United States persons on any day during the taxable year of such foreign corporation.

Special Rule for Foreign Insurance Corporations

Section 954(b) provides for an alternative definition of "controlled foreign corporation" to include a foreign corporation deriving income from insurance of United States risks, as determined under Section 952(b), if the gross amount of consideration in respect of such risks exceeds 75% of the gross amount of all consideration in respect of all risks. In such case the foreign corporation deriving income from insurance is a "controlled foreign corporation" if more than 25% of the total combined voting power of all classes of stock is owned, directly or indirectly, by United States persons. The House Committee report (page 60) states that this alternative definition is "designed to cover cases where the principal business is the U. S. risks but the control is decreased in order to avoid the application of this provision." However, the alternative definition covers legitimate insurance operations abroad in situations in which the quantum of control is not within the power of United States persons.

Unnecessarily Broad Definition of "Controlled Foreign Corporation"

One of the principal objections to the definition of "controlled foreign corporation" is that a United States investor will not know whether he has invested in a "controlled foreign corporation" or not. The attribution rules set forth in Section 955 magnify this problem. In this connection it is appropriate to contrast the definition of "controlled foreign corporation" with the definition of "foreign personal holding company" in Section 553 of the Code, which requires ownership by not more than five individuals. The purposes of the Bill would appear to be satisfied if a "controlled foreign corporation" is defined as a foreign corporation in which five or fewer United States persons own, directly or indirectly, more than 50% of the voting stock. Compare subparagraph (C) of Section 953(b)(2) of the Bill, dealing with "qualified property."

"Controlled Foreign Corporations" Organized in "Less Developed" Countries

Subsection (c) should be revised to read as follows: "For purposes of Section 953(b)(2)(C) the term 'controlled foreign corporation' includes not only a controlled foreign corporation as defined by subsection (a) but also, in case the laws of a less developed country do not permit five or fewer United States persons to own, directly or indirectly, more than 50% of the voting stock, such lesser percentage of ownership equal to or in excess of 10% as is permitted." Under the present drafting, if more than 50% of the voting stock of a foreign corporation organized under the laws of a less developed country *may* be held by United States persons, the maximum percentage *must* be obtained before the corporation is considered to be a "controlled foreign corporation". This is presumably unintentional. Furthermore, provision should be made for a *de minimis* rule, and 10% of the voting stock is suggested as a reasonable minimum in the light of proposed Section 953(b)(2)(C).

Drafting Points

The following drafting points are suggested:

1. Section 954(a) and (b) refer to stock which is owned "directly or indirectly (within the meaning of Section

955(b)).'' Section 955(b) sets forth constructive ownership rules but the words ''directly or indirectly'' are not defined. Accordingly, it would appear preferable to state as a new subparagraph: ''(d) Section 955(b) shall apply in determining the ownership of stock for purposes of this section.'' The words ''(within the meaning of Section 955 (b))'' could then be deleted from Section 954(a) and (b).

2. Assuming that the special rule for insurance is retained, which we suggest is at least questionable, subsection (b) should be revised so as to provide ''the term 'controlled foreign corporation' includes not only a '*controlled* foreign corporation' as defined by subsection (a) but also *a foreign corporation* [instead of 'one'] of which more than 25% of the total combined voting power of all classes of stock is owned, directly or indirectly'' by United States persons.

F. Stock Ownership Rules

Section 955 sets forth rules for determining stock ownership for purposes of Sections 951, 952(a)(1)(C) and 954.

Proposed Section 955(a) Embodies a New Principle

Section 955(a)(2) embodies a new principle under which stock in a foreign subsidiary owned by an intermediate foreign corporation is considered as being owned proportionately by the U. S. shareholders for purposes of allocating to the shareholders income of the foreign subsidiary which the intermediate foreign corporation has not received. This causes the United States persons to be taxed on income which they may never receive. (The same principle would apply to foreign partnerships, trusts and estates.) This tax treatment is more severe than the present treatment of income of a foreign personal holding company, which is included in the gross income of its United States shareholders only if it is first includible in the gross income of the foreign personal holding company.

Effects of Attribution Rules

In many situations it will be extremely difficult to tell whether a corporation is a "controlled foreign corporation" under the attribution rules. For example, many foreign corporations issue bearer shares so that there are no record owners and there is no practical way of determining the identity of the actual owners. A United States corporation acquiring less than 50% of the voting stock of a foreign corporation may find that the foreign corporation is a "controlled foreign corporation" by reason of the ownership of shares of the foreign corporation either by other Americans or by another foreign corporation which has American shareholders. These situations are discussed in some detail at pp. 76-78 below.

Ownership of shares of foreign corporations by widely held mutual funds in the United States, even though such ownership is limited, may result in "controlled foreign corporation" status because mutual funds are deemed to own the shares owned by their numerous individual stockholders. Finally, substantial foreign corporations, particularly those whose shares are listed on stock exchanges in the United States, may find that they and their subsidiaries are "controlled foreign corporations."

The administrative burdens and other consequences flowing from the broad definition of "controlled foreign corporation" could be avoided by restricting the definition to closely held foreign corporations and creating an exception to the attribution rules for widely held corporations.

Section 955(b)(2) May Change the Voting Stock Requirement of Proposed Section 954(a)

The definition of "controlled foreign corporation" in Section 954(a) requires 50% of the total combined voting power of all classes of stock to be owned by United States persons. However, it appears from subparagraph (B) of Section 955(b)(2) that if a corporation owns more than 50% 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 result being that a person owning less than 50% of the voting stock but more than 50% of the total value of outstanding stock, perhaps in the form of preferred stock, might be considered to own all of the voting stock so that the foreign corporation would be a "controlled foreign corporation." It is not clear that this result was intended.

Drafting Points

The following drafting points are suggested:

1. Subsection (b) (line 24, page 124) should be revised to refer to United States persons "owning more than 50% of *the total combined voting power of* all classes of stock."

2. Paragraph (1) of subsection (b) (line 5, page 125) refers to a "nonresident alien individual (other than a foreign trust or foreign estate)." The parenthetical phrase appears to be inappropriate and should be replaced by a sentence to the effect that "This paragraph shall not apply to a foreign trust or foreign estate."

3. Paragraph (2) (lines 8 and 9, page 125) could be clarified by beginning "In applying the first sentence of subparagraph (A) and *the first sentence of subparagraph* (B) * * *." Similar changes could be made in two places in paragraph (3).

G. Exclusion from Gross Income of Previously Taxed Earnings and Profits

The primary purpose of proposed Section 956 is to avoid a double tax when amounts previously taxed to United States persons under proposed Section 951(a) are (i) actually distributed by the controlled corporation or (ii) invested in non-qualified property. In addition, the section is intended to prevent a second inclusion in income under proposed Section 951(a) when an amount previously taxed to a United States person (but not distributed) is actually distributed by one foreign controlled corporation to another. Finally, rules are set forth allocating actual distributions to earnings and profits, the first distributions being deemed to have been paid out of earnings and profits which were invested in non-qualified property, then out of earnings and profits taxed as Subpart F income, and lastly, out of untaxed earnings and profits.

Relationship to Proposed Sections 956(d) and 958(b)(2)

Subsection (a) of proposed Section 956 provides that previously taxed earnings and profits are excluded from gross income when subsequently distributed. Under these circumstances, the provisions of proposed Section 956(d), declaring that amounts so excluded shall not be treated as dividends and the provisions of proposed Section 958(b)(2) declaring that such amounts may be treated as gain from the sale or exchange of property under certain circumstances create ambiguities. Whether an amount which is excluded from gross income is "not" a dividend is usually irrelevant and would appear not to be meaningful in the proposed Bill. Similarly, the characterization of such amounts, under proposed Section 958(b)(2), as gain from the sale or exchange of property has no tax effect if such amounts are excluded from gross income. If proposed Section 958(b)(2) is intended to include such amounts in income under given circumstances, it may very well fail to do so since it may not override the clear exclusion language in Section 956(a).

Ambiguities in Exclusion Concepts

Subsection (a) of proposed Section 956 is intended to provide rules of exclusion from gross income in two distinct separable situations: (i) where previously taxed income is actually distributed to U. S. persons and (ii) where previously taxed income is not distributed but is invested in non-qualified property. This second rule does not actually relate to avoidance of double taxation but is simply a device to measure the amount of non-taxed earnings which should be taxed to U. S. persons under proposed Section 951(a)(1)(B) (increase in non-qualified property). It therefore does not belong in proposed Section 956(a) but should be incorporated directly into proposed Section 951(a)(1)(B) and/or Section 953(a)(2)(A), to the extent relevant.

The failure to separate out the second rule of proposed Section 956(a) and place it in the proper context requires the use of multiple cross references among proposed Sections 951(a)(1)(B), 956(a)(2), 956(c)(1) and 953(a)(2)(A) which may be confusing. For example, Section 951(a)(1)(B) taxes U. S. persons with their share of an increase in non-qualified property

> "but only to the extent not excluded from gross income under section 956(a)(2)."

Section 956(a)(2) provides that amounts which are or have been included in gross income under Section 951(a) shall not be again included

> "when * * * such amounts would, but for this subsection, be included under section 951(a)(1)(B)."

Section 956(c)(1) provides that distributions shall be charged first to earnings and profits which have been

> "included in gross income under section 951(a)(1)(B) (or which would have been included except for Section 956(a)(2))."

Section 953(a)(2)(B) reduces investment in non-qualified property as of the close of the preceding year (for the purpose of determining the increase in non-qualified property for the year in question)

> "by amounts paid during the taxable year to which section 956(c)(1) applies."

Although there are minor semantic difficulties in certain of the cross references, the sections may all be rationalized and the intended result ultimately reached. However, the fact that two or more separable concepts are included in single subsections and the fact that each subsection may depend upon a number of other subsections (e.g., Section 953(a)(2)(B) refers to Section 956(c)(1) which in turn refers to Sections 951(a)(1)(B) and 956(a)(2) which in turn refer to each other) does not make for clarity. Consideration should therefore be given to redrafting the various provisions to correct these deficiencies.

Effect of Allocations

Subsection (c) of proposed Sections 956 provides that distributions to shareholders of controlled corporations shall be deemed to be allocable, first, to increases in non-qualified property, second, to previously taxed Subpart F income (reduced by Subpart F income invested in non-qualified property) and, finally, to untaxed earnings and profits.

Although the general purpose of the subsection is to permit previously taxed distributions to be received tax-free before amounts are allocated to non-taxed earnings, the allocation of the first distributions to investment in non-qualified property has the effect of automatically increasing investment in non-qualified property, by reason of proposed Section 953(a)(2)(A). Thus, an actual dividend payment is deemed to be a distribution of non-qualified property. Proposed Section 953(a)(2)(A) provides that investment in non-qualified property, *as of the close of the preceding year,* is reduced by such amount. Under proposed Section 953(a) the increase in non-qualified property for any year is the difference between non-qualified property at the close of the preceding year and non-qualified property at the close of the year in question. Thus, even if there has been no actual change in non-qualified property during the year, non-qualified property is deemed to be increased by the amount of the dividend payment and such "increase" is taxed to U. S. persons under proposed Section 951(a)(1)(B).

Although the above result is probably unintended, it may be rationalized on the theory that the very payment of a dividend is proof that the amount paid was not needed in the business (and therefore constituted non-qualified property). This type of reasoning may very well make it practically impossible to repatriate profits since such repatriation will invite a second tax. On the other hand, unless a provision of this type is in the Bill, current earnings may be distributed tax-free if prior earnings have been invested in non-qualified property. Since the decision as to which of these competing goals is the more desirable one is a matter of legislative policy, our committee takes no position thereon.

Failure to Exclude Distributions to Non-U. S. Persons

Subsection (c) of proposed Section 956 is technically deficient in that it does not, by its terms, discriminate between distributions to U. S. persons and distributions to non-U. S. persons in respect of previously taxed earnings. Under the literal language of the subsection, a distribution is deemed to exhaust previously taxed earnings whether paid to the U. S. or the foreign shareholder. If applied literally, the purpose of the subsection may be defeated since a U. S. shareholder may not be able to recoup profits previously taxed to the extent that dividends are paid to foreign shareholders.

For example, if a controlled corporation, owned 60% by U. S. persons and 40% by non-resident aliens, realizes $100 of Subpart F income in 1963, $60 will be taxed to the U S. persons under proposed Section 951(a)(1)(A). If, in the following year, the controlled corporation pays a $60 dividend to shareholders, the entire amount will be deemed to be a distribution of previously taxed earnings under proposed Section 956(c)—although only $36 (60% of $60) will actually be paid to U. S. persons and the balance, $24, will be paid to non-resident aliens. When the remaining $40 of the 1963 earnings are paid out, the part thereof paid to U. S. persons will be fully taxable. The U. S. shareholders will, therefore, have been taxed upon $60 but will be able to recoup only $36.

The section should be corrected to reach the intended result.

Accounting for Different Tax Attributes of Various Blocks of Stock Would Be Extremely Complex

Section 956 provides that income which has previously been taxed to a U. S. shareholder shall not again be taxed when such income is distributed. Since Subpart F income is currently taxed only to those U. S. shareholders of a controlled foreign corporation who own at least 10% of the stock of such corporation, the taxability of distributions out of Subpart F income will depend upon whether the particular block of stock was owned by a 10% or more shareholder at the time the Subpart F income was earned.

Thus, changes of stock ownership may produce different blocks of stock on which future distributions will or will not be taxable, depending on their history.

For example, shareholder A owns 5% of a stock of a controlled foreign corporation and shareholder B owns 10%. The Subpart F income is currently taxable to shareholder B but not to shareholder A who will be taxed only when a distribution is made. In 1970, before any Subpart F income is distributed, shareholder B buys the stock of shareholder A. B will then have two blocks of stock with different attributes. Distributions out of earnings prior to 1970 will be taxable to the extent attributed to the 5% acquired from A but exempt to the extent attributable to shareholder B's original block.

Assume further that shareholder C owning 5% of the stock of the same foreign corporation acquires B's 15% in 1975. C would then have some shares with respect to which distributions would be tax-free, some with respect to which distributions would be taxable to the extent they are out of pre-1970 earnings, and some taxable to the extent they are out of pre-1975 earnings. The accounting complexities involved in maintaining separate records for these various attributes, particularly in cases where shares are frequently bought and sold, could be extremely burdensome. This is particularly true in the case of a publicly held corporation where the purchaser, buying through a broker, doesn't know whose shares he is buying and, therefore, has no way of knowing whether or not the shares he is acquiring are those carrying a tax-free distribution privilege.

It is also possible that there may even be trading in the favorable tax attributes since it is likely that stock which carries a substantial privilege of tax-free distribution may sell at a higher price than the stock which does not carry such a privilege. It seems unlikely that the statute intended to create such a result.

H. Special Rules for Foreign Tax Credit

The primary purposes of proposed Section 957 are to attribute to a domestic corporate shareholder of a foreign corporation a portion of the foreign taxes paid by the foreign corporation in the year in which there is included in the income of the domestic shareholder an amount determined under proposed Section 951(a), to avoid a double foreign tax credit to the United States shareholder in both the year in which the parent is taxed upon the foreign corporation's income under proposed Section 951(a) and the year in which the foreign corporation actually makes distribution, and to provide rules for increasing the foreign tax credit limitation in the year in which a distribution of previously taxed earnings is received from a controlled corporation.

Complexities in "Deemed Paid" Foreign Taxes

Proposed Section 957(a)(3) treats distributions of previously taxed amounts as "dividends" for purposes of determining the "deemed paid" foreign taxes under present Section 902 of the Code. Under present law, however, a dividend is deemed paid out of the most current earnings and profits of the paying corporation. Under the proposed bill this rule is apparently changed by operation of proposed Section 956(c) which attributes distributions first to previously taxed earnings and profits. The change will result in substantial complexities in applying present Section 902.

For example, a controlled corporation may have realized the following earnings and paid the following foreign taxes:

Year	Sub. F Inc.	Increase in Non-Qual. Prop.	Non-Sub. F Inc.	Foreign Taxes Paid
1963	$100	$ —	$200	$130
1964	$200	$ —	$200	$160
1965	$100	$350	$200	$130
1966	$ —	$100	$200	$100
1967	$100	$ —	$200	$130

On December 31, 1967 the corporation pays a dividend of $1,000 to shareholders. If the Committee has properly interpreted proposed Sections 957(a)(3) and 956(c), the "deemed paid" taxes under present Section 902 would be determined as follows:

1. The first $100 of dividend would be attributed to the increase in non-qualified property in 1966 which would have been taxed to U. S. persons only to the extent of $50, since the remaining $50 would be deemed attributable to $50 of Subpart F income realized in 1963 (the total 1964 and 1965 Subpart F income and $50 of the 1963 Subpart F income being deemed attributable to the increase in non-qualified property in 1965). Thus, for Section 902 purposes, the foreign taxes of the controlled corporation for 1963 are allocated to the shareholder first, followed by the foreign taxes of 1966.

2. The next $350 of dividend would be attributed to the increase in non-qualified property in 1965 none of which would have been taxed because attributable in full to the 1965, 1964 and 1963 Subpart F income. Thus, for Section 902 purposes the controlled corporation's foreign taxes for 1965, 1964 and 1963 would next be allocated to the shareholder.

3. The next $100 of dividend would be attributed to the Subpart F income of 1967.

4. The remaining $450 of dividend would be attributed to the previously untaxed earnings as follows: $200—1967;

$150—1966 ($50 of the non-Subpart F income having been deemed invested in non-qualified property in 1966); and $100—1965.

Accordingly, upon a single $1,000 dividend in 1967, in lieu of the present "last-in-first-out" rule applicable to Section 902 computations, the earnings and profits of the controlled corporation would be deemed distributed for Section 902 purposes in the following order and amounts:

$ 50	1963
$ 50	1966
$100	1965
$200	1964
$ 50	1963
$300	1967
$150	1966
$100	1965

It is recommended that serious study be given to the possibility of revising the proposed Section 902 treatment to avoid adding additional substantial complexities to an area which is already extremely complex.

Special Rules for Foreign Tax Credit Limitation in Year of Receipt of Previously Taxed Earnings and Profits

Subsection (b) of proposed Section 957 is intended to correct inequities which would result under the present law relating to foreign tax credits because of the operation of proposed Sections 951 and 956. Under present law, foreign tax credits are available to a shareholder in the year in which income is actually accrued or received whereas under Section 951, an amount is included in the gross income of a United States person without reference to the year of accrual or receipt, and, in the case of increases in non-qualified property (proposed Section 951(a)(1)(B)), without reference to the year the income is earned. Under proposed Section 956, an amount previously included in the gross income under proposed Section 951(a) is excluded when actually received. Since foreign taxes are normally imposed when income is earned or distributed, some relief provision is required to avoid obvious inequities.

Subparagraph (2) of proposed Section 957(b) provides such relief by setting forth a formula under which the foreign tax credit limitations of present Section 904(a) are increased in the year in which a distribution, excluded from gross income under proposed Section 956(a), is received by the United States person. The formula looks back to the year in which the income of the controlled corporation was included in the gross income of the United States person under Section 951(a) and permits the limitation to be increased in the actual year of distribution by the amount by which the limitation was increased in the year of taxability because of the inclusion of such amounts in income. However, under Section 957(b)(2)(B) such increase in limitation is reduced by the taxes "allowable" as a credit under Section 901 in the earlier year which would not have been allowable except for the inclusion in income of amounts under Section 951(a).

The primary difficulty with this approach is that it again compounds the complexities in the foreign tax credit area. Reference is made to the discussion under proposed Section 957(a) for an example of how a single dividend payment may be allocated back to a number of prior years in a completely non-uniform fashion. Under the formula in proposed Section 957(b)(2), the foreign tax credit limitation in each of such prior years would have to be recomputed to determine the foreign tax credit limitation in the actual year of distribution.

A second difficulty with the formula in proposed Section 957(b)(2) is that it apparently does not take into account the effect of carrybacks and carryovers of foreign taxes. For example, if a corporate taxpayer has excess foreign taxes paid in a given year, such excess may be used by it in any one of seven other years (two years back and five years forward). However, if an excess foreign tax becomes usable in any particular year because there is included in gross income in such year an amount under proposed Section 951 (a), the relief available under proposed Section 957(b)(2) is reduced without reference to whether such excess could have otherwise been used in a later year. The result may be to prevent a taxpayer from using foreign taxes which would otherwise have been available to him or to permit him to use excess foreign taxes which would otherwise have expired.

A further difficulty in the application of proposed Section 957(b)(2) relates to the fact that the year of distribution may occur many years after the years of taxability. Since the foreign tax credit limitation in the year of distribution depends upon the foreign tax credit limitations in the years of taxability, such prior year may remain open for this purpose well beyond the time when the applicable statute of limitations would have closed the year for all other purposes. Furthermore, since the foreign tax credit limitations in the years of taxability depend upon concepts of taxable income during such years, it is not clear, under the proposed Bill, whether either the taxpayer or the Government or both may reaudit or revise taxable income computations in the earlier years to determine the proper foreign tax credit limitations in such years. At the least, taxpayers may be required to maintain records and supporting data for periods substantially beyond present requirements.

A relatively minor difficulty in applying proposed Section 957(b)(2) may arise if the year of taxability of the foreign income under proposed Section 951(a) was a loss year for the United States person. Under these circumstances, there would have been no increase in foreign tax credit limitation in the earlier year and, consequently, there would be no increase in limitation in the year in which the distribution is actually received. Subparagraph (4) of subsection (b) apparently recognizes the problem in cases where the year of distribution is a loss year for the U. S. taxpayer but does not refer to the case in which the prior year resulted in a loss.

Subparagraph (3) of proposed Section 957(b) provides that no deduction under Section 164 of the Code for foreign taxes allocable to previously taxed income is allowable in a year in which previously taxed distributions are received, if the taxpayer did not elect to take foreign taxes as credits in both the year of actual distribution and the year in which gross income was increased under proposed Section 951(a). Substantially the same conditions appear in proposed Section 957(b)(1) as pre-conditions for the relief afforded by that section. The effect of these requirements is to impose upon taxpayers the impossible burden of guessing in the earlier year in which amounts are taxable under proposed Section 951(a), what their tax status will be in future years when distributions attributable to such year are received. Since the future year of distribution is unknown at the time and the income, credits, etc. of such year is unknowable, there is no rational way for taxpayers to make this determination. Furthermore, the problems are compounded if the stock of a controlled corporation has been acquired from other U. S. persons. The result of losing a deduction or credit for foreign taxes in the year of distribution for making a bad guess in the earlier year may be tantamount to a penalty where none is actually intended.

I. Adjustments to Basis of Stock in Controlled Foreign Corporation

Proposed Section 958 is intended to avoid double taxation in a case in which (i) an amount has been included in gross income of a United States person under Section 951(a), and (ii) the stock in the foreign corporation is subsequently disposed of before cash distributions are received by the United States person at least equal to the amounts theretofore included in income. The method used is to increase the stock basis of United States persons in the controlled foreign corporation by the amount of income required to be included in gross income under proposed Section 951(a) and to reduce stock basis by distributions received which are excluded from gross income under proposed Section 956(a).

Treatment of Amounts Excluded from Gross Income as Gain from a Sale or Exchange of Property

As pointed out in the discussion under proposed Section 956(a), the exclusion from gross income provided for distributions which were taxable in prior years is inconsistent with the provision in proposed Section 958(b)(2) treating such amounts as gain from the sale or exchange of property to the extent that they exceed the adjusted basis of the stock in the foreign corporation. It would appear that the primary rule of proposed Section 956(a), that amounts previously taxed may be distributed without further tax to shareholders, can be construed as an overriding principle whether or not the adjusted basis of the stock of the controlled foreign corporation is exceeded by distributions which are nontaxable under Section 956(a). If the legislative intent is to tax amounts which are excluded from gross income where they exceed basis, e.g. in the hands of a purchaser of the stock, proposed Section 956(a) should be revised to make this clear.

J. Integration with Personal Holding Company Treatment

Section 13(b) of H.R. 10650 amends Section 551(b) of the Code relating to foreign personal holding companies but does not attempt to amend sections of the Code relating to personal holding companies. Since controlled foreign corporations may be personal holding companies, revisions may be required. Our Committee has not had time to consider this problem in detail. However, it would appear that at least one area requires consideration — whether amounts taxed to United States shareholders under proposed Section 951(a) should not be deemed to be a dividend for purposes of the dividends paid deduction. The problem would probably be resolved adequately if the Committee's recommendation made elsewhere in the report that U. S.

source income be excluded from Subpart F income (whether or not the controlled foreign corporation is engaged in business in the U. S.) is adopted.

K. Suggested Amendment of Section 367

In view of the change in concept of United States taxation of foreign income under Section 13 of the House Bill, consideration should be given to whether Section 367 of the Internal Revenue Code will continue to serve its intended purpose. Under Section 367, certain exchanges and reorganizations which would be tax-free between domestic corporations are deemed to be taxable if one or more foreign corporations are involved, unless the Commissioner is first satisfied that the transaction is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes.

Section 367 first came into the law as Section 112(k) of the Revenue Act of 1932 and has remained in the law to date without substantial change. The purpose of the section was to prevent tax avoidance which might result if an American taxpayer were permitted to contribute appreciated property, tax-free, to a foreign corporation which could then sell such property without U. S. tax. In the absence of Section 367, the proceeds of sale might then be distributed tax-free to the American shareholder by means of a merger, liquidation or other reorganization. To avoid this result, it was determined to permit tax-free organizations, reorganizations and liquidations, only if the Commissioner was first satisfied that the purpose of the transaction was not primarily tax avoidance. (See page 20, H. Rept. 708, 72d Cong., 1st Sess.; and pp. 26-27, S. Rept. 665, 72d Cong., 1st Sess.) In practice, the section covers gain attributable to any source.

In light of the provisions of Sections 13 and 16 of the proposed Bill, which are intended to impose ordinary income tax upon U. S. persons with respect to earnings of foreign controlled corporations, the restrictive requirements of Section 367 may no longer be necessary, except possibly in a much narrower area than at present. Moreover, Sections 13 and 16 of the proposed Bill can easily be revised, if necessary, to take care of any tax avoidance possibilities which might remain if Section 367 were eliminated in respect of such corporations.

On the other hand, the suggested modification of Section 367 as applied to controlled corporations would permit U. S. persons to conduct their businesses without the necessity of obtaining a prior ruling involving considerable expense, delays and time consuming formalities. Similarly, U. S. persons would then be able freely to reorganize foreign corporate structures with an eye toward economic reality rather than the tax laws. This freedom of operation will become especially important if Section 16 of the House Bill is enacted since any reorganization of foreign corporations may impose upon the shareholder substantial ordinary income taxes.

For the foregoing reasons, it is recommended that the possible revision of Section 367 to conform to the changes made in the proposed Bill be given serious study.

Sec. 16—Sales or Exchanges of Stock in Controlled Foreign Corporations.

Under present law, earnings accumulated in U. S.-controlled foreign corporations will usually be taxed by the United States as capital gain where the U. S. shareholder (1) sells the stock of the foreign corporation or (2) causes the foreign corporation to be liquidated.

Section 16 of the Bill would add to the Code a new Section 1248 intended to tax as ordinary income part of the gain realized from both a sale and a liquidation of a controlled foreign corporation (H. Rep. No. 1447 at page 76). The proposed Section 1248 would tax such a gain as ordinary income to the extent of the U. S. shareholder's proportionate share of the accumulated earnings and profits of the foreign corporation, provided that the U. S. shareholder owns, directly or constructively, 10% or more of the stock of the foreign corporation. In some cases, a foreign tax credit would be allowed for the foreign income taxes paid on the accumulated earnings and profits by the foreign corporation.

A. Policy Considerations.

One of the major purposes of a lower tax rate on capital gains is to limit the amount of tax payable on gains which do not regularly arise in the normal course of business. The capital gains tax thus prevents the harsh tax consequences that might result if gain, representing value accrued over many years, were bunched in the year of disposal and were taxed at rates which, in the case of an individual, would normally be much higher than would be applicable had the gain been realized ratably over the period during which the property was held. The capital gains tax provisions also give recognition to the fact that the proceeds from extraordinary sales are frequently reinvested in other capital assets.

The Bill recognizes that capital gains treatment should remain applicable to many investments in foreign enterprises. It continues capital gains treatment for a less than 10% stockholder in a U. S. controlled foreign corporation but denies such treatment to a 10% or more stockholder. Moreover, capital gains treatment is continued in the case of a U. S. shareholder owning as much as 50% of the stock of a foreign corporation, provided the balance of the shares is owned by foreigners.

Withdrawal of capital gains treatment may be justified where the investment is part of a device to convert ordinary income into capital gains. Existing law recognizes this distinction and denies capital gains treatment in domestic corporate tax avoidance situations such as preferred stock bailouts (Section 306) and collapsible corporations (Section 341).

However, the great majority of U. S.-controlled foreign corporations are not tax avoidance devices but are the legitimate vehicles for operating businesses abroad. Moreover, the undistributed earnings of those foreign corporations engaged in "tax avoidance" would be taxed currently to the U. S. shareholder under Section 13 of the Bill. Therefore, the proposed denial of capital gain treatment would apply primarily to previously accumulated earnings and to current non-tax-avoidance income. The new provision treats all sales and liquidations of controlled foreign corporations as though they were tax avoidance devices. We believe this to be discriminatory since no parallel rule is applicable to sales or liquidations of domestic corporations.

In many "less developed" areas of the world, such as Puerto Rico, complete or partial exoneration from local taxation, usually for a limited period of years, has been offered to U. S. enterprises as an inducement for establishment of local businesses which promote the economic and social progress of the country. It has been the policy of our Government to encourage establishment of businesses in these "less developed" areas, particularly in Puerto Rico. The corporate structures used for this purpose were created in good faith to accord with the U. S. tax rules then in existence.

For example, the tax exemption granted by the Puerto Rican Industrial Incentive Act has encouraged many U. S. businesses to establish activities in Puerto Rico and thus contribute to our national policy of aiding the social and economic progress of Puerto Rico.

Some of these businesses chose to operate in Puerto Rico as U. S. corporations under Section 931 of the Code, while others were set up as Puerto Rican corporations. Both have enjoyed complete exemption from U. S. taxes as well as Puerto Rican taxes, so long as the earnings were not repatriated either by way of dividends or liquidations.

In many instances, the initial tax exemption period accorded eligible industries under the Puerto Rican Industrial Incentive Act is now drawing to a close. Many of these corporations will, as originally planned, liquidate and the assets will thereafter be operated as a branch of the U. S. enterprise.

The impact of the proposed Section 1248, however, is to create an anomaly. The U. S. enterprise which chose to operate in Puerto Rico through a domestic corporation qualifying under Section 931 of the Code can now liquidate either (A) at no U. S. tax cost under Section 332 if more than 80% of its shares are held by a U. S. parent company, or (B) at the cost of only a capital gains tax in the case of other shareholders. By contrast, the U. S. shareholders of the enterprise which chose to operate through a Puerto Rican corporation will be faced with the prospect of paying the full 52% U. S. tax (or more in the case of unincorporated taxpayers) on all gain to the extent of accumulated earnings of the Puerto Rican corporation, and also a capital gains tax on any excess.

It is therefore apparent that the change in the preexisting U. S. tax rules will arbitrarily penalize those who, in good faith, happen to operate in Puerto Rico with a locally incorporated company. Under these circumstances, many U. S.-owned foreign enterprises may feel compelled to retain both Puerto Rican assets and all other foreign assets indefinitely behind the protective screen of the foreign corporation.

Other countries, both developed and "less developed", have offered other types of tax incentive programs to attract foreign investment within their boundaries. These tax incentives frequently take the form of liberal depreciation or a so-called "investment allowance", all of which have the effect of lowering the tax rates in the foreign country. Moreover, many foreign countries require that legal or statutory reserves be set aside in determining income subject to local taxation, and these, too, operate to reduce the effective foreign tax burden.

These foreign investment incentives would be defeated if ordinary U. S. tax rates were levied on accumulated earnings and profits when the foreign corporation is liquidated or its stock is sold. In either event, the resulting gain to the U. S. shareholder, to the extent of such shareholder's share of the accumulated earnings and profits of the foreign corporation, presumably computed on a U. S. tax basis, would be taxed at ordinary rates. Moreover, there would be little relief from the foreign tax credit, if allowable, because of the reduced taxes paid to the foreign country by virtue of the special tax incentive allowances.

The proposed Section 1248 would vitiate tax incentives granted by foreign countries insofar as U. S. businesses are concerned. It would indirectly give foreign-controlled businesses a competitive advantage which could seriously impair our nation's balance of payments. It would encourage the non-repatriation of foreign assets. Finally, it would unfairly penalize the use of locally-incorporated companies, even in "less developed" areas and even though required by local law.

We therefore urge the Congress to weigh these policy considerations carefully before changing the present method of taxing capital gains on sales and liquidations of foreign corporations.

B. Unfairness of Taxing Prior Accumulated Earnings.

Under the proposed Section 1248, gain realized from the sale of stock in, or liquidation of, a controlled foreign corporation would be taxed to the 10% U. S. shareholder as ordinary income to the extent of earnings and profits accumulated during the entire 49 years that the Federal income tax law has been in effect.

This provision is inconsistent with the other provisions of the Bill, which are solely prospective in their application. Thus, the Bill provides that ordinary income tax treatment on sale of stock of a "foreign investment company" is applicable only to earnings accumulated after December 31, 1962 (proposed Section 1246(a)(2)). In this connection, it should be noted that the great number of corporations to which the proposed Section 1248 would apply are not tax shelters as are "foreign investment companies".

The new Section 1248 would probably be applicable largely to forced sales, brought about by the growing insistence of foreign countries, particularly in the "less developed" parts of the world, for partial local ownership of local business. A growing number of governments now demand local participation as the price for doing business within the country, and in some cases impose discriminatory taxes on business which do not comply. For example, sales by U. S.-owned corporations of stock of Mexican mining corporations have been made necessary by amendments to the Mexican mining law.

A large number of foreign corporations have been in operation for many years, so that the obtaining of records necessary to compute accumulated earnings and profits for as many as fifty years would be extremely burdensome, if not impossible. Many of these records may no longer be available, particularly records constituting proof of payment of past foreign income taxes, which would be needed to support the foreign tax credit.

To apply the new rule to earnings and profits accumulated prior to 1962 would be particularly unfair because (1) under Section 1248(d) gain not attributable to accumulated earnings and profits may be taxed as ordinary income if the taxpayer cannot prove the amount of the foreign corporation's accumulated earnings, and (2) the full credit for foreign income taxes will not be allowed if the taxpayer cannot prove the exact amount of foreign taxes paid in the distant past.

Lastly, to apply Section 1248 to earnings and profits accumulated prior to 1962 will often result in such earnings being taxed at a much higher rate than would have been applicable if the earnings had been subject to U. S. tax in each year when earned. Such current repatriation of earnings may not always have been feasible because of currency blockages, restrictions imposed by foreign lenders. and the normal requirements of an expanding business.

We therefore recommend that, if it is enacted, the proposed change should be made applicable only to earnings and profits accumulated in taxable years beginning after December 31, 1962.

C. Inequitable Operation of Constructive Ownership Rules.

Ordinary income treatment will apply only to "controlled foreign corporations" as defined in the proposed Section 954. Under the rules of constructive ownership in proposed Section 955, U. S. minority shareholders of publicly-held foreign companies are deemed to own a portion of the stock of other foreign corporations owned by such publicly-held foreign companies. The result of this rule is, in many common situations, to treat as U. S.-controlled a corporation which is clearly controlled by foreigners or in which the control is divided equally between Americans and foreigners.

There are many "joint ventures" between domestic corporations and foreign-owned foreign corporations which use the medium of a foreign-incorporated affiliate owned equally by the U. S. corporation and the foreign corporation. If none of the stock of the foreign corporate partner is owned by U. S. persons, the joint venture company is not deemed to be U. S.-controlled. However, if one share of stock of the foreign corporate partner is owned by a U. S. person, the joint venture company becomes American-controlled by virtue of the attribution rule of proposed Section 955(a)(2) which provides that stock owned by a foreign corporation shall be deemed to be proportionately owned by its shareholders.

There are many other "joint venture" companies where the U. S. corporation is a minority partner, with one or more foreign corporations having the majority interest. The foreign "partner" is often a publicly-held foreign corporation owned largely by foreign nationals but with a substantial number of U. S. shareholders. In many instances, the U. S. ownership of the "joint venture" company is under 50% so as to comply with foreign laws requiring majority ownership by nationals of the foreign country. An example of the latter situation is found in France with respect to corporations doing government business. Similar requirements are imposed by Mexico with respect to mining corporations.

Under the Bill, whether the "joint venture" company is considered U. S. or foreign-controlled will, in many instances, depend upon the extent to which U. S. persons own shares of stock of large, publicly-held foreign corporations, such as Courtaulds, Ltd.; Farbenfabriken Bayer A. G.; Fiat S. P. A.; Imperial Chemical Industries, Ltd.; Imperial Tobacco Co., Ltd.; Mitsubishi Chemical Industries, Ltd., Rolls-Royce Ltd.; Unilever Limited; Unilever N. V.; and Volkswagenwerk A. G. The number of U. S. persons owning shares in these corporations may be impossible for the U. S. corporate "partner" to establish, particularly since many countries permit use of bearer shares, the true owners of which are generally unknown.

Thus, under the proposed Section 954, a "joint venture" foreign corporation which is really foreign-controlled would, in many situations, be considered U. S.-controlled. Furthermore, small variations in the U. S. ownership of a minority stock interest in a publicly-held foreign corporation could result in substantially different tax results to a U. S.-minority "joint venturer" in a foreign business. In short, the Bill would permit taxation to be determined on the basis of factors over which the U. S. "partner" frequently has little knowledge and no control.

We recommend that a more realistic and practical definition of U. S. control be adopted to prevent foreign "joint venture" companies from being considered American-controlled where the direct U. S. ownership of the "joint venture" company represents a 50% or smaller interest and the foreign "partner" is a publicly-held foreign enterprise which is clearly foreign controlled.

This could be accomplished by providing that a U. S. person shall not be considered as owning voting stock of a foreign "joint venture" corporation owned in part by a foreign-controlled foreign corporation unless (a) such U. S. person owns, directly or indirectly, more than 10% of the stock of the foreign-controlled "partner", or (b) the U. S. shareholders as a group own, directly or indirectly, more than 50% of the stock of the foreign corporate "partner".

Earnings Should be Limited to Stock Disposed Of

Section 1248 provides that when stock of a controlled foreign corporation is sold or redeemed, the gain will be taxed as ordinary income to the extent of the shareholder's "proportionate share" of the earnings and profits. This language should be clarified to limit ordinary income treatment to the earnings attributable to the shares sold.

For example, if a 50% shareholder sells half of his stock, only half of his share of earnings should be taxed as ordinary income. As the Bill reads, there might be ordinary income to the extent of the shareholder's entire proportionate share of the earnings.

D. Time During Which Corporation Must Be U. S.-Controlled

Under the proposed Section 1248, a U. S. person may be taxable at ordinary income tax rates even though during all the time he held the stock the foreign corporation was never U. S.-controlled. For example, if a domestic corporation sells its controlling interest in a foreign corporation to a group comprised largely of foreigners but with at least one U. S. person acquiring a 10% interest, such U. S. person would be taxed under Section 1248 if he resold his shares within 5 years.

There appears to be no valid reason for this result. Presumably, taxation of part of the gain as ordinary income where the foreign corporation is not U. S.-controlled when the sale occurred, but was U. S.-controlled at some time within the 5 preceding years, was intended to preclude capital gains treatment where the sale by the U. S. person or persons is part of a series of several related steps.

We accordingly recommend that Section 1248(c) be changed to provide, as an additional requirement for application of Section 1248(a) and (b), that the U. S. shareholder must have owned stock of the foreign corporation during the time when it was a "controlled foreign corporation".

E. Inequitable Differences in Treatment Between Sales and Redemptions

1. *Foreign Tax Credits*—Under the proposed Section 1248(a), the gain from the redemption of stock of a controlled foreign corporation would be taxed as a dividend to the extent of the U. S. shareholder's proportionate share of the corporation's post-1913 accumulated earnings and profits. As a corollary to such dividend treatment, the owner of 10% or more of the stock would be entitled to a foreign tax credit for the foreign income taxes paid with respect to his share of the foreign corporation's accumulated earnings and profits. When the U. S. shareholder sells his stock in the foreign corporation, however, he is not allowed a foreign tax credit under the Bill.

We see no valid reason for this failure to allow a foreign tax credit to the U. S. shareholder when the accumulated earnings and profits of the foreign corporation are, in effect, realized through the sale of the stock. There could be no compounding of the benefits of such a credit since the intent of the Bill is apparently to tax the purchaser only with respect to subsequent earnings accumulated during his period of ownership. Failure to allow the credit seems inconsistent with the purpose of taxing the foreign earnings "to the extent of the excess of the U. S. tax over the foreign tax", as stated on page 58 of H. Rep. No. 1447.

We therefore recommend that, if the proposed Section 1248 is enacted, a foreign tax credit should be allowed where the U. S. shareholder of a controlled foreign corporation realizes his share of the corporation's accumulated earnings and profits through a sale of his stock.

2. *Amount Taxed as Ordinary Income*—In the case of a sale of stock, Section 1248 applies only to earnings and profits accumulated during the period the stock was held by the seller (Section 1248(b)). However, in the case of a liquidation, the proposed statute apparently applies to earnings accumulated even before the seller acquired the stock (Section 1248(a)).

Obviously, there can be no tax avoidance on the part of a seller with respect to earnings and profits accumulated prior to the time of his acquisition of the shares. We believe therefore that if Section 1248 is enacted, subsection (a) should be changed to make it clear that in the case of a liquidation, ordinary income treatment would apply only to the shareholder's proportionate share of the earnings and profits of the foreign corporation accumulated during the period the stock exchanged was held by such person.

3. *Reduction of Accumulated Earnings and Profits*—A redemption of stock, including redemptions described in Section 1248(a), will effect a reduction in the distributing corporation's earnings and profits in accordance with the rules set forth in Section 312(a) of the Code. However, under the Bill there will be no reduction in the earnings and profits of a controlled foreign corporation upon the sale of its stock by a 10% U. S. stockholder, whose gain, nevertheless, would be subject to tax as ordinary income under Section 1248(b).

The objective of the proposed Section 1248 is to tax at ordinary income tax rates the 10% U. S. shareholder of a controlled foreign corporation on his share of the foreign accumulated earnings and profits if such shareholder, in effect, realizes some of that income through a redemption or sale of his stock. Consistent with that objective, there should be a reduction in the controlled foreign corporation's earnings and profits for any amounts which are treated as ordinary income in the hands of the selling shareholder, regardless of whether the ordinary income treatment results from sale or redemption of the shares. If this is done only on a redemption and not when shares are sold, part of the earnings and profits of the controlled foreign corporation would be subjected to U. S. tax twice, once under the constructive repatriation theory of Section 1248(b), and again when actually repatriated as a declared dividend.

We recommend that, if Section 1248 is enacted, a correlative amendment to Section 312 of the Code also be made to provide for the reduction in accumulated earnings and profits of a controlled foreign corporation by the amount of ordinary income taxed to the selling shareholder in the case of sales of stock coming within the purview of Section 1248(b). It is recognized that this recommendation may involve administrative and policing difficulties, but it is believed that adequate controls could be worked out within the framework of the enlarged information requirements of Sections 6038 and 6046.

F. Inequitable Differences in Treatment of Gains and Losses.

Section 1248 would tax the 10% or more shareholder on gains resulting from sales or redemptions of stock of controlled foreign corporations at ordinary income tax rates to the extent of the shareholder's share of the accumulated earnings and profits of the foreign corporation. However, losses resulting from any such sales or redemptions would be deductible, if at all, only as capital losses, regardless of whether or not the loss, or any part thereof, was incurred as a result of the foreign corporation's operations during the selling shareholder's period of ownership.

The inequity resulting from this provision is even more pronounced if the U. S. shareholder is a corporation owning 80% or more of the stock of a liquidating foreign corporation. In such event no loss deduction whatsoever would be allowed to the domestic parent since the transaction would fall squarely within the tax-free provisions of Section 332 of existing law pursuant to which no loss would be recognized. Failure to obtain a prior ruling under Section 367 (required in most cases where foreign corporations are involved in tax free reorganizations) would not cure the defect since Section 367 can only be invoked where recognition of gain, not loss, is at issue.

Consideration should therefore be given to providing in Section 1248 that loss resulting from sale or redemption of stock of a controlled foreign corporation shall be recognized as an ordinary loss to the extent of the U. S. shareholder's proportionate share of the aggregate of net operating losses of the foreign corporation realized during such shareholder's period of ownership, and without regard to the provisions of Section 332.

G. Suggested Changes to Prevent Avoidance

The purpose of proposed Section 1248 could probably be negated if the U. S. shareholder were to transfer stock of a controlled foreign corporation to a domestic subsidiary in a tax-free exchange under Section 351 of existing law.

Under proposed Section 1248(b) the amount taxable as ordinary income is limited to the shareholder's share of the earnings and profits of the foreign corporation accumulated during the period the stock was held by the selling shareholder. Thus, the domestic subsidiary in the example cited would realize almost no ordinary income under Section 1248(b) if it were to sell the stock of the "controlled foreign corporation" because it had held the stock for only a short period. Furthermore, since it would hold the shares of the foreign corporation with a substituted basis, almost the entire gain on the sale would be taxed as capital gain.

The impact of proposed Section 1248 could probably also be avoided if the U. S. shareholder were to transfer the stock of each of his controlled foreign corporations to separate domestic corporations tax-free under Section 351. Thereafter, sale of one or more of the tainted foreign corporations could be effected merely by selling the stock of the domestic holding company. The buyer could liquidate the domestic holding company tax-free, and under Section 334(b)(2) take a stepped-up basis for the shares of the foreign corporation so acquired equivalent to the cost to him of the shares of the liquidated domestic holding company.

The step transaction doctrine developed by the courts could probably be utilized to prevent some, but not all, of the transactions that might be used to effectuate the foregoing tax avoidance devices. However, if Section 1248 is to be enacted, we recommend that an amendment be made providing that earnings and profits attributable to stock in a controlled foreign corporation which has a carryover basis shall include earnings and profits accumulated during the period the shares were owned by the transferor. A provision of this type is contained in proposed Code Section 1246(c) for foreign investment companies (Section 15(a) of the Bill).

If such change is made, then Section 1248(c) would also have to be changed to reduce the U. S. person's proportionate share of the accumulated earnings and profits of the the proposed Section 951 (Section 13 of the Bill) to the person from whom the selling shareholder acquired the stock. A similar problem is dealt with in proposed Section 956(a) dealing with exclusion from gross income of earnings and profits previously taxed under Section 951.

We also recommend that Section 1248 should include a provision that stock of a domestic corporation acquired for stock of a controlled foreign corporation in a tax-free transaction should be considered as stock of a controlled foreign corporation so long as such domestic corporation owns the stock of the controlled foreign corporation. A somewhat similar rule is provided in Section 306(c)(1)(C) of the present Code relating to preferred stock received as a stock dividend.

Sec. 20—Returns of Information as to Foreign Corporations.

Section 20 of HR 10650 amends present Sections 6038 and 6046 and adds a new Section 6678. These sections deal with information that must be filed with the Treasury with respect to certain foreign entities and the civil penalties which may be incurred for failure to file such information.

Amendments of Section 6038

Present Section 6038 requires that a domestic corporation file an annual information return (Form 2952) for each foreign corporation which it controls. As amended, Section 6038 would require the filing of such returns, not only by domestic corporations, but also by U. S. citizens and residents, domestic partnerships and domestic estates and trusts with respect to any foreign corporation which such persons control. Control is redefined to include most of the constructive ownership rules of Section 318(a). The definition of control is also extended to include more than two levels of ownership.

Similar or Related Information Should be Reasonable.

In addition to the information now required, the amended Section 6038(a)(1) would authorize the Secretary or his delegate to require "the furnishing of any information which is similar or related in nature" thereto.

There can be no objection to requiring the furnishing of information needed to determine the U. S. tax liabilities of a U. S. taxpayer. However, the Treasury's right to information should be exercised in a manner that will not unduly burden taxpayers, e. g., by requiring them to assemble enormous quantities of detailed data which is not readily available from records kept in the ordinary course of business. We therefore believe that the proposed amendment should give some recognition to the right of taxpayers not to be subjected to unreasonable demands for supplementary figures which can be prepared only by an expenditure of time and funds disproportionate to their probative value to the Treasury.

The proposed amendment would apparently permit the Secretary or his delegate to demand information without regard to the reasonableness of the request, so long as in his opinion the information was "similar or related" in some way to the information specified in Section 6038(a)(1)(A)-(E). Since the failure to file such information results ipso facto in reduction of foreign tax credits, we recommend that the proposal be modified to make explicit the requirement of reasonableness.

Penalty Provisions Are Broader than Necessary

Present Section 6038(b) provides that certain penalties shall be imposed for failure to furnsh the required information. The Bill proposes to broaden the scope of present Section 6038(b) to include denial of foreign tax credits under Section 901 as well as those under Section 902. Such penalties can be imposed administratively by the Secretary or his delegate without reference to the courts.

We believe that penalties should not be imposed in those cases where the taxpayer has attempted in good faith to comply with the statute and the regulations thereunder. In some instances the U. S. taxpayer will not be able to secure the information required, e. g., because his foreign associates refuse to give it or because local law prevents its divulgence. Moreover, failure to file information may result from honest inadvertence, particularly where the U. S. taxpayer holds stock in many foreign corporations some of which may have been inactive for years. The taxpayer who fails to supply all of the required information under such circumstances should not be penalized.

Although the proposed penalty provisions of Section 6038 in part carry over existing law, we question the fairness of disallowing a percentage of the total foreign tax credits claimed by the U. S. taxpayer, even though the missing information may concern only one of many controlled foreign companies. Accordingly, we urge that the penalty be applied only to the credits referable to the particular foreign corporation with respect to which the default has occurred. In this way, the punishment will more nearly fit the crime.

Amendments of Section 6046

Present Section 6046 requires an information return (Form 959) to be filed by any citizen or resident who is or becomes an officer or director of any foreign corporation, or from any U. S. shareholder who owns or acquires more than 5% of the stock of such corporation, within 60 days of the creation, organization or reorganization of such foreign corporation.

The Bill would amend Section 6046 by deleting the 60 day limitation and requiring the filing of an information return by any U. S. citizen or resident who is an officer or director or shareholder with more than a 5% interest on January 1, 1963 or who acquires such position or status after that date. A supplementary return would be required whenever a U. S. shareholder acquires an additional 5% interest in the value of the stock.

Inconsistency between Title and Text

Under present law, a return is due only if there is a creation, organization, or reorganization of a foreign corporation. Under the proposal, a return would be due if there is a change of officer or director or of the prerequisite stock ownership. To avoid confusion, the title to Section 6046 should be changed to conform with the changed substance of that Section.

We believe, however, that reporting of a corporate organization or reorganization should continue to be required. Under the Bill, no report need be filed in the event of a reorganization of a foreign corporation if there is no change in American officers or directors and no increase in American stock ownership over 5%. Thus, an event in which the Treasury may have an interest may go unreported.

Unnecessary Returns Should Not Be Required

Under the proposal, events will have to be reported to the Treasury which may have little or no importance,

e. g., the mere change of an officer or director of a newly organized company.

Repetitive returns would be required under the Bill where a U. S. shareholder makes a series of purchases of stock in a foreign corporation. The successive returns would be a nuisance for the U. S. shareholder but would contain little or no new information for the Treasury.

We suggest that the most efficient method of acquiring information without burdening taxpayers and the Treasury with repetitive returns would be to require the filing of a return only when:

1. An American first becomes an officer, director or substantial shareholder.

2. A major corporate reorganization occurs.

Moreover, if a United States person must file an annual information return under Section 6038, then no additional return should be required under Section 6046. A comparison of the present Form 2952 (required under Section 6038) with the present Form 959 (required under Section 6046) indicates that little information is required by Form 959 that Form 2952 does not call for. Thus, information as to the place and date of organization of the foreign corporation, the names of its shareholders, the classes of stock outstanding, and the business purposes of the corporation are required by both forms. The additional information now required by Form 959 relating to procedures involved in the formation of a foreign corporation could readily be supplied as part of the annual return on Form 2952. In this way all of the information would be supplied only once and on an annual basis.

The Necessity for Regulations

We suggest that the types of information to be reported by the taxpayer under Section 6046 should be set forth in Regulations adopted in accordance with the Administrative Procedure Act, i.e. after hearings on proposed regulations have been held. Regulations developed in this way would preclude some of the problems arising under the present Form 959 which now requires information often irrelevant or unavailable in the event of a reorganization of a foreign corporation, especially if it was formed many years ago. Such Regulations should contain definitions of the terms "organization" and "reorganization" so that the present uncertainty as to their meanings will be eliminated.

The Five Per Cent Ownership Provision is Unrealistic

Proposed Section 6046(a)(2)(A) and (B) require the filing of an information return when a United States person acquires five per cent in value of the stock in a foreign corporation and also when additional amounts of five per cent or more are acquired.

Clearly, this provision imposes obligations that are often impossible of fulfillment. For example, a U. S. shareholder who acquires 5% of the shares of a long-established foreign corporation may have difficulty in obtaining information as to the company's organization many years earlier. In view of his minority position, such information may not be available to him. We therefore suggest that such returns be limited to shareholders owning more than fifty per cent in value or voting power of the stock in the foreign corporation.

Proposed Section 6046(c) sets forth rules of constructive ownership of stock for the purpose of the five per cent requirement. We suggest that no return be required if no United States person beneficially owns the shares of the foreign corporation. Such a revision would preclude the necessity of filing a return where, for example, a child resident in the United States would be required to file a return concerning a foreign corporation which is owned by his father who is a noncitizen and nonresident of the United States.

Addition of New Section 6678

Section 20 adds a new section to the Internal Revenue Code numbered 6678 which would impose a civil penalty of $1,000 on any person who fails to file a return under Section 6046 at the time provided or does not provide the information required, unless failure is due to a reasonable cause.

It is suggested that no penalty be imposed if failure to file is due to unavailability of records as a result of a minority position, foreign law or similar reason.

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TAX SECTION

NEW YORK STATE BAR ASSOCIATION

Reports on Sections 2, 3, 4, 9, 12, 14, 15 and 19 of the Revenue Bill of 1962, H.R. 10650

April 24, 1962

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TAX SECTION
NEW YORK STATE BAR ASSOCIATION

Report on the Portion of the Revenue Bill of 1962, H.R. 10650

as adopted by the House of Representatives
on March 29, 1962

relating to

the Investment Credit, Appearances with respect to Legislation and Gain on Disposition of Depreciable Property

Committee on Corporate Tax

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INVESTMENT CREDIT

"Section 38 Property" Defined

The most important definition in section 2 of the Bill is that of "section 38 property" contained in proposed section 48(a). The definition states in part that "the term 'section 38 property' means—

"(A) tangible personal property, or

"(B) other tangible property (not including a building and its structural components) but only if such property—

"(i) is used as an integral part of manufacturing, production, or extraction or of furnishing transportation, communications, electrical energy, gas, water or sewage disposal services, or

"(ii) constitutes a research or storage facility used in connection with any of the activities in clause (i)."

It is apparent from the Ways and Means Committee Report (at 11-12, A17-19) that this definition standing alone does not carry out the intent of Congress. Under normal legal usage, the statutory definition would seem to include fixtures under subparagraph (B), but the Committee report indicates that fixtures are to be considered tangible personal property under subparagraph (A). Subparagraph (B) was apparently designed to include property which is of such a type that it might not be includable under (A). For example, the components of an oil refinery or railroad trackage or, conceptually, certain real property. However, these items (with the exception of real property—if included in (B)) would probably be considered fixtures under local law and, following the rationale of the Committee report, would seem to be includable as fixtures under subparagraph (A).

To the extent that the use of the term "tangible personal property" in subparagraph (A) is intended to differ from its usual legal definition, the statute should be clarified.

Property Becoming Public Utility Property

Proposed section 47(a)(2) provides that if property taken into account in determining qualified investment becomes "public utility property", "the tax under this chapter for such taxable year shall be increased by an amount equal to the aggregate decrease in the credits allowed under section 38 for all prior taxable years which would have resulted solely from treating the property, for purposes of determining qualified investment, as public utility property (after giving due regard to the period before such change in use)".

The intent of the parenthetical expression "(after giving due regard to the period before such change in use)" is unclear. The table at page A14 of the report of the Committee on Ways and Means indicates that the credit is to be a combination of the credit which would be available if the property were used as public utility property from the beginning and the credit which would be available if the property had an original estimated useful life equivalent to its actual period of non-utility use. However, even the table on page A14 on the report does not make entirely clear what the draftsman had in mind. It is suggested that this parenthetical expression be deleted and a rule of more mechanical application substituted therefor.

A draftsman's oversight seems to have occurred in this subsection (47(a)(2)) through the omission of the following language which ought to be included to conform with subsection (a)(1):

> "before the close of the useful life which was taken into account in computing the credit under Section 38"

This language should be inserted immediately following the parenthetical phrase "(within the meaning of Section 46(c)(3)(B))."

Affiliated Groups and Consolidated Returns

Proposed section 46(a)(5) relating to the amount of the credit (and subsections (c)(2)(C) and (c)(3)(C) of section 48 relating to the amount of used section 38 property) would limit the credit available for an affiliated group (as defined by section 1504(a) of the Code but without the exclusions afforded by section 1504(b)) to the maximum amount of credit available to a single taxpayer, whether or not the affiliated group files a consolidated return. The credit for each member would be reduced by apportioning the maximum credit among the members in a manner to be prescribed by regulation. Furthermore, under the percentage modifications to section 1504(a) made by section 48(c)(3)(C) and the inclusion in "affiliated group" under section 46(a)(5) of corporations otherwise excluded by section 1504(b) from the definition of an affiliated group under section 1504(a), the limitations are applicable to some groups of corporations which are not permitted to file consolidated returns under section 1504(a).

The limitation of the available credit with respect to members of an affiliated group which does not file a consolidated return and with respect to related corporations which are unable to file a consolidated return under section 1504 seems undesirable. If this broad application of the credit limitation was directed at the multiple corporation problem, it reflects a piecemeal approach to that problem, complicating rather than simplifying the structure of the Internal Revenue Code, and should be discouraged.

The broad power granted to the Secretary or his delegate to reduce the credit available to each member of an affiliated group by apportioning the maximum credit among members of the group could result in unjustified reductions or losses of the credit; and if the credit limitation is retained in its present form these powers should be limited. For example, the apportionment of part of the credit to a member of an affiliated group having little or no taxable income would seem unfair when the group has a consolidated net income and files a consolidated return. Even where the group does not or cannot file a consolidated return it seems unjustified to authorize regulations which could apportion a part of the total credit to a member of the group which has no taxable income or is not subject to United States taxation (for example, a foreign corporation under section 1504(b)). In view of the apparent intent of this provision to combine multiple corporations into a single entity for credit purposes, the credit available to the members of the group should be usable by any member having taxable income or, if consolidated returns are filed, by the group itself and the statute should so provide.

Property Predominantly Outside the United States

Under proposed section 48(a)(2)(A), the general rule is set forth that section 38 property does not include property which is "predominantly" outside the United States. The Ways and Means Committee Report states that this term "means that the property must be physically located outside the United States more than 50 percent of the time during any one taxable year." Rather than include as vague a term as "predominantly" in the statute, it is suggested that the 50 percent rule be specifically set forth.

APPEARANCES WITH RESPECT TO LEGISLATION

1. *Present Law*

Section 162 of the present law provides:

> "There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, * * * ."

The Commissioner, following his understanding of certain cases decided by the courts, promulgated Regulations 1.162-15(c)(1) and (2), which provide in part as follows:

> "Expenditures * * * for the promotion or defeat of legislation * * * or for carrying on propaganda (including advertising) * * * to promote or defeat legislation or to influence the public with respect to the desirability

or undesirability of proposed legislation are not deductible as a business expense, *even though the legislation may directly affect the taxpayer's business.* * * *

"Dues and other payments to an organization, such as a * * * trade association * * * are deductible in full unless a substantial part of the organization's activities consists of one or more of those specified in the first sentence of subparagraph (1) of this paragraph. If a substantial part of the activities of the organization consists of one or more of those so specified, deduction will be allowed only *for such portion of such dues and other payments as the taxpayer can clearly establish is attributable to activities other than those so specified.* * * *" (Emphasis added)

As the law now stands, the substance of these regulations has been upheld under specific attack in *Cammarano* v. *U. S.* and *F. Straus & Sons, Inc.* v. *U. S.*, 358 U. S. 498 (1959).

2. *Changes Proposed by Section 3 of the Revenue Act of 1962*

Section 3 of the Revenue Act of 1962 would redesignate the present subsection (e) of Section 162 as subsection (f) and add a new subsection (e) to Section 162. Proposed Section 162(e) would allow the deduction of "ordinary and necessary" expenses incurred in direct connection with (A) appearances before, submitting statements to, or sending communications to legislative committees or individual legislators or (B) communication of information between the taxpayer and an organization of which he is a member, with respect to legislation of direct interest to the taxpayer and, additionally, as to (B) above, of direct interest to the organization. It would also allow the deduction of that portion of the dues paid to the organization which is attributable to the expenses of the activities, described in (A) and (B) above, carried on by the organization. Expenses for campaigning for or against candidates for public office, or for influencing the general public or segments thereof with respect to legislative matters, elections, or referendums are specifically made non-deductible.

Section 3 would apparently deny a taxpayer's deduction of the portion of dues paid to an organization attributable to the organization's expenses in conducting a "grassroots" campaign or campaigning for or against candidates for public office. Under the present Regulation § 1.162-15(c), this portion of the dues would be deductible, provided such activities and other activities listed therein do not comprise a substantial part of the organization's total activities.

3. *Committee Recommendations*

(1) Add on line 16, page 26 of H.R. 10650, after the word "dues", the words "and other payments."

> *Discussion:* Since the Report of the House Ways and Means Committee accompanying H.R. 10650 states that a taxpayer's presentation of information bearing on the impact of legislation on his trade or business is necessary for a proper valuation of the legislation by the legislators (H.R. Rep. No. 1447, 87th Cong., 2d Sess. 17 (1962)), there appears to be no rational distinction between allowing the deduction of a portion of the *dues* paid to an organization attributable to its expenses in performing this function for its members, and not allowing the deduction of *payments*, other than what might be clearly characterized as dues, attributable to its expenses in performing the same function. See the present Regulation § 1.162-15(c) which Section 3 purports to change. That Regulation uses the words "dues and other payments." It is therefore believed that the omission of the words "and other payments" was an oversight.

(2) Delete from lines 19-20, page 26 of H.R. 10650, the words "activities described in subparagraphs (A) and (B) carried on by such organization," and add, in place thereof, the words "type of activities described in subparagraphs (A) and (B) carried on by such organization with respect to legislation or proposed legislation of interest to a significant number of the members of such organization."

> *Discussion:* The Report of the House Ways and Means Committee accompanying H.R. 10650 states that

dues to an organization may be deductible although not all of the organization's legislative activities are connected with each member's trade or business, provided all the organization's legislative activity is related to the trade or business of a significant number of the members. H.R. Rep. No. 1447, 87th Cong., 2d Sess. 18 (1962). The proposed statute, as worded, does not appear to allow this. Thus, the foregoing change is recommended.

(3) Delete from line 4, page 27 of H.R. 10650, the words "or segments thereof".

Discussion: The provision of proposed § 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 on legislative matters affecting taxpayer's business, the cost of which should be deductible.

GAIN ON DISPOSITION OF DEPRECIABLE PROPERTY

In general, this section would add a new section designated § 1245 to the Internal Revenue Code of 1954, relating to gain on dispositions of certain depreciable property.

1. Section 1245 provides, in subsection (a) thereof, ordinary income tax treatment for gain upon the disposition of depreciable personal property to the extent of deductions for depreciation or amortization of emergency facilities under § 168, after December 31, 1961. Subsection (b) of § 1245 excepts, in whole or in part, from this new ordinary income treatment: (i) transfers by gift and at death; (ii) transfers in liquidation qualifying under § 332; (iii) transfers to controlled corporations qualifying under § 351; (iv) "reorganization" transfers under §§ 361, 371(a) and 374(a); (v) partnership contributions under § 721 and distributions under § 731; (vi) "like kind" exchanges under § 1031; (vii) involuntary conversions under § 1033, and (viii) other exchanges under §§ 1071 and 1081.

By failing to provide a reference to § 1245 in those provisions that are overridden by § 1245, section 14 could be misleading, especially to those not familiar with the entire Code. To illustrate, after enactment of § 14, § 336 will provide:

> "Except as provided in section 453(d), no gain or loss shall be recognized to a corporation on the distribution of property in partial or complete liquidation."

The section should be amended to refer as well to the exception for § 1245. Similar amendments would be required, for example, in §§ 337, 1031, 1033, 1071, 1081, 1231 and 1238.

2. With respect to subsection (a)(2) of § 1245, no reason suggests itself for adding to the usual burden of proof imposed upon the taxpayer. Accordingly, it is suggested that the last sentence of paragraph (2) be changed to eliminate the words: "the taxpaper can establish by adequate records or other sufficient evidence that."

3. With respect to the same subsection (a)(2) of § 1245, the provision should also make clear that a deduction is not "allowed" unless it results in a tax benefit. Compare § 1016(a)(2), especially subparagraph (B) thereof. For example, if a taxpayer deducted on his return $100 of depreciation (which was also the amount allowable), but incurred a deficit in taxable income in excess of $100 for that year, and the deficit was not available as a net operating loss carryover or carryback, it would appear that the $100 would be included in the taxpayer's "recomputed basis," even though he received no tax benefit therefrom.

Accordingly, it is suggested that the last sentence of subsection (a)(2), disregarding for this purpose the suggestion made in the preceding Item 2, be amended to read as follows:

> "For the purpose of the preceding sentence, if the taxpayer can establish by adequate records or other

sufficient evidence that the amount (a) allowed for depreciation, or for amortization under section 168 for any taxable year, and (b) resulting (by reason of the depreciation so allowed) in a reduction for any taxable year of the taxpayer's taxes under this subtitle (other than chapter 2, relating to tax on self-employment income), was less than the amount allowable, the amount added for such taxable year shall be the amount allowed to the extent that it resulted in such a reduction."

4. Section 1245(a)(3) is not sufficiently clear as excluding from ordinary income treatment (as is assumed to be the intention) a building constructed by a lessee. Under the Bill as written, it is conceivable that a leasehold interest in real property will be held to be personal property under "(A)," and the limitations relating to "building" and "tangible" are found only in subparagraph (B).

To clarify the intended result it is suggested that the phrase "(not including a building or its structural components)" be deleted from subparagraph (B) and that the beginning of paragraph (3) be amended to read as follows (italicized material added):

> "For purposes of this section, the term 'section 1245 property' means any property (other than livestock *or a building or its structural components*) . . ."

5. Subsection (b)(2) of § 1245 should be clarified to cover other cases in which the property is included in a decedent's taxable estate, even though the property is not transferred at death. The most common situation is property held as joint tenants and as tenants by the entirety which under § 113(a)(5) of the 1939 Code and prior law was held not to have been acquired by "bequest, devise or inheritance," *Lang* v. *Comm.*, 289 U.S. 109 (1933). These situations are set forth in § 1014(b) of the Code.

Accordingly, section 1245(b)(2) should be revised to read as follows:

> "(2) TRANSFERS AT DEATH. Except as provided in section 1014(c) (relating to income in respect of a

decedent), subsection (a) shall not apply to a transfer at death of property the basis of which in the hands of the transferee is determined under section 1014."

6. Subsection (b)(3) of § 1245 is deficient in not excluding from the application of § 1245 other tax-free transactions where the basis of the property is not increased in the hands of the transferee as a result of the transaction, for example, a transaction covered by § 1055 of the Code, relating to transactions under the Merchant Marine Act or the Merchant Ship Sales Act, or a distribution by an estate or trust to its beneficiaries. It is not even entirely clear from the statute that a sale by one corporation to another, both of which are included in a consolidated return, would not result in tax.

One solution might be to provide a general rule that § 1245 shall be inapplicable where the basis of the property is determined by its basis in the hands of the transferor, with such exceptions as are specified in the statute. This would tend to avoid an unintended oversight of situations where, as a matter of policy, § 1245(a) should be inapplicable.

7. Under present law, in the case of property carried in group or composite accounts, the normal retirement of an asset from such an account does not result in gain or loss. Instead, such dispositions are reflected in the reserve for depreciation. Thus, a normal retirement from a multiple asset account does not constitute a "sale or exchange" under § 1231. The fact that assets in the same account may have varying useful lives is taken into account in determining the average useful life. On the other hand, the term "disposition" in § 1245(a)(1) might be construed as having broader applicability.

It does not appear that it was intended that the normal retirement of an asset from a group or composite account should result in income. Moreover, the recomputation of basis on a normal retirement would require records of the individual properties in the group or composite account. Accordingly, the normal retirement of an asset carried in a group or composite account should be excepted from the meaning of "disposition" under § 1245(a)(1).

8. The last sentence of paragraph (3) in subsection (b) provides:

> "This paragraph shall not apply to a disposition to an organization (other than a co-operative described in Section 521) which is exempt from the tax imposed by this chapter."

It is not certain whether a charitable organization which is liable for unrelated business tax is "exempt from tax imposed by this chapter." The sentence would be clearer and less susceptible to misconstruction if it referred to "organizations described in § 501(c) and (d)."

9. There is a serious need for a provision to prevent the bunching in one year of ordinary income representing the recovery of depreciation deductions for more than one year. Some sort of spread-back, similar to that in § 1301 of the existing Code (relating to compensation from an employment), should be afforded. The problem is particularly acute as to individual taxpayers because of their more steeply graduated tax rates but would also exist as to small corporations in low income brackets.

TAX SECTION
NEW YORK STATE BAR ASSOCIATION

REPORT ON FOREIGN TRUSTS AND WITHHOLDING PROVISIONS (AS THEY AFFECT TRUSTS AND ESTATES) OF THE REVENUE BILL OF 1962, H.R. 10650

as adopted by the House of Representatives on March 29, 1962

COMMITTEE ON INCOME TAXATION OF TRUSTS AND ESTATES

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SECTION 9

The purpose of this Section is to treat United States beneficiaries of foreign accumulation trusts created, or added to, by United States grantors in substantially the same manner as beneficiaries of domestic trusts distributing their income currently. This would be accomplished chiefly by modifications of the existing "throw-back" rules so as to include in their operation all income of the trust exceeding current distributable net income, for all years governed by the 1954 Code.

The Committee approves the purpose of the Section (although it recognizes that a legitimate argument could be made as to its "retroactive" feature in the case of pre-existing foreign trusts, in most of which the total taxes paid by the trusts and the trust beneficiaries will be more than the amount which would have been paid if a domestic trust with the same dispositive provisions had been involved).

Attention is called, however, to the possible distortion of a beneficiary's tax in respect of capital gains realized in the trust if he uses (as in many cases practical considerations would require him to do) the optional "short-cut" method provided for in proposed Code Sec. 669(a)(1)(B) for determining the maximum tax owed by a United States citizen or resident who receives an accumulation distribution from a foreign trust. Under this method, the beneficiary's "gross income" for the taxable year in which the accumulation distribution is made and for each of his two taxable years immediately preceding such year is recomputed, and the increase in tax for each of such three years attributable to the increased amount of gross income is determined. The aggregate of the increases in tax for the three-year period is divided by three to arrive at the average increase in tax for such three years. This average increase in tax is then multiplied by the number of preceding taxable years of the trust from the income of which the distribution is made, and the amount involved is the beneficiary's tax liability. The result of this "averaging" would be that if there were net capital losses in the three test years, any capital gains attributable to earlier years would be disregarded, to the beneficiary's benefit, but if there were gains in the test years and losses in earlier years such losses would be disregarded and the result would be detrimental to the beneficiary. The distortion could be avoided by provision for segregating capital transactions and taxing the net long term gains which constitute a part of the accumulation distribution at 25% and the remainder of the distribution under the "short-cut" method.

Also, it would seem advisable to make clear in section 9 what effect its provisions will have upon the operation of Code Sec. 1491, which provides that when stock or securities are transferred by a United States citizen or resident to a foreign trust an excise tax equal to 27½% of the excess of the value of the stock or securities so transferred over its adjusted basis in the hands of the transferor is imposed. Sec. 1492 provides that the tax imposed by Sec. 1491 shall not apply if before the transfer it has been established to the satisfaction of the Secretary or his delegate that the transfer is not pursuant to a plan having as one of its principal purposes the avoidance of Federal income taxes. Sec. 1493 provides that a trust shall be considered a foreign trust if, assuming a subsequent sale by the trustees of the transferred property, the profit, if any, from the sale would not be included in the gross income of the trust. Since the proposed amendment to Sec. 643(a)(6) includes all gains from the sale or exchange of capital assets in gross income of a foreign trust, it would appear that Sec. 1491 would no longer have any application (at least in the case of such a trust created by a United States citizen or resident). Furthermore, the proposed legislation would effectively prevent the avoidance (but not the postponement) of Federal income taxes through the use of foreign trusts, and it would seem that the Secretary or his delegate would be compelled to rule that Sec. 1491 would not apply.

SECTION 19

Section 19 provides for the withholding of income tax by the payor on interest, dividends, and patronage dividends. The section among other things amends Code Sec. 642(a), which relates to special rules for credits and deductions in the case of estates and trusts, by adding thereto a new paragraph (4). This paragraph provides that for purposes of any credit or refund any tax deducted or withheld on any amounts received by an estate or trust will, in accordance with regulations prescribed by the Secretary of the Treasury or his delegate, be considered as having been deducted and withheld from each beneficiary in an amount which, when added to the amounts paid, credited, or required to be distributed to him, equals the amounts which would have been paid, credited, or required to be distributed to him in the absence of the withholding provisions, and that any tax which is not considered as withheld from a beneficiary shall be considered as withheld from the estate or trust.

The report of the House Committee on Ways and Means indicates that the procedure envisioned is for the estate or trust to ''gross-up'' the net dividends and interest received by it so as to enable it to determine the distributions to the beneficiaries and the amount of tax to be considered as withheld from each beneficiary. The beneficiary will then show in the schedule provided on his return for reporting income from trusts or estates the information supplied by the executor or trustee as to his share of the dividends and interest and of the withheld tax.

The Committee believes that the general procedure provided for the allocation of the withheld tax between beneficiaries and the trust or estate itself is satisfactory. No problems should be encountered with respect to simple trusts, i.e., trusts where income is required to be distributed currently. The operation of the procedure may be somewhat more complicated with respect to estates and complex trusts, i.e., trusts where the income is not required to be distributed currently, or where a part of the income is distributed and the balance is retained.

There are, however, serious practical questions in connection with proposed Code Sec. 3483, providing for exemption certificates, as applied to estates and trusts. It would appear that no exemption can be claimed by a beneficiary of an estate or trust, who will therefore be relegated to the refund provisions of proposed Sec. 3484; and thus a charitable beneficiary, or an individual otherwise entitled to claim exemption from withholding, will be treated differently than if it or he were the recipient of the income directly instead of through the estate or trust in that there will be incurred the trouble and expense (which a direct recipient would not have) of suffering withholding and applying for refunds. The Committee suggests that proposed Sec. 3483(b)(3), giving the Secretary or his delegate the authority by regulation to extend the exemption provided by Sec. 3483(a), in a manner consistent with the other provisions of the Section, to amounts paid through nominees or to custodians or jointly to two or more individuals, be broadened to cover amounts paid to estates or trusts. It is to be recognized, however, that the use of exemption certificates would probably have to be limited to estates or trusts where all the income beneficiaries are tax-exempt organizations or to simple trusts having only one income beneficiary; and thus only partial amelioration of the inequity would result.

Apart from these points, it would seem that any comments on the application of the withholding procedure in connection with estates and trusts must await publication of proposed regulations.

TAX SECTION
NEW YORK STATE BAR ASSOCIATION

Report on Withholding Provision of the Revenue Bill of 1962, H.R. 10650

as adopted by the House of Representatives on March 29, 1962

Committee on Practice and Procedure

Laurence F. Casey, *Chairman*

3843

Section 19 of the Bill adds new Chapter 25 to Subtitle C of the Code to provide a system for withholding of tax at the source on certain payments of interest, dividends and patronage dividends, the provisions of which are applicable to payments made on and after January 1, 1963. Set forth below are the principal ambiguities in the section which have come to the Committee's attention, followed by a more detailed analysis of the proposed system and the administrative problems and hardships to taxpayers inherent therein.

1. Withholding in respect of non-cash dividends will raise serious mechanical problems for payors and should not be required (see p. 23, *infra*).

2. The exclusion from dividends subject to withholding in favor of amounts described in section 1373, see proposed section 3462(b)(7), deserves clarification (see p. 23, *infra*).

3. Bill section 19(b)(1) should be expanded to permit an accrual basis taxpayer to take credit for the withheld tax in the year for which the amount subject to withholding is accrued (see p. 24, *infra*).

4. Proposed section 3485 should expressly provide for the filing of quarterly refund claims by the organizations described therein (see p. 30, *infra*).

5. It is suggested that section 19(c)(1) be deleted, or, if withholding in excess of treaty rates is to be required, that the section be rewritten to provide that any such excess withholding shall constitute an overpayment for which quarterly claims for refund may be filed (see p. 32, *infra*).

* * * * *

I. Income Subject to Withholding (Bill Sec. 19(a)(1)).

A. *Interest.*

Proposed Sections 3451-3452 would be added to the Code to provide for withholding at the source on payments of interest on (i) corporate obligations with interest coupons or in registered form, or "of a type offered by corporations to the public" (in the latter case, to the extent provided in regulations), (ii) interest on bank deposits, (iii) amounts paid by a mutual savings bank, savings and loan association, building and loan association, or similar organization upon deposits, investment certificates or withdrawal or repurchasable shares, (iv) interest on amounts held by an insurance company under an agreement to pay interest thereon, (v) interest on deposits with stock brokers, and (vi) interest on obligations, including non-interest bearing obligations, of the United States.

Withholding is not required with respect to: interest payable upon state and municipal obligations; any payments by a foreign government, an international organization, or by a foreign corporation or nonresident alien not engaged in business within the United States; payments on bank deposits, certain payments by organizations described in (iii) above and on certain United States discount obligations, to a state, a foreign government, or an international organization; interest payments upon which withholding is required pursuant to sections 1441 and 1442; any amounts on which a withholding agent is required to deduct or withhold tax with respect to tax-free covenant bonds; and, under regulations, payments on deposits in school savings accounts.

Evidently withholding is required where the payee concurrently receives and pays interest to the withholding agent, e.g., a customer who has both a debit balance and a credit balance with a broker, since the Ways and Means Committee Report (H. Rept. 1447, p. A139) states that "the term 'payment' includes constructive payment." However, the point deserves clarification.

B. *Dividends.*

Under proposed Sections 3461 and 3462, every person who pays a dividend must deduct and withhold a tax equal to 20% of the amount thereof. The term "dividend" means any distribution which is a dividend as defined in section 316 and any payment made by a stock broker to any person as a substitute for a dividend. Exceptions from the term "dividend" include the following: distributions in stock or rights which are not includible in the recipient's gross income under section 305; any distribution to the extent that it is treated as an amount received on the sale or exchange of property or on which gain or loss to the recipient is not recognized; any amount which is included in gross income as a taxable dividend by reason of section 302, 306, 356 or 1081(e)(2) of the Code; amounts paid by a corporation which has filed a consolidated return for the preceding year with the payee corporation; any amount subject to withholding under sections 1441-1442 (relating to payments to nonresident aliens and foreign corporations); and any amount paid by a foreign corporation not engaged in trade or business within the United States. Under section 3462(b)(7), the term "dividend" does not include "any amount described in section 1373 (relating to undistributed taxable income of electing small business corporations) * * *". The Report states (p. A145): "Amounts actually distributed by such a corporation to its shareholders are subject to the requirement of withholding if they are included in the definition of dividends contained in Chapter 25." However, under Sec. 1375(d) distributions by such corporations of undistributed income previously taxed to shareholders are not considered as dividends. This ambiguity needs clarification.

Constructive dividends, e. g., one resulting from cancellation of a stockholder's liability to the payor, as well as property dividends, would be subject to withholding; and apparently this would be true of any payment for the benefit of a shareholder by any corporation having an earned surplus. It is difficult to believe that if withholding upon dividends were limited to cash payments, the objectives of the Bill would be seriously jeopardized. Also it seems unreasonable to render the agent liable for penalties and additions plus exposure to criminal sanctions for failure properly to deduct and withhold where the tax is in fact paid by the taxpayer.

II. Withholding Procedures.

Under the proposed system, the withholding agent will simply remit or credit to the payee 80% of the amount otherwise payable and remit 20% thereof to the District Director; no receipt for, or any notice whatever respecting, such remittance of tax will be issued to the payee. In his return, the payee will "gross up" the amount received or credited by adding 25% thereto, reporting the higher amount, and under proposed section 39 (Bill Sec. 19(b)(1)), credit may be claimed for the amount withheld "against the tax imposed *** for the taxable year in which such amount is received." The words "or accrued" should be added to enable accrual basis taxpayers to match the credit against the accrued income. A parent may claim credit for taxes over-withheld in respect of payments to a dependent child, if the latter has filed no claim for credit or refund with respect thereto. While these procedures tend to minimize the inconvenience and expense of the system to payors, the Service will be able to make only a token verification of such credits, the credits will further complicate return forms which will have to be expanded to differentiate between items which are "grossed-up" and those upon which tax has not been withheld, and even with the simplest forms and instructions, the record-keeping burden of small taxpayers will be substantially increased.

III. Exemption Certificates.

The Bill endeavors to mitigate the hardship from withholding of taxes in excess of the actual tax liability of low-bracket or non-taxable recipients by various measures, including (i) filing of exemption certificates, (ii) provisions for quarterly refund claims, and (iii) the allowance of credits for taxes withheld upon payments to withholding agents against their own withholding liabilities and/or liabilities for withheld employment and wage taxes. The magnitude of the over-withholding problem and the inadequacies of the above measures fully to relieve its impact, is evident from testimony and statistics presented in the 1961 Hearings of the Ways and Means Committee, the Minority Report upon the Bill, in recent statements by the Commissioner of Internal Revenue and statements during the House debates upon the Bill, for the accuracy of which, however, this Committee cannot vouch. Thus, it is stated that in the case of a married couple, each over 65 with no dependents, having only dividend income and claiming standard deduction, a 20% rate will result in over-withholding on all dividends received under $24,950 (or under $32,103 if deductions equal 13% of adjusted gross income); and if the same persons receive only interest subject to withholding, over-withholding will result if the standard deduction is used, on all amounts received under $19,000 (or under $24,384 if the deductions equal 13% of adjusted gross income). See Hearings, Vol. 3, pp. 2389-2391. It seems illusory to say, as do proponents of the Bill, that over-withholding will not affect low-income persons over age 18 in view of their right to file exemption certificates. In order to file such certificate, such person must reasonably believe that

> "He will not (after the application of credits against tax provided in Part IV of Subchapter A of Chapter 1, other than the credits under sections 31 and 39) be liable for the payment of any tax * * *."

Part IV covers five pages of the Code, and the complex rules of proposed section 39 require three pages of the Bill. Thus, even with the simplest forms and instructions, and assuming such person can differentiate between the items of income for which certificates are permissible, many individuals, mindful of possible civil and criminal sanctions, will not undertake such filing, particularly if the amounts are small, nor, once withholding occurs, will they undertake to file the equally complex quarterly refund claim discussed below, for the same reasons. Under these circumstances, it seems clear that, because of the small amounts involved, and the complexity of the exemption certificate and quarterly refund procedures, the government will be unjustly enriched, in many cases, by receipt of substantial amounts to which it is not entited; and this is the basic and principal objection to the proposed withholding system.

Proposed Section 3483(a) prescribes the classes of payees entitled to file exemption certificates, as follows:

1. If a certificate is filed by an individual under age 18, any amounts thereafter payable by a withholding agent to such individual and before the beginning of a calendar year during which he will attain age 18 are, with the exceptions noted below, exempt from withholding. A separate certificate must be filed with each withholding agent from which such individual is entitled to receive payments otherwise subject to withholding.

2. As noted above, if an individual who has attained age 18 during the calendar year files a certificate stating his reasonable belief that he will not, after application of certain credits allowable under Part IV, Subchapter A, Chapter 1, be liable for payment of any taxes for the taxable years covered by such certificate, then all amounts payable by the withholding agent to such individual, with exceptions noted below, during the period such certificate is in effect shall be exempt from withholding.

3. A tax-exempt organization (other than a cooperative described in section 521) upon filing a certificate showing its exemption, shall be exempt from withholding upon (i) interest on bank deposits, (ii) interest on amounts paid by a mutual savings bank, savings and loan association, building and loan association or similar organization described in proposed section 3452(a)(3), and (iii) amounts realized upon surrender or redemption of certain noninterest bearing obligations of the United States issued on a discount basis, but shall not be exempt with respect to dividends and interest payments on corporate securities.

4. Under regulations prescribed by the Secretary, exemption from withholding may be extended to (i) amounts, other than dividends, paid to nominees, (ii) any amounts paid to custodians, and (iii) any amounts paid jointly to two or more individuals.

5. In no event will an exemption certificate prevent withholding upon interest on corporate securities, interest on U. S. obligations (except certain discount obligations) or in respect of transferable certificates or shares issued by an organization specified in paragraph 3(ii) above.

The operation of the foregoing provisions is illustrated in the following table:

EXEMPTION CERTIFICATES ALLOWABLE

	Interest: Bank Deposits	Interest: Corporate Securities	Savings & Loan Association Payments	Interest: U. S. Obligations		Dividends
				Int. Bearing	Ser. E Bonds	
Persons under 18	Yes	No	Yes No *	No	Yes	Yes
Persons over 18	Yes	No	Yes No *	No	Yes	Yes
Foreign governments, states, and tax-exempt organizations	Yes	No	Yes No *	No	Yes	No
Nominees**	Yes	No	Yes No *	No	Yes	No
Custodian**	Yes	No	Yes No *	No	Yes	Yes
Jointly-held investments**	Yes	No	Yes No *	No	Yes	Yes

* applies to transferable certificates or shares.

** to be prescribed by regulations.

While Section 19 represents a commendable effort to avoid undue burdens and expense to payors, the above exemption provisions are, in many respects, illogical and discriminatory. Why, for example, must an exempt organization submit to withholding on dividends and be deprived of such amounts for as long as a year (not being eligible to file quarterly refund claims discussed below, and in many cases, unable to credit such amounts against payments which would otherwise be required with respect to withheld employees' income taxes and social security taxes) when the much broader class of persons under 18 is relieved therefrom? Why, in the face of their total exemptions from tax under sections 116 and 892, must the relatively few states and foreign governments submit to withholding on dividends and corporate bond interest? And why should not corporate bond interest paid to a child, as well as dividends, be exempt from withholding? The Committee Report (p. A150) states that " * * * the exemption may not be extended to dividends on stock held in a street name." This could seriously cripple the use of nominee registrations widely used for many years by banks and trust companies to facilitate transfers and deliveries of securities. (Hearings, Vol. 3, p. 2558.)

IV. Quarterly Refund Claims by Individuals.

A. *Who May File.*

A refund claim may be filed respecting tax deducted and withheld upon amounts received by an eligible individual during any quarter (other than the fourth quarter of his taxable year) and respecting any tax deducted and withheld on amounts received by him during any prior quarter of such year but with respect to which no allowable claim for refund has been filed, limited to the amounts discussed below, except that refunds shall be made pursuant thereto only if the amount claimed or allowable exceeds $10. The following individuals are eligible to file such a claim:

1. a single individual who reasonably expects that his gross income for the taxable year will not exceed $5,000;

2. a married individual who reasonably expects that his aggregate gross income and that of his spouse for such year will not exceed $10,000;

3. a head of a household, or a surviving spouse (as defined in section 2(b)) who reasonably expects that his gross income for such year will not exceed $10,000; and

4. any child who reasonably expects that no deduction would be allowed for him to his parent under section 151(e)(1)(B) for the latter's taxable year, beginning with or within the calendar year in which such claim is filed. Since the term "child" is not defined except perhaps indirectly by the reference to section 151(e)(1)(B), detailed regulations will be needed with respect to the age at which a child can competently determine that no deduction will be allowable for him under section 151 and to enable the parent or guardian, in proper cases, to file the requisite claim.

B. *Limits Upon Refund.*

In no event may a refund under this provision exceed a claimant's "refund allowance" as of the time the claim is filed. The "refund allowance" (definition of which covers a full page of the Bill) is an amount equal to the *excess* of 22% of (i) the deduction for present exemptions, plus (ii) the retirement income credit (as defined in section 37(c) and limited under section 37(d)) for the taxable year, less (iii) amounts (other than the amounts subject to withholding under Chapter 25) which the claimant reasonably expects to be included in gross income for such year, *over* any taxes with respect to which an allowable claim has been previously filed under this provision during said year. It seems certain that even with the simplest forms and instructions, many persons entitled to relatively small amounts will not file claims therefor.

C. *Processing of Claims.*

A basic objection to the quarterly claim procedure where the claimant need not, indeed cannot, furnish any supporting proof of over-withholding, is that it may lead to wholesale erroneous or fraudulent claims of which there will be no possibility of advance verification since, as Chairman Mills has stated (Cong. Rec. March 28, 1962, p. 4880), refunds are to be made in two to three weeks after the claim is filed.

V. Special Procedures and Credits.

A. *States and Other Tax-Exempt Organizations.*

Under proposed section 3505 (Bill sec. 19(d)(1)), a state or tax-exempt organization (other than a cooperative described in section 521) will be allowed a credit respecting taxes withheld under Chapter 25 upon amounts received during a calendar quarter against such person's liability for such quarter respecting FICA taxes and withheld taxes on wages, providing claim therefor is made at the time of filing of returns covering the latter taxes. If the withheld tax is not claimed currently as a credit under proposed section 3505, no such credit may be claimed for a later quarter against FICA and withheld employees' income taxes. If the tax withheld upon amounts paid to such state or exempt organization exceeds amounts taken as credits under section 3505, then the excess is subject to refund under proposed section 3485 (Bill section 19(a)(1)). This credit mechanism will, of course, be unavailable to such entities as a foreign government, international organization or a foreign central bank of issue, and it is not clear from section 3485 whether such organizations may file quarterly claims or only an annual claim for refund after the close of the taxable year. If quarterly claims may be filed, section 3485 should clearly so provide. Otherwise, such entities should be made eligible to file exemption certificates under proposed section 3483, since it would be questionable policy to deprive such entities of their income for a year or longer. Also, the credit system will afford no relief to an exempt organization which has substantial income subject to withholding but only a few employees.

B. *Corporations.*

Since the effective rate of tax upon dividends paid to corporations and subject to withholding will not exceed 7.8%, over-withholding of tax in respect of such dividends will result in such cases and involve an overpayment in the case of any corporation operating at a loss or entitled to a net operating loss deduction. Under proposed section 3487, a corporation may offset the tax withheld under Chapter 25 upon amounts paid to it against tax it is required to withhold under such provisions; and, under proposed section 3486, withheld amounts not so credited are subject to refund upon the filing of a claim therefor after the close of the quarter to which it pertains and on or before the close of its taxable year. While the closing sentence of section 3486(a) should not be construed as cutting off the right to file a refund claim in the regular course within the normal period therefor, the sentence should clearly so provide.

Beyond this, it is believed that corporations thus subjected to over-withholding (whether by reason of their not having paid dividends or other amounts subject to withholding or otherwise) should be entitled to claim credit for any such excess against their liabilities for such quarter in respect of FICA taxes or withheld employees' income taxes. It seems particularly unfair that a corporation having an operating loss and needing its investment income for working capital, should be penalized by having to forgo such income until after the close of the taxable year involved.

C. *Nonresident Aliens.*

An exclusion from interest and dividends subject to withholding under chapter 25 is provided in sections 3452(b)(5) and 3462(b)(5) with respect to payments to nonresident aliens and foreign corporations; see the Committee's statement (p. 88) that chapter 25 does not apply to payments "made to non-resident aliens or foreign corporations where there already is a special form of withholding by the payor under present law, * * *". However, 20% withholding will apply to such payments under proposed amendments of sections 1441 and 1442 (Bill section 19(c)(1)) providing that in respect of amounts described in sections 3452(a) and 3462(a) the tax required to be deducted and withheld under sections 1441 and 1442 shall not, by reason of the provisions of any treaty, be less than 20% of such amounts. Apparently, it is not intended by this provision to modify treaties fixing a lower withholding rate since, with respect to section 19(c)(1), the Committee Report states (p. 93):

> "This, of course, does not change the actual rate of tax in such cases and any excess amounts withheld can be recovered by the alien through refund claims."

It seems questionable policy to deprive citizens of treaty countries of portions of their income and subject them to the burden of filing refund claims. However, if this is essential to the withholding system, it seems that such persons should be entitled to file quarterly refund claims.

D. *Nominees.*

Section 19(c)(2) of the Bill would add new section 1444 to the Code. Under this provision, a nominee who at present would deduct U. S. tax at the 30% rate or treaty rate respecting payments to a nonresident alien or foreign corporation, will notify the payor that the nominee is required to deduct tax upon such payment pursuant to section 1441 or 1442, whereupon the payor will deduct such tax at the 20% rate from amounts paid to the nominee for transmittal abroad; and the nominee shall be entitled to a credit against its liability to withhold tax under section 1441 or 1442 for amounts so deducted and withheld for the payor under chapter 25. Where, in the absence of a treaty, the 30%

rate applies to such payments, the nominee will, or course, withhold an additional 10% of the amount which was initially due from the payor to such nonresident alien or foreign corporation.

* * * *

Upon consideration of the testimony and data on this subject presented to the Ways and Means Committee in 1959 and during the 1961 Hearings, plus the statements in the Majority and Minority Reports of the Committee respecting the Bill and during the House debates thereon, the Committee believes that the magnitude of the over-withholding problem and resulting unjust enrichment of the government from receipt of small amounts to which it is not entitled, justify and require substantial broadening of the exemption and relief provisions along the lines discussed above.

* * * *

TAX SECTION

NEW YORK STATE BAR ASSOCIATION

Report on the Portion of the Revenue Bill of 1962, H.R. 10650

as adopted by the House of Representatives on March 29, 1962

relating to

Entertainment Expenses
Earned income from sources without the United States and Foreign Investment Companies

Committee on Personal Income Taxation

Carbery O'Shea, *Chairman*

Renato Beghé
A. B. Chapman, Jr.
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Entertainment Expenses

Section 4 would add a new Section 272 to the Code to disallow certain entertainment expenses and business gifts, otherwise deductible as business expenses, with nine defined exceptions and to require substantiation by adequate records or evidence of traveling expenses and any entertainment expenses not otherwise disallowed. It also would amend Section 162(a)(2) relating to allowable travel expenses for meals and lodging.

I. General views on Section 4.

Our Committee condemns most strongly the abuses which occur in the entertainment, business gift, and expense account area. We have serious doubts, however, that Section 4 would eliminate the abuses or add an effective weapon to the arsenal the Internal Revenue Service now has.

The Internal Revenue Service today has adequate means to eliminate the "expense account way of life" which some taxpayers follow to provide themselves with "deductible" personal living expenses. What has been lacking is strict enforcement by the revenue agents. Far too often are overstated or personal entertainment expenses, entertainment having only remote connection with business, and ridiculously high entertainment and travel expenses allowed or compromised by a revenue agent who has made an inadequate check of the records or facts. Negligence and fraud penalties in abuse cases are seldom imposed. Substantiating records or corroborating proof is too infrequently demanded or checked. There is too much publicity about what entertainment and business expenses are taken or "gotten away with," and far too little on what the Service will not tolerate and what the "cost" is to the taxpayers who are caught.

Legislation outlawing certain entertainment expenses will do little to improve tax morality. The reason is simply that a particular expense in one instance can be a truly proper and fair business expense, but under other circumstances deduction of the same item of expense by another taxpayer may be a fraud on the revenue.

The first taxpayer would be outraged that his true business expense is not deductible as an entertainment expense. Today he honestly lists it as a proper deduction; tomorrow, if outlawed by statute, he may be sorely tempted to adopt subtle and surreptitious means to obtain the tax benefit of his expense. His tax morality is then lowered or destroyed. One need only recall the era of prohibition, or OPA price restrictions to realize that legislation unfair to the honest, breeds violations and general disrepect for the whole law. The taxpayers today who are abusing the entertainment expense deduction will be hampered a little, but will find a way out. They always do.

Our Committee believes that the vast majority of businessmen honestly deduct or charge for only properly allowable entertainment expenses really having a necessary and direct relation to their business. When they travel their meals, lodging and expenses are not exorbitant. It is the minority who abuse the deduction privilege. It is not difficult to spot them and for the revenue agents to deal severely with them. Because the concentration is not on this minority, the numbers are perhaps increasing each year rather than decreasing. The Service today has all the remedies it needs: substantial or total disallowance of estimated expenses of items as to which written records are not difficult to keep, or of expenses as to which direct business relationship is not shown or is too remote, or imposition of fraud or negligence penalties where clear or deliberate abuse appears. There are still untried administrative procedures such as perhaps no allowance by the revenue agent of entertainment expense deductions until after review or with permission by a special group of agents in each district office. Other procedures are available.

II. Technical aspects.

(a) Proposed Section 274 is unnecessarily long and complex. This arises from the negative approach adopted, namely, that no entertainment expense is an allowable deduction, unless (1) the taxpayer establishes it directly relates to the active conduct of his business or the entertainment facility likewise meets that test and primarily is used to further his business, except that such rules are waived in nine specific cases which normally are not thought of as involving entertainment and (2) it is substantiated by records or corroboration.

Subsections (d) through (e) and (g), comprising 81 lines of print, could be eliminated by drafting subsections (a) and (b) in the affirmative, namely by providing that a deduction otherwise allowable as a business expense shall not be allowed as a deduction if it is for an entertainment activity or facility or a gift, as defined therein, unless the taxpayer establishes the requirements stated in subsections (a)(1)(A) or (B), or if it is a gift the amount is not over $25.

To establish under present law that an entertainment item is an ordinary and necessary expense, it must be shown to be directly related to the active conduct of the taxpayer's business. It is difficult then to see what section 274(a)(1) and (2) adds to the Code. We recognize that the Committee Report states requirements not expressed either in the present or proposed statute, such as for example, that the entertainment be in a place conducive to business discussions or negotiations. We can only assume these statements in the Committee Report are inadvertent references to prior drafts of the proposed statute since no such requirements are now in proposed Section 274. Otherwise we must vigorously object to legislation by committee reports. If this is what Congress really intends it should expressly so provide in the statute. Oblique insertions of such requirements in exceptions, such as subsection (d)(1), is too indirect a method of expressing legislation.

(b) Subsection (b)(1), second sentence, should be amended to make clear that it will not apply to the payor or payee of payments to widows of deceased employees.

The courts generally hold that such so-called reasonable salary continuance payments to widows are gifts. The second sentence of subsection (b)(1) should expressly provide that it does not apply to payments treated as a gift to widows or relatives of a deceased employee whether the amount be over or under the $5,000 amount in Section 101(b) of the Code.

It must be pointed out that $25 is so small in amount that it can only lead to subterfuges. To illustrate, a man invited to dine at the home of another in connection with a business matter can send an appropriate flower plant or other gift costing $25 to his host's wife in appreciation for her efforts, but he cannot dine there again and so express his appreciation. Must he the second time send the flowers or gift to the children or the husband or to their favorite charity?

(c) Subsection (c) intends to, but may not really abolish the *Cohan* case rule. "Sufficient evidence corroborating his own statement" can be interpreted to spell out the basis underlying the *Cohan* rule.

If the word "amount" means, as the General Explanation stated, the "exact amount" then the provision may be intolerable. Receipts for every expenditure for a taxi, the tip for a waitress, etc. will make enforcement a farce. If the Secretary makes sensible and flexible regulations which fit varying circumstances, then this provision for substantiation by records will greatly aid, in our view, the proper enforcement of entertainment expense deductions. If, on the other hand, it is based merely on a percentage of the government per diem allowance (which may have little relation to the expenses of a busy sales manager), then little will be done to bring about better self-control by taxpayers of these types of business expenses.

(d) Subsection (d)(1) will be a revenue agent's dream. If he is a Yankee baseball fan, he may consider it sacrilegious or impossible to discuss business when Mantle is at bat. And yet many a businessman knows it might be the exact moment to cinch the order he seeks from his guest. Depending upon his own personal experiences or proclivities one revenue agent may think a bar is conducive to business discussion, while another thinks the contrary. The inconsistencies which will result will be irritating to taxpayers.

(e) Subdivision (d)(6) should be amended to add the word "directors." A director's meeting is not a stockholders meeting, and directors may not be employees.

(f) Subsection (d)(7) should be amended to include business meetings and conventions of professional organizations, such as bar and medical associations, even if they are not described in Section 501(c)(6) and exempt from taxation under Section 501(a). Some bar associations are not so exempt because they advocate legislation for court reform or improvements in local codes of procedure or even the Internal Revenue Code. Obviously, expenses of attending a bar association meeting or convention should not be denied merely because it may not be tax exempt. The same holds true for many other types of organizations.

(g) Subsection (f) is confusing. A facility, such as a company automobile, may be primarily used to further the taxpayer's business, but in a particular instance used for pleasure. Under subsection (a)(1) it would be a proper business facility under paragraph (B) thereof, but the depreciation deduction or gasoline deduction for the particular pleasure use, of course, should be denied. Subsection (f) would, however, attempt to make the portion of the automobile represented by the single pleasure drive not a business asset.

The trouble, of course, with all these exceptions is that exceptions entail specification, and specification always leads to omissions, inequities and loopholes. By redrafting the entire Section in a non-negative manner the exceptions can all be eliminated, the Section greatly shortened and all the difficulties inherent in these exceptions avoided.

(h) Subsection (g), of course, is unnecessary and redundant. Section 7805 of the Code already provides all, if not more, authority than subsection (g) would grant to the Secretary.

(i) Section (b) of Section 4 makes what appears to be an innocent amendment of striking from Section 162(a)(2) relating to traveling expense the words "entire amount" in the phrase "including the entire amount expended for meals and lodging" and substituting for the words "the entire amount" the words "a reasonable allowance for amounts." Since to be allowable at all today, the amounts expended for meals and lodging must be ordinary and necessary business expenses, only such part of the entire amount expended as is reasonable and necessary can be deducted. Income Tax Regulations § 1.162-2 so provides.

If the words "reasonable allowance" in the proposed change are to be interpreted to mean the amount is to be "ordinary and necessary," then the only objection to the change is that it is unnecessary since such is the law today. If, on the other hand, the words "reasonable allowance" mean what the revenue agent thinks should be a reasonable allowance, then a Pandora's Box will have been opened. It will lead to innumerable controversies, or worse still to fraudulent "padding of expense accounts" with incidental traveling expenses to make up the difference between the amount for meals the agent thinks is a reasonable allowance and the amount spent which is in fact an ordinary and necessary business expense.

If businessmen while traveling are to be limited to "a reasonable allowance" determined by Treasury Regulation based on a government per diem or percentage thereof, or determined by the varying concepts of particular revenue agents (who may think that if the second-rate hotel is good enough for the poor government employee who must make ends meet on his per diem then it is good enough for the businessman), the proposed change in Section 162(a)(2) may cause more resentments and more costly minor controversies by more taxpayers than anything in the Bill. Taxpayers are in favor of closing loopholes and stopping tax abuses, but above all they resent bureaucratic regulation which would tell them that what they honestly spend as ordinary and necessary is not deductible because it exceeds what some unknown bureaucrat says is a "reasonable allowance."

In the interests of better taxpayer relations to improve our self-assessment system, Section (b) of Section 4 of the Bill should be deleted.

Earned Income from Sources without the United States

Section 12 would make various amendments to Section 911 (relating to earned income from sources without the United States) and amend Sections 72(f)(2) (relating to the computation of the employees' contributions to his cost for an annuity).

I. Recommended technical changes.

A. Section 911(c)(2) has the purpose of determining the excludable amount by relating the earned income payments to the year the services are performed. In theory this is unobjectionable; in practice, however, it may lead to many or unnecessary refund claims. Thus, an individual may receives $5,000 in December 1964 as an advance salary for him to start working abroad on January 1, 1965. Under the claim of right doctrine this may be taxable to him in 1964. In 1965 for services he receives the remaining $15,000 on his $20,000 annual salary for services performed abroad. In all fairness he should be entitled to exclude the entire $20,000 since it is received for foreign services. Under Section 911(c)(2) he would claim exclusion in 1965 for both the $5,000 received in 1964 and the $15,000 received in 1965 since they are "considered received in the taxable year" he performs the services. He must, therefore, claim refund for the unnecessary tax paid for 1964 on the $5,000 advance salary. This difficulty could be eliminated by inserting after the word "received" the words "for services performed or to be performed", and before "in the" the word "only".

B. Section 911(c)(4) in plain fairness should be amended so as not to apply to unusable blocked foreign currencies or amounts which the taxpayer cannot obtain until disposition of a law suit or other claim to recover the earnings be made abroad. It is unfair that salary which cannot be received by reason of foreign exchange restrictions, nationalization of the foreign corporation for which he worked, or until disposition of a bona fide salary law suit, should be denied exclusion when the delay in receiving the money must await final disposition of these matters. This could be remedied by inserting at the end of Section 911(c)(4) the following: "unless the taxpayer shows to the satisfaction of the Secretary or his delegate that the amount could not inure to his benefit during the foregoing period by reason of governmental restrictions of the foreign country or until the disposition of a claim, action or other proceedings to recover such amount."

While Section 911(c)(4) is designed to prevent exclusion of amounts received over a number of years, perhaps long after the person has ceased performing his services, by spreading income through use of deferred compensation and similar arrangements, it may be questioned whether Americans working abroad should be denied the exclusion merely because of such delay in receipt. Spreading income over a number of years may be the only way of protecting an American against high foreign taxes, discriminatory foreign taxes imposed against "foreigners," or foreign currency restrictions. The deferred compensation arrangement coupled with an appropriate exclusion may be the necessary inducement to the executive for him to go abroad to perform a task of great benefit to our country. Section 911(c)(4) is based on the premise (which is just not so in many cases) that Americans working in all foreign countries, including less developed countries, enjoy the same protection, privileges and benefits existing in our country.

C. Section 911(c)(5)(B) is consistent with the theory of subsection (c)(4). The two should stand or fall together. Section 911(c)(5)(A), however, is too harsh. An American working abroad who remains under the American retirement pension plan usually receives the same benefits as his associates working in the United States. In such a case it is logical that both should be taxed alike as Section 911(c)(5)(A) provides. However, as is frequently the case, the American working abroad must come under the retirement plan of the foreign subsidiary or of an independent foreign corporation for which he works. Such foreign plans normally provide much smaller benefits than do American plans due to the lower salary scales or special conditions existing abroad. The exclusion of his retirement income earned for services performed abroad then becomes an important means of putting him, to some degree, on a parity with the person retiring under an American pension plan. Perhaps Section 911(c)(5) should be limited only to persons covered by an American pension plan providing the same benefits for persons working abroad or in the United States, or reduce the excludable amount for pensions by the amount similar employees covered by an American plan must include in their gross income.

II. Policy Problems.

As to the Section 911 amendments, some comments on policy of Section 911 may be appropriate. In the light of international trade and dollar drain problems of our country many persons feel that there should be a reconsideration in depth of the basic policy of Section 911.

Many feel that our country would gain much more by adopting, as almost all other countries have, the policy of not taxing citizens or residents on their earnings from working abroad. Other countries find that this tax inducement leads to its citizens working abroad with the natural result that such persons direct businesses, and arrange for purchases of machinery and other articles from, their home country, rather than other countries. In addition, they send money earned abroad back to their home country, thereby increasing its wealth and gold reserves.

Again whether a true bona fide resident of a foreign country for a lengthy period should be free from taxation on his earned income, or even be taxed as a nonresident alien, deserves some study. Having thrown his lot with the foreign country, is it fair for the United States to tax him in the same manner as if he resided here?

The words "bona fide resident" is so elusive that consideration might be given to whether a time period requirement for such nonresidence may be one means of preventing the abuses which have occurred in recent years. Study might be made of whether the seventeen months' requirement should be reduced to a considerably shorter period in order to encourage Americans to take positions abroad. Whether or not the distinction between persons falling within the resident or seventeen months rules should be preserved, it is difficult to justify the allowance of the $35,000 exclusion to a person who has been a bona fide resident of a foreign country for three years, but to limit the exclusion to $20,000 in the case of the seventeen months' man who actually has worked abroad for over three years, merely because he retains his American residence.

Most serious consideration should be given to whether the $20,000 limit is not entirely too low. It should certainly be high enough to induce our more able executives, managers and engineers to take positions of responsibility abroad where they can be in a position to direct more purchases of heavy industrial and other products from our country, which today are being purchased from Germany or other countries by the present foreign managers of such purchasing companies. It is understood that many instances of this exist, with consequent damage to our foreign trade and economy. The loss of revenue by increasing the limitation may be far less than the millions lost by American goods not being sold abroad in sufficient quantities. Generally, it is probably true that little, if any, U. S. dollar exchange would be lost by increasing the limitation since most personal service income earned abroad is paid either in foreign currencies or in American dollars remitted to the United States.

Your Committee takes no position on any of these policy views. It does favor, however, an overall and impartial study of the effect of Section 911 on our foreign trade and general economy, on our ability to compete and sell abroad, on our dollar exchange and on areas of tax abuse. In this way it can then be decided what type of provision should be adopted which will serve the best interests of our country.

Foreign Investment Companies

Section 15 would add new Sections 1246 and 1247 to the Code to be effective for years beginning after December 31, 1962. In essence the objective is to discourage by onerous tax provisions U. S. citizens and residents from investing in or continuing to hold stock of a foreign investment company and to force their liquidation.

I. General observations on Section 15.

Strenuous objection can be made to what the Committee Report on p. 72 describes as the "tax avoidance" involved in foreign investment companies. It describes such companies as having (1) no U. S. securities and, therefore, no U. S. source dividends and interest, (2) making no current dividend distributions, as U. S. regulated investment companies do to avoid tax by "passing" 90% of their dividend income on to their shareholders, and (3) reinvesting their earnings in growth investments, (4) so that Americans can avoid tax by investing in such companies and later selling their stock as a capital gain. Obviously such a situation does not involve tax avoidance or anything improper. It is no more to be condemned than would the American investing in any ordinary growth foreign corporation which does not ordinarily declare dividends but reinvests its earnings who makes a capital gain sale when the stock rises in price.

The tax avoidance situation which does exist, and which our Committee heartily favors being eliminated, is the foreign investment company which operates like the so-called Canadian investment company. Fortunately Section 15 is directed at this tax avoidance and not that described in the Committee Report.

The tax avoidance foreign investment company is one which (1) does invest in U. S. securities with the result that its dividends from U. S. sources are subject under a Tax Convention to U. S. tax at only a 15% withholding rate (2) has no U. S. business and makes its capital security transactions abroad so it has no other U. S. tax and because it is foreign owned has little Canadian tax, and (3) declares no dividends so that U. S. shareholders never have ordinary dividend income, (4) with the result that the U. S. shareholders are expected to make their profit by sale of their stock at the capital gain rate. In effect the U. S. shareholders receive at the capital gain tax rate the benefit of the U. S. dividends on which only the 15% Treaty rate withholding tax has been paid.

II. Technical aspects of Section 15.

(1) Proposed new Section 1246 would treat gain from the sale or exchange (made after December 31, 1962) of stock in a foreign investment company, as gain on the sale of a non-capital asset to the extent of the taxpayer's ratable share of the corporation's earnings and profits accumulated for years beginning after December 31, 1962. This Section will not apply if Section 1247 applies.

Section 1246(a)(1) applies this rule if the foreign corporation is a foreign investment company *at any time* during the period the taxpayer held such stock. The American taxpayer should be charged with ordinary income on the sale of his stock to the extent of his ratable share of the earnings and profits accumulated only while the foreign corporation is a foreign investment company. To tax him as ordinary income on earnings accumulated in years when it was merely a foreign corporation is inequitable. This could be eliminated by inserting at the end of Section 1246(a)(1) the phrase "in which at any time during such a taxable year it was a foreign investment company."

(2) By Section 1246(a)(2) the taxpayer's ratable share of the accumulated earnings is limited to the earnings (A) for the period during which he held such stock, but (B) excluding earnings taxed to him under Section 951 (controlled foreign corporation provisions) or Section 551 (foreign personal holding company). While the (A) limitation is apparently intended as a relief provision for the tax-

payer, it is objectionable on two scores: first, it is subject to the objections pointed out in paragraph (1) above, and second, it will cause enormous complications. Corporate earnings and profits are invariably determined only on an annual basis. Any other determination is merely tentative and subject to various adjustments. How the determination could be made "for the period," i.e. the number of days during which the taxpayer held his stock would be so impractical to determine that the statutory relief supposedly given would become practical nightmare. Particularly is this so since under Section 1246(a)(3) the taxpayer has the burden of establishing the amount of the corporate accumulated earnings and his share thereof.

If the suggested amendment to Section 1246(a)(1) made in paragraph (1) above is adopted, the taxpayer will be given the real relief to which he is entitled and Section 1246(a)(2)(A) should then be eliminated.

(3) Section 1246(a)(3) provides that all the gain will be ordinary unless the taxpayer establishes "the amount" of the corporate accumulated earnings and his share thereof. It is too harsh to tax *all* the gain as ordinary income merely because the taxpayer cannot show the exact amount of accumulated profits. Few taxpayers could meet this burden without the fullest cooperation from the foreign corporation. Only a large controlling shareholder is in a position to demand such cooperation. The little shareholder would, therefore, be the one who pays ordinary tax on his entire gain.

The provision at the very least should be altered to provide that to the extent he establishes that his gain is not gain taxable to him under Section 1246(a)(1), he can treat it to that extent as gain from the sale of a capital asset. A similar change should be made in Section 16 of the Bill wherein Section 1248(d) imposes the same burden in connection with gain from certain redemptions, liquidations and sales of stocks to foreign corporations.

(4) Section 1246(b) includes as a foreign investment company a foreign corporation investing or trading in securities at a time when over 50% of the voting power or the value of all classes of stock is held directly or indirectly, (with stock ownership attribution rules applying) by U. S. persons. This is broad enough to encompass a U. S. owned foreign holding corporation owning the stocks of various operating companies, which is not really an investment company of the kind Section 15 is intended to cover. Not even the limitations in Section 1248(c), applicable to exempt from the somewhat similar ordinary gain sale provision in Section 16 of the Bill, apply to alleviate. This is entirely too harsh and probably was not intended.

To limit Section 15 to the true foreign investment company, Section 1246(b)(2) should be amended to change "the business of investing, reinvesting" to "the business of actively investing and reinvesting,". This change should eliminate from the Section the holding company which does not operate like an investment company.

It should also be mentioned that whether Section 1246 will apply to a particular shareholder, may depend upon whether 50% of the stock is owned under the attribution rules by Americans. This may be appropriate for personal holding companies which have only few shareholders, but it is an impractical test where there may be many stockholders or the stock may be bearer stock.

TEXACO, INC.,
New York, N.Y., May 1, 1962.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance of the Senate,
Senate Office Building, Washington, D.C.

MY DEAR SENATOR BYRD: I am greatly concerned over proposals in H.R. 10650, now being considered by your committee, that would require income tax withholding from payments for dividends and interest. Such legislation, in my opinion, is detrimental to the best interests of our country and should not be enacted.

Income tax withholding on dividends and interest is basically unsound. Across-the-board withholding, without provision for variations and exemptions, results in gross overwithholding with numerous adverse consequences, including financial hardship to persons living on modest, fixed incomes. If variations and exemptions are provided in an attempt to do equity, severe and expensive administrative burdens are placed upon payors. The provisions of H.R. 10650, in seeking a middle ground, combine the undesirable features of both extremes. Furthermore, any type of withholding on dividends and interest would, without increasing tax collections, siphon off into consumption channels savings dollars that otherwise would be left by investors to accumulate in their savings or investment accounts.

The proposed withholding also is unnecessary. The combination of information returns, taxpayer identification numbers, and automatic data processing methods, if adequately utilized and supplemented by an appropriate audit program, should enable the Internal Revenue Service to eliminate any underreporting of dividends and interest. Failure to utilize these means is not a reason for resorting to the extreme measure of withholding.

Our views are presented in more detail in the attached statement, which I respectfully submit for your consideration.

Very sincerely yours,

AUGUSTUS C. LONG.

STATEMENT OF TEXACO, INC., WITH RESPECT TO WITHHOLDING OF INCOME TAX ON INTEREST AND DIVIDENDS AS PROVIDED IN SECTION 19 OF H.R. 10650

Texaco believes that income tax withholding on dividends and interest is detrimental to the public welfare, and accordingly that section 19 of H.R. 10650 should not be enacted.

Withholding proposals of this nature have been before Congress four times in the last two decades, and it has become obvious that any procedure for withholding on interest and dividends will result in gross overwithholding with consequent financial hardship to many persons, in severe administrative complexities and expense to payors of dividends and interest, or in a combination of both.

If there were withholding from dividend and interest payments at a 20 percent rate, without consideration of the taxable or nontaxable status of the receipient, there would be overwithholding from large numbers of persons and organizations not subject to any tax and from persons subject to tax, but at a rate less than 20 percent. Such a procedure would be harmful to charitable organizations, employee welfare funds, pension trusts, and to persons with little or no income tax liability. Withholding also would seriously affect corporations receiving interest or dividends, but having no net income.

In all cases of overwithholding, the receipients would be deprived of the use of the withheld funds until refunds could be claimed and granted, and would permanently lose any additional interest that might have been earned during the period of deprivation. Also, overwithholding on dividends and interest income of charitable organizations, pension trusts, welfare funds, and retired and unemployed persons may seriously affect their ability to meet current expenses.

It is also probable that any refunding procedure, aside from administrative problems and expense to the Government, would involve preparation and processing costs which could have a marked effect upon small charities, trusts, etc.

Another result of withholding would be a permanent loss of savings. Savings and loan associations and savings banks ordinarily credit interest directly to the savers' accounts. Thus, interest is automatically saved and begins to earn interest itself. Under the withholding procedure only 80 percent would be credited and saved automatically. There would be a similar loss of savings in stock investment plans, investment trust accounts, etc. Human nature being wha it is, it is unlikely that a cash amount equivalent to the withholding would be added to the account.

There can be no doubt that withholding upon dividends and interest would raise serious problems for many individuals. There would be no provision for receipts or information to payees setting forth the amounts withheld. Due to lack of knowledge or understanding on the part of many persons, it is certain that even with the most carefully drafted provisions covering refund or credits in income tax returns for tax withheld, there would be confusion, errors, frustration, and probably permanent loss to many nontaxable persons. This inescapably leads to the conclusion that the Treasury would be unjustly enriched by this withholding at the expense of those least able to afford the loss. It is furthermore foreseen that corporations and other payors would be subjected to endless explanations to payees as to the handling of their accounts.

There would be a considerable number of savers who would understand the complexities involved in withholding, refunding, and crediting, but who, to avoid the work and irritation involved, would shift their savings into other investment forms, the interest or returns on which would not be subject to withholding. Such shifts in investment might well have serious effects upon the economy.

If, in order to alleviate the hardship and unfairness of withholding without exceptions, provision were made for recognizing each payee's particular tax situation, or for providing receipts for amounts withheld, the task placed upon payors of dividends and interest would present overwhelming difficulties from an administrative standpoint. It is not difficult to visualize a complete administrative breakdown resulting from attempts to adjust withholding rates to the probable tax liability of each recipient of dividend and interest income.

Section 19 of H.R. 10650 attempts to reduce overwithholding by providing that persons who expect to have no tax liability for the year may file an exemption certificate and avoid withholding for that year; individuals under 18 may file exemption certificates and avoid withholding until they reach 18 whether or not they expect tax liability; and exempt organizations, in the case of savings accounts and Government savings bonds, can file exemption certificates. Also, tax-exempt organizations, as well as married couples expecting less than $10,000 gross income and single persons expecting less than $5,000 gross income, if they expect to have less liability for the year than the amount withheld, may file quarterly claims for refund.

Unfortunately, the foregoing provisions of section 19 designed to avoid overwithholding in certain circumstances have the effect of placing severe and expensive administrative burdens on payors of dividends and interest without appreciably relieving overwithholding and financial hardship. As a practical matter, the provision for exemption certificates, inapplicable where there is the possibility of any tax liability whatsoever, will be available only to a few; and the provision for quarterly refunds, with its gross income limitations, is so restrictive that it would preclude refunds to taxpayers who, for such reasons as overwithholding on wages, could demonstrate that they would have no tax due on their dividend and interest income.

Texaco believes that income tax withholding on interest and dividends is undesirable in any form. As pointed out above, across-the-board withholding without exceptions results in gross overwithholding with consequent injustice and financial hardship to many persons. On the other hand, under any system devised to equate withholding to the recipient's tax liability, severe administrative and financial burdens would be placed upon the payors of dividends and interest. Attempts to reach a middle ground, such as in section 19 of H.R. 10650, combine the worst features of both extremes and offer little, if any, relief.

Texaco further believes that withholding of tax on interest and dividends is unnecessary Payors of interest and dividends presently are required to file information returns to the Government where dividends to a recipient exceeds $10 for the year or interest paid to a recipient exceeds $600 a year. Beginning next year, payors must, under legislation enacted but recently, obtain identification numbers from their payees and show the numbers on information returns. These reporting requirements, which themselves place expensive administrative burdens upon payor corporations, together with automatic data processing procedure already being operated by the Internal Revenue Service, and in conjunction with reasonable audit procedures should make it possible to eliminate such revenue loss as exists due to nonreporting of dividends and interest.

Section 19 of H.R. 10650 should not be enacted.

Exports of American Books

Statement of the American Book Publishers Council and the American Textbook Publishers Institute to the Senate Finance Committee Proposing Certain Amendments to Section 13 of H.R. 10650, May 3, 1962

This statement is submitted by the two principal associations of book publishers in the United States. The American Book Publishers Council is composed of c mpanies publishing general and trade books. The American Textbook Publishers Institute has as members companies publishing textbooks and reference works. The members of these two associations do an annual business of well over $1 billion per year (of which some $90 million is exports). This is over 90 percent of the business done by American firms in these fields.

THE BACKGROUND

Since the close of World War II it has been the policy of the U.S. Government to encourage public and private activities designed to project to peoples abroad "a full and fair picture of American life," and to project especially a picture of the educational, scientific, and cultural achievements of the American people. "The battle for men's minds" is now considered a central factor in the strategy of U.S. foreign relations.

The operations of the U.S. Information Agency, now spending over $100 million a year, are perhaps the best knows among the various U.S. efforts in this area. The Department of State carries on an extensive program of educational and cultural exchanges; it has helped to stimulate the scholarship and fellowship programs which bring more than 40,000 advanced foreign students a year to the United States, although the great majority of these students are financed by sources other than the U.S. Government. Because USIA libraries could not possibly secure adequate distribution abroad of U.S. books and periodicals, the Congress 10 years ago established an information media guarantee program to help publishers and others with their currency-conversion problems; this program still functions in certain countries in which normal sales are not possible. Under the AID and Alliance for Progress programs, great emphasis is being placed on the development of education as an important requisite for economic progress. Still another example of the special role books and other cultural materials are recognized to play in modern foreign relations is the Florence Agreement, a treaty approved by the U.S. Senate which exempts such educational materials from tariffs. Some 35 other countries have adhered to this treaty.

The publishing industry has been proud to play its part in the nationwide effort to present America at its best and most thoughtful. In addition, as one of the most rapidly growing export industries it is making a contribution on the financial side of the balance-of-payments problem.

That America must be presented at its best becomes increasingly clear. The French Government was first in the field of what might be called cultural propoganda, with activities to advance the teaching of the French language and to promote French art, dating back to near the turn of the century. Between the two World Wars the German Government launched a program of subsidizing distribution of German scientific and technical reports, on the theory that "trade follows the book." The British entered the field with their "British Council." Now, of course, the Soviets are striving to outdo all other nations in the scale and scope of their efforts to push and promote Russia and Communist books throughout the world.

THE PROBLEM

Books published in the United States, and notably those which can be classified as educational, scientific, and cultural, have enjoyed increasing receptivity abroad in recent years, largely because of their intrinsic merit. They are distributed increasingly in countries where English is not the native language, as well as in English-speaking countries, and, of course, in developed countries as well as underdeveloped countries (and many would rate the value of this to the United States at least as high in the former as in the latter). Our book exports have been growing in the postwar period at a rate of over 10 percent per year and we now rank only slightly behind Great Britain in this export field.

American publishers are now learning how to take greater initiative in selling abroad. Some have established foreign subsidiaries, and others will follow if present experiments are successful. This expansion abroad, actual and potential, could be blocked or handicapped—perhaps inadvertently—if one portion of H.R. 10650, "the Revenue Act of 1962," is approved by the Senate in the language adopted by the House. We refer to section 13 of the bill which would require the immediate taxation of U.S. publishing companies as well as others for the earnings of their foreign subsidiaries unless certain technical requirements were met.

It is a simple thing for U.S. companies to capitalize on a few quick sales in the oversea markets and then withdraw. However, it is another thing to leave the profits in the foreign countries and plow them back into the building of a permanent distribution center for U.S. educational and informational media. With this in mind, it is submitted that those features of the new tax bill which impose an immediate U.S. income tax on the profits of foreign subsidiaries of American companies engaged in distributing educational and informational media abroad are out of harmony with the objectives of U.S. foreign policy and contrary to the best interests of the United States. Such proposals, if enacted, could cause American companies in these fields to "pull in their horns" and to look to the American taxpayer for subsidies and guarantees on their foreign efforts in the future, if any efforts are made. They would also tend to reduce the growth in exports of American books, which is becoming an increasingly important source of foreign exchange earnings for the United States.

One American publisher has said:

"We are just beginning to learn how to distribute our books and other educational materials abroad. I fear that, if this particular provision of the new revenue bill is adopted, we may have to pull out of some of the so-called developed countries where it has begun to expand, and to abandon other expansion projects abroad.

"Our principal product is sets of books, but we also sell other books as well. We are learning how to sell these books by American methods abroad (including in countries where English is not the dominant language) and this means we sell sets of books on the installment plan with the purchasers having 2 years or more to pay. This immediately complicates our problem of financing. We deliver the sets of books when they are ordered, and we pay commissions and maintain our offices abroad, but we don't begin to show cash 'earnings' on the sale of a set until after most of the monthly payments have been made—not until the last few payments. This means we are faced with an expensive problem of financing. The only practicable way for us to handle this financing is to use the earnings of an established foreign subsidiary, before U.S. taxes, to finance the development of a newer subsidiary.

"From the point of view of the Treasury, of course, the amounts of money that would be involved in an exemption for educational and informational media is very small."

THE REMEDY

The remedy here is relatively simple. In view of the special role American books are playing and can increasingly play abroad, in broad support of American foreign policy objectives, it is recommended that books and other media of communication which are deemed by the Secretary of the Treasury or his delegate to be educational, cultural, scientific, or informational should be exempted from those provisions of the pending bill which call for immediate taxation here of certain income of foreign subsidiaries. Because of the phraseology of the act, two amendments are felt to be necessary to achieve this end, and they are appended to this memorandum. These amendments would not only help to promote our foreign policy objectives but would contribute in a positive way to our balance-of-payments problem

PROPOSED AMENDMENTS

In section 952 of the code (which is found in sec. 13 of the pending revenue bill) insert in (e) (2)A, after the words "which is purchased", the following: "exclusive of books, including textbooks, educational and scientific books and journals, and encyclopedias, and exclusive of other media of communications which, under regulations prescribed by the Secretary or his delegate, are deemed to be educational, scientific, cultural, or informational in nature."

In section 13, insert in section 952(e), immediately after (6)(B), the following:

"(C) For purposes of subparagraph (A) and (B) dividends shall not constitute foreign base company income to the extent that such dividends under regulations prescribed by the Secretary or his delegate are properly chargeable to the earnings and profits which are excluded from the definition 'foreign base company sales income' under subsection (e)(2) in respect of books, including textbooks, educational and scientific books and journals, encyclopedias or other media of communications which are deemed to be educational, scientific, cultural, or informational in nature."

RITTER CO., INC.,
Rochester, N.Y., May 2, 1962.

Re sections 6 and 13 of H.R. 10650.

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

DEAR MR. CHAIRMAN: As vice president and treasurer of Ritter Co., Inc., Rochester, N.Y., I am writing to express the opposition of my company to sections 6 and 13 of H.R. 10650.

Ritter Co. manufactures dental, medical, and hospital equipment such as dental chairs, operating tables, operating lights and sterilizers in plants in Rochester, N.Y., and Cincinnati, Ohio. For the past 28 years Ritter Co. has carried on manufacturing and selling activities in Western Europe. We have wholly owned subsidiaries in Germany and France and own a 49 percent interest in an English company. We have no tax haven or foreign base company.

Our total investment in our three foreign subsidiaries as of December 31, 1961, amounted to $326,465. During the single year 1961 dividends and fees received from these foreign subsidiaries totaled $442,875, more than a third more than our total dollar investment in such enterprises. In the past 15 years, 1946 through 1961, we have received dollar remittances from our foreign investments totaling $2,550,000.

SECTION 13

It is common knowledge that the tax rates in Germany, France, and England are close to or above the U.S. corporate tax rate. Accordingly, after giving credit for foreign taxes paid, the United States would obtain little or no additional revenue from our company under the proposals contained in section 13 of the bill. However, we are greatly concerned about the endless complications and the great amount of additional expense which will be involved in determining the taxable income of our foreign subsidiaries under U.S. tax concepts if the arbitrary and complex provisions included in section 13 become law.

As we understand it from reading Secretary Dillon's testimony before your committee, the Treasury proposals, for balance-of-payments reasons, are intended to discourage the investment of private capital overseas which is tax induced, but the proposals "are not directed against foreign investment as such." If this is the case, we would urge your committee not to enact broad legislation which strikes at all legitimate operating business abroad but rather that you tailor any legislation that might be enacted to the so-called tax haven. To go further and to require every American-controlled foreign operating company to take on the endless complexities of section 13, will create insoluble administrative problems for both taxpayers and the Government in areas where there is little, if any, tax abuse. Certainly the difficulties of interpreting the inordinately complex provisions of section 13 and thereafter of computing the amounts involved to the satisfaction of the Service will require expenditures of time and effort on the part of both taxpayers and the Internal Revenue Service far out of proportion to any possible benefit that the Government might expect to obtain. Quite frankly I am appalled at the thought of the thousands of American-owned companies operating abroad trying to find personnel in Germany, France, and England and other countries of Western Europe, South America, Asia, and Africa who are familiar with or can be trained in the intricacies of the U.S. tax code, and in particular the arbitrary and complex provisions of section 13.

While we are of the view that any legislation in this area should be confined strictly to the problems of tax haven abuses, if section 13 remains applicable to operating businesses abroad, there are a number of objectionable features which should be cleared up. These include:

(1) The requirement that retained earnings of a manufacturing company be reinvested in "substantially the same business." This provision would serve to severely restrict management's freedom of action and will create enormously difficult problems. For example, our German subsidiary, Ritter, A.G., until 1960 manufactured only dental equipment. In that year, however, Ritter, A.G., embarked on a 5-year expansion program which included not only modernization of the company's dental product line but also the construction of manufacturing facilities for medical and hospital equipment. This expansion program, estimated to cost $1,500,000, is being financed entirely with Ritter, A.G., resources and does not require us to send dollars to Germany. The first items of medical equipment will be manufactured by our German subsidiary some time this year, with the first items in the hospital line to get underway in 1963. Under section 13 a question may arise as to whether the manufacture of hospital equipment by Ritter, A.G., is substantially the same trade or business as the manufacture of dental and medical equipment. If it is not, then Ritter Co. may be caught under the so-called 5-year "seasoning" rule for qualified investment, even though our foreign subsidiary was committed to its expansion program long before the Kennedy administration took office.

(2) Section 13 subjects to tax currently in this country income imputed to a controlled foreign corporation from the use of patents, copyrights and exclusive formulas and processes. Such imputed income is defined as the amount that would be obtained as a payment "in the arm's length transaction with an unrelated person." This provision will be practically impossible to administer. Moreover, it unfortunately has its widest application to manufacturing subsidiaries abroad such as Ritter, A.G., where the problem of tax abuse is nonexistent. Moreover, as in the case of Ritter, A.G., most of these foreign manufacturing subsidiaries are probably paying dividends each year far in excess of any royalty income that might be imputed to them under the bill. For example, last year Ritter, A.G., paid Ritter of Rochester over $180,000 for the use of patents, know-how and technical services. In addition it paid its parent company dividends in excess of $260,000. Even if we assume (as seems unlikely) that under section 13 the imputed patent income of Ritter, A.G., would exceed the fees actually remitted for the use of the patents developed in the United States, it is inconceivable that the excess would be anything more than a small fraction of the dividend payments of Ritter, A G. Consequently, under section 13 Ritter of Rochester would have no additional tax to pay by reason of the imputed patent provisions, but it would have to go through the increditably complex computations called for by the bill in order to be able to prove to an examining revenue agent that the net imputed patent income was far below actual dividend distributions. We would urge that the imputed patent provisions be dropped from section 13. We see no reason why royalty income derived from patents developed in the United States should be treated any differently than other so-called base company income.

(3) Section 13 in certain cases taxes U.S. shareholders of controlled foreign corporations on the undistributed earnings and prots of their foreign subsidiaries. Earnings and profits is a U.S. tax concept which depends for its starting point upon taxable income as determined under the U.S. Internal Revenue Code. The tax systems of Germany, France, and England do not, as is obvious, match ours in all respects. Items which are deductible there may not be allowed as a deduction under our law, or the timing of the deduction may differ materially, as in the case of depreciation where the industrialized nations of Western Europe are generally much more liberal than in this country.

The problem of redetermining for U.S. income tax purposes the income earned by our foreign subsidiaries on the basis of U.S. tax concepts will create enormously difficult and complex problems. We are having considerable trouble now getting timely annual reports from Ritter, A.G., determined under German tax concepts, let alone adjusting them to reflect the U.S. law. Moreover, under section 13 the intricate computations dealing with investment in nonqualified property and imputed patent income are apparently required even though dividends, royalties, and other distributions actually received by the U.S. parent company from its controlled foreign subsidiary exceed any amounts of income that would otherwise be taxable under section 13.

We can see no justification for a law which requires us to make such arbitrary and time-consuming computations where the end result is to show that we have little or no additional taxable income to report. For this reason we would urge again that section 13 be limited to the tax haven abuse situation and that it not be made applicable, generally, to operating companies. If it does apply to us, however, it is obvious that a clarifying amendment is needed to provide how earnings and profits of controlled foreign subsidiaries are to be computed. We would urge that you adopt the recommendation of the American Institute of Certified Public Accountants which would permit computations to be made under section 13 on the basis of generally accepted accounting practices in force in the foreign country rather than requiring taxpayers in all cases to keep two sets of books in order to meet the demands of the proposed legislation. At the very least if the U.S. tax system is to be superimposed upon our foreign subsidiary operations, we should have some means of taking advantage of the various elections provided in the code for domestic corporations—such things as the method of depreciation, elections relative to installment sales, research costs, and the like.

SECTION 6

Section 6 of the bill would add a new section 482(b) to the Internal Revenue Code. This provision would include specific definitions of "arm's-length price" and would give the Commissioner the authority to use an arbitrary and inflexible allocation formula in the case of sales of goods between related organizations, in the absence of an arm's-length price. The following are some of the problems that we see in this new provision:

(1) The proposed definition of "arm's-length price" could easily become very inflexible in operation. Thus, a taxpayer may be forced into the arbitrary allocation formula of section 482(b) even though, from all the facts and circumstances, it is clear that the intercompany prices are entirely reasonable.

(2) If added to the code, the new allocation rules are justifiable only if they are confined in their operation solely to areas in which some motivation exists for unreasonable pricing arrangements. Certainly the proposed changes should have no application to those cases where the foreign tax rate payable by the related foreign corporation is anywhere close to the U.S. income tax rate.

(3) A major defect in the formula is that the factors which must be used by the Secretary are heavily weighted against the exporter of U.S.-made goods. For example, the formula appears to require the comparison dollar for dollar of total investment in fixed assets with selective operating expenses, namely, selling expenses and payroll. The undue weight given total investment in fixed assets in the formula will automatically place practically all the profits on the manufacture and distribution of goods in the hands of the manufacturer.

If the allocation formula is to be at all reasonable it should not lump together unlike items (fixed assets on the one hand with operating expenses on the other). It is suggested therefore that the property factor in the allocation formula be represented by operating expenses properly attributable to assets used in the production, distribution, and sale of the goods. This would mean for example that depreciation, rent, repairs, and the like would be taken into account in a formula which would include expenditures for payroll and selling expenses. Such a formula would have two virtues: (*a*) It would be more simple than the formula called for under the bill; (*b*) in the normal case it would provide a fairer allocation of income between the manufacturing and distribution activities of the related enterprises.

(4) Under section 6 of the bill the Commissioner is authorized to establish a conclusive allocation formula by regulation. In other words, as the bill now stands the taxpayer, in the absence of an arm's-length price, must use the allocation formula prescribed by the Secretary unless he can show that the Secretary has been arbitrary or capricious in refusing to accept the taxpayer's suggested alternative method of allocation. We feel strongly that the taxpayer should have some opportunity for court review of an alternate method of allocation since in any given case the Treasury's conclusive formula could give a highly inequitable and unjust result. It is recommended therefore that proposed section 482(b)(2)(B) be amended to provide that the taxpayer can use an alternate method of allocation if he can establish to the satisfaction of the Secretary or by the clear preponderance of the evidence to the court that his method clearly reflects income. Such a provision is clearly needed since under the formula authorized in the bill no adjustment is made to reflect material differences in cost levels, such as wage levels, between the United States and foreign countries. Without the possibility of such an adjustment in an appropriate case, the arbitrary allocation factors provided in the bill would be patently unfair.

Sincerely yours,

JOSEPH P. FOX.

(The following memorandum was submitted for the record at the request of Senator Albert Gore, as discussed on p. 3715:)

MINNESOTA MINING & MANUFACTURING CO.,
St. Paul, Minn., May 10, 1962.

HON. HARRY FLOOD BYRD,
Chairman of the Committee on Finance,
Senate of the United States,
Washington, D.C.

DEAR SENATOR BYRD: At the conclusion of my testimony on May 2, 1962, Senator Gore, of Tennessee, made the following comment:

"Would you take a look at the language which has been cited by Mr. Woodworth and if you have any suggestions for further changes submit a memorandum for the committee."

The language referred to by Senator Gore is the language on pages 36–42 of H.R. 10650 relating to section 6 which would amend section 482 of the Internal Revenue Code.

We have given further consideration to the provisions of section 6, and we feel that section 482 as it is now constituted authorizes the Secretary or his delegate to distribute, apportion or allocate income, deductions, credits, or allowances among related corporations in order to prevent evasion of taxes or to clearly reflect the income of such organizations; and for this reason we are not submitting any proposed changes.

We still feel, as we testified, that the adoption of section 6 would likely result, in our case, in substantially reducing our U.S. exports. We feel that if section 6 is adopted, the formula will become the rule rather than the exception and the burden of proof in all cases will be upon the taxpayer to establish that his transactions were so-called arm-length transactions. As Senator Curtis pointed out, the question of a fair price between our domestic company and its controlled subsidiary will not be raised until the audit of the company's returns 2 or 3 years after the sale is made, and if an adjustment in the profits to the parent company is made upward, it will mean that the parent company will be taxed upon a part of the profits which has already been taxed by the foreign country to the controlled foreign company.

Our company is engaged in manufacturing and selling many products, and it will be next to impossible to determine what assets are used and to the extent used in the production and distribution of these products. Equally impracticable will be the determination of compensation paid to employees engaged in the production of this property and the advertising and selling expenses resulting therefrom. Our recommendation is that section 6 as contained in H.R. 10650 be eliminated.

It is impossible to determine what income of our foreign subsidiaries would be taxed annually to the parent company even though not distributed The reason is that the earnings of a controlled foreign company may be taxable to a U.S. shareholder if derived from the use of U.S. patents, copyrights, exclusive formulas and processes, foreign-base company income and the earnings invested in nonqualified property, under certain circumstances even though the income has not been received by the U.S. shareholders

The passage of this bill will tend to constrict the carrying on of research within the United States and will export research to foreign countries. The bill also will discourage the expansion of controlled foreign corporations into new product lines unrelated to their present business This is particularly true to a company such as ours which is engaged primarily in activities related to new product development resulting from research.

In addition, the passage of sections 6 and 13 would create constant and continuing administrative problems for both the taxpayers and the Internal Revenue Service.

Yours very truly,

ROBERT H. TUCKER, *Secretary.*

(Whereupon, at 4:30 p.m., the committee adjourned, to reconvene at 10 a.m., Thursday, May 3, 1962.)

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