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

MAY 3 AND 4, 1962

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REVENUE ACT OF 1962

THURSDAY, MAY 3, 1962

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

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

Present: Senators Byrd, Kerr, Gore, Talmadge, Hartke, Williams, Carlson, and Bennett.

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 Chair recognizes the distinguished Senator from New York, Senator Javits.

We are very glad to have you, Senator.

STATEMENT OF HON. JACOB K. JAVITS, U.S. SENATOR FROM THE STATE OF NEW YORK

Senator JAVITS. Mr. Chairman, I thank the committee for its customary courtesy in giving me an opportunity to be heard.

Mr. Chairman, I would not presume to testify on a subject of this complexity unless I had real reason to and I would like to state to the committee my reasons very briefly.

I have never encountered a tax bill which has exercised the financial and business community of New York more than this one. As the chairman knows, my home and place of my birth is New York City, which is the financial center of the country and today perhaps of the world, and I have been subjected, quite properly, to extended conferences on this bill by the most distinguished leaders in the business and financial fields, who express their gravest disquiet as to its consequences.

So, for that reason, even had there been no other, I would have felt it my duty to express my views before the committee before the committee acted.

The other reason is that, as the Chair and other members know, for a very long time I have been rather involved in the foreign economic policy of our Nation. I serve now as chairman of one of the great international parliamentary committees which deals with the subject and in that area I have had some specialized knowledge which I believe bears directly on this tax bill and perhaps may be of some use to the committee.

So, Mr. Chairman, without for a minute presuming to be a tax expert, which I am not, these are my reasons for testifying.

Mr. Chairman, there are three items of the tax bill to which I would like to address myself: First, the withholding of taxes on dividend and interest income; second, the investment credit as an incentive for business modernization; and, third, taxation of income of foreign subsidiaries of U.S. business firms.

On the first, the withholding provision, Mr. Chairman, we must be clear-eyed. I have, as a matter of fact, rather mildly but nonetheless definitely taken to task my own savings banks in New York which represent $24 billion or thereabouts in actual deposits, for not making it clear to their own depositors—although many claim that they are—that we would not impose any new taxes through this withholding, but these represent taxes which should be paid. The question is whether it is practicable to collect them in this fashion. The amount is large, involving an alleged $850 million a year, as the committee so well knows, and the expectation of recouping through withholding is $650 million a year. And, yet, it is only 1 percent of the $78 billion of corporate and individual income taxes which is expected to be collected in fiscal 1963.

Hence, I think it is fair to apply the test of practicality in this withholding tax and I come regretfully to the conclusion that by the test of practicality the measure which came from the other body is impractical and should be rejected, and that another approach should be adopted.

In the direction of some other approach I would like to lay before the committee a few suggestions.

One, I have found relatively less opposition on the part of the payors of interest to a reporting system by which they would be required to file an information return and to send a copy to the taxpayer. From my own investigations into the matter—and, as I say, I have had an enormous exposure to those who don't like the bill in its present form—they would even go down to the level of $10 in interest as well as dividends as a basis for information returns.

Also it is possible to amend the income tax form—I make this as a second suggestion—to require "yes" or "no" answers to specific questions dealing with savings accounts or ownership of stock in corporations.

And then it would be possible to require the taxpayer who answers "yes" to annex copies of these information returns to his income tax form.

The third point is that, obviously, the automatic data processing system which will take full effect, as I understand it, by 1966, would give much tighter control over this matter, a fact which could be widely publicized.

Now all of those three items which I have described would come under what we lawyers call an action with an in terroram effect, in short, by facing the taxpayer with the requirement for a commitment on his part, he would be put in concern over whether he would be caught up with if he didn't follow through and pay the tax which is required by the law.

Those are my three suggestions on withholding if the committee decides to turn down the withholding idea. If the committee should decide to take the withholding idea, then I would also like to leave with the committee some suggestions on that score.

I think the idea of an annual certificate by those who are under age or are in the nontaxpaying status is quite an onerous requirement. It seems to me that there ought to be some consideration given to some element of permanency for such a certificate or to the taxpayer's responsibility to cancel or withdraw it, when it no longer is to have effect.

Another suggestion that I believe is worthy of the committee's consideration is to give authority, which, though not novel, would be novel in its scope, to the collector of internal revenue, to exempt by regulation additional classes of taxpayers from withholding, or to reduce the rate of withholding, or to make other changes of that character in the system, when, in his judgment, the difficulties outweigh the advantages of applying withholding to a certain set of circumstances of a certain class of persons.

Now the collector does exercise some such authority in respect to foreign taxpayers. We have checked—and perhaps the committee staff would do even better than we could—and we have found there are one or two instances in which that kind of authority is given to the collector, and it has seemed to me and my staff that if the committee should make the major decision—which I hope it doesn't—that withholding is essential, then the possibility should be considered of giving it greater flexibility by giving some authority to the collector.

The second matter which I would like to address myself to is the investment credit as an incentive to business modernization.

There, Mr. Chairman, I am well aware of the claims that it might represent a windfall to some and not enough to others. For myself I do not feel that there is any basic objection to the investment credit proposal but I must respectfully submit that I do not believe it is the way in which the modernization of the American industrial plant will be achieved. I think that the amounts involved are not great enough and, as has been properly said, the ambit of its applicability is not selective enough for that purpose. And so I would like—rather than to object to this particular provision which I do not believe, as I say, is going to do the job but to which nonetheless I have no basic objection to—to enlist myself with those who are strongly urging the President and the administration to engage in the immediate revision of our depreciation tax schedules for machinery and equipment.

I think there may be a tendency, Mr. Chairman—and I have no evidence to base it on, but it would just seem to be almost evident on its face—for the administration to put its weight and energy and time behind this investment tax credit proposal in the expectation that this represents one of its important legislative achievements, rather than to drive forward vigorously to follow up the opening which has already been presented by the revision of depreciation allowances with respect to textile machinery to move into other fields. I believe very strongly that this would be much more fruitful, much more likely to have results, infinitely more acceptable to the business communities, from everything I have been able to ascertain, and I would urge that, whatever happens to this investment tax credit, the administration

move with the greatest celerity and the greatest vigor into the depreciation schedule reforms which I think are absolutely critical to American business.

I am sure the committee has had a whole group of figures—and it is not looking to me for that, but we certainly have seen this in the Joint Economic Committee—which demonstrates that our whole productive plant is getting dangerously behind the times in terms of modernization and that one of the great responsibilities which we carry in respect of what appears to be endemic unemployment, unaffected by the fact that we are recovering from this latest recession quite effectively, is the rebuilding and modernizing of the American industrial plant.

Revision of depreciation schedules is absolutely essential in our national interest—in our defense interest and in our world interest—and I would hope that we in the Senate could be so clear and unequivocal and strong on that subject as to make the administration understand that this is what we want, as I say, whatever may happen to the investment credit proposal in this bill.

Now the third item, Mr. Chairman, is by all orders the most vexing to the business community—especially that part of the business community which is very large in its operations. Mr. Chairman, I know that no Senator, no matter how critical we may be of the excess exercise of power, will for a moment wish to affirm that the great companies of our country which do operate overseas are entitled to any less of our concern and solicitude, in terms of their success and the cially in view of the fact of which I am deeply convinced by all of my work abroad, that American private investment and our foreign trade are critical elements in the economic viability of the whole world and in the likelihood of our being successful in the cold war.

Now I have never seen in my own experience such discontent in the business and financial community as there is over this proposal for the treatment of earnings of foreign subsidiaries.

I do not believe, and I say this in all sincerity, that this is attributable to any narrow view of wanting to get away with taxes. I think that the community would readily accept all of the tightening up and buttoning down of those foreign corporate operations which result in avoiding taxes through financial investment in arbitrages and financial operations and so forth. Some people will be very unhappy, of course, but I am speaking of the community as a whole.

Mr. Chairman, I believe that the taxation of foreign subsidiaries' income, by the method proposed in the bill, would be unwise and not in our national interest.

I believe it should be rejected and another method substituted, and I would like the privilege, if I may, Mr. Chairman, of submitting a proposal for that purpose which I will describe briefly in this testimony which obviously the committee wants to keep within reasonable limits, and then submit, if I may, to the committee, the text of an amendment which I have in mind.

Now there are two aspects to this question of the taxation of the income of foreign subsidiaries: First, the problem of the use of foreign subsidiary corporations for the purpose of escaping domestic taxes properly due the United States.

As I said before, I believe responsible businessmen will agree with the Congress and the Treasury that these abuses must be halted by effective legislation and by the implementation of legislation already on the books.

But the other and broader question is one of the national interest of the United States in U.S. foreign investment. It has been the basic policy of the Nation for many decades, under both Democratic and Republican administrations, to rely on the flow of long-term private investments overseas as a basic component of our foreign economic policy.

The beneficial impact on domestic U.S. employment and profit of long-term private investments overseas under a system of competitive enterprise have not been questioned until the administration presented its tax proposals which the administration itself widely suggested will discourage such investment.

Now my principal plea is that new legislation should distinguish between these two aspects and avoid injuring the broad national interest in the process of correcting specific abuses.

I think the administration's proposals go far beyond the elimination of the abuses and will, I believe, discourage U.S. direct private investment in the fully developed nations of the free world, those in Western Europe, Canada, and Japan, and will probably discourage such investment generally.

That is one thing, Mr. Chairman, that I hope the committee will consider.

I know that a great effort has been made to make a distinction between investments in industrialized countries and investments in newly developing countries. From 16 years of experience in this field, as a legislator, and 20 years of experience before that in business and in the law, I would say, Mr. Chairman, that, once you inhibit the flow of direct private investment overseas, it is not going to be selective. You are not going to inhibit it for the industrialized areas and encourage it for the newly developing areas.

In the first place, that doesn't take account of indirect investments which often occur. We often invest in industrialized countries, from which, in turn, investment moves out into newly developing countries. Second, it is just not the habit of those who invest money to make this distinction.

If they are going to reduce their investments, they are going to reduce them in the developed countries and in the newly developing countries as well.

Provisions in the bill before the committee may or may not effectively prevent the instances of tax evasion cited by the administration. But I am confident that they will represent an adverse development in the foreign economic policy of the United States, and in the effort to help existing oversea investments keep competitive under changing world market conditions.

Since there are methods to prevent tax evasion with a minimal adverse effect on the continued, natural, economically sound flow of investments, I should like to turn my attention to the deleterious effect of measures which will discourage U.S. private oversea investment.

I have three questions in that regard: One, how can it be shown that discouragement of that amount of investment and reinvestment in oversea facilities which takes place as the result of present methods of taxation would have a substantial effect in rectifying the U.S. balance-of-payments deficit?

Second, even if reasonable proof could be given that the discouragement of such investment and reinvestment would favorably influence our short-term, balance-of-payments position, what would be the result over the next two decades? (As I understand it, that is the way the Treasury is projecting it.)

And third, since the balance of payments is only one manifestation of our total U.S. foreign economic policy position—actually serving as one device for measuring the strength of this position—what purpose would be served by inducing a short-term improvement in the balance of payments, if such an improvement took place at the expense of undermining the base of our total foreign economic policy?

Now, Mr. Chairman, instead of going into the details of the assumptions made by the Treasury and its well-known exhibit III. I would like permission to have inserted as part of my testimony a memorandum prepared by my staff in which those assumptions are very sharply questioned, and, of course, I will make copies available to all members.

The CHAIRMAN. Without objection it will be inserted in the record.

Senator JAVITS. Mr. Chairman, I would like to come now to the idea which I would like to propose to the committee.

The international responsibilities and the domestic welfare of the United States demand an expansion, not a contraction of U.S. private investment overseas. Our economic way in the world is forward and outward.

I see no other likely course to peace with freedom than the full commitment of our Nation to its undeniable leadership of the free world.

Mr. CHAIRMAN. I am Chairman, by the grace of my colleagues and my colleagues in other parliaments, of the Economic Committee of the NATO Parliamentarians' Conference. I have been Chairman of that Committee, which has upon it delegations from the other 14 NATO parliaments, for 4 years, and the statement which I have just made, Mr. Chairman, is the result of my deeply considered judgment that, in order to win the cold war, we must accelerate materially the oversea private investment of the United States as well as of the industrialized European countries and of Japan and Canada.

Without that we could easily fail. This is the prime consideration of national policy, and I respectfully submit that no tax law which will inhibit that process can be considered in the interest—in the overriding interest in terms of peace and winning the cold war—of the United States.

I believe that the House-passed version of section 13 of the bill which is before the committee, by not distinguishing between tax abuses and legitimate foreign investment, will not forward the U.S. economic and foreign policy objectives.

Accordingly, as I have stated, I intend to introduce shortly, as a suggestion for the committee's consideration, an amendment to section 13 which would make this distinction. I will submit it in text, Mr. Chairman, but I would like to describe it as follows:

This amendment will be designed to tax U.S. shareholders of certain foreign corporations without deferral if the earnings and profits of such corporations are accumulated unreasonably abroad rather than being paid to the shareholders as dividends.

May I repeat that, Mr. Chairman?

My thought, which I would like to present to the committee as a possible alternative, is to penalize the unreasonable accumulation of surplus abroad, but to simplify the rules which have impeded the full application of that type of statute in the United States. This is the fundamental idea which I would like to suggest to the committee as a possible alernative.

In effect, section 13, as so amended, would treat the deferral of foreign corporation profits as tax avoidance only if there is no business related reason for such deferral, rather than as virtually per se tax avoidance as section 13 does in its present form.

It should be noted that sections 6 and 16 of the bill before the committee accomplish a great deal to eliminate true tax abuses in the foreign field.

For example, a present-day U.S.-parent corporation may sell goods to its Panamanian subsidiary at an artificially low price with a true sales profit retained without the U.S. tax consequences in Panama. Section 482 of the code has been available to reallocate the sales income to the U.S. parent, but that provision has been difficult for the Commissioner to apply. Now, section 6 of the bill, while it may be criticized as adopting too objective a test and one which may be unreal in certain situations, will nonetheless give the Commissioner an effective method of correcting this type of abuse.

As another example under present law, profits may be deferred for a considerable period in a foreign corporation after which the corporation is completely liquidated at capital gains rates to its shareholders. There is thus not only a change in the tax deferral but a change in the income of the U.S. tax. Section 16 of the bill before the committee will eliminate the change in character of such income by generally denying capital gains treatment for the subsequent liquidation.

Thus section 13 of the bill before the committee is left to cope primarily with the problems of deferral in the area of taxation while attempting also unsuccessfully, as I believe, to serve an additional purpose in the area of the U.S. balance-of-payments position. Modified by an amendment such as I have suggested, section 13 would constitute a relatively direct approach to the problem of the taxation of profits of foreign corporations controlled by U.S. persons. Because it is a direct approach, it would be effective primarily as implemented by regulations of the Internal Revenue Service and decisions of the courts. In that regard I might say that if you have real zeal on the part of the Commissioner of Internal Revenue to collect taxes on this kind of accumulation abroad, so much the better, provided we give him a law where the exercise of zeal will really recoup taxes that ought to be recouped instead of, in my opinion, seriously inhibiting what should be the proper foreign economic policy of the United States.

The amendment to section 13 which I will submit is modeled basically on sections 531 to 537 of the Internal Revenue Code which tax the unreasonably accumulated earnings of domestic corporations.

However, certain changes will be necessary because of the different contexts in which the two sets of provisions would operate, Under section 531 the accumulated earnings tax is asserted against the domestic corporation rather than the stockholders, whereas under section 13 the tax must ultimately be asserted against the shareholders in view of the lack of jurisdiction to assert a tax against the foreign corporation itself. Also, while the tax on the corporation imposed by section 531 of the code is considered a surtax or penalty tax, the tax upon stockholders under section 13 should be an ordinary income tax.

The principal change will be that the provisions contained in section 534 of the code relating to the shifting of burden of proof to the Government would not be applied to foreign corporations because the Commissioner is at a greater disadvantage in obtaining factual information overseas.

Apart from these differences, I believe that the accumulated earnings approach patterned on section 531 of the code offers a valid test for differentiating between tax haven and legitimate operations abroad in keeping with the policy objectives which I have urged and will avoid the pitfall of materially inhibiting oversea private investment on the part of potential American investors.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, Senator Javits. You have made very valuable suggestions and the Chair will see that the staff brings your recommendations before the committee when it goes into executive session to mark up the bill.

Senator Kerr?

Senator KERR. No questions.

The CHAIRMAN. Senator Carlson?

Senator CARLSON. No questions.

Senator BENNETT. I have just one question, Mr. Chairman.

In this approach you are suggesting on section 13 there is just one thing that puzzles me.

Here is a corporation that is operating abroad, its business is growing, it is anxious to expand. Would that be a valid reason for accumulating earnings?

Senator JAVITS. I think it would, depending upon the cogency of its plans, the length of time which it took to put them into effect, and the general good faith involved.

I might say this, to my dear friend and colleague, we often hear this word "good faith" employed and Senators are inclined to rather jump at it and say, "Well, what kind of a standard is that?"

But isn't it a fact that every day, in thousands of courtrooms throughout the United States, juries are deciding just such questions of whether "A" was driving too fast when he hit "B," whether he used reasonable care, and so on and so forth.

So, I think in this particular case, it is certainly susceptible of proof. There are courts in which this matter can be litigated, and I would contemplate that a company legitimately desiring to expand and saving its earnings for that purpose, proceeding with deliberate speed to make its plans for that expansion, to spend its money, et cetera, should not fall within the inhibition of the statute, as I have presented it. But a company which is just talking about it, saying

"We are going to one day" and isn't really getting at it, it seems to me should fall within that inhibition.

Senator BENNETT. This is one of the areas in which it will be difficult to decide, and perhaps if we had a commissioner who was proceeding with the kind of zeal you recommended earlier he might inhibit growth abroad by making it difficult for a company to demonstrate that it was actually accummulating enought capital so that it could successfully move into a new market.

Senator JAVITS. If I may just conclude, because I know the chairman wants to get on, with just making two points on that question:

One, we start from a base which is very sluggish. There have been mighty few collections on this score in this country, and it has been beset with difficulty especially because of the burden-of-proof requirement which I would change.

So we start from a sluggish base. That itself is in a sense a slowdown factor for any excessive zeal, and a lot of decisions, of course, would contribute to that, of course.

The second point is that you are facing business with a pretty serious choice. They see themselves that there is a very serious loophole here that has got to be plugged. You can't fail to break some eggs, and given the choice between the kind of thing which is projected in this bill, which really and sincerely is considered by American business to be most harmful to it in the broadest governmental sense as well as in the private enterprise sense, I think that they will gladly settle for something like this where at least they have got a chance to argue, even with a zealous Internal Revenue Commissioner.

Senator BENNETT. I agree with you.

I would much prefer this personally to the language in the present bill. But I am wondering whether it would be possible to nail it down even more definitely.

Senator JAVITS. Well, you have got a lot of good experts, Senator Bennett.

Senator BENNETT. Thank you.

Senator JAVITS. Thank you.

The CHAIRMAN. Thank you very much, Senator.

Senator JAVITS. Thank you.

(The amendment, analysis of Treasury exhibit III, and Senator Jacob K. Javits' prepared statement follow:)

AMENDMENTS

Intended to be proposed by Mr. Javits to the bill (H.R. 10650) to amend the Internal Revenue Code of 1954 to provide a credit for investment in certain depreciable property, to eliminate certain defects and inequities, and for other purposes, viz: On page 104, line 8, strike out "955(a)" and insert "954(a)".

On page 104, beginning with line 14, strike out all through line 25 on page 105 and insert the following:

"(A) his pro rata share (determined under paragraph (2)) of the corporation's unreasonably accumulated income for such year (to the extent not excluded from gross income under section 955(a)(2)), and

"(B) his pro rata share (determined under paragraph (3)) of the corporation's income derived from the insurance of the United States risks for such year.

"(2) PRO RATA SHARE OF UNREASONABLY ACCUMULATED INCOME.—The pro rata share referred to in paragraph (1)(A) in the case of any United States person is the amount which would have been distributed with respect to the

stock which such person owns (within the meaning of section 954(a)) in such corporation if on the last day, in its taxable year, on which the corporation is a controlled foreign corporation it had distributed pro rata to its shareholders an amount—

"(A) which bears the same ratio to its unreasonably accumulated income for the taxable year, as

"(B) the part of such year during which the corporation is a controlled corporation bears to the entire year.

"(3) PRO RATA SHARE OF INCOME FROM INSURANCE OF UNITED STATES RISKS.—The pro rata share referred to in paragraph (1)(B) in the case of any United States person is the amount which would have been distributed with respect to the stock which such person owns (within the meaning of section 954(a)) in such corporation if on the last day, in its taxable year, on which the corporation is a controlled foreign corporation it had distributed pro rata to its shareholders an amount—

"(A) which bears the same ratio to its income derived from the insurance of United States risks for the taxable year, as

"(B) the part of such year during which the corporation is a controlled foreign corporation bears to the entire year.

On page 106, line 4, strike out "955(b)" and insert "954(b)"

On page 106, lines 16 and 17, strike out "subpart F income of such company" and insert "any amount under subsection (a) with respect to such company"

On page 106, beginning with line 18, strike out all through line 21 on page 107 and insert the following:

"SEC. 952. DEFINITIONS.

"(a) UNREASONABLY ACCUMULATED INCOME.—

"(1) IN GENERAL.—For purposes of this subpart, the term 'unreasonably accumulated income' means, in the case of any controlled foreign corporation, the amount of the earnings and profits for the taxable year which is accumulated beyond the reasonable needs of the business, including the reasonably anticipated needs of the business.

"(2) EXCLUSION OF UNITED STATES INCOME.—In determining the unreasonably accumulated income of any controlled foreign corporation for any taxable year, proper adjustment shall be made for income includible in gross income under this chapter (other than this subpart) as income derived from sources within the United States of a foreign corporation engaged in trade or business in the United States.

"(3) DETERMINATION OF EARNINGS AND PROFITS AND REASONABLE NEEDS OF THE BUSINESS.—The earnings and profits of any controlled foreign corporation for any taxable year and the reasonable needs of the business of any controlled foreign corporation, including the reasonably anticipated needs of the business, with respect to any taxable year, shall be determined, for purposes of this subpart, under regulations prescribed by the Secretary or his delegate.

On page 108, line 13, strike out "subsection (a)(1)(A)" and insert "this subpart".

On page 110, beginning with line 9, strike out all through line 13, on page 122.

On page 122, line 14, strike out "954" and insert "953".

On page 122, line 20, strike out "955(b)" and insert "954(b)".

On page 122, line 24, strike out "952(a) (1) (A)" and insert "952(b)".

On page 123, line 5, strike out "955(b)" and insert "954(b)".

On page 123, strike out lines 12 through 19.

On page 123, line 20, strike out "955" and insert "954".

On page 124, lines 19 and 20, strike out "951(b), 952(a) (1) (C), and 954" and insert "951(b) and 953".

On page 124, lines 23, 24, and 25, strike out "to treat 5 or fewer United States persons as owning more than 50 percent of all classes of stock entitled to vote of a controlled foreign corporation,".

On page 125, line 2, strike out "954" and insert "953".

On page 126, line 13, strike out "956" and insert "955".

On page 126, line 23, strike out "951(a) (1) (B)" and insert "951(a) (1) (A)".

On page 127, line 6, strike out "955(a)" and insert "954(a)".

On page 127, lines 15 and 16, strike out "955(a)" and insert "954(a)".

On page 128, lines 6 and 7, strike out "951(a) (1) (B)" and insert "951(a) (1) (A)".

On page 128, line 8, strike out "956(a) (2)" and insert "955(a) (2)".
On page 128, line 10, beginning with "951(a)", strike out all through line 13, and insert the following: "951(a) (1) (B) (but reduced by amounts not included under section 951(a)(1)(A) because of the exclusion in section 955(a)(2), and".
On page 128, line 17, strike out "957(a) (3)" and insert "956(a) (3)".
On page 128, line 21, strike out "957" and insert "956".
On page 130, line 3, strike out "956" and insert "955".
On page 130, line 16, strike out "956(a)" and insert "955(a)".
On page 132, line 1, strike out "956(a)" and insert "955(a)".
On page 133, line 23, strike out "956(a)" and insert "955(a)".
On page 134, line 14, strike out "958" and insert "957"
On page 134, line 21, strike out "955(a) (2)" and insert "954(a) (2)".
On page 135, line 8, strike out "956(a)" and insert "955(a)".
On page 135, line 12, strike out "956(a)" and insert "955(a)".
On page 136, strike out lines 1 through 4 and insert the following: "section 951(a) (relating to amounts included in gross income of United States persons) for such taxable year as his pro rata share of the unreasonably accumulated income of such company or as his share of the income of such company derived from the insurance of United States risks.".
On page 136, line 7, strike out "957" and insert "956".
On page 136, in the matter following line 9, strike out "957" and insert "956".
On page 136, in the matter following line 11, strike out "957(b)" and insert "956(b)".
On page 137, line 8, strike out "958" and insert "957".
On page 95, line 9, strike out "957(a)" and insert "956(a)".
On page 103, in the matter following line 19—

(1) strike out "Sec. 952. Subpart F income defined" and insert "Sec. 952. Definitions";

(2) strike out "Sec. 953. Investment of earnings in nonqualified property."; and

(3) strike out "954", "955", "956", "957", and "958" and insert, respectively, "953", "954", "955", "956", and "957".

Analysis of Exhibit III to Secretary Dillon's Statement Submitted to the Senate Finance Committee, April 2, 1962

I. INTRODUCTION

The contention of the Treasury Department, as expressed in exhibit III to Secretary Dillon's statement to the Senate Finance Committee on April 2, 1962, is that in analyzing the effect of direct investment abroad on the balance of payments, the two types of flows which are usually compared—the outflow of new capital and the income and export receipts for a given year, or a 5- or 10-year period—are, in good part, not related one to the other. The Treasury asserts that the dividends, and most of the export receipts, of 1 year or a period, have been generated by investment over many years prior to the current year or period, and that that portion of the inflows which has been generated by past investment has nothing whatsoever to do with the outflow of the current year of period in question.

This approach is illustrated in chart 1 of Treasury exhibit III, based on the data in tables A–1–A–5 in the appendix, showing the cumulative amount of capital outflow to manufacturing subsidiaries in Canada and Western Europe over the period 1952 to 1960, and the cumulative amount of dividend inflows, receipts from fees and royalties, and net export receipts estimated to have been generated (*a*) by the new investment and (*b*) by the reinvestment of earnings over the period which were made on this new investment.

Since information in this amount of detail is not known for this entire period, the Treasury was obliged to develop it statistically from the available data. According to the Treasury, the results of this exercise, as shown in chart 1, make it clear that the cumulative deficit generated by new direct investment in other developed countries grew in every year after 1953; i.e., that every year the new capital outflow exceeded the inflows generated by the growth in investment outstanding subsequent to the year 1952. Although conceding that the cumulative inflows would eventually overcome the cumulative outflow, the Treasury states that the "catching up" period takes from 12 to 15 years.

The Treasury further contends that the proposed legislation to tax U.S. parent companies currently on the foreign earnings of their foreign subsidiaries would have both a "deterrent effect" and a "switch effect" on direct investment abroad. They estimate that 10 percent of the present rate of capital outflow would be deterred from going abroad, and that earnings would be switched from reinvestment abroad to the payment of dividends, increasing the dividend by about 20 percent. While these factors would have an immediately beneficial effect on the balance of payments—i.e., less capital outflow and larger dividend inflow—they would also reduce the growth and size of our firms abroad. In time, the dividend at the higher rate would be smaller than the dividend at the old rate. There would also be a corresponding reduction in other income from foreign subsidiaries as well as in receipts from exports to foreign subsidiaries.

While conceding that the new tax proposal would stunt the growth of our firms abroad, the Treasury contends, as illustrated in chart 2 of exhibit III, supported by data in table A–6 and A–7 in the appendix, that the "deterrent" and "switch" effects would favor our balance of payments for the next 10 to 15 years.

II. TREASURY'S ANALYSIS OF DIRECT INVESTMENT FLOWS

The Treasury's technique of analyzing the effect of direct investment abroad on the balance of payments, as illustrated in exhibit III, is based upon four ratios which are used to measure the return flows from foreign investment, as follows:

(*1*) *Earnings ratio.*—The ratio of earnings during the year to the total value of the investment at the beginning of the year (made up of each year's new capital outflow plus capital outflows of previous years from the given starting point and reinvested earnings on such previous capital outflows (table A–2).

(*2*) *Dividend ratio.*—The ratio of common dividends to total earnings (table A–3).

(*3*) *Other income ratio.*—The ratio of other income from such investment to the total value of the investment at the beginning of the year, including royalties, management fees, interest, and preferred dividends (table A–4).

(*4*) *Net exports ratio.*—The ratio of net exports (exports less imports) relating to such investment to the total value of the investment at the beginning of the year (table 4).

With these ratios determined (as discussed below), the application of this technique to Canada and Western Europe is as follows:

(1) The actual capital outflow of $127 million is entered in 1952 but no inflows are computed on it (apparently on the theory that this outflow occurred during 1952 whereas the ratios are applied to the value of investment at the beginning of the year).

(2) The 1952 capital outflow is treated as the opening investment for 1953 and the ratios are then applied to this figure.

(3) The earnings ratio of 14.7 percent for Canada and Western Europe is applied to the $127 million investment, giving $18.7 million of earnings.

(4) The dividend ratio of 45.4 percent is applied to the $18.7 million of earnings, giving $8.5 million of dividends.

(5) The difference between earnings of $18.7 million and dividends of $8.5 million, or $10.2 million, is added to the investment as reinvested earnings.

(6) The other income ratio of 2.3 percent is applied to the $127 million investment, giving $2.9 million of other income.

(7) The net export ratio of 8 percent is applied to the $127 million investment, giving $10.2 million of net export.

(8) The inflows for the year from the investment consist of $8.5 million in dividends, $2.9 million in other income and $10.2 million of net exports, for a total of $21.6 million.

(9) The opening investment of $127 million is increased during the year by $10.2 million of reinvested earnings and $20 million of new capital inflow, making the value of the investment at the beginning of 1954 $157.2 million. The same ratios are then applied to this value in determining results for 1954.

(10) The net effect on the balance of payments in 1952 has been a capital outflow of $127 million against which no inflows are computed in that year. For

1953 there was a total inflow of $21.6 million and a capital outflow of $20 million, or a net inflow of $1.6 million.

(11) This same process is then repeated each year.

On the basis of these computations the relationship between the inflows and the outflows is determined on an annual and on a cumulative basis. Chart 1 of exhibit III (and supporting table A–5) shows that (with the exception of 1953) there was an annual net outflow for each year from 1952 to 1960, inclusive; and that by the end of 1960, the cumulative net outflow had reached $1,009 million. In connection with this, it is stated in exhibit III as follows (p. 196, p. I, Senate Finance Committee hearings):

"We hasten to add immediately that at some point this situation should right itself; the cumulative deficit should get smaller and eventually disappear unless new investment continues to grow at an ever increasing rate as it has been doing in recent years, and this hardly seems likely. But clearly the "catching up" period is a long one indeed if the capital outflow keeps growing, even at a steady rate. If the outflow from 1963 forward grows at a steady 10 percent a year, which has been the average over the last 8 years, there would be no net improvement in our balance of payments until 1975; i.e., inflows would not catch up to outflows on a cumulative basis until 1975."

This statement is somewhat misleading. After referring to the results shown in chart 1 for the period 1952–60, the above would seem to indicate that if the figures supporting chart 1 were extended on the basis of increasing the capital outflow by 10 percent a year, the cumulative deficit in existence in 1960 would not be overcome until 1975. What in fact was meant was that if a wholly new projection were to be made on this basis, and employing the same ratios used for Canada and Western Europe, the net deficit accumulated from 1962 would not be overcome until 1975. This is the basis for the assertion by the Treasury that the elimination of any amount of capital outflow would contribute favorably to our overall balance of payments position over at least the next 10 to 15 years.

A more realistic perspective can be obtained by extending the figures illustrated in chart 1 to 1972, covering a total of 20 years. In making this projection the same ratios are used that were used in the period shown, and the capital outflow is deemed to increased by 10 percent annually after 1960.[1] This computation is contained in table 1–A attached to this memorandum. Table 1–A shows that commencing in 1964 there will be a regular annual net inflow from these investments and the next deficit accumulated from 1952 will be overcome in 1969.

The most striking aspect of viewing this matter over a 20-year period, instead of limiting it as the Treasury does to the period of cumulative net deficit, is the tremendous surge in annual net inflow that is estimated to commence in about 1964. Once the investment abroad begins to mature and to add some reinvested earnings to its earnings base, the return inflows amply overcome the increasing capital outflows and the net inflows begin to mount in a steep curve upwards. For example, table 1–A estimates that the cumulative net deficit will reach its maximum in 1963 of $1,730.9 million, then will begin to reverse itself in 1964 and will climb sharply to a cumulative net inflow in 1972 of $5,918.4 million. Moreover, whereas the maximum annual deficit in any previous year had been $364.3 million in 1960, the annual net inflow in 1972 is estimated at $2,050.2 million. And with the value of the investment having grown from $127 million in 1952 to $27,776.8 million in 1972, the future net inflows can be expected to mount and compound endlessly.

It is important to bear in mind that this extension to 20 years is based entirely on Treasury statistics and assumptions. In dealing with too brief a period to permit the new investment abroad to mature and begin to pay off, chart 1 indicates only that our investments in Canada and Western Europe since 1952 have put us into a deficit in our balance of payments, and it fails to show that on the basis of these same statistics and assumptions we are now on the brink of a major contribution to the balance from these investments.

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[1] Note that with the capital outflow in 1960 being unusually high as a result of the large Ford transaction in the United Kingdom, a 10-percent rate of annual increase based on this 1960 figure results in estimated capital outflows in later years which are probably far higher than will occur. If so, this greatly distorts the computation for these later years.

III. TREASURY'S ANALYSIS OF EFFECT OF PROPOSED TAX LAW

As stated above, the Treasury contends that the proposed legislation will deter new capital investment to the extent of 10 percent and will switch earnings from reinvestment to dividends, increasing the latter by 20 percent. The effect of this is illustrated in chart 2. Table A–6 in the appendix supports the "switch effect" and table A–7 supports the "deterrent effect." The claim is made that the increased inflow from larger dividends (from old as well as new investments) and the reduction in capital outflow will favor the balance of payments for from 10 to 15 years, after which period the benefits of these two effects will be overcome by the loss of inflow caused by the restriction in growth of our investments abroad.

Once again, however, chart 2 and its supporting tables carries the computation only far enough to illustrate the point being made. As shown in table A–6, the cumulative loss in net exports and other income does not overcome the "switch effect" of increased dividends until the 14th year; but if the computations in table A–6 are extended on the same basis to 20 years, the cumulative loss would be increasing sharply.[2] And although, as shown in table A–7, the cumulative loss in other income and net exports does not overcome the "deterrent effect" of less capital outflow until the 12th year, if the computations in table A–7 are extended on the same basis to 20 years, the cumulative loss would exceed the cumulative reduction in capital outflow by $5,134 million. It is quite apparent, therefore, that the compounding effect of reinvested earnings is substantial, and that any analysis of the effect of interrupting or reducing the rate of investment should cover a sufficient period to permit that compounding effect to manifest itself fully.

It should be noted that chart 2 bears no relation to chart 1. It depicts not the total effect of the tax proposal on direct investment abroad, but only the incremental effect of that proposal. Moreover, there are two pecularities in the way it is computed:

(1) In measuring the switch effect, the footnote to table A–6 states that "for purposes of analysis we separate out the deterrent effect to be considered subsequently, and assume it zero here." Then in table A–7 the deterrent effect is measured without regard to the switch effect.

It would seem that these two effects are inextricably interrelated and should be measured in a single computation.

(2) In measuring the switch effect in table A–6, the earnings ratio is fixed at 12 percent and the combined other income-net export ratio at 10 percent instead of the 14.7 percent and 10.3 percent, respectively, used in table A–7 in measuring the deterrent effect.

Because of the highly theoretical nature of chart 2 and the fact that it is derived wholly from a projection into the future based on statistics from the past, an attempt is made in the tables attached hereto to analyze the switch effect and the deterrent effect in a simpler form. Accordingly these two effects are applied in accordance with the assumptions contained in exhibit III to the 20-year projection from 1952 to 1972, inclusive. In this way it is impossible to compare the effect of the law if it had been in effect since the beginning of 1952 for a period of 20 years with the estimated results without the law.

Since the switch effect would apply to earnings on investments prior to 1952, it is necessary in making this comparison to include the effect of the law on inflows from pre-1953 investments as well as on inflows from post-1952 investments. Accordingly, tables 1–A and 1–B attached compute inflows from new and old investments, respectively, under the existing law (with deferral) and tables 2–A and 2–B, attached, compute inflows from new and old investments, respectively, under the proposed law (without deferral). In tables 1–B and 2–B no capital inflows after 1952 are included, the investment consisting of the amount in existence at the end of 1952 increased by reinvested earnings in subsequent years. All capital outflows after 1952 are entered in tables 1–A and 2–A.

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[2] There is an apparent error in the visual translation of the table A–6 figures to chart 2, in that the cumulative dividend gain in one year is compared with the cumulative loss of the previous year.

In order to compare the effect of the proposed change in the tax law, it is necessary to compare the combined net inflows computed in tables 1–A and 1–B (with deferral) with the combined net inflows computed in tables 2–A and 2–B (without deferral). On both an annual and a cumulative basis, the large inflows from the old investment are sufficient to overcome the annual net outflows on new investments. From 1953 to 1962 the combined annual net inflows without deferral exceed the combined annual net inflows with deferral, but in 1963 this situation reverses, and the combined annual net inflow with deferral moves ahead sharply so that in 9 years—at the end of 1972—the cumulative net deferral inflows exceed the cumulative net without deferral inflows by $2,268.1 million.

Focusing now on the new investment alone, as shown in tables 1–A and 2–A, it will be noted that whereas the cumulative net outflow in table 1–A reaches a maximum in 1963 of $1,730.9 million, the new law, as shown in table 2–A, would have the result of reducing this maximum (reached in the same year) by only $291.7 million to $1,439.2 million. But the new law would also reduce the cumulative net inflow over the 20-year period by $370.9 million. Moreover the value of the new investment at the end of 20 years with deferral would be $27,776.8 million compared to a value without deferral of $22,970.5. Accordingly, by the end of the 20th year, the deferral investment is in a position to move quickly far ahead of the nondeferral investment.

The effect of the new tax on the old investment is even more significant, as shown by comparing tables 1–B and 2–B. The "switch" of earnings from reinvestment to dividends, with these earnings based on the large bulk of past investments, is a substantial factor in stepping up the inflow in the early years. Accordingly, the cumulative inflow from old investments without deferral is greater than the cumulative inflow with deferral until 1964. During these years, however, the old deferral investment is reinvesting more earnings and is growing at a faster rate than the without deferral investment. Finally by 1960 the old deferral investment is sufficiently larger so that its annual dividends, even at a lower rate, and other inflows, have exceeded the without-deferral investment. From this point on the inflows from the old deferral investment climb sharply, and for the 20-year period they exceed the without-deferral inflows by $1,897.2 million cumulatively. Moreover, at the end of the 20-year period the value of the old deferral investment is $17,412.9 million compared to $13,742.3 million for the without-deferral investment.

Finally, since we are talking about a proposal to change the Internal Revenue Code, some effort should be made to compare the revenue to be raised from direct investment abroad with and without deferral. Since there are a lot of imponderables involved, it is difficult to make an exact mathematical comparison. However, some idea can be obtained by comparing the amount of taxable U.S. income to be returned under the two situations. Based on the tables attached hereto, these are as follows (millions of dollars):

WITH DEFERRAL

	New investment	Old investment	Total
Dividends	$8,994.9	$11,376.9	$20,371.8
Other income	3,099 9	3,923.1	7,023.0
Total	12,094 8	15,300.0	27,394.8

WITHOUT DEFERRAL

	New investment	Old investment	Total
Dividends	$9,032.8	$11,773.6	$20,806 4
Other income	2,632.8	3,411.3	6,044 1
Total	11,665.6	15,184.9	26,850.5

Thus, there will be less taxable income received from abroad under the proposed new tax than under a continuation of the present taxing system. Moreover, in addition to more income from abroad with "deferral," there will be more domestic income from exports to foreign subsidiaries. The tables attached indicate that there will be a total of net exports with "deferral" of $24,430.2 million compared to a total without "deferral" of only $21,023.3 million.

In summary, if the effect of the new tax proposal is analyzed over a 20-year period, it will have a decidedly unfavorable effect on the balance of payments and will provide the Treasury with considerably less revenue.

IV. STATISTICAL METHODOLOGY IN EXHIBIT III

The purpose of this analysis is not primarily to criticize the statistics and assumptions contained in exhibit III. Much thought and effort have gone into that document and it makes a sound contribution to this important debate. In this analysis an attempt is made to draw further conclusions from the material contained in exhibit III by extending the charts and tables, on the same basis used by the Treasury, to cover what might be considered a more representative period in which to analyze financial problems of such massive scope and impact. At the same time, however, some mention should be made of the statistical limitations involved in attempting to draw the conclusions contained in exhibit III.

Although it has been recognized that in evaluating direct investment abroad there should be taken into consideration not only dividend income but also other inflows, such as royalties, management fees, and receipts from exports, very little evidence of these other factors exists. Figures for dividends, interest, and branch income are regularly gathered by the Department of Commerce, but the other figures are not. Thus, it is apropriate to make some brief comment as to the adequacy of the statistical basis for the basic ratios used in the tables and charts of exhibit III.

A. *Earnings ratio*

This is based on figures which are regularly published by the Department of Commerce. Table A–2 of exhibit III compares the ratio of total earnings for the 4-year periods 1953–56 and 1957–60 to the total values of manufacturing investments at the close of the years 1952–55 and 1956–59, respectively, and for the entire 8-year period. The ratios for the second 4-year period for both Canada and Western Europe are lower than those for the first 4-year period as well as for the 8-year period. These lower ratios are used for the entire 8-year period. The separate ratios for Canada and Western Europe are weighted in the same proportion as the direction of capital flow to the area for the 1957–60 period; i.e., 71.1 percent to Europe and 28.9 percent to Canada.

Comment

(1) With actual earnings ratios available for the first 4-year period which are higher than those for the latter 4 years, the use of the lower ratios for the entire 8-year period is questionable in any attempt to depict the actual situation.

(2) Obviously a ratio developed from statistics of a period which is known to have been in a state of great change are not appropriate for projecting figures for many years into the future. For example, the ratio does not take into account the improved conditions of currency convertibility, the EEC, the proposed, new trade program, the possibility of a North Atlantic Trading Community, etc.

(3) It should be noted that the 1957–60 period represented years of heavy investment abroad, so that there were relatively more immature investments in the second than in the first 4 years. As these new investment mature, an earnings ratio based on their early years will no longer be appropriate in estimaitng their earnings.

(4) A very substantial query should be raised at the assumption that, in determining the amount of return on investment from any given date, it should be assumed that earnings on investments prior to that date do not depend to any extent on investments made after that date. Some provision should be made to take into account the fact that there should be attributed to investments made after the given date some credit for maintaining some part of the earnings already established through investments made prior to that date.

B. Dividend ratio

The dividend ratio is based upon unpublished information supplied by the Department of Commerce relating to earnings and common dividends of manufacturing subsidiaries abroad for the period 1953 to 1960. Again comparing the 4-year averages of 1953–56 and 1957–60, and the full 8 years, it will be noted that there is an increase in later years in the dividend ratios and here the higher 1957–60 ratio was used for the entire 1953–60 period.

Comment

(1) These dividend figures uniformly show increasing ratios of payouts during the second 4-year period, and the use of the 1957–60 ratio for the future fails to take into consideration this trend. This ratio increased by 13 percent in Canada between the two 4-year periods and by 11 percent in Western Europe.

(2) Moreover, 1957–60, known to be a period of heavy investment abroad, was also a period of heavy reinvestment of foreign earnings. The same motives that caused investments to be stepped up also resulted in stepped up reinvestment. Therefore the 1957–60 payout ratios, even though higher than those for the previous 4 years, are probably not appropriate for later years when investment activity becomes more normal.

C. Other payments ratio

Since the payout ratio was limited to dividends on common stock of foreign subsidiaries, a factor had to be included to reflect other payments by manufacturing subsidiaries abroad, such as dividends on preferred stock, interest, royalties, and management fees. The only information of this type available is contained in the Department of Commerce publication, U.S. Business Investments in Foreign Countries (1960), relating to the year 1957.

Comment

(1) The 1957 figures relate to a period when the general nonconvertibility of many foreign exchanges against the dollar made it difficult for a foreign subsidiary to pay a fee or royalty to a U.S. parent.

(2) There are also a number of other types of payments made by a foreign subsidiary to its U.S. parent or by employees of the foreign subsidiary to other parties in the United States, out of funds earned abroad, which are difficult to measure, such as—

(*a*) Expenses of a foreign company's headquarters office in United States.

(*b*) U.S. bank deposits of U.S.-owned foreign companies ("working capital float").

D. Net export ratio

The only figures specifically relating to exports and imports attributable to foreign subsidiaries are those contained in the Department of Commerce special study for 1959 and 1960. (See letter from Under Secretary Gudeman to Chairman Wilbur Mills dated June 22, 1961, included in vol. I, p. 427, of the May-June 1961 hearings reports.)

Comment

(1) The net export ratio is an average of the 1959–60 figures which is an insufficient basis upon which to project a forecast very far into the future.

(2) In the case of Europe the 2 years are not properly comparable. The average fails to reflect the 50-percent increase in exports to Europe and the 57-percent decrease in imports from Europe between 1959 and 1960. An average of these two rapidly changing situations is therefore of doubtful value.

(3) The 1959–60 figures include as attributable to the foreign subsidiaries only those shipments which were sent to the subsidiaries or, if sent to third parties, upon which the U.S. parent paid the foreign subsidiary a commission. A manufacturing subsidiary may often develop the sale of products in its U.S. parent company's line which are not manufactured by the subsidiary, without receiving any sales commission.

(4) Exports attributable to trading subsidiaries (substantial figures in both 1959 and 1960) were not included. In many situations, manufacturing and training activities are carried on side by side although using separate subsidiaries for each. From the standpoint of developing export sales it is often the existence of the manufacturing subsidiary, capable of providing service to local customers, that enables the sales subsidiary to make the sale.

(5) Finally, there is a question whether exports should be related entirely to the size of direct investment abroad. This size may have little to do with changes in the volume and sales abroad from year to year. Sales will fluctuate with the state of business abroad, with little regard to changes in the size of the investment. Therefore it might be more appropriate to use a ratio made up of a combination of two export figures: (*a*) capital goods exports related to the size of the investment abroad (or, perhaps, of fixed assets, if available), and (*b*) other exports related to sales of our foreign firms.

Aside from the inadequacy of the statistical base upon which to extend estimates into the future and the other comments made above, there are criticisms that can be made of some of the assumptions in exhibit III.

In analyzing the effect of exhibit III, the proposed tax change fails to take into consideration two important consequences that are likely to result, other than increased dividends and reduced investment abroad, which would have a material effect on the results shown in chart 2.

(1) *Increase in foreign tax rate.*—To the extent foreign subsidiaries have been employing artificial corporate structures abroad to achieve savings in foreign taxes at an additional cost of operations, such arrangements might be discontinued and higher foreign taxes would be paid. In addition foreign governments may introduce retaliatory taxation if the United States enacts this legislation. Such an increase in foreign taxes would correspondingly reduce the ratio of foreign earnings to foreign investment. Accordingly, it probably would be incorrect to compare "deferral" and "no deferral" at the same earnings rate.

(2) *Loss of competitiveness.*—Burdened with heavier taxation than their competitors, foreign subsidiaries would suffer a steady attrition in their earnings rate, which would be felt well within the 15-year period referred to in exhibit III.

Exhibit III makes the following suggestions to meet this problem:

(*a*) Reduce the level of dividends to shareholders: This would not only undermine the assumption upon which the "switch effect" is based, it would also result in the U.S. parent company paying the new tax based on the foreign subsidiaries' earnings.

(*b*) Borrow funds to pay the taxes: This would, of course, cause a steady reduction in the earnings ratio as the interest obligation mounted, making it inappropriate to use the same earnings ratio to compare "deferral" and "no deferral" situations.

V. BALANCE OF PAYMENTS EFFECT FROM A SINGLE INVESTMENT

An additional projection (see table 3), based on the assumptions made by the Treasury but taking a more realistic annual return for exports from Western Europe—8.5 percent instead of 4.1 percent—is of the greatest interest. This projection traces the record of recovery from a single investment made at the end of 1961, and thus omits the highly speculative annual increase of new investments assumed by the Treasury. Such a single investment in Western Europe would begin to return a net balance of payments profit by 1966—during the fifth year. Such a single investment in Canada would be recovered during the fourth year, and for the world as a whole the return would also exceed the investment during the fourth year.

Extension of Chart I of Exhibit III to a Total of 20 Years

Comparison of export of direct investment abroad on the balance of payments with and without "Deferral" using exhibit III statistics and assumptions

TABLE 1-A.—POST-1952 INVESTMENTS WITH "DEFERRAL"

[Millions of dollars]

	1952	1953	1954	1955	1956	1957	1958	1959	1960	1961	1962
1. Total capital, beginning of period		127.0	151.2	241.8	351.2	563.4	912.6	1,149.9	1,612.2	2,379.6	3,271.6
2. New capital inflow		20 0	72 0	90 0	184.0	304.0	164.0	370.0	638 0	701.0	771.0
3. Reinvested earnings (5−6)		10.2	12.6	19.4	28.2	45 2	73.3	92.3	129.4	191 0	262 6
4. Total capital, end of period	127.0	157.2	241 8	351.2	563.4	912.6	1,149.9	1,612.2	2,379 6	3,271.6	9,305.2
5. Earnings (14.7 percent of 1)		18.7	23.1	35 5	51.6	82 8	134.2	169.0	237.0	399.8	480.9
6. Dividends (45.4 percent of 5)		8.5	10.5	16.1	23.4	37 6	60.9	76.7	107.6	158.8	218.3
7. Other income (2.3 percent of 1)		2.9	3.6	5.6	8.1	13.0	21.0	26.4	37.1	54 7	75.2
8. Net exports (8 percent of 1)		10.2	12.6	19.3	28 1	45.1	73.0	92.0	129.0	190 4	261.7
9. Total inflow (6+7+8)		21.6	26.7	41.0	59.6	95.7	154.9	195.1	273.7	403.9	555.2
10. Annual net inflow:											
Post-1952 investments (9−2)	−127.0	1.6	−45.3	−49.0	−124.4	−208 3	−9.1	−174.9	−364.3	−297 1	−215.8
Pre-1953 investments (line 8, table 1-B)		630.2	680.8	735 4	794.6	858.3	919.1	1,002.9	1,083.4	1,170.4	1,264.3
Total	−127.0	631 8	635 5	686.4	670.2	650.0	910.0	828.0	719.1	873.3	1,048.5
11. Cumulative net inflow:											
Post-1952 investments	−127.0	−125 4	−170.7	−219.7	−344 1	−552.4	−561.5	−736.4	−1,100.7	−1,397.8	−1,613.6
Pre-1953 investments (line 9, table 1-B)		630.2	1,311.0	2,046 4	2,841.0	3,699.3	4,618.4	5,621.3	6,704.7	7,875.1	9,139.4
Total	−127.0	504.8	1,140.3	1,826.7	2,496.9	3,146.9	4,056 9	4,884.9	5,604.0	6,477.3	7,525.8

	1963	1964	1965	1966	1967	1968	1969	1970	1971	1972	Total
1. Total capital, beginning of period	4,305.2	5,498.8	6,873.1	8,450.7	10,258.0	12,323.3	14,678.4	17,359.5	20,405.8	23,861.6	[illegible] 127.0
2. New capital inflow	848.0	933.0	1,026.0	1,129.0	1,242.0	1,366.0	1,503.0	1,653.0	1,818.0	2,000.0	16,832.0
3. Reinvested earnings (5−6)	345.6	441.3	551.6	678.3	823.3	989.1	1,178.1	1,393.3	1,637.8	1,915.2	10,817.8
4. Total capital, end of period	5,498.8	6,873.1	8,450.7	10,258.0	12,323.3	14,678.4	17,359.5	20,405.8	23,861.6	27,776.8	27,776.8
5. Earnings (14.7 percent of 1)	632.9	808.3	1,010.3	1,242.3	1,507.9	1,811.5	2,157.7	2,551.8	2,999.7	3,507.7	19,812.7
6. Dividends (45.4 percent of 5)	287.3	367.0	458.7	564.0	684.6	822.4	979.6	1,158.5	1,361.9	1,592.5	8,994.9
7. Other income (2.3 percent of 1)	99.0	126.5	158.1	194.4	235.9	283.4	337.6	399.3	469.3	548.8	3,099.9
8. Net exports (8 percent of 1)	349.9	439.9	549.8	676.1	820.6	985.9	1,174.3	1,388.8	1,632.5	1,908.9	10,782.6
9. Total inflow (6+7+8)	730.7	933.4	1,166.6	1,434.5	1,741.1	2,091.7	2,491.5	2,946.6	3,463.7	4,050.2	22,877.4
10. Annual net inflow:											
Post-1952 investments (9−2)	−117.3	.4	140.6	305.5	499.1	725.7	988.5	1,293.6	1,645.7	2,050.2	----------
Pre-1953 investments (line 8, table 1-B)	1,365.8	1,475.4	1,593.9	1,721.3	1,859.9	2,009.1	2,170.3	2,344.5	2,532.7	2,735.4	----------
Total	1,248.5	1,475.8	1,734.5	2,026.8	2,359.0	2,734.8	3,158.8	3,638.1	4,178.4	4,785.6	----------
11. Cumulative net inflow:											
Post-1952 investments	−1,730.9	−1,730.5	−1,589.9	−1,284.4	−785.3	−59.6	928.9	2,222.5	3,868.2	5,918.4	----------
Pre-1953 investments (line 9, table 1-B)	10,505.2	11,980.6	13,574.5	15,295.8	17,155.7	19,164.8	21,335.1	23,679.6	26,212.3	28,947.7	----------
Total	8,774.3	10,250.1	11,984.6	14,011.4	16,370.4	19,105.2	22,264.0	25,902.1	30,080.5	34,866.1	----------

Comparison of export of direct investment abroad on the balance of payments with and without "Deferral" using exhibit III statistics and assumptions—Continued

TABLE 2-A.—POST-1952 INVESTMENTS WITHOUT "DEFERRAL"

[Millions of dollars]

	1952	1953	1954	1955	1956	1957	1958	1959	1960	1961	1962
1. Total capital, beginning of period	127.0	127.0	153.6	228.8	325.3	512 9	821.2	1,024 3	1,426.6	2,097 3	2,870.0
2. New capital inflow		18.0	64.8	81.0	165 6	273.6	147.6	333.0	574.2	630.9	693.9
3. Reinvested earnings (5-6)		8.6	10.4	15.5	22.0	34.7	55.5	69.3	96.5	141.8	194 1
4. Total capital, end of period	127.0	153.6	228 8	325 3	512.9	821 2	1,024.3	1,426.6	2,097.3	2,870 0	3,758 0
5. Earnings (14.7 percent of 1)		18 7	22 6	33.6	47.8	75.4	120.7	150.6	209.7	308.3	421.9
6. Dividends (54 percent of 5)		10.1	12 2	18.1	25.8	40 7	65.2	81.3	113.2	166.5	227.8
7. Other income (2.3 percent of 1)		2.9	3 5	5.3	7.5	11 8	18.9	23.6	32.8	48.2	66.0
8. Net exports (8 percent of 1)		10.2	12.3	18.3	26 0	41.0	65.7	81.9	114.1	167.8	229 6
9. Total inflow (6+7+8)		23.2	28.0	41.7	59.3	93 5	149.8	186.8	260.1	382.5	523.4
10. Annual net inflow:											
Post-1952 investments (9-2)	−127.0	5.2	−36 8	−39.3	−106 3	−180.1	2.2	−146.2	−314.1	−248.4	−170 5
Pre-1953 investments (line 8, table 2-8)		677.1	723.0	771.8	824 1	879.7	939.3	1,002.9	1,070.6	1,142 9	1,220.3
Total	−127.0	682.3	686.2	732 5	717.8	699 6	941.5	856.7	756 5	894.5	1,049.8
11. Cumulative net inflow:											
Post-1952 investments	−127.0	−121 8	−158.6	−197.9	−304 2	−484.3	−482.1	−628.3	−942.4	−1,190.8	−1,361.3
Pre-1953 investments (line 9, table 2-B)		677.1	1,400.1	2,171.9	2,996.0	3,875.7	4,815.0	5,817.9	6,888.5	8,031.4	9,251.7
Total	−127.0	555.3	1,241.5	1,974.0	2,691.8	3,391.4	4,332.9	5,189.6	5,946.1	6,840.6	7,890.4

	1963	1964	1965	1966	1967	1968	1969	1970	1971	1972	Total
1. Total capital, beginning of period	3,758.0	4,775.3	5,937.9	7,262.8	8,770.0	10,480.8	12,418.9	14,611.4	17,041.1	19,829.6	127 0
2. New capital inflow	763.2	839.7	923.4	1,016.1	1,117.8	1,229.4	1,352.7	1,487.7	1,636.2	1,800.0	15,148.8
3. Reinvested earnings (5-6)	254.1	322.9	401.5	491.1	593.0	708.7	839.8	942.0	1,152.3	1,340.9	7,694.7
4. Total capital, end of period	4,775.3	5,937.9	7,262.8	8,770.0	10,480.8	12,418.9	14,611.4	17,041.1	19,829.6	22,970.5	22,970.5
5. Earnings (14.7 percent of 1)	552.4	702.0	872.9	1,067.6	1,289.2	1,540.7	1,825.6	2,047.9	2,505.0	2,914.9	16,727.5
6. Dividends (54 percent of 5)	298.3	379.1	471.4	576.5	696.2	832.0	985 8	1,105.9	1,352.7	1,574.0	9,032.8
7. Other income (2.3 percent of 1)	86.4	109.8	136.6	167.0	201.7	241.1	285.6	336.1	391.9	456.1	2,632.8
8. Net exports (8 percent of 1)	300.6	382.0	475.0	581.0	701.6	838.5	993.5	1,168.9	1,363.3	1,586 4	9,157.7
9 Total inflow (6+7+8)	685.3	870.9	1,083.0	1,324.5	1,599.5	1,911.6	2,264.9	2,610.9	3,107.9	3,616.5	20,823.3
10. Annual net inflow·											
Post-1952 investments (9-2)	−77.9	31.2	159.6	308 4	481.7	682.2	912.2	1,123 2	1,471.7	1,816.5	
Pre-1953 investments (line 8, table 2-B)	1,302.9	1,390.9	1,485.3	1,585.3	1,692.5	1,807.0	1,929.1	2,059.6	2,198.8	2,347.7	
Total	1,225.0	1,422.1	1,644.9	1,893.7	2,174.2	2,489.2	2,841.3	3,182.8	3,670.5	4,164.2	
11. Cumulative net inflow:											
Post-1952 investments	−1,439.2	−1,408.0	−1,248.4	−940.0	−458.3	223.9	1,136.1	2,259 3	3,731.0	5,547.5	
Pre-1953 investments (line 9, table 2-B)	10,554.6	11,945.5	13,430.5	15,015.8	16,708.3	18,515.3	20,444.4	22,504.0	24,702.8	27,050.5	
Total	9,115.4	10,537.5	12,182.1	14,075.8	16,250.0	18,739.2	21,580.5	24,763.3	28,433 8	32,598.0	

Comparison of export of direct investment abroad on the balance of payments with and without "Deferral" using exhibit III statistics and assumptions—Continued

TABLE 1-B.—PRE-1953 INVESTMENTS WITH "DEFERRAL"

[Millions of dollars]

	1952	1953	1954	1955	1956	1957	1958	1959	1960	1961	1962
1. Total capital, beginning of period		3,713.0	4,011 0	4,332 9	4,680 7	5,056.4	5,462.2	5,908 6	6,382.9	6,895.2	7,448.6
2. Reinvested earnings (4-5)		298 0	321.9	347 8	375 7	405.8	446 4	474 3	512.3	553.4	597.8
3. Total capital, end of period	3,713 0	4,011.0	4,332 9	4,680 7	5,056 4	5,462.2	5,908 6	6,382 9	6,895 2	7,448 6	8,046.4
4. Earnings (14.7 percent of 1)		545.0	589 6	636 9	668 1	743 3	802 9	868.6	938.3	1,013.6	1,094 9
5. Dividends (45.4 percent of 4)		247 8	267.7	289 1	312.4	337.5	356.5	394 3	426.0	460 2	497.1
6. Other income (2.3 percent of 1)		85 4	92 2	99 7	107.7	116.3	125 6	135 9	146.8	158.6	171.3
7. Net exports (8 percent of 1)		297 0	320.9	346.6	374.5	404 5	437.0	472.7	510 6	551 6	595.9
8. Annual inflow (5+6+7)		630 2	680 8	735.4	794.6	858 3	919.1	1,002.9	1,083.4	1,170.4	1,264 3
9. Cumulative inflow		630.2	1,311.0	2,046.4	2,841 0	3,699 3	4,618 4	5,621.3	6,704.7	7,875.1	9,139.4

	1963	1964	1965	1966	1967	1968	1969	1970	1971	1972	Total
1. Total capital, beginning of period	8,046 4	8,692.2	9,389.9	10,143.5	10,957 1	11,836 5	12,786.5	13,812.8	14,921 5	16,119 2	3,713.0
2. Reinvested earnings (4-5)	645.8	697.7	753 6	813 6	879.4	950 0	1,026.3	1,108 7	1,197.7	1,293.7	13,699.9
3. Total capital, end of period	8,692.2	9,389.9	10,143 5	10,957.1	11,836.5	12,786 5	13,812.8	14,921.5	16,119.2	17,412 9	17,412.9
4. Earnings (14.7 percent of 1)	1,182.8	1,277.8	1,380.3	1,490 1	1,610.7	1,740 0	1,879.6	2,030.5	2,193.5	2,369.5	25,076 8
5. Dividends (45.4 percent of 4)	537.0	580.1	626 7	676.5	731 3	790.0	853.3	921 8	995 8	1,075 8	11,376 9
6. Other income (2.3 percent of 1)	185.1	199.9	216 0	233 3	252.0	272 2	294 1	317.7	343.2	370.1	3,923.1
7. Net exports (8 percent of 1)	643 7	695.4	751 2	811.5	876.6	946 9	1,022 9	1,105.0	1,193 7	1,289.5	13,647.6
8. Annual inflow (5+6+7)	1,365 8	1,475 4	1,593 9	1,721.3	1,859.9	2,009 1	2,170 3	2,344.5	2,532.7	2,735.4	26,947.6
9. Cumulative inflow	10,505.2	11,980.6	13,574 5	15,295.8	17,155.7	19,164.8	21,335.1	23,679 6	26,212.3	28,947.7	

TABLE 2-B.—PRE-1953 INVESTMENTS WITHOUT "DEFERRAL"

	1952	1953	1954	1955	1956	1957	1958	1959	1960	1961	1962
1. Total capital, beginning of period	----------	3,713.0	3,964.1	4,232.1	4,518.3	4,823.8	5,150.0	5,498 3	5,870.1	6,267.0	6,690.8
2. Reinvested earnings (4-5)	----------	251.1	268.0	286 2	305.5	326.2	348.3	371.8	396.9	423.8	452.4
3. Total capital, end of period	3,713.0	3,964 1	4,232.1	4,518.3	4,823.8	5,150.0	5,498.3	5,870.1	6,267.0	6,690.8	7,143.2
4. Earnings (14.7 percent of 1)	----------	545.8	582.7	622.1	664 2	709.1	757.1	808.3	862.9	921.2	983.5
5. Dividends (54 percent of 4)	----------	294.7	314.7	335.9	358.7	382.9	408.8	436.5	466 0	497.4	531.1
6. Other income (2.3 percent of 1)	----------	85.4	91.2	97.3	103.9	110.9	119.5	126.5	135.0	144.1	153.9
7. Net exports (8 percent of 1)	----------	297.0	317 1	338.6	361.5	385.9	412.0	439.9	469 6	501.4	535.3
8. Annual inflow (5+6+7)	----------	677.1	723.0	771.8	824.1	879.7	939.3	1,002.9	1,070.6	1,142.9	1,220.3
9. Cumulative inflow	----------	677.1	1,400.1	2,171 9	2,996.0	3,875.7	4,815 0	5,817 9	6,888.5	8,031.4	9,251.7

	1963	1964	1965	1966	1967	1968	1969	1970	1971	1972	Total
1. Total capital, beginning of period	7,143 2	7,626.2	8,141.9	8,692.5	9,280.3	9.907.8	10,577.7	11,293 0	12,056.6	12.871.9	3,713.0
2. Reinvested earnings (4−5)	483.0	515.7	550.6	587.8	627.5	669.9	715.3	763.6	815 3	870 4	10,029.3
3. Total capital, end of period	7,626 2	8,141.9	8,692.5	9,280.3	9,907 8	10,577.7	11,293 0	12,056.6	12,871.9	13,742.3	13,742.3
4. Earnings (14.7 percent of 1)	1,050.1	1,121.1	1,196.9	1,277.8	1,364.2	1,456.4	1,554.9	1,660.1	1,772.3	1,892.2	21,802.8
5. Dividends (54 percent of 4)	567.1	605.4	646.3	690 0	736.7	786.5	839.6	896.5	957.0	1,021.8	11,773.6
6. Other income (2.3 percent of 1)	164 3	175 4	187.3	199.9	213 4	227.9	243 2	259 7	277.3	296 1	3,411 3
7. Net exports (8 percent of 1)	571 5	610.1	651.4	695 4	742.4	792.6	846.2	903 4	964.5	1,029.8	11,865 6
8. Annual inflow (5+6+7)	1,302.9	1,390.9	1,485.0	1,585.3	1,692 5	1.807.0	1,929.1	2,059.6	2,198.8	2,347.7	27,050.5
9. Cumulative inflow	10,554.6	11,945.5	13,430.5	15,015.8	16,708 3	18,515 3	20,444.4	22,504 0	24,702.8	27,050.5	----------

TABLE 3.—*Computation of period elapsed in recovering direct dollar investment abroad—using adjusted[1] Bell ratios and a single 1,000 capital outflow, Jan. 1, 1962*

	1962	1963	1964	1965	1966
CANADA					
1. Total capital, beginning of period	1,000	1,055	1,113	1,175	-------
2. Reinvested earnings (4—5)	55	58	62	65	-------
3. Total capital, close of period	1,055	1,113	1,275	1,240	-------
4. Earnings (9.6 percent of 1)	96	101	107	113	-------
5. Dividends (42.3 percent of 4)	41	43	45	48	-------
6. Royalties and fees (1.8 percent of 1)	18	19	20	21	-------
7. Net exports (17.7 percent of 1)	177	187	197	208	-------
8. Total inflow (5+6+7)	236	249	262	277	-------
9. Net dollar outflow from 1961 investment	−764	−515	−253	+24	-------
WESTERN EUROPE					
1. Total capital, beginning of period	1,000	1,089	1,187	1,293	1,409
2. Reinvested earnings (4—5)	89	98	106	116	126
3. Total capital, close of period	1,089	1,187	1,293	1,409	1,535
4. Earnings (16.8 percent of 1)	168	183	199	217	237
5. Dividends (46.7 percent of 4)	79	85	93	101	111
6. Royalties and fees (2.5 percent of 1)	25	27	30	32	35
7. Net exports (8.5 percent of 1) [1]	85	93	101	110	120
8. Total inflow (5+6+7)	189	205	224	243	266
9. Net dollar outflow from 1961 investment	−811	−606	−382	−139	+127
CANADA AND WESTERN EUROPE					
1. Total capital, beginning of period	1,000	1,080	1,167	1,261	1,362
2. Reinvested earnings (4—5)	80	87	94	101	109
3. Total capital, close of period	1,080	1,167	1,261	1,362	1,471
4. Earnings (14.7 percent of 1)	147	159	172	185	200
5. Dividends (45.4 percent of 4)	67	72	78	84	91
6. Royalties and fees (2.3 percent of 1)	23	25	27	29	31
7. Net exports (11.16 percent of 1) [1]	112	121	130	141	152
8. Total inflow (5+6+7)	202	218	235	254	274
9. Net dollar outflow from 1961 investment	−798	−580	−345	−91	+183
LATIN AMERICA					
1. Total capital, beginning of period	1,000	1,063	1,130	-------	-------
2. Reinvested earnings (4-5)	63	67	71	-------	-------
3. Total capital, close of period	1,063	1,130	1,201	-------	-------
4. Earnings (9 percent of 1)	90	96	102	-------	-------
5. Dividends (30.2 percent of 4)	27	29	31	-------	-------
6. Royalties and fees (1.6 percent of 1)	16	17	18	-------	-------
7. Net exports (41.5 percent of 1)	415	441	469	-------	-------
8. Total inflow (5+6+7)	458	487	518	-------	-------
9. Net dollar outflow from 1961 investment	−542	−55	+463	-------	-------
REST OF WORLD					
1. Total capital, beginning of period	1,000	1,103	-------	-------	-------
2. Reinvested earnings (4-5)	103	113	-------	-------	-------
3. Total capital, close of period	1,103	1,216	-------	-------	-------
4. Earnings (18.7 percent of 1)	187	206	-------	-------	-------
5. Dividends (45.1 percent of 4)	84	93	-------	-------	-------
6. Royalties and fees (1.7 percent of 1)	17	19	-------	-------	-------
7. Net exports (47.8 percent of 1)	478	527	-------	-------	-------
8. Total inflow (5+6+7)	579	639	-------	-------	-------
9. Net dollar outflow from 1961 investment	−421	+60	-------	-------	-------

[1] Substitutes 8.5 percent (1960 ratio) for 4.1 percent (1959–60 average) for Western average.

TABLE 3.—*Computation of period elapsed in recovering direct dollar investment abroad—using adjusted[1] Bell ratios and a single 1,000 capital outflow, Jan. 1, 1962*—Continued

	1962	1963	1964	1965	1966
LATIN AMERICA AND REST OF WORLD					
1. Total capital, beginning of period	1,000	1,077			
2. Reinvested earnings (4–5)	77	83			
3. Total capital, close of period	1,077	1,160			
4 Earnings (11 7 percent of 1)	117	126			
5. Dividends (34 3 percent of 4)	40	43			
6. Royalties and fees (1.4 percent of 1)	14	15			
7. Net exports (43.2 percent of 1)	432	465			
8. Total inflow (5+6+7)	486	523			
9. Net dollar outflow from 1961 investment	−514	+9			
WORLD					
1. Total capital, beginning of period	1,000	1,080	1,166	1,259	
2. Reinvested earnings (4–5)	80	86	93	100	
3. Total capital, close of period	1,080	1,166	1,259	1,359	
4. Earnings (14 percent of 1)	140	151	163	176	
5. Dividends (43 percent of 4)	60	65	70	76	
6. Royalties and fees (1.7 percent of 1)	17	18	20	21	
7. Net exports (16.75 percent of 1) [1]	168	181	195	211	
8. Total inflow (5+6+7)	245	264	285	308	
9 Net dollar outflow from 1961 investment	−755	−491	−206	+23	

[1] Substitutes 8 5 percent (1960 ratio) for 4.1 percent (1959–60 average) for Western average.

STATEMENT OF SENATOR JACOB K. JAVITS, U.S. SENATOR FROM THE STATE OF NEW YORK ON H.R. 10650, TO AMEND THE INTERNAL REVENUE CODE

I appreciate this opportunity to discuss before you briefly the proposed withholding tax on dividend and interest income and the investment credit provision in the bill under consideration. I hope to speak at greater length on the problems involved in the tax proposals dealing with income of foreign subsidiaries of U.S. business firms.

I. WITHHOLDING TAX ON DIVIDEND AND INTEREST INCOME

In a time of grave national peril, when our responsibilities are so great, those of us who are convinced that these responsibilities must be met fully also have an obligation to see that tax resources are available for our undertakings. Nor can we overlook the essentiality of a fair assessment of the tax burden so that it does not fall unduly upon some, while others who are equally liable to taxation escape.

It is our duty in the Congress to consider well the claims of the administration that it needs the revenue rightfully due from nonpayment of taxes on dividend and withholding income. The administration contends that there is widespread failure in the payment of such taxes—an estimated revenue loss of $850 million per year, of which the Treasury hopes to recoup $650 million through the withholding process.

To put the matter in perspective, although $650 million represents a very considerable sum, it is still less than 1 percent of the total of $78 billion in corporate and individual income taxes which the administration expects to collect during fiscal year 1963. Thus, consideration should be given to the practicality, measured in terms of inconvenience, expense, and possible inequity, of collecting the tax revenue which may be recovered.

By this test, the measure which came from the other body is impractical and should be rejected and another approach adopted.

A number of ideas have been proposed to deal with these practicalities. I am sure that the members of this committee are well aware of these alternatives but I should like to summarize them from the point of view of practicality which I am attempting to present.

1. To require payers of both interest and dividends in amounts over $10 annually to file information returns with the Treasury—as is already done with dividends under present law—and to add the new requirement that copies of the information returns be sent to the taxpayers with clear notice that the amounts recorded must be included in the recipients' taxable income.

2. To amend the income tax return form to require the taxpayer to answer "yes" or "no" to the questions, "Do you have a savings account?" and "Do you own stock in a corporation?" Furthermore, to require the taxpayer who answers "yes" to annex to his return a copy of the information return sent to him by the payer.

3. To publicize widely the institution of the automatic data processing system under which every taxpayer's return will be matched against the information returns filed by the payers.

4. If there is to be withholding, to eliminate the requirement that those over 18 who expect to owe no tax must file exemption certificates each year, making such certificates permanent, subject to any change in tax status, and thus particularly reducing the burden upon those over 65 who have a special tax status. Furthermore, to authorize the Secretary of the Treasury to issue regulations exempting additional classes of taxpayers from withholding, reducing the rate of withholding, or making other changes in the system, when in his judgment difficulties outweigh the advantages of the particular provisions.

II. INVESTMENT CREDIT AS AN INCENTIVE TO BUSINESS MODERNIZATION

Although I have no basic objection to the investment credit proposal, I believe that to stimulate automation and new equipment, an immediate modernization of tax depreciation schedules is more important and effective and should go forward without regard to what happens to the investment credit proposal in this bill.

I have recently urged the President to issue an order speeding up the work currently being undertaken by the Treasury to bring up to date our longstanding and now unrealistic tax depreciation schedules on machinery and equipment. The testimony of businessmen—even those who may profit extensively from the investment credit feature—indicates an overwhelming preference for a revision of depreciation schedules as against investment credit.

It is necessary to consider the administration's claim that the investment credit proposal would provide more direct help at less cost in the short run. However, it appears that the longrun cost may be higher. The pressures on the U.S. budget which are expected to last far into the future cannot be ignored in the interest of temporary advantages nor can we ignore the preferences of those who are expected to apply constructively the tax benefits granted.

III. TAXATION OF INCOME OF FOREIGN SUBSIDIARIES OF U.S. BUSINESS FIRMS

I believe the taxation of foreign subsidiaries income by the method proposed to be unwise in our national interest. It should be rejected and another method substituted. I am submitting a proposal for that purpose.

I would like to make a sharp distinction between two aspects of this question.

First, there is the problem of the use of foreign subsidiary corporations for the purpose of escaping domestic taxes properly due to the United States. I believe that responsible businessmen will agree with the Congress and the Treasury that these abuses must be halted by effective legislation and by implementation of legislation already on the books.

Second, there is the broad question of the national interest in U.S. foreign investment. It has been the basic policy of this Nation for many decades, under both Democratic and Republican administrations, to rely on the flow of direct long-term private investment overseas as a basic component of our foreign economic policy. Furthermore, the beneficial impact on domestic U.S. employment and profit of long-term private investment overseas under a system of competitive enterprise had not been questioned until the administration presented its tax proposals which, it is widely suggested, will discourage such investment.

My principal plea is that new legislation should distinguish between these two aspects and avoid injuring the broad national interest in the process of correcting specific abuses.

The administration's proposals go beyond elimination of abuses and will, I believe, discourage U.S. direct private investment in the fully developed nations of the free world—Western Europe, Canada, and Japan—and will probably discourage such investment generally. The provisions in H.R. 10650 may or may not effectively prevent the instances of tax evasion cited by the administration, but I believe they will be an adverse development in the foreign economic policy of the United States and in the effort to help keep existing oversea investments competitive under changing world market conditions.

Since there are methods to prevent tax evasion with a minimal adverse effect on the continued, natural economically sound flow of investments, I should like to turn my attention to the deleterious effect of measures which will discourage U.S. private oversea investment. In this connection certain questions come to my mind:

1. How can it be shown that discouragement of that amount of investment and reinvestment in oversea facilities which takes place as the result of present methods of taxation would have a substantial effect in rectifying the U.S. balance-of-payments deficit?

2. Even if reasonable proof could be given that the discouragement of such investment and reinvestment would favorably influence our short-term balance-of-payments position, what would be the results over the next two decades?

3. Since the balance of payments is only one manifestation of the total U.S. foreign economic policy position—actually serving as one device for measuring the strength for this position—what purpose would be served in inducing a short-term improvement in our balance of payments, if such an improvement took place at the expense of undermining the base of our total foreign economic policy?

The assumptions of the Treasury as put forth in exhibit III submitted by the Secretary of the Treasury during his testimony before this committee are used to demonstrate a short-term advantage to our balance-of-payments position, if the proposals for discouraging U.S. direct oversea private investment are enacted. An analysis prepared by my office puts a different perspective on this matter and I would like to submit it to the committee for consideration.

The international responsibilities and the domestic welfare of the U.S. demand an expansion of U.S. private investment overseas—not a contraction. Our economic way in the world is forward and outward. There is no other likely course I see to peace with freedom than a full commitment of our Nation to its undeniable leadership of the free world.

For these reasons I believe that the House-passed version of section 13, by not distinguishing between tax abuses and legitimate foreign investment, will not forward the U.S. economic and foreign policy objectives. Accordingly, I intend to introduce shortly as a suggestion for the committee's consideration an amendment to section 13 which will make this distinction.

This amendment to section 13 of H.R. 10650 will be designed to tax U.S. shareholders of certain foreign corporations without deferral if the earnings and profits of such corporations are accumulated unreasonably abroad, rather than being paid to the shareholders as dividends. In effect, section 13 so amended would treat the deferral of foreign corporation profits as tax avoidance only if there is no business-related reason for such deferral, rather than as per se tax avoidance as does section 13 in its present form.

It should be noted that sections 6 and 16 of H.R. 10650 accomplish a great deal to eliminate true tax "abuses" in the foreign field. For example, at present a U.S. parent corporation may sell goods to its Panamanian subsidiary at an artificially low price, with the true sales profit retained without U.S. tax consequences in Panama. Section 482 of the code has been available to reallocate the sales income to the U.S. parent, but that provision has been difficult for the Commissioner to apply effectively. Section 6 of the bill, while it may be criticized as adopting too objective a test and one which may be unreal in certain situations, will give the Commissioner an effective method of preventing this type of abuse.

As another example, under present law profits may be deferred for a considerable period in a foreign corporation, after which the corporation is completely liquidated at capital gains rates to its shareholders. There is thus not only tax "deferral," but a change in the character of the income and the resultant

U.S. tax. Section 16 of the bill would eliminate the change in character of such income by generally denying capital gains treatment to the subsequent liquidation.

Thus, section 13 of H.R. 10650 is left to cope primarily with problems of "deferral" in the area of taxation, while attempting also, unsuccessfully, as I have suggested, to serve an additional purpose in the area of the U.S. balance-of-payments position. Modified by the amendment I will submit to the committee, section 13 would constitute a relatively direct approach to the problem of taxation of profits of foreign corporations controlled by U.S. persons. Because it is a direct approach, it would be effective primarily as implemented by regulations of the Internal Revenue Service and decisions of the courts.

The amendment to section 13 to be submitted will be modeled basically on sections 531 through 537 of the Internal Revenue Code which tax the accumulated earnings of domestic corporations. However, certain changes will be necessary because of the different contexts in which the two sets of provisions would operate. Under section 531 the accumulated earnings tax is asserted against a domestic corporation rather than the stockholders, whereas under section 13 the tax must ultimately be asserted against the shareholders in view of the lack of jurisdiction to assert a tax against the foreign corporation itself. Also, while the tax on the corporation imposed by section 531 of the code is considered a surtax or "penalty" tax, the tax upon stockholders under section 13 is an ordinary income tax. The principal change will be that the provisions contained in section 534 of the code relating to the shifting of burden of proof to the Government would not be applied to foreign corporations because the Commissioner is at a greater disadvantage in obtaining factual information overseas.

Apart from these differences, I believe that the accumulated earnings approach patterned upon section 531 of the code offers a valid test for differentiating between tax haven and legitimate operations abroad, in keeping with the policy objectives which I have urged.

The CHAIRMAN. I submit for the record a memorandum from Mr. Carter W. Atkins, president, Connecticut Public Expenditure Council, Inc., 21 Lewis Street, Hartford, Conn.

(The memorandum follows:)

MAY 3, 1962.

Hon. HARRY F. BYRD,
Chairman, Senate Committee on Finance:

We State taxpayer-research organizations, now operating in 32 States, are of the firm opinion that section 3 of the Revenue Act of 1962 (H.R. 10650), would put such restrictions upon us and upon our members as to prohibit us from exercising the function for which we were created. Our organizations, many in existence for more than 20 years, are established for the purpose of studying government, primarily and particularly, at the State and local levels and for the dissemination of factual information about government to public officials and the general public.

Our organizations have the support of a large segment of the taxpaying public who believe that the study of government and the publication of facts about it is essential to our system of government. With the support of these taxpayers we have made a great contribution to raising the level of citizen and official understanding of government, especially State and local, in our respective States. We, therefore, ask your favorable consideration of the removal of the possibility, which exists in section 3, of the serious curtailment of this citizen endeavor and possibly its very existence.

We propose the following alternatives, either of which, we believe, would substantially remedy the difficulty:

A. Substitute for the present languages in section 3 the language in the Kerr-Hartke bill S. 467 or the language in the Boggs bill H.R. 640, which was approved by the House Ways and Means Committee, July 1, 1961, or

B. Strike from section 3 all of "Limitation (2–B)" lines 3, 4, 5, and 6, page 27, or

C. The following amendments, viz:

On page 26, line 20, after the period insert the following: "The deduction allowed by subsection (a) shall also include that portion of the dues or other amounts paid or incurred during the taxable year in carrying on any trade or business with respect to an organization of which the taxpayer is a member

and which is organized and operated primarily to study and analyze governmental affairs (including legislation or proposed legislation) and to publish and distribute to its members and to the public reports and information pertaining to such governmental affairs, but only if such organization is not organized or operated for profit and no part of its net earnings inures to the benefit of any private shareholder or individual."

On page 27, line 6, before the period insert the following: "(other than by the publication and distribution to its members and to the public of reports and information described in the last sentence of paragraph (1) by an organization described in such sentence)".

Respectfully submitted.

CARTER W. ATKINS,
President, Connecticut Public Expenditure Council, Inc.

The above statement is concurred in by the following State taxpayer research organizations:

Arizona Tax Research Association
Florida Taxpayers Association, Inc.
Georgia Tax Research Foundation, Inc.
Associated Taxpayers of Idaho
Taxpayers Federation of Illinois
Indiana Taxpayers Association
Iowa Taxpayers Association
Massachusetts Federation of Taxpayers Associations, Inc.
Minnesota Taxpayers Association
Missouri Public Expenditure Survey
Montana Taxpayers Association
Nebraska Tax Research Council, Inc.
Nevada Taxpayers Association
New Hampshire Taxpayers Federation
New Jersey Taxpayers Association, Inc.
The Taxpayers Association of New Mexico
Citizens Public Expenditure Survey, Inc. (N.Y.)
North Carolina Citizens Association, Inc.
North Dakota Taxpayers Association, Inc.
Ohio Public Expenditure Council
Oklahoma Public Expenditures Council
Oregon Tax Research
Rhode Island Public Expenditure Council
Greater South Dakota Association
Texas Research League
Utah Taxpayers Association
Washington State Research Council
Public Expenditure Survey of Wisconsin
Wyoming Taxpayers Association
Raymond A. Kimball, executive director, Colorado Public Expenditure Council

The CHAIRMAN. I submit for the record the statement of H. Neil Mallon, chairman of the executive committee of Dresser Industries, Inc., in lieu of his appearance before the committee.

STATEMENT OF H. NEIL MALLON, CHAIRMAN OF EXECUTIVE COMMITTEE, DRESSER INDUSTRIES, INC.

My purpose in filing this statement is to bring to your attention aspects of the pending bill on taxation of foreign income which will—

Seriously impair our national interests;

Reduce domestic employment;

Aggravate our already serious balance-of-payments difficulties and increase the outflow of gold;

Undermine the administration's reciprocal trade program; and

Add to the dislocation of business and of labor which the President has recognized will result from the trade program.

Indeed, those features of the bill to which I refer will tend to frustrate the expressed objectives of the administration in proopsing this legislation.

I am convinced that the taxation of income of foreign subsidiaries, as provided in the bill, would be contrary to our national interest and is of doubtful constitutionality. Since you will hear much on this subject from others, I will confine my remarks to the adverse effects of the bill upon the large segment of industry which has only moderate foreign investment but which contributes significantly to our export trade.

I. THE PROBLEM

In commenting upon our balance-of-payments difficulties, the President recently stated:

"Above all, we must harness the energies of all our people—in labor and management as well as government—to the vital task of keeping our industry competitive and expanding our exports."

The Secretary of the Treasury, in reporting on the balance of payments, stated that "we must * * * achieve still larger commercial surplus by competing more vigorously with producers of other countries, both in foreign markets and at home."

He added: "Longrun equilibrium will be reached and maintained only if private industry * * * actively seeks out and fully exploits its export opportunities * * * (Americans must demonstrate) bold initiative in seizing export opportunities that the circumstances require."

In the President's message on the reciprocal trade agreements program, he stated: "To maintain our defense, assistance, and other commitments abroad, while expanding the free flow of goods and capital, we must achieve a reasonable equilibrium in our international accounts by offsetting these dollar outlays with dollar sales."

He added: "Our efforts to expand our economy will be importantly affected by our ability to expand our exports—and particularly upon the ability of our farmers and businessmen to sell to the Common Market."

"European manufacturers, however, have increased their share of this rapidly expanding market at a far greater rate than American manufacturers * * * our efforts to prevent inflation will be enforced by expanded trade * * *. The American businessman, once the authority granted by this (reciprocal trade) bill is exercised, will have a unique opportunity to compete on a more equal basis in the rich and expanding market abroad which possesses potentially a purchasing power as large and as varied as our own."

In his testimony before this committee on April 2 Secretary Dillon, in urging adoption of the investment credit features of the pending bill, stated: "It is essential to our competitive position in markets both here at home and abroad that American industry be put on the same basis as foreign industry. Unless this is done increased imports and decreased exports will unnecessarily add to our balance-of-payments deficit."

Many industry representatives before this committee and before the House Ways and Means Committee have also emphasized the paramount importance to our national interests of a vital and expanding export trade. Mr. Stanley Ruttenberg, director of research for the AFL-CIO, stated in his testimony before you on April 4: "* * * Much can be done—and now is being done by other governments—to legitimately stimulate exports."

He suggested that your committee consider various techniques for accomplishing that objective and added: "In our view, this committee would perform a great service by thoroughly studying the feasibility of these and all other export stimulating alternatives."

Yet, the bill now before this committee would sweep into a single tax-gathering net—

Foreign manufacturing subsidiaries;

Foreign subsidiaries performing an essential function in export trade stimulation; and

Foreign subsidiaries whose only function is tax avoidance.

By failing to take into account the special problems of export trade, the bill would impede export development. It would defeat the vital objective of stimulating our exports, an objective on which the President, the Secretary of Treasury, the Secretary of Commerce, and all segments of American private industry and labor are in common agreement. Should your committee conclude that foreign investment in the developed countries should be deterred (and I hope you will not do so) and that the use of sham tax haven subsidiaries should be prevented (with which I am in wholehearted sympathy) there remains the problem of how to accomplish these objectives while, at the same time, stimulating our export trade.

I will propose for your consideration a remedy for this problem. This remedy will convert the export deterrents of the bill into an export incentive. At the same time, this remedy will provide a simple and workable means for distinguishing between foreign subsidiaries which perform no function other than tax avoidance and foreign subsidiaries which play an important role in promoting our export trade.

The bill before you makes a distinction between developed and less-developed countries and purports to furnish an incentive toward greater participation by American industry in development of the latter countries. I submit that the United States is an underdeveloped country in the sense that it has not taken full advantage of the free world's burgeoning export markets. As a result, domestic growth, domestic employment, and our country's gold reserves have suffered.

II. DRESSER INDUSTRIES AND U.S. EXPORTS

The problem and its solution can be illustrated by a brief description of the role which Dresser Industries, typical of a large segment of American industry, plays in our export economy. To demonstrate how this bill will defeat its declared objectives I will explain briefly the functions performed by our foreign subsidiaries, functions which are essential to our export business. I will then outline the enervating effects which the pending bill will have on our export business, and the pressure it will exert upon us to increase our foreign investment and manufacture in the developed countries, reduce our domestic payroll, and decrease our sales of American-made products.

A. Dresser's products and facilities

In 16 domestic subsidiaries or divisions, Dresser manufactures a wide variety of products and supplies, technical services essential to the chemical, petroleum, natural gas, oil and gas transmission, water and sewerage treatment and distribution, electric power, and other industries. Our products include compressors, pumps, pipe couplings, drilling rigs, industrial blowers, electronic instruments, and numerous types of specialized oilfield exploration, drilling, and production devices and materials. Substantially all of our manufacturing and production facilities are situated in the United States. We have only one foreign manufacturing facility—a British plant for the manufacture of drilling bits. This plant is jointly owned with British interests and was established only because exchange controls prevented us from otherwise serving the British Commonwealth markets and other soft currency areas. Our only other foreign production comes from the mining and processing of minerals in Nova Scotia, Mexico, Greece, Iran, and Venezuela, which enable us to obtain a source of supply and to serve remote areas not otherwise available or accessible. We also have interests in several small assembly operations in countries which set up insurmountable barriers to export of the completely assembled product.

B. Dresser's export organization

Our entire export program (except with respect to Canada) is handled through what we call the Dresser A.G. group. With headquarters in Switzerland and Liechtenstein, the Dresser A.G. group serves as the selling and servicing organization to promote the maximum possible distribution outside the United States of products manufactured by U.S. subsidiaries and divisions of Dresser Industries, Inc. In South America, three subsidiaries of Dresser A.G. perform technical oilfield servicing activities. These utilize a substantial investment in equipment manufactured by us in the United States.

Through its combined operations, Dresser A.G. has 15 different office locations in 12 different countries. It has 550 employees engaged in sales, service, sales engineering, and similar services, all of which are essential to the sale of our equipment and the maintenance of our foreign market position. Employees located in Europe, Africa, South America, Japan, and India travel extensively to most other countries of the world in order to promote our products. Dresser A.G. personnel have arranged about 147 different sales agency agreements with sales agents in 122 different countries, and its personnel provide continuing contact, encouragement, advice, and assistance to these agents. Dresser A.G., through its combined resources, conducts its operations in practically all the non-Communist bloc countries of the world except the United States and Canada.

Besides direct selling, servicing, and sales engineering activities, Dresser A.G. conducts market surveys to develop more complete coverage of the foreign market; it seeks out technological developments and new inventions which might be beneficial to manufacturing processes employed by our domestic factories; and it assists in working out credit transactions and currency and exchange problems for foreign purchasers of our products. For all of the varied services and activities which Dresser A.G. performs for our U.S. subsidiaries and divisions Dresser A.G. is paid sales representation commissions.

The propriety of these commissions has been recognized by the Internal Revenue Service with which, after intensive audit, we have worked out a basis upon which compensation is payable to Dresser A.G. by the American companies it serves. Clearly, Dresser A.G. is not a "sham" tax haven company or a "skeleton" sales company. It is performing a vital and indispensable function in developing and maintaining the market for our U.S. products throughout the world.

C. Dresser's contribution to exports, domestic employment, and balance of payments

Dresser Industries is not one of the giants of American business. Yet through aggressive use of the Dresser A.G. sales organization and facilities we have made a significant contribution to the country's favorable balance of trade. In 1952, when the Dresser A.G. group was formed, our net inflow of funds from abroad was $295,000. By 1956, this net inflow was increased to more than $30 million. In 1960, our foreign trade contributed about $43 million to America's balance of payments. The total net inflow of funds from the time the Dresser A.G. group was formed until last October amounted to about $223 million. Our foreign sales of U.S. manufactured products during the past 3 years have averaged approximately $38 million per year.

In testimony before this committee on April 24, the spokesman for International Telephone & Telegraph Co. pointed with pride to his company's contribution to the U.S. export and balance-of-payments postion. In the past 10 years, he stated, ITT had exported $175 million of goods and generated a $400 million inflow of payments. ITT has a net worth of about four times that of Dresser and net sales of about four times ours. Yet, during the past 10 years, we have exported approximately $235 million of U.S. products and generated about $223 million of net inflow of foreign funds. This is a striking illustration of the vital role which companies such as ours can play in fulfillment of the administration's export and balance-of-payments objectives. It demonstrates the urgency of my appeal that Congress do nothing which will impair the efficacy of export trading subsidiaries like Dresser A. G.

In addition to the significant contribution which Dresser's export trade has made to our country's balance of payments, during the past 3 years over 5,800,000 man-hours of factory labor have been devoted to the production of exported products. There is no way to determine how many additional man-hours of labor are attributable to our export trade as the result of our purchase of materials, components, supplies, and services from others. If we assume that our suppliers' sales require the same number of man-hours per dollar as did ours, this additional employment due to our exports amounted to 3,405,000 man-hours.

III. ADVERSE EFFECTS OF PENDING BILL

A. Competitive disadvantage

We hope to continue to do our part in improving the balance of payments and in promoting full employment. We cannot do so unless we will be competitive with foreign manufacturers who already enjoy many advantages not available to us. Many foreign manufacturers use Swiss or other subsidiaries to perform substantially the same functions as are performed by our Dresser A. G. group. No foreign country imposes a tax on the earnings of such subsidiaries until repatriated. A recent check by our European counsel has disclosed no evidence that any European country is contemplating such action and Dr. Dan Throop Smith has testified that his investigation led to the same conclusion.

The Secretary of the Treasury has stated to you that the tax disadvantage to American firms under the pending bill is offset by the direct controls on foreign investment imposed by most European countries and he has cited the United Kingdom situation as an example. But, notwithstanding the serious balance-of-payments problems which have confronted the United Kingdom and which have impelled it to maintain exchange controls even to the present day, the United Kingdom exempts from current taxation the income of a special class of oversea trade corporations. As Secretary Dillon has informed you, the Chancellor of the Exchequer recently proposed a tightening of restrictions on foreign investment but, at the same time, approved investments which will produce clear and commensurate benefits to United Kingdom export earnings and to the balance of payments. Thus, they recognize that, in meeting the monetary problems which require exchange control, they must avoid any tax or exchange control deterrent to Britain's international trading position.

In urging upon you the granting of a tax credit for domestic investment in depreciable property, the Secretary has stated that—

"American industry must compete in a world of diminishing trade barriers, in which the advantages of a vast market, so long enjoyed here in the United States, are now being or are about to be realized by many of our foreign competitors."

He has cited the "tried and proven" domestic investment stimulation techniques presently in use in the United Kingdom, Belgium, and Canada and in the process of being enacted by the Australian Parliament. If foreign practices are relevant to the validity of his proposal to grant an investment credit, are they not also relevant to the validity of his proposals for the taxation of foreign income? Some typical foreign practices with respect to taxation of foreign income are—

The United Kingdom does not tax the earnings of an oversea trade corporation until repatriated.

Belgium subjects foreign earnings of its citizens to a preferential rate of tax equal to only one-fifth the general rate.

Australia and the Netherlands exempt most foreign income entirely, even when repatriated.

France does not apply its corporation tax to profits earned abroad through a branch or permanent establishment.

Italy does not apply its corporation tax at all to foreign earnings.

Many other countries provide similar exemptions or concessions with respect to earnings of their citizens and domestic corporations.

In all countries where no such concessions exist the income of foreign subsidiaries is immune from domestic tax at least until repatriated.

Further details of the tax laws governing our principal foreign competitors will be found in the appendix to the statement filed with this committee on behalf of the International Economic Policy Association.

B. Industry's adjustment to disadvantage

How will American industry react in the face of more favorable tax regimes enjoyed by our competitors throughout the world and current taxation of our foreign subsidiaries by the United States? Dresser and many other companies with established foreign markets for products produced in the United States will be compelled to take drastic action to meet the new situation. Such action may take one or more of the following forms:

1. Establish new foreign manufacturing facilities, or expand existing ones, particularly in the industrialized countries of Western Europe. If both manufacturing and selling profit is to be subject to the full burden of U.S. tax it will be preferable in many instances to maintain full manufacturing and selling facilities in one or more European countries. The total tax burden on the enterprise would be roughly the same as if conducted from the United States, due to the foreign tax credit. Since the tax factor would then be neutral, the advantages of local identification, lower production costs, easier and more rapid accommodation to local practices, technologies, and preferences, and a simpler operating structure would militate in favor of an export of capital and of jobs. The U.S. Treasury would suffer a loss not only of tax on the foreign trading subsidiaries' income but also of tax on the manufacturing profit and payrolls now generated in the United States. Our balance of payments would deteriorate and our gold reserves would be further impaired.

2. Carry on foreign operations in the same manner as at present, but with repatriation of a sufficient portion of the foreign earnings to provide funds to pay the U.S. tax thereon. The reduction in the resources available to the foreign selling company would materially impair its capacity to perform existing sales and service functions and this impairment would be reflected in decreased sales and a reduction in U.S. exports. Again the Treasury would suffer a loss of tax revenues. Domestic employment would decline. Our balance of payments would deteriorate and the outflow of gold would be accelerated.

3. Carry on foreign operations as at present, with the parent company paying the U.S. tax on foreign earnings out of its own funds, leaving the subsidiary's resources intact. This would reduce the funds available to the parent for domestic investment and for adaptation of its productive facilities to the changing needs of foreign markets. In effect, the domestic investment incentives sought by the administration through the investment credit provisions of the pending bill would be canceled out to the extent of the tax on foreign earnings and the upgrading which the administration seeks in order to make us more competitive would be retarded or stalled.

4. Divert efforts now exerted to develop or expand foreign markets into increased efforts to expand domestic markets through more intensive promotion, new product development, etc. While this would be of temporary benefit to the domestic economy, it would cause our country's international economic position to deteriorate and result in abandonment of many foreign markets to our foreign competitors.

IV. THE MYTH OF TAX NEUTRALITY

The argument that the pending bill would achieve tax neutrality has confused the issue. It diverts attention from the central problems of export expansion, employment protection, balance-of-payments improvement, and stemming the outflow of gold. This confusion results from the fact that the term has been given different, and irreconcilable, meanings and from the fact that, whatever it means, its accomplishment is impossible.

A. Tax neutrality in business decisions

A memorandum submitted by the Treasury to the House Ways and Means Committee states:

"The Treasury asks that deferral be ended for income earned in the industrialized countries so that future investment decisions cannot be distorted by tax considerations."

Perhaps in the theoretically ideal economy investment and other business decisions could be made as though taxes did not exist. But in the real economic environment to which we must adapt ourselves taxes, whether imposed or not imposed, must enter into our decisions. And as I have illustrated above, the imposition of so-called tax neutrality between foreign and domestic income does not divorce tax considerations from business decisions since it may then become more, rather than less, desirable to increase foreign investment, or may become less, rather than more, desirable to exploit export trade opportunities.

B. Tax neutrality among American taxpayers

In his statement to this committee, the Secretary of the Treasury stated:

"Neutrality is a fundamental principle of taxation in the United States * * *. The burden of proof for not following the general principle should be on those who wish to continue a departure from that neutrality.

* * * * * * *

"* * * there should be equality in the tax treatment of similar groups of taxpayers. 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."

The Secretary begs the central question by assuming that foreign and domestic corporations are similar groups of taxpayers. He would place on opponents to the foreign tax provision of this bill the burden of sustaining departure from a principle which has never been followed in our entire tax history or in the tax history of any other nation. Surely the burden of proof should be on those who would depart from the distinction between taxation of domestic and foreign corporations which has existed for almost 50 years. The Treasury itself would give only lipservice to the principle it urges on others for the entire bill is full of differentiations in the treatment of similar groups of taxpayers. For example:

(1) Section 13 would discriminate between the tax treatment of foreign corporations 50 percent or more controlled by Americans and those of which Americans hold less than 50-percent control.

(2) Section 13 would discriminate between a controlled foreign corporation which invests in a business existing on December 31, 1962, and one which invests in a business established after that date.

(3) Section 13 would discriminate between a controlled foreign corporation which invests in one area of the world and one which invests in another.

(4) Section 13 would discriminate between a controlled foreign corporation which deals with a related person and one which has identical dealings with an unrelated person.

(5) Section 13 would discriminate between a controlled foreign corporation which uses American patents and one which uses foreign patents.

(6) Section 13 would discriminate between U.S. shareholders of 10 percent or more of the shares of a controlled foreign corporation and the holders of less than 10 percent.

(7) Section 2 of the bill would grant the investment credit in respect of investment in property situated in the United States but not in respect of property situated abroad.

(8) Section 12 would discriminate between foreign residents and domestic residents and between foreign residents and foreign sojourners.

Some of these distinctions are valid. Others are not. But the validity or invalidity of any of these distinctions is not determined by its conformity or nonconformity to the principle of tax neutrality. It is determined by considerations of equity. It is determined by fiscal and economic objectives. It is determined by administrative feasibility. To inject into the discussion the dubious principle of tax neutrality among taxpayers adds nothing to resolution of the problem since, even if the principle existed, the ultimate decision to follow it or depart from it must be made on other grounds.

C. Tax neutrality between American and foreign competitors

I have already discussed the importance of equality of opportunity between American exporters and their foreign competitors. It is this equality of opportunity and not tax neutrality which should be our guide. Our concern is with exports. The market is abroad. Foreign manufacturers and American manufacturers vie for supremacy in that market. If we wish to maintain or increase our share we must, insofar as possible, achieve tax neutrality between our manufacturers and their foreign counterparts. These are the similar groups. We cannot bring the burden of taxation on foreign competitors up to our level, but, in some measure at least, we can keep the burden of tax on our exporters down to theirs.

V. THE ILLUSORY PRIVILEGE OF TAX DEFERRAL

The Treasury and its supporters have made frequent reference in these hearings to the "privilege of tax deferral." The issue is clouded by repeated statement of a condition that does not exist. The result of the proposed legislation is obscured by a semantic twisting of the fact. There is no present privilege. The Treasury does not seek to end tax deferral but to institute a system of tax anticipation.

To speak of Congress failure to tax currently the income of foreign corporation as a "privilege" assumes that it has the inherent right to all of a citizen's income and gains whether or not realized. It assumes that all income and gains belong to the Government and that, to the extent the Government captures less than all, it confers a privilege. Mere failure to exercise a power to tax is not tantamount to the grant of a privilege. One who pays tax of 20 percent of his income is not the beneficiary of a privilege merely because the Treasury has left him with 80 percent. By the same token, the shareholders of a domestic corporation are not granted a privilege merely because they are not taxed on the corporation's undistributed earnings.

To tax income not received, or realized, or enjoyed is not to eliminate deferral but to establish prepayment of tax which may never properly be owing. The bill would require that a taxpayer anticipate his future income and pay tax on the amount of income anticipated. If the anticipated income is lost or not received, or is received in a year when the applicable rate is lower, or is received in a year when the taxpayer has a domestic loss in excess of the receipt—the excess anticipated tax will not be refunded. This is pay-as-you-go carried to an absurdity.

The bill would not cancel a privilege of tax deferral. It would impose an unjust regime for tax anticipation.

VI. PROPOSALS TO STIMULATE EXPORTS

A. Reasons underlying the proposal

I respectfully urge that this committee give careful study to the facts and views developed so ably in the testimony on April 25 of Mr. Eldridge Haynes, president of Business International. Mr. Haynes has demonstrated the important contribution of oversea trading subsidiaries to our balance of payments, to our exports, and to domestic employment, and the damaging effects which this bill would have on their ability to continue to contribute to our Nation's well-being—

He revealed that in 1959–60 32 such companies, with aggregate equity investment of only $10.5 million produced $277 million of inflow of foreign funds.

He showed that 83 percent of investments of these trading companies went to the less developed areas of the world.

His analysis of the pending bill demonstrated that these subsidiaries would be so hamstrung by its provisions as to make their continued sales efforts on behalf of U.S. exports almost useless.

He showed that the bill is in reality an antiexport bill.

He presented information on the tax laws of 13 competing nations which shows that most of these, even now, provide more favorable treatment of foreign income than does the United States and that all would be distinctly more favorable to their exporters if H.R. 10650 should become law.

He showed that our European competitors use subsidiaries in low-tax countries more extensively than do U.S. corporations.

Mr. Haynes suggested that "there should be a distinction made between the sham foreign subsidiary and the legitimate, substantive operating foreign subsidiary" so that the legitimate foreign trading companies will be allowed to compete on equal terms with our foreign competitors. I wish to propose a technique whereby this can be done.

Insofar as the foreign taxation provisions of the bill affect foreign subsidiaries performing substantial functions in the distribution of American-made products they can, at best, have no beneficial effect whatsoever upon our export trade, balance-of-payments position, or domestic employment. At worst, their effects will be detrimental to the Treasury, to industry and to labor. The Joint Committee on Internal Revenue and the Treasury estimate the revenue effects of this provision to range only from $50 million to $85 million per year as applied to all controlled foreign corporations. Thus, it is clear that the yield from applying these provisions to foreign export trading corporations will be too small to justify their enactment from revenue considerations alone.

A tax measure which raises little revenue, which cannot possibly contribute to expansion of our export trade and which is likely to result in its contraction is not compatible with the President's injunction to "harness the energies of all our people * * * to the vital task of * * * expanding our exports."

If the portions of this bill which subject controlled foreign corporations to current taxation are adopted in principle the urgency for an export trade promotion incentive measure will increase. What is needed is a measure which will effectively stimulate our export trade. I would like to urge just such a measure upon you. The pending measure contemplates that investment in less developed countries will be stimulated by exempting from current taxation earnings which are so invested. I suggest that by this same means export trade can be stimulated.

B. Proposed amendment to section 13

I suggest that, if section 13 of the bill is to be enacted, it be amended by establishing a special class of corporation, to be called an "export trade corporation" the income of which will be exempt from current taxation provided it meets certain conditions designed to insure that it is actively and aggressively promoting the export of American goods and products and that it is not a sham.

The amendment I suggest should be carefully tailored to insure accomplishment of its objective to stimulate export trade and to deny its benefits to corporations not serving that objective. This can be done, in general terms, as follows:

1. Require that the corporation be primarily engaged in foreign operations by imposing a condition that substantially all of its income be foreign.
2. Insure that the corporation is engaged in export trading and is responsible for the export of American products by imposing a condition that a substantial portion of its income be from the sale or use abroad of exported products and the performance of services essential to export.
3. Provide a "motive power" to impel the corporation in the direction of increasing our export trade, by requiring that it spend abroad a high proportion of its income on the promotion or use abroad of exported products.
4. Provide a "brake" against use of a sham corporation as an ostensible export trade corporation, by the same means—since a corporation which spends substantial sums abroad on trade promotion could not be a sham.

If a corporation meets the above tests, its income, to the extent it bears the requisite relationship to trade promotion expenses (item 3 above), should be exempt from the current taxation provisions of subpart F. Thus, the only "concession" to an export trade corporation would be that its qualifying income would be subject to the same tax treatment as under existing law.

C. Proposed amendment to section 6

1. *Inequity of the formula.*—If this proposal to provide a special incentive to export trade promotion commends itself to the committee, one important substantive change must be made in section 6 of the pending bill in order to make inapplicable what is, in any event, an arbitrary and unrealistic formula for allocating taxable income from the sale of tangible property between a domestic and foreign corporation under common control. This formula would allocate the taxable income arising from the sale of property between the two corporations on the basis of their respective assets used in the production, distribution, and sale of the property, plus compensation of officers and employees attributable thereto, plus sales and other sales promotion expenses attributable to the property.

Where the sale is between a domestic manufacturing company and a foreign sales and service company (such as an export trade corporation) the effect of the formula is to place on one side of the scale the entire aggregation of land, factory buildings, machinery, and capital equipment accumulated by the manufacturer over a period of many years and the payroll of the entire labor force required to operate these facilities and produce the end product. On the other side of the scale is placed the payroll of the relatively smaller but, on the average, more highly skilled and specialized sales and service force of the foreign company, together with the relatively small amount of assets required to operate a sales and service organization.

The formula would appear to be unrealistic when applied to any two corporations engaged in entirely different industrial and commercial activities. But when applied to a manufacturing concern on the one hand and a sales and service organization on the other it fails to recognize that the net income of manufacturing and selling concerns is not proportionate to their respective assets and expenses. Furthermore, it gives equal weight to assets which subsist from year to year on the one hand and to compensation and expenses which must be reintroduced into the economic stream each year (since they create no asset) on the other. In addition, it treats the asset dollar, the labor dollar, the sales dollar, the servicing dollar and the advertising dollar as though each is productive of the same amount of income. Yet it is clear that even dollars invested in different types of assets, such as land, buildings and machinery, are not equally productive. If existing section 482 (under which the burden of proof is even now on the taxpayer) does, as the Treasury claims, permit unreasonable diversion of income to foreign corporations to the detriment of the Treasury, the proposed amendment to section 482 would merely create a new inequity to the detriment of the taxpayer. It hardly seems more just to permit the Treasury to obtain tax on income which has not been earned that it is to permit the taxpayer to escape tax on income that has been earned.

2. *Effect of formula on export trade incentive.*—Application of this formula to any two companies would allocate their combined incomes between them in an unrealistic and inequitable manner. If it were applied to a domestic manufacturer and its qualified export trade subsidiary it would strip all incentive from the export trade corporation provisions. More often than not, a qualified export trade corporation would be unable to establish "an arm's length price." Foreign sales and servicing organizations are usually established by American manufacturers to deal with products which, because of their specialized nature or peculiar selling or servicing problems, cannot be distributed effectively by established independent distributing organizations, and because it is necessary for the manufacturer to keep closer control over the sales and servicing policies than does the manufacturer of a standard product who may be in a position to lose interest in it once it leaves the factory premises.

Furthermore, as applied to the proposed export trade corporation, if an unreasonable allocation of profit to that corporation should result, any temporary loss to the Treasury will be compensated by reciprocal benefits to the Treasury and to the economy as a whole. For each dollar of "excess" profit diverted to the export trade corporation it would be required to spend additional sums on export trade promotion in order to qualify the additional income for the pro-

posed exemption and make that diversion effective. If it did not make the expenditure, the income would be included in the gross income of the U.S. shareholders in any event, and if it did make the expenditure our interests in stimulating export trade would be served, and on the average, the expenditure could be expected to produce additional sales of export products and thereby generate additional income taxable in the United States.

3. *Proposal on section 6.*—Therefore, I would like to make the following additional suggestions with respect to amendment to the present bill:

(*a*) Whether or not the export trade promotion proposal is adopted, section 6 of the bill should be amended to the effect that the formula, when applied, shall not be effective to reduce the taxable income of the foreign corporation below 200 percent of its aggregate expenses.

(*b*) If the export trade promotion proposal is adopted but the committee does not feel that the above limitation should apply in all cases, the above limitation should be made applicable only to allocations of income between a domestic corporation and a controlled foreign corporation which qualifies as an export trade corporation.

(*c*) If either of the above suggestions commend themselves to the committee, the formula approach to allocation of income should be made inapplicable to sales to a qualified export trade corporation and the principles of existing section 482 should apply.

(*d*) If, instead of adopting the proposed export trade corporation amendment, Congress eliminates from the bill the entire section 13, then the section 6 formula should be revised to a more realistic and workable basis or it should be eliminated. Section 6, by itself, would strip oversea trading subsidiaries of any significant benefits by depriving them of the right to earn a reasonable profit from their activities and subjecting them to more restrictive treatment than are the oversea trading subsidiaries of our foreign competitors. If section 6 alone were enacted, the effects on our export trade would be virtually as destructive as would section 13. Therefore, if section 13 is not enacted, section 6 should either provide that the allocable profit shall not be less than a prescribed realistic proportion of the foreign subsidiary's expenses or the formula should be stricken entirely. Actually, with the increased information which will be available to the Revenue Service under section 6038 of the code, and with more intelligent and aggressive application of the principles of section 482 the Revenue Service will have ample means to prevent the arbitrary siphoning off of domestic income to oversea trading subsidiaries.

VII. CONCLUSION

I respectfully urge your committee's most serious consideration of the substantial benefits to our economy, our balance-of-payments position, and our domestic employment which would flow from the export stimulus provided by the program which I have outlined. I am sure that this committee is deeply concerned with the problems of maintaining our international trading position in the face of rising foreign competition. You share with the administration, industry, and labor the sense of urgency with which we face any prospect of rising imports, dwindling gold reserves, and the threat of mounting unemployment. I am convinced that the proposal which I urge for your earnest consideration would represent a significant force in preserving our position in a world which is moving forward. If we do not move with it, it will move without us.

The CHAIRMAN. The next witness is Thomas Gardiner Corcoran of American International Underwriters.

STATEMENT OF THOMAS G. CORCORAN, AMERICAN INTERNATIONAL UNDERWRITERS

Mr. CORCORAN. Mr. Chairman, my associate is Duncan Lee, of American International Underwriters.

My name is Thomas Gardiner Corcoran. I am a lawyer with offices in Washington, D.C. I appear on behalf of the American International group of insurance and insurance agency companies. For the past 40 years these companies have specialized in applying

modern American plans and methods in all lines of insurance to oversea markets on foreign risks; for example, lives and property located in foreign countries.

These American International companies now do business in most countries and territories in the free world. Because of the growing nationalism throughout the world which favors domestic as against alien insurers, these companies must frequently and increasingly be foreign corporations. They therefore are subject to the impact of the bill before you in the provisions relating to controlled foreign corporations.

U.S. insurance companies doing business abroad are as necessary as U.S. banks abroad to serve American oversea business. It is obviously important to our international commerce and international position to have vigorous U.S.-controlled insurance companies operating overseas, particularly with the increased volume of international trade we anticipate in the foreign trade bill.

If this increased demand for insurance protection is not met by U.S.-owned companies, it will be supplied by foreign insurance.

This U.S. insurance of foreign risks which can only be carried on in foreign countries cannot adversely affect the balance of payments. Selling insurance in foreign countries does not take jobs away from Americans in the United States. It is an "invisible" export of American services abroad, the kind of invisible export that has always constituted one of the chief economic resources of the British Empire through Lloyd's and the great British insurance companies. It is obviously therefore not an activity to be discouraged for the purposes of this bill.

Moreover, for national policy reasons broader even than the purposes of this bill, these insurance companies should be given affirmative encouragement.

For a nation engaged in a cold war, its external insurance industry is important for what it adds to our economic and political strength wherever it reaches, as well as its inflow of ultimate profit.

Like banks abroad, insurance companies abroad, and particularly life insurance companies, are financial institutions whose investment practices and policies alone can influence for this Nation's good will and benefit the foreign communities in which these companies do business.

Those ablest practitioners of foreign policy, the British, who have always understood that for an international power foreign trade, foreign investment, and foreign policy are all of one piece have for years deliberately developed the position of their insurance companies in the international market as one of the deepest sources of their economic and political strength.

With the expansion of U.S. international business since the war, U.S. controlled foreign insurance companies have begun to compete vigorously with other foreign companies for this oversea business.

But H.R. 10650 in its present form will, unintentionally I am convinced, make it practically impossible for such U.S. companies to compete with foreign companies for business abroad, and in particular for business written in U.S.-dollar currency.

I say "unintentionally," because I have had indications that the members of the House committee with the concurrence of the Treasury

would probably have removed the problem if there had been time for further refinement in the House.

I will now discuss briefly the most serious of problems created by the bill's present provisions, and changes suggested. Where necessary the discussion will be amplified in annexes to this statement which I ask permission to introduce into the committee's record.

The CHAIRMAN. Without objection, they will appear in the record following your oral presentation.

I. INVESTMENT OF INSURANCE COMPANY FUNDS

Mr. CORCORAN. The first change which I suggest should be made to free these U.S.-controlled foreign insurance corporations of unintended disabilities is a change in sections 952(e) and 953.

Under these sections, in conjunction with section 951(a), there is "tax-through" of the income from certain passive investments described as "foreign base company income."

And there is further tax-through of the other earnings of a U.S.-controlled foreign corporation in the amount of its increase in investments in "nonqualified property."

Such nonqualified property includes (among other things) all U.S. securities and investments other than U.S. Government bonds and bank deposits.

But these U.S.-controlled foreign insurance companies cannot cover their commitments without being able to invest without penalties their reserves in portfolio-type investments including U.S. investments other than U.S. Government bonds, nor can they compete with non-U.S.-owned foreign insurance companies which can invest freely in passive investments and in the U.S. investment market—all to the benefit of the balance of payments.

In this respect insurance companies are in much the same position as banks. There is an express exception of U.S.-owned foreign banks from tax-through on "foreign base company income" in section 952(e), but no corresponding exception for insurance companies.

The intent of the draftsman of sections 952(e) and 953 was quite evidently to influence and control the direction, both as to territory and as to types of enterprises, of the investment which a U.S.-controlled foreign corporation could make of its profits without sacrificing tax deferral.

However, as the sections are drawn they would similarly restrict the investment of all the reserves and surplus of these insurance companies, a very small part of which is profits.

Such investment in the United States both helps the balance of payments and provides capital for jobs in the United States. There is therefore no reason to interfere with the prudent investment practices of insurance companies. Strictly controlled by the various insurance departments throughout the world to which the companies are subject, and having to take into consideration stability, yield, and diversification, such companies must assure their policy owners maximum security while obtaining the necessary income in stable currencies to meet their obligations.

British, German, and Swiss competitors competing for the same business in the same foreign markets are free to invest their reserves in the stable U.S. economy.

Why should not the American-owned company be equally free to invest foreigners' money in the United States?

Since the prime problem is the balance-of-payments position, surely it is in the interest of our balance-of-payments position to encourage, not prohibit, the investment of this foreign-owned money in U.S. securities.

It is urged, therefore, that the reserves and surplus of insurance companies writing foreign risks be freed of the investment restrictions of H.R. 10650 by amending sections 953(e)(5) and 953(b)(2) to provide additional exceptions for these insurance reserves in accordance with the recommendations of the Association of Casualty & Surety Companies and the National Board of Fire Underwriters, filed with this committee on April 11, 1962.

These points have been discussed with Treasury staff members who have indicated that they understand the desirability of meeting the problem. (See annex A for a fuller discussion.)

II. INSURANCE AND REINSURANCE OF U.S. RISKS

The obvious purpose of section 952(b)(1) in H.R. 10650 is to tax the "reinsurance" of captive U.S. business in paper foreign reinsurance companies set up only for the purpose of accumulating tax free the profits on controlled U.S. business.

The section is drafted so tightly, however, that U.S.-controlled foreign insurance companies doing a bona fide and substantial foreign risk business in foreign countries are practically precluded from accepting any normal reinsurance arrangements including U.S. risks which are not controlled business.

Some such acceptance is practically unavoidable by any foreign insurance company in the ordinary course of business in the international reinsurance market.

The capacity of modern insurance business to accept almost any kind and amount of insurance is based on a minute subdivision of risks which is effected by reinsurance and the reinsurance of reinsurance in the international reinsurance markets centering in Europe. The reinsurance is effected in this market substantially by exchanging packages of percentages of risks.

Considering how much of world business is U.S. business any package which another foreign company offers a U.S.-controlled foreign company is almost statistically certain to include some portion of a U.S. risk.

It is impracticable for a U.S. company to pick over each package of reinsurance to exclude any portions of U.S. risks or to do accounting necessary for tax purposes to separate its reinsurance profit on the portions of U.S. risks from the profits or portions of non-U.S. risks.

Trying to be nontechnical in a highly technical field, I have put the case in its simplest form only to indicate the problem because legitimate international reinsurance is one of the most complicated mechanisms in international commerce as well as being utterly indispensable to the conduct of modern business.

I suggest the committee consider the statement in this connection of the National Board of Fire Underwriters and the Association of Casualty & Surety Companies already in your record and previously

referred to, and specifically the proposed amendments of section 952(b)(1) and 954(b) which these associations have offered.

These amendments would leave the Internal Revenue Service with ample scope to proceed against abuse situations without injuring the position of bona fide insurance companies.

Only in recent years when Europe was temporarily short of capital have U.S.-owned insurance companies been able to establish a real foothold in the European market.

In view of the closer association with Europe which we anticipate, these companies should be able to stay and expand in the European market. But this will be impossible if because of the present restrictions in the bill they are unable to do a reinsurance business in accordance with the rules by which this business is conducted in Europe. And if they are barred from writing reinsurance these companies cannot profitably operate even as direct insurers.

III. DEFINITION OF "CONTROLLED FOREIGN CORPORATION"

Another serious difficulty for these controlled foreign insurance companies arises from the definition of such companies in section 954 and the 10 percent tax-through rule under section 951(b).

As financial institutions and sources of investment capital whose investment policies are important to the economies of the foreign countries in which they operate, they are particularly likely to need or have foreign stockholders pressed upon them.

The American international companies are not a subsidiary operation. The principal foreign operating companies are owned by individual U.S. citizens and foreign partner stockholders. In this respect they represent beyond themselves a growing type of controlled foreign corporation in which there is a foreign participation in ownership—a participation which the State Department urges.

The problem I now describe is, therefore, a general problem, not only of the American international insurance companies, but of all controlled foreign corporations which have or may have foreign stockholders. It arises because during the House deliberation the definition of controlled corporation was changed from 50 percent U.S. ownership by five or fewer stockholders (the old personal holding company test) to simply 50 percent U.S. ownership.

Section 951(b) provides that a stockholder owning 10 percent or more of a controlled foreign corporation (which is now described only as 50 percent U.S. owned) is taxed through as if he had received a dividend on his share of the earnings of the corporation irrespective of whether he receives the dividend or could control the payment of the dividend to cover himself.

Lesser U.S. stockholders are not so taxed and any foreign stockholder can have up to full 50 percent of ownership of the corporation without being liable taxwise or being out of pocket if a covering dividend is not declared or a forbidden reinvestment policy followed.

If the ownership of the U.S. 50 percent is so split among small or noninterested stockholders, concentrated foreign ownership for its own reasons can prevent the declaration of the dividend or a reinvestment policy which would prevent taxthrough.

The 10 percent U.S. owner is vulnerable to the tax but out of control to protect himself from its consequences. In such case he

will have to sell down to below 10 percent to protect himself from taxes on nonexistent dividends—and he cannot sell to other Americans so that any of them would have more than 10 percent.

In the familiar foreign personal holding company situation with which the foreign business community is completely familiar there has always been applied the reasonable principle that taxthrough will only occur if the person taxed through is in a position to protect himself by control of the corporation.

This has become standardized in the test that the corporation must be owned 50 percent or more by five or fewer U.S. nationals whom it is reasonably assumed have collectively the power to declare dividends or change the character of the corporation's income.

At one stage in the deliberations in the House committee it seems that "controlled foreign corporation" for all purposes in the bill was so defined. When later this definition was changed to simply 50 percent owned by any number of U.S. nationals it divorced control from liability to taxthrough. The substantial but noncontrolling U.S. stockholder—the more-than-10 percent American who probably best represents sensitivity to the general policy interests of the United States and the most active owner-manager of the corporation can now find himself in an intolerable tax exposure which logically will result in passing to the strongest foreign stockholder the real control of the enterprise started with American capital.

The strong American will have to sell down under the critical 10 percent but since no other American can have more than 10 percent the highest and most likely market will be foreign partners who can with tax impunity accumulate any desired percentage of ownership and control—even more than 50 percent.

This result is not necessary to the purposes of the bill and there is nothing to be gained from any point of view—the balance of payments, U.S. tax revenues, or the overall position of the United States in the world—to encourage the loss to foreigners, possibly at discouraged or distressed prices, of control of U.S. capital already gone overseas under a different foreign policy from that implicit in this bill. Nor is there any need to deny U.S. stockholders in mixed ownerships situations as large a proportion of individual itnerest as foreign stockholders may hold.

Several methods have been proposed to cure this situation. The Treasury understands the need. The remedy most familiar to stockholders of foreign corporations would be to change the definition of a controlled foreign corporation for all purposes in the bill to the old personal holding company definition of one owned 50 percent by five or fewer U.S. persons.

Annex B is a longer discussion of the problem and this proposed solution.

IV. SECTION 6046 REPORTS

This 10 percent problem ties into a reporting problem. Since it does not serve the overall national policy of the United States to create unnecessarily situations where U.S. stockholder owners have to step out of controlling ownership of U.S. capital, it likewise does not serve the overall national policy to create, again unnecessarily, situations where American officers and directors have to step out of positions in the management of mixed corporations.

But this could follow from the provision for reports provided in the proposed amendment of section 6046, Internal Revenue Code, made by section 20 of the bill. For reasons more fully developed in annex C attached to this statement this reporting provision as now drawn can create a situation in mixed corporations where American officers and directors subject to reports of unlimited extent and frequency will be pressed by their foreign partners to resign their officerships and directorships in order to protect these foreign partners against the consequences of release of information.

And the foreign partners will have strong reason to acquire control of the corporation if necessary and so prevent reporting they may not want. The result can be that the U.S. Treasury will not get information but that the American interest in the mixed corporation will lose its position in the management. Five percent stockholders who have no real power per se will be put under burdens they cannot perform.

Section 20 of the bill in its present form is so tight that it puts an impractical burden upon stockholders, directors, and officers of foreign corporations, especially when these corporations can be controlled by foreign associates.

The staff of the Treasury again, I believe, understands there is a problem here. One remedy would be to require reports again only when there is personal holding company type ownership of the controlled foreign corporation; for example, ownership of 50 percent or more by five or fewer U.S. persons, and (as explained in annex C) to incorporate the title of section 6046 in the effective text.

V. GAINS FROM SALES OR EXCHANGES

Loss of U.S. control of U.S. capital in mixed foreign-controlled corporations will be accelerated if there is retained in the bill the provisions of section 16 which provide that any 10 percent American stockholder concerned about the tax consequences of the new legislation will have to dispose of his holdings before the effective date of this bill or lose retroactively the benefits of the present capital gains position which he holds and has held, possibly for decades.

If this retroactive denial of his present capital gains position—in effect a capital levy—stays in the bill, stockholders in doubt about selling will sell immediately to avoid the increase in tax, and it is quite certain that many arrangements have already been made to sell contingent upon the imminent passage of the bill. It is possibly for this reason that Secretary Dillon in his appearance before this committee indicated that he would not press for the retention of this retroactive levy.

VI. EARNED PERSONAL INCOME ABROAD

One last point which bears deeply upon the preservation as much as possible of American capital and its competitive position abroad is the controversy about the withdrawal in section 12 of the bill of the exemption for earned income of U.S. employees resident abroad.

Properly analyzed this is not a question of these U.S. citizens avoiding their tax responsibilities or being treated as a privileged class. It is a question of policy of whether the Nation wants effective

management by U.S. nationals of U.S. private investment abroad, and is willing to pay the price for it.

The extravagances of a few movie stars obscure the fact that the safety, productivity, and the profitability of mines and plantations, of oil wells and factories, of ships, of services like export distribution, insurance and banking, of intelligence, and of the prestige values of American engineering and of American medicine in foreign countries, depend upon the quality and the continual willingness of vigorous and competent Americans and their families to live in the second-class civilization which by the standards of American men and women every other civilization now is. There are many exemptions from taxation in the American tax law for particular ends of public policy. Exemption for Puerto Rican citizens, as has been pointed out, is a case in point.

Administratively the compensation of many of these individuals is made up of many noncash items which now for the first time will be valued for income tax purposes.

The impositions of the ceilings even now embodied in section 12 (which the Treasury wants to restrict even further), no matter how they equate with taxes of equivalent amounts of income in the United States, will result in a sudden diminution of the take-home pay standard of living of these individuals to a degree that would shock any U.S. taxpayer faced with an equivalent sudden decrease in his standard of living.

If you are interested in the able management of American capital abroad in these particular places you don't want these people thinking for the next 5 years about nothing except how to make out their first income tax.

The all important fact in the situation is that the great bulk of these men, particularly from $50,000 down, are indispensable to the protection and productivity of American capital invested abroad out of all proportion to their numbers or their compensation. They will either have to be compensated as they require or they will come home.

By the same tests of "take home" compensation U.S. capital will be able to nor able to recruit their successors from U.S. citizens. This is not a matter of fairness. It is a policy judgment as to the economic value of qualified U.S. citizens supplementing the usefulness of U.S. capital overseas.

For a nation which consumes 65 percent of the world's raw materials (see Paley report) the considerations involved are not unimportant.

Two practical suggestions are offered. (1) Table 13 offered by the Treasury to supplement the President's tax message last year if studied carefully will show how few abuse situations there really are.

In all the world, as the Treasury tables show, out of 39,482 people who benefit by this exemption, there are only 246 permanent residents with earned incomes of over $50,000 and less than 4,000 with incomes of $20,000 to $50,000.

A top limit would be set at not less than $50,000, below all of the flagrant cases cited by the Treasury and, if necessary, the length of residence necessary to qualify for such $50,000—to eliminate movie star birds of passage—be raised as the bill now proposes to 3 years.

(2) A phasing-in period for whatever level would make the adjustment to the first income taxes more manageable both for the individuals and the employers.

May I speak generally. Before the war I was active in the formation of the Export-Import Bank under Mr. Stanley Reed and Mr. Jesse Jones.

During the war I was not unacquainted with the operations of the Board of Economic Warfare and since that time I have participated in the actual formation and management of many American corporations abroad. It has been estimated that there is now invested overseas some 32 billions of U.S. private capital.

In the postwar period it seemed that official pressure to press American private capital abroad was an application of the lesson learned during the war of how important oversea economic assets and their tentacles were in war, hot or cold.

All of us remember the problem we had with the enormous power of the German chemical and pharmaceutical business in South America.

Now, since the war, Government policy was pressing American investors to take immediate advantage of opportunities for a quick buildup of a capital position abroad while our prewar competitors in foreign trade and foreign investment temporarily did not have the capital to renew or augment their capital position abroad. Quick acquisition of a substantial capital position in producing assets abroad could compensate for natural advantages our eventual competitors would later have by way of cheaper labor costs and deeper concern for foreign trade.

We now have to accept official judgment of the people who have the responsibility, and a new foreign policy and changed attitude toward foreign investment is required by present conditions both in respect of balance of payments and in respect of domestic employment and in respect of underdeveloped countries.

But it cannot be overlooked that there could be other factors now at work which might rapidly change the factors determining either foreign economic policy or domestic employment prospects. New events and new ideas might make our burden of payments overseas less onerous; new events and new ideas might go further to create future employment in the United States than the backhanded effect of the denial of tax deferral on income of foreign investment.

Also, investment in underdeveloped countries may be doubtfully accelerated by limiting tax deferral to underdeveloped countries.

The forward-planning businessman who expects to wait 4 or 5 years before an investment turns into a taxable profit is not unaware that the present distinction in the bill between developed and underdeveloped countries can be changed without reference to Congress by an executive finding.

Possibly unreasonably he feeels that an underdeveloped country can become rapidly developed for any reasonable reason—possibly even as an economic sanction. For instance, certain Latin American countries at present characterize as underdeveloped nations might be accorded such upgrading as a matter of hemispheric discipline.

Under all these potentials while meeting the demands of the new policy, and the problem of balance of payments, it would seem worth taking care not to incur unnecessary impairments of capital positions already achieved and advances already made overseas. My old boss, Justice Holmes, used to say about the Sherman antitrust law that its

theory was "Everyone has to compete, but no one is allowed to win the competition."

That compassionate policy does not exist in international trade. There someone does win the competition and the loser loses for keeps.

Again within the imperatives of the balance-of-payments problem and the domestic employment situation and the inexhaustible demands of underdeveloped countries a tentative change of policy should not unnecessary force U.S. capital investment abroad into competitive conditions in which it has to lose too long.

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

Senator KERR?

Senator KERR. No questions.

The CHAIRMAN. Senator Williams?

Senator WILLIAMS. No questions.

The CHAIRMAN. Senator Gore?

Senator GORE. No questions.

The CHAIRMAN. Senator Talmadge?

Senator TALMADGE. No questions.

The CHAIRMAN. Thank you very much.

(The annexes referred to follow:)

ANNEX A TO STATEMENT OF THOMAS G. CORCORAN

INVESTMENT OF INSURANCE COMPANY FUNDS

What concerns me is that the U.S.-owned insurance companies will be unable to function at all in the international insurance market and make any profit to be available for any form of taxes unless they are able to invest their reserves—not their profits—free of the proposed investment restrictions. It seems to me that such companies should be particularly favored from a tax standpoint because (*a*) they originate dollars abroad to contribute to the dollar inflow rather than outgo, and (*b*) their reserves invested in the United States contribute to the pool of capital invested or available for investment in U.S. industry. If, as Secretary Dillon's recent statement reiterates, the rationale behind the proposed changes in the taxation of foreign trade is redress of the balance of payments and increase of funds available for investment in U.S. industrial plants, it is affirmatively desirable that the reserves of these companies can be invested in the United States.

Despite this I am not urging that such companies be given any special favorable treatment regarding the taxation of their shareholders on the companies' true profits; I am only arguing here that "controlled" foreign insurance companies should not be treated any less favorably than any other "controlled foreign corporation"—which means that the new tax impact should fall only upon their profits. But unless the kind of amendment I am suggesting is made as to qualified investments, H.R. 10650 goes further than that. Its tax impact falls not only upon profits of such insurance companies but also upon their reserves, which has a completely different significance, because insurance company reserves are completely different from the ordinary commercial company's profits. The result is an unjustified and possibly unintended discrimination against insurance companies.

Sections 951 and 953 of the House bill tax through to the 10-percent stockholder, in addition to subpart F income, other income of a controlled foreign company up to the amount of the stockholder's pro rata share of the company's increase in investment in "nonqualified" property, notably U.S. investments. The drafters of these sections clearly had in mind the case of a foreign trading or manufacturing company whose only funds available for investment are its operating profits. The drafters obviously did not consider the case of an insurance company, much the greater part of whose funds for investment are not profits but the reserves of its policyowners.

In respect of these reserves, insurance companies are fiduciaries. Especially is this true in the case of life insurance, where reserve assets represent the long-term savings of individuals. This is why these companies are usually subject

to regulation by their local insurance commissioner as to what investments they may make of such funds.

Insurance companies would expect to be treated as to profits like any foreign controlled company. But a controlled foreign insurance company should not be subject to restrictions on the investment of its reserves as distinguished from its profits for at least the following reasons:

1. To restrict the investment of reserves discriminates against insurance companies. Other foreign controlled corporations are only restricted as to reinvestment of profits. You would not limit a manufacturing company as to where it could purchase its operating assets of manufacturing materials; but the corresponding operating assets of an insurance company are its investments—an insurance company makes its profits substantially out of its inventory of investments as a manufacturing company makes its profits out of its inventory of materials.

2. A U.S.-owned company must be free to invest in U.S. securities the reserves for its U.S dollar contracts on foreign risk or else be forced to take an impossible exchange gamble for its policyholders as well as its stockholders: a life insurance company in particular cannot gamble.

3. To restrict the investment of the reserves of a U.S.-owned foreign insurance company is especially unwarranted since the reserves of the company are not the profits of U.S. stockholders but the property of policyowners who for the most part are foreign nations.

4. To be competitive with foreign owned companies as to rates, regardless of the currency of the contract, the U.S.-owned company must have the same investment freedom with respect to all of its reserves.

5. It cannot be too much emphasized that the companies we are talking about—writing foreign risks—are not taking any jobs or capital out of the United States or doing any business which could be done in the United States and that on the central problem of the balance of payments they are a direct help to the U.S. international dollar balance because they take dollars out of foreign countries and bring them to the United States. From the point of view of balance of payments, it should surely be Treasury policy to encourage the investment of such reserve assets in the United States.

In speaking of insurance company "reserves" which should be freely invested I include the normal amount of surplus which an insurance company must maintain for the proper protection of its policyowners.

Naturally what has been said here concerning investment restrictions in section 953 applies equally to the restriction resulting from tax-through of so-called foreign base company income as defined in section 952(e). Since U.S.-owned foreign insurance companies as financial institutions are in substantially the same position as U.S.-owned foreign banks, there should be a specific exception for them in section 952(e) similar to the banking exception which appears as section 952(e)(5).

I have gone into this matter at some length because the present investment provisions of H.R. 10650 when applied to insurance companies produce anomalous and unintended results which I feel can injure the ultimate purposes of the Treasury itself and that this result should be corrected.

Annex B to Statement of Thomas G. Corcoran

DEFINITION OF "CONTROLLED FOREIGN CORPORATION"

Section 13 of H.R. 10650 taxes through to any "United States person" owning 10 percent or more of the stock of a "controlled foreign corporation" (defined in the bill as being over 50 percent owned by U.S. nationals) his pro rata share of certain categories of the company's income regardless of whether or not such income is in fact received by the stockholder in the form of dividends.

This is the same treatment now accorded under present law to stockholders of any percentage of a "foreign personal holding company" (50 percent owned by five or fewer U.S. citizens or residents)—but with two important differences: (*a*) operating income as well as the familiar foreign personal holding company type income, i.e., dividends, interest, rents, royalties, etc., will frequently be taxed through; (*b*) the foreign personal holding company ownership test has been abandoned. The result under the proposed new legislation is that the tax penalties upon the 10-percent stockholder have become far more severe

and his capacity to protect himself from these penalties by complying with the law has been reduced—to the point that he will often and increasingly be powerless to avert them and his only practical remedy will be to dispose of his holdings.

The stockholder of a "foreign personal holding company" can always put himself in funds to pay the tax-through by declaring dividends. By definition, a foreign personal holding company is over 50 percent owned by five or fewer U.S. citizens or residents each of whom, irrespective of his percentage of ownership, is under the same compulsion to find the money to pay his tax-through and who collectively, being over 50 percent, have the necessary control to force the declaration of the required dividends.

Under H.R. 10650 a U.S. person holding 10 percent or more, but less than effective control, in a foreign corporation is in a very different position. Personally he has a strong motive either to avert tax-through by avoiding the lines of business and areas of investment which result in tax-through, or, if he cannot avert tax-through, to declare the dividend which will cover his tax. However, his company will often be controlled by fellow stockholders who have no such motive, and frequently have opposing ones. In recent years, U.S. business abroad has come under great and increasing pressure to take in local partners, either to satisfy local legal requirements or from sheer business necessity. And now the announced policy of the U.S. Department of State is practically to demand local participation in American enterprises overseas. Such foreign stockholders cannot be expected to accept the limitations of H.R. 10650 on the company's operations or investments. They cannot be expected to pay out profits if there are favorable opportunities to reinvest them abroad—and not just in less developed countries. The foreign businessman is reluctant enough to pay his own taxes, to say nothing of making money available to pay the taxes of others. The foreigner, in short, is under no tax compulsion to observe the rules of H.R. 10650. Nor are the scattered other U.S. stockholders who hold less than 10 percent.

The substantial but noncontrolling U.S. stockholder thus finds himself in a severe bind. The extent of this bind is not limited to suffering tax-through without any assurance of having the dividends to pay the tax. Even if the company has in fact had no subpart F income and has not increased its nonqualified investments, he must sustain a most onerous burden of proof to the Internal Revenue Service that this is so. Without control he may well be unable to force the production of the corporate records he will need to do so. (Even a U.S. stockholder with less than 10 percent may have difficulty in proving that he is below the 10-percent limit.) Foreign stockholders are not notoriously eager to expose their financial affairs to the scrutiny of their own governments by way of making disclosures to the U.S. Government. Furthermore, even if the company's business and investments do not produce tax-through income today, there is no assurance that the controlling majority will not change this picture tomorrow.

Obviously, no prudent U.S. businessman will any longer be able to accept the hazards and uncertainties of a minority position in a "controlled foreign corporation." It is also obvious that he must and will do as a practical matter to avoid this intolerable squeeze. Unless he controls the corporation, he will inevitably divest himself of enough of his shares to bring himself below the critical 10-percent limit.

This divestment is more likely to be made by sale to foreigners than to other U.S. nationals. Where foreign partners are already in the picture they—and frequently their governments—will apply strong pressure to give them the first refusal of any stock the Americans have to sell. Even where at present there are no foreign partners, there will be such pressure reinforced by announced State Department policy.

U.S. nationals, on the other hand, will be handicapped as prospective purchasers from the more than 10-percent stockholders who have to divest. Each of them must be careful not to reach the 10-percent limit himself. Furthermore, the purchaser must be unrelated to the seller or any other purchaser, and it will be inconvenient and difficult to parcel out a large holding among enough unrelated U.S. purchasers to keep each of them out of the danger zone.

Most important of all, because the divested shares will be more valuable to the foreigner can accumulate the controlling percentage with tax impunity. The them. A single block of 99 shares which controls the company is worth far more than the sum of 11 holdings of 9 shares each, none of which gives control. The foreigner can accumulate the controlling percentage with tax impunity. The American is compelled to keep his holdings well below the level of possible control.

Once started, the process of divestment is not likely to stop at the 9-percent level. There will be many U.S. shareholders who will find that such a holding is not worth the trouble, since it is wholly insufficient to influence company policy. The effective U.S. owner-management which developed the company in past years will have been fragmented and destroyed. As foreign control increases the U.S. stockholders' reduced investment will be held at the mercy of alien management. Even when the company remains over 50 percent U.S. owned, effective foreign control will be made easier by the fact the foreign minority holding can and will be concentrated while the U.S. majority must be atomized among small unrelated stockholders. There can be no doubt that in many cases under this accelerating pressure of adverse tax and business considerations the U.S. stockholder, even though he is under 10 percent, will drop out of the picture altogether.

It is not suggested that all U.S. enterprises abroad will follow this process of fragmentation and divestment. The pattern described above is most probable in situations which may be the most desirable for the U.S. economy by bringing into the United States a maximum of return payments for each dollar of outgoing investment, in situations in which there are foreign partners and the control position of the U.S. stockholder is marginal. At the least it can be said that at present enough U.S. foreign enterprises will be caught in this process so that a very substantial segment of U.S. investment already abroad will pass into foreign control and with it U.S. facilities for earnings abroad and U.S. instruments of policy abroad. It can also be said that this process will accelerate as foreign participation inevitably increases and the U.S. interest becomes more and more a minority interest.

To prevent this result it is urged that the Senate Finance Committee return to the earlier approach of the House Ways and Means Committee, which defined a controlled foreign corporation as one owned over 50 percent by five or fewer U.S. persons. This is a modification of the personal holding company test, modified to include corporate stockholders, but essentially the same test that has been tried and found workable in the past and one with which American businessmen feel familiar. The merit of such an ownership test is that it insures that the tax pressure of the new legislation is brought to bear only upon stockholders who are in a position to respond to the pressure in the ways the Treasury intends. Under H.R. 10650 as it now stands many U.S. holders of foreign stocks will have no alternative to getting out. Presumably, the Treasury does not intend to drive the U.S. investor out of the foreign field. In any case it is certain that no responsible Congress would want such a result.

Annex C to Statement of Thomas G. Corcoran

AMENDMENT PROPOSED BY SECTION 20(b) OF H.R. 10650 TO SECTION 6046, INTERNAL REVENUE CODE

The proposed amendment to section 6046, Internal Revenue Code, in H.R. 10650 is regretfully impractical and should be modified as suggested herein to insure the maximum usefulness of the section.

As the amendment now appears it would completely rewrite section 6046 with respect to (*a*) those who have to make returns, (*b*) the frequency with which they have to make returns, and (*c*) the contents of the returns.

(*a*) *and* (*b*). *Who must report and how often.*—Section 6046 in its present form requires reports to be made by any U.S. citizen or resident who within 60 days after the creation or organization or reorganization of a foreign corporation becomes an officer, director, or 5-percent stockholder of the company. Such report must be made within 90 days after such creation, organization, or reorganization of the company.

The H.R. 10650 amendment would require reports of any such person who was such officer, director, or stockholder on January 1, 1963, or who becomes such thereafter, imposing in the case of a stockholder liability to report whenever he acquires an additional 5 percent. The report must be made within 90 days after the individual acquires the relationship to the foreign company which makes him liable to report.

(*c*) *Content of report.*—In its present form the language of section 6046 is clear that the report relates to the creation or organization or reorganization of a foreign corporation.

But there is no such tie-in in the proposed amendment in H.R. 10650 except for the heading of the section, which of course has no legal effect. Except for the ineffective heading the report can call for any information which "the Secretary or his delegate prescribes * * * as necessary for carrying out the provisions of the income tax laws."

Except for a foreign corporation that is effectively controlled by U.S. citizens or residents, these broadened requirements now impose an unfair and impractical burden.

Foreign corporation managements are going to assume section 6046 is going to "fish" for approximately the same information as section 6038 for retransmission to their own tax authorities whom they do not cherish.

A mere 5 percent U.S. stockholder, not a controlling stockholder, simply will have no power to compel those who do control a foreign corporation to give him information to comply with the Secretary's requirements which the foreign corporation itself does not want made public. And for the same reasons the same non-U.S. controlling stockholders simply will not tolerate U.S. officers and directors in their foreign corporations.

To restore the section to maximum usefulness it is therefore recommended:

1. The requirement to report be limited to situations where there is effective control by U.S. stockholders, control according to the familiar personal holding company ownership test; i.e., ownership of 50 percent or more by five or fewer U.S. stockholders. Reports should only be required from stockholders within this control group of five or fewer and from officers and directors where such ownership exists.

2. The fact that the reports are intended only with respect to the organization, reorganization, or acquisition of stock in a foreign corporation should be made entirely clear by inserting such language, the language of the heading, into the text of the section. This might most conveniently be done by making the insert after the word "return" in the first line of subsection (a).

3. To avoid the present unnecessarily burdensome multiplicity of reports from many individuals a single report should be sufficient to discharge the obligations of all officers, directors, and stockholders who are liable to report.

4. In simple fairness to an individual liable to report, but without control of the information, his personal liability should be limited to reporting information within his possession or knowledge or under his control.

With these changes the legitimate requirements of the Treasury for necessary information should be satisfied within the practical limits of what can be obtained.

Income excluded under sec. 911 of the code on returns filed in 1960 as disclosed on forms 2555, by size of excluded income and continent

Continent and size of excluded income	Residence				Physical presence				Total			
	Number (1)	Percent (2)	Amount (3)	Percent (4)	Number (5)	Percent (6)	Amount (7)	Percent (8)	Number (9)	Percent (10)	Amount (11)	Percent (12)
ALL CONTINENTS												
Total	39,482	100 0	$418,906,940	100.0	11,232	100 0	$92,175,510	100.0	50,714	100.0	$511,082,450	100.0
Not stated	1,458	3 7			373	3 3			1,831	3.6		
Under $5,000	11,785	29.8	32,750,427	7.8	2,451	21.8	6,402,207	6 9	14,236	28.1	39,152,634	7.7
$5,000 under $10,000	9,076	23.0	62,650,725	15 0	4,376	39.0	32,014,862	34.7	13,452	26.5	94,665,587	18.5
$10,000 under $20,000	13,149	33 3	186,718,941	44 6	3,806	34 7	50,538,567	54 8	17,045	33 6	237,257,508	46.4
$20,000 under $50,000	3,768	9 5	100,000,678	23.9	130	1.2	2,794,622	3 0	3,898	7.7	102,795,300	20.1
$50,000 under $100,000	204	5	12,991,339	3.1	5		302,945	.3	209	.4	13,294,284	2 6
$100,000 under $500,000	35	.1	5,835,576	1 4	1		122,307	.1	36	.1	5,957,883	1 2
$500,000 and over	7		17,959,254	4 3					7		17,959,254	3.5
NORTH AMERICA												
Total	11,199	100.0	109,420,551	100.0	1,166	100.0	8,398,037	100.0	12,365	100.0	117,818,588	100.0
Not stated	510	4 6			92	7.9			602	4.9		
Under $5,000	3,299	29.5	10,894,623	10.0	289	24.8	828,079	9.9	3,588	29.0	11,722,702	9.9
$5,000 under $10,000	3,068	27.4	21,447,700	19 6	464	39.8	3,171,618	37.8	3,532	28 6	24,619,318	20.9
$10,000 under $20,000	3 309	29.5	45,767,243	41 8	306	26.2	3,997,446	47.6	3,615	29 2	49,764,689	42.2
$20,000 under $50,000	935	8.3	25,368,822	23 2	13	1.1	275,266	3 3	948	7.7	25,644,088	21.8
$50,000 under $100,000	73	.7	4,603,566	4 2	2	2	125,628	1 5	75	.6	4,729,194	4 0
$100,000 under $500,000	4		755,510	.7					4		755,510	.6
$500,000 and over	1		583,087	5					1		583,087	.5
SOUTH AMERICA												
Total	9,238	100 0	121,937,893	100.0	1,398	100 0	13,382,853	100 0	10,636	100 0	135,320,746	100.0
Not stated	226	2 4			37	2 6			263	2 5		
Under $5,000	1,761	19.1	4,786,298	3 9	230	16.5	692,055	5.2	1,991	18 7	5,478,353	4.0
$5,000 under $10,000	1,660	18.0	12,697,092	10.4	502	35 9	3,914,723	29.3	2,162	20.3	16,611,815	12.3
$10,000 under $20,000	4,004	43 3	58,406,618	47.9	604	43.2	8,044,366	60 1	4,608	43.3	66,450,984	49.1
$20,000 under $50,000	1,522	16 5	39,804,562	32.6	23	1.6	536,805	4.0	1,545	14.5	40,341,367	29.8
$50,000 under $100,000	51	.6	3,238,838	2.7	1	.1	72,597	.5	52	.5	3,311,435	2.4
$100,000 under $500,000	13	.1	2,204,485	1 8	1	.1	122,307	.9	14	.1	2,326,792	1.7
$500,000 and over	1		800,000	.7					1		800,000	.6

WESTERN EUROPE												
Total	5,249	100.0	61,484,793	100.0	3,216	100.0	25,622,333	100.0	8,465	100.0	87,107,126	100.0
Not stated	263	5.0			117	3.6			380	4.5		
Under $5,000	1,429	27.2	3,645,129	5.9	843	26.2	2,067,621	8.1	2,272	26.8	5,712,750	6.6
$5,000 under $10,000	1,195	22.8	8,971,965	14.6	1,125	35.0	8,643,243	33.7	2,320	27.4	17,615,208	20.2
$10,000 under $20,000	1,746	33.3	24,132,851	39.3	1,099	34.2	14,228,547	55.5	2,845	33.6	38,361,398	44.0
$20,000 under $50,000	559	10.6	15,406,084	25.1	32	1.0	682,922	2.7	591	7.0	16,089,006	18.5
$50,000 under $100,000	46	.9	3,022,909	4.9					46	.5	3,022,909	3.5
$100,000 under $500,000	9	.2	1,375,655	2.2					9	.1	1,375,655	1.6
$500,000 and over	2		4,930,200	8.0					2		4,930,200	5.7
EASTERN EUROPE												
Total	22	100.0	152,781	100.0	9	100.0	42,689	100.0	31	100.0	195,479	100.0
Not stated	5	22.7			1	11.1			6	19.4		
Under $5,000	5	22.7	12,378	8.1	5	55.6	18,837	44.1	10	32.3	31,215	16.0
$5,000 under $10,000	4	18.2	30,858	20.2	2	22.2	13,468	31.5	6	19.4	44,326	22.7
$10,000 under $20,000	8	36.4	109,545	71.7	1	11.1	10,393	24.3	9	29.0	119,938	61.4
$20,000 under $50,000												
$50,000 under $100,000												
$100,000 under $500,000												
$500,000 and over												
ASIA												
Total	9,776	100.0	105,478,366	100.0	3,385	100.0	28,961,887	100.0	13,161	100.0	134,440,253	100.0
Not stated	238	2.4			73	2.2			311	2.4		
Under $5,000	2,754	28.2	7,343,036	7.0	548	16.2	1,389,009	4.8	3,302	25.1	8,732,045	6.5
$5,000 under $10,000	2,529	25.9	15,025,362	14.2	1,416	41.8	9,685,763	33.4	3,945	30.0	24,711,125	18.4
$10,000 under $20,000	3,549	36.3	51,046,367	48.4	1,307	38.6	17,002,372	58.7	4,856	36.9	68,048,739	50.6
$20,000 under $50,000	665	6.8	17,141,256	16.3	40	1.2	830,628	2.9	705	5.4	17,971,884	13.4
$50,000 under $100,000	30	.3	1,882,159	1.8	1		54,115	.2	31	.2	1,936,274	1.4
$100,000 under $500,000	8	.1	1,394,219	1.3					8	.1	1,394,219	1.0
$500,000 and over	3		11,645,967	11.0					3		11,645,967	8.7
AFRICA												
Total	3,436	100.0	16,789,515	100.0	561	100.0	4,278,191	100.0	3,997	100.0	21,067,706	100.0
Not stated	184	5.4			19	3.4			203	5.1		
Under $5,000	2,216	64.5	5,383,142	32.1	162	28.9	422,170	9.9	2,378	59.5	5,805,312	27.6
$5,000 under $10,000	550	16.0	3,969,610	23.6	223	39.8	1,700,307	39.7	773	19.3	5,669,917	26.9
$10,000 under $20,000	422	12.3	5,690,345	33.9	148	26.4	1,963,515	45.9	570	14.3	7,653,860	36.3
$20,000 under $50,000	62	1.8	1,617,618	9.6	9	1.6	192,199	4.5	71	1.8	1,809,817	8.6
$50,000 under $100,000	2	.1	128,800	.8					2	.1	128,800	.6
$100,000 under $500,000												
$500,000 and over												

Income excluded under sec. 911 of the code on returns filed in 1960 as disclosed on forms 2555, by size of excluded income and continent—Con.

Continent and size of excluded income	Residence				Physical presence				Total			
	Number (1)	Percent (2)	Amount (3)	Percent (4)	Number (5)	Percent (6)	Amount (7)	Percent (8)	Number (9)	Percent (10)	Amount (11)	Percent (12)
OCEANIA												
Total	413	100.0	$3,106,696	100.0	563	100.0	$4,480,067	100.0	976	100 0	$7,586,763	100.0
Not stated	22	5.3			13	2.3			35	3.6		
Under $5,000	208	50.4	471,305	15.2	126	22.4	365,556	8.2	334	34.2	836,861	11.0
$5,000 under $10,000	60	14.5	443,778	14.3	231	41.0	1,749,212	39.0	291	29.8	2,192,990	28 9
$10,000 under $20,000	97	23.5	1,352,447	43.5	190	33.7	2,301,649	51.4	287	29.4	3,654,096	48 2
$20,000 under $50,000	23	5.6	618,392	19.9	3	.5	63,650	1.4	26	2.7	682,042	9.0
$50,000 under $100,000	2	.5	115,067	3.7					2	.2	115,067	1.5
$100,000 under $500,000	1	.2	105,707	3.4					1	.1	105,707	1.4
$500,000 and over												
COUNTRY NOT REPORTED												
Total	149	100.0	536,345	100.0	934	100.0	7,009,444	100.0	1,083	100.0	7,545,789	100.0
Not stated	10	6.7			21	2.2			31	2.9		
Under $5,000	113	75.8	214,516	40.0	248	26.6	618,880	8.8	361	33.3	833,396	11.0
$5,000 under $10,000	10	6 7	64,360	12.0	413	44.2	3,136,528	44.7	423	39.1	3,200,888	42.4
$10,000 under $20,000	14	9.4	213,525	39.8	241	25.8	2,990,279	42.7	255	23.5	3,203,804	42.5
$20,000 under $50,000	2	1.3	43,944	8.2	10	1.1	213,152	3.0	12	1.1	257,096	3.4
$50,000 under $100,000					1	.1	50,605	.7	1	.1	50,605	.7
$100,000 under $500,000												
$500,000 and over												

The CHAIRMAN. The next witness is Mr. Warren S. Adams of the Corn Products Co.

Mr. Adams, take a seat, sir.

STATEMENT OF WARREN S. ADAMS II, GENERAL COUNSEL, CORN PRODUCTS CO.

Mr. ADAMS. My name is Warren S. Adams II. I am general counsel of Corn Products Co. On behalf of this company, I submit this statement in opposition to the proposals contained in section 13 (concerning controlled foreign corporation income) of H.R. 10650. These proposals will hereinafter be referred to as the "Treasury's proposals." There will also be disapproving mention of section 11 (gross-up).

Corn Products Co. is a U.S. corporation, the preponderantly great majority of whose shareholders are U.S. citizens.

The company is engaged in the manufacture of food and industrial products made from corn and other agricultural commodities. It exports throughout the world where it can and there is demand for its products, and, where it cannot but there is demand, it manufactures and distributes locally.

The company is truly international, with subsidiaries in Europe, Asia, Africa, Canada, Central America, and South America. As such, it firmly believes in the freest practicable international trade, and supports the objectives of the President's trade expansion bill, H.R. 9900, the principles of which, however, it believes, and here states, are controverted by the Treasury's proposals.

A. THE CORN PRODUCTS SITUATION

In March of this year, I had occasion to write to one of the Treasury's officials with reference to its proposals and their impact on Corn Products Co. With apologies to my correspondent for any breach of the proprieties—and none is intended—in revealing the contents of a personal letter, I think I cannot better set forth this company's situation than to record here excerpts from that letter as follows:

> * * * First: I might start by quoting from the March 1962 Fortune article about this company:
>
> "* * * But far from compounding present U.S. balance-of-payment difficulties, the foreign operations of Corn Products have eased them. In the past 10 years the company has earned some $100 million overseas, of which about 70 percent has been remitted back to this country to the benefit of the U.S. international position no less than of the shareholders.
>
> "But Corn Products has been grinding out more than dollars abroad. It has also been using its foreign operations as the source of ideas for expanding its business at home."
>
> The article is an interesting one, and presents a pretty fair picture of the company's operations. We supplied basic isolated facts for the article as requested, but, as you no doubt know, we would have had nothing to do with their arrangement nor the theme of the piece.
>
> Second: The Treasury's tax proposals will bite this company to the tune of $2 million a year. And, yet, I know of nothing reprehensible that we are doing in the foreign field by way of playing games with the U.S. Treasury. We do have a Swiss holding company stup, and it is also the repository of royalties and fees. Here, though, let me say that: (*a*) The setup was not organized by us, it was acquired in the process of our acquisition of a Swiss-Germ soup business, which incidentally, we have brought to this country (and it is contributing to the

expansion of the U.S. economy); and (*b*) the royalties and fees referred to are not connected with U.S. owned or generated trademarks and services, but with European marks and services. These royalties and fees come out of high-tax countries into Switzerland and are used to finance our total foreign operation in developed and underdeveloped countries. Being scrutinized by the fiscs of the foreign countries involved, these royalties and fees are only a reasonable percentage of the earnings of the paying companies.

We tried at one time to unwind the holding company setup, but the amount of the Swiss tax involved gagged us. Except for this holding company situation, our subsidiaries are, by and large, held directly by Corn Products, whose policy with respect to its overall foreign earnings is to remit about 70 percent and plow back the balance as "seed corn."

Third: We are a food company primarily. This means we operate on a low margin of profit. The $2 million added tithe referred to above is, as a consequence, important to us, moreover, there is in Europe tremendous competition in the food industry. We have to meet this competition and we have to invest money in Europe in the process. For us the Treasury's proposals mean not that we shall no longer invest money in Europe, but that a significant part of the investments we will have to make to protect our present investment there will be more costly than heretofore, and, thus, return less profit for remission to the United States. To this I add that our present investment in Europe was built up on the long established U.S. tax theory of what the Treasury's propagandists are calling tax deferral—which, of course, it is not. Is this tax equity?

Fourth: We have become quite disturbed about the kind of publicity that has attended the Treasury's proposals.

For example, the New York Daily News published a series of articles entitled "Loopholes, Inc." The articles were well publicized. Their main theme, which was luridly embellished, was that the United States was being bilked out of hundreds of millions of dollars yearly by American corporations who needed only two things—"gall" (which we prefer to call courage and vision) "plus a little thing called a foreign subsidiary."

Having spent some 15 years of my legal life operating in the foreign field, I can tell you the articles provided agonizing reading. Just who inspired the articles, is something I do not know. I do know, though, that they were monstrously untrue as far as this company and such few others with whose foreign operations I am familiar are concerned.

Please understand * * * that I am not mad at you or any one else. I am, however, deeply concerned about the unfair, it seems to me, bind in which the Treasury's proposals will put this company. I am distressed, as a lawyer, that a large step is being taken in the direction of taxing income that has not been received and breaking down the theory of the separate identity of the corporate entity. And I am disappointed at the unwillingness of the Treasury to delineate abuses specifically and strike only at them.

B. THE INVALIDITY OF THE NEUTRALITY AND EQUITY CONCEPTS

The rationale of the Treasury's proposals is based on the high-sounding, but, in present context, more than dubious, concepts of neutrality and equity. The transparency of the neutrality concept is quite clear.

In one breath it is stated that "neutrality is a fundamental principle of taxation in the United States." In the very next breath the same spokesman says "historically we have not adhered to the tax neutrality concept as it relates to domestic and foreign corporate income" (nor in other areas of taxation).

And in still another breath we are told that this fundamental principle, which is honored far more in the breach than in the observance, should be followed as far as investments in developed countries are concerned, but should be disregarded as far as investments in underdeveloped countries are concerned—someone in the executive department making the determination from time to time as to which country falls into which category—thereby determining tax rates, normally a function of the Congress.

Thus, we find that neutrality is a guiding principle when one result is desired, but is not a guiding principle when another result is desired. As a consequence, it becomes clear that the real question is not neutrality, but, as was said in "Alice in Wonderland," "Who is going to be the master?" It is clear that neutrality is not.

One is reminded of the story of the Irishman, who, during World War II, said, "I know we are neutral, but who are we neutral against?"

In this case, it would appear to be the legitimate businessman operating abroad—who has been the best friend that the United States has had as far as international trade and balance of payments are concerned.

Now, this concept of equity—or its twin, equality. It is stated:

> One of the most fundamental of the guiding principles in American taxation is that there should be equality in the tax treatment of similar groups of taxpayers.

It seems almost monstrous pedantry to talk about equity or equality in the tax area. The business of branches, foreign or domestic, is taxed totally differently than the business of subsidiaries, foreign or domestic (and the Treasury's proposals would not attempt to treat them the same).

And yet the same kind of business is being done by all. We do not complain of this situation, we merely point out that it exists. Presumably they are not considered "similar groups of taxpayers."

To seek to achieve tax equality between two taxpayers, it would seem indisputable that the total taxes to which the two taxpayers are subject should be examined and equated. Otherwise, it is like trying to create two men equal physically by cutting off the right arm of each to the same length. They will then be equal physically in respect of their right arm but only in that respect.

Foreign subsidiaries have totally different tax problems than domestic corporations. We do not think that equality of tax treatment as between the U.S. corporation that operates a foreign subsidiary and a U.S. corporation that does not is achieved by ignoring the numerous taxes to which the foreign subsidiary is subject and for which there is no equivalent counterpart in the United States.

In addition to differing tax problems, foreign subsidiaries face totally different risks than domestic corporations. The two have totally different competitive problems. In short, the two simply can't be equated realistically. Nor can the U.S. corporation which operates a foreign subsidiary be equated with the U.S. corporation that does not—and look at the hodgepodge that is created when the U.S. corporation that does not operate a foreign subsidiary does operate a domestic subsidiary and pays an intercorporate divident tax, or is enabled to forgo paying the same by not declaring a dividend.

They are not "similar groups of taxpayers." It is submitted that proper comparisons for equality of tax treatment can be made only between the foreign subsidiary and companies competing with it abroad. These are "similar groups of taxpayers."

We might restate the foregoing this way. The Treasury argues that the fact that the earnings of a foreign subsidiary of a U.S. corporation are not taxed to the U.S. corporation as they are made, but only as they are paid, whereas all the earnings of a U.S. corporation

that does not have a foreign subsidiary are taxed to it as they are made, acts as an incentive to a U.S. corporation to invest in foreign operations via a foreign subsidiary rather than in domestic operations, and presents an inequity in tax treatment to the U.S. corporation that does not have a foreign subsidiary.

Looked at strictly from the point of view of equity between the two corporations, the infirmity of the argument is clear. Each corporation had an equal opportunity (and would equally have had to stand the risks thereof) of investing in foreign operations via a foreign subsidiary.

The tax consequences to both would have been the same. Can the corporation that chose not to take the opportunity—and the risk—to operate abroad complain of inequity in tax treatment? Of course not. Looked at from the point of view of investment incentive, it would seem clear that all the necessary facts are not before us. Taxation is merely one factor to be considered in making an investment. Projections of rate of return, which is the key, will not only take into consideration U.S. taxation, but also foreign taxation, political and other risks, competition, et cetera. All must be considered. To operate, as the Treasury would, on one factor, U.S. taxation—in the name of achieving equity—does not equalize, it distorts. It does not effect equity; it merely affects.

There is a further facet to this "equity" proposition that should not become lost in the welter of words on this subject, and that is that most foreign subsidiaries have been built up and investments in them made on the basis of the long-standing and well-established principle of taxation—referred to by the Treasury's propagandists as the "tax deferral privilege," which, of course, it is not; see infra page 3718—which has been universally applied, that no tax is due from a shareholder in respect of the earnings of a corporation until a dividend has been paid by the corporation. This rule is applicable as between a domestic subsidiary and a domestic corporation, as well as between a foreign subsidiary and a domestic corporation.

Under such circumstances, it seems the very antithesis of equity to change this rule this late in the game. Indeed, Professor Surrey, who is reputed to be the chief tax architect of the Treasury's proposals, said in 1959 in a burst of foregotten virtue:

> * * * Should the rule that our tax may be deferred by use of a foreign subsidiary be continued? On this question, tax history, the fact that the organization of so much of our foreign investment is built on this rule, and the desirable accommodation to international relationships which it produces, all favor continuance of the rule.

This, we would say, is a remarkably clear statement with respect to the lack of equity of the present proposals.

C. BALANCE OF PAYMENTS AND EXPORT OF JOBS

Let us now turn to the matters of balance of payments and export of jobs.

As far as the balance-of-payments problem is concerned, we believe that the many figures produced only add up to enmeshment in a gigantic numbers game, and where the absolute truth lies is difficult, if not impossible, to determine.

The incontrovertible fact, however, and the one that should light the way through the confusion that the mass of figures has produced, is that the only reason that U.S. investments are made abroad is to bring money back to the United States. And this money will be brought back just as soon as it reasonably and intelligently can be brought back. A Swiss franc in Switzerland fundamentally has no value to a U.S. corporation unless that franc can be translated, in the reasonably foreseeable future, into dollars.

The reason why foreign earnings are in some instances not brought back immediately to the United States is because vision and intelligence indicate that if they, too, are invested in more plant abroad they will, in the foreseeable future, produce even more earnings to be brought back to the United States. It seems completely anomalous in these days and times of talk of dynamic growth and expansion that roadblocks should be placed in the way of such growth and expansion.

In any event, and looking this situation right straight in the eye, we would say that the Treasury's proposals are going to have nothing but an unfavorable impact on the balance-of-payments problem.

Doing business by U.S. corporations in Europe will be more costly, less profitable, and then just plain less as a result of these proposals. That does not bode well for the balance-of-payments problem. Moreover, there will be less for U.S. investment.

As for the statement that to continue to permit investments freely abroad is tantamount to exporting U.S. jobs, we believe this to be a false proposition and myopic in the extreme.

In our view, foreign investments create many U.S. jobs. In the wake of operations established abroad follow U.S. made plant and equipment, U.S. fabricated goods semifinished goods and intermediates, and U.S. extracted raw materials, all giving jobs to U.S. citizens in the United States, and, incidentally, all bringing money (U.S. tax and job generating) into the United States.

In this connection, it should be remembered that those countries where we have our largest investment are our best customers. In addition, in the wake of operations established abroad follow U.S. scientists, U.S. technicians and other U.S. workers. This, too, means jobs for U.S. citizens and money brought into the United States.

If concern is felt for the dearth of jobs in the United States, it is not at all clear how obstructing the creation by a U.S. entrepeneur of a job abroad will solve that situation. As Abraham Lincoln once said, "You cannot make a poor man rich by making a rich man poor."

If the climate is not right for creating a job in the United States, the job won't be created. If the climate is right for creating a job abroad, the job will be created. If, however, the U.S. entrepreneur is hindered or prevented from creating that job, the national of another country will create it, and the money flowing from that job will flow into the country of the other national and strengthen its economic sinews for the increasing, intense economic competition with the United States.

The same point can be made with respect to the theory of the present proposals that investment money should and will, as a consequence of these proposals, be channeled to the underdeveloped countries of the world. Investment money will not go to underdeveloped countries because of hampering investments in the developed countries.

The underdeveloped countries today have many inducements for investment money. The reason investment money is not going there is not because of the so-called tax deferral privilege available in respect of earnings from the industrialized countries of Western Europe, but, because, even with the very real tax and other incentives existing in the underdeveloped countries, total conditions for investment there are not right.

Investment money is both timid and wary. It will not be lured to go where total conditions for investment are not appropriate. This seems to be a fact of investment money life.

Moreover, if investment conditions are right in industrialized Western Europe, and a U.S. businessman is hindered from making an investment there, the investment will be made by nationals of another country, who will reap the rewards of their investment for themselves and their country.

D. THE PRIMARY CONSIDERATION SHOULD BE THE FOREIGN TRADE OF THE UNITED STATES

The foreign trade of the United States, wherever it can profitably go, should be considered of primary importance, and should not in any way be hampered or hindered. We believe, and feel that all enlightened people believe, that foreign trade is the way to peace. We believe that the standard of living and the economic strength of the peoples of the free world are dependent upon, and enhanced by, ever-increasing foreign trade and competition in the foreign trade field. If an expanding and flourishing foreign trade is the ideal, and we firmly believe it to be, this country should not even remotely be thinking in terms of the present proposals, which would operate as a clear detriment to it.

The great trading countries of the world, such as Britain, Holland, Japan, and France, recognize these facts, and all accord very real subsidies to their nationals who operate in the foreign trade field. Indeed, in certain instances these subsidies are conditioned upon earnings in the foreign field not being repatriated.

It is against subsidized competitors such as these that U.S. foreign traders must compete. The U.S. foreign trader needs understanding of his special problem in this regard, and not the present proposals, which, in this area, would distort even more competitive market conditions already distorted by the subsidies available to competitors.

The U.S. foreign trader is not asking for a subsidy. He does, however, want, and we think he should be entitled to, all the flexibility that the present laws give him to adapt, as his judgment dictates, to the changing competitive conditions in his market, foreign taxes—not United States, for they are inevitable—being one of the important ones, subsidies to competitors being another.

It seems utterly and unspeakably wrong for this country to pursue a policy that is opposed to the freest possible use of the money, efforts, and ingenuity of U.S. entrepreneurs who have had the courage and vision to devote their efforts to, and undertake the risks of, trading beyond the snug and secure walls of this country, and who have produced so mightily for the United States—taxwise and every otherwise. Is not the free movement of goods, labor, and capital the ideal of the Trade Expansion Act—H.R. 9900—and of a rising competitive force, the Common Market?

E. COMPLEXITIES, CONSTITUTIONALITY, INEQUITIES, TREATIES, AND LOOSE LANGUAGE

If the Treasury's proposals are enacted, we are of the opinion that the complexities of tax reporting in the foreign field, already aggravatingly complex, would be compounded manyfold.

Today we are seeking desperately for an answer and an end to the fantastic intricacies of the income law as it is presently constituted, and the overwhelming blizzard of paperwork which it entails. The proposals are more than a backward step in this regard. There must be a better and simpler way.

In addition, there is the problem of the constitutionality of the proposals. To tax one on income that has not been received, and, indeed, may never be received, as for instance, if subsequent losses wiped out dividend paying ability, would seem to deny due process.

Morover, the problem of tax treaties is not an easy one. Certainly the proposals would accomplish by indirection what the tax treaties were designed to eliminate, and are, consequently, in violation of the spirit of the treaties. These problems and the many inequities that the proposals themselves generate—it is our understanding that there are many, and that the Treasury will concede this as a fact—others have presented, or will present, to this committee.

The mention of tax treaties, however, does prompt us to call to the attention of this committee the possibility that those countries of Western Europe that have a lower tax rate than the United States may, if the Treasury's proposals are adopted, raise their tax rates on U.S. businesses to 52 percent. Then there will be nothing for the United States to tax, and no compulsion, which the proposals were to supply, on the U.S. businessman to bring anything back to the United States.

The Treasury has countered to the effect that no government would do this because it would hurt the businesses of their own citizens as well, and if a special tax were levied only with respect to U.S. businesses this would be a tax treaty violation.

We think complete answer to the Treasury's counter is found in section 21 of the proposed legislation. This section provides that if any provision contained in the proposed legislation contravenes any tax treaty, then the proposed legislation shall have precedence over the treaty. If the United States can abrogate its treaty obligations thus cavalierly—an iniquitous thing on its face—why cannot a foreign government do the same?

We feel that the Treasury has used reprehensibly loose language in its approach to this problem. More illustrative than anything else of this is the reference to the application of the long-established rule that no tax is due from a shareholder in respect of the earnings of a corporation, be the corporation a foreign or a domestic corporation, until a dividend has been paid by the corporation as tax deferral and a special privilege. It is not a deferral, for no tax was due. It is not a special privilege, for it is the general taxation scheme, and has been so since the beginning of the income tax law.

Coupled with talk about a tax deferral privilege is the statement that to the extent that U.S. business abroad enjoys this so-called tax deferral privilege, it is operating on an interest free loan from the U.S. Government.

What a perversion of the simple truth.

There is no tax deferral, and there is no interest-free loan from the U.S. Government in any proper sense of the words.

It might just as well be said that every one of us is operating on an interest-free loan from the U.S. Government because the Government does not take all of our income in taxes as it might well do—or most of it if the power to tax is not quite the power to destroy—and thus, to the extent the Government does not do so, it is loaning us money interest free.

The simple answer is, it isn't so—except perhaps in Russia or in some other totally communized society.

F. GROSS-UP

A word about gross-up. This is simply another step in the Treasury's apparently calculated design to break down the time-honored separate identity of the corporation, and tax that which has not been received.

It is interesting to note that the House Ways and Means Committee states as its only reason for the gross-up provision that it is necessary so that the taxation of a foreign branch may be equalized with that of a foreign subsidiary. The actual fact is that this does not accomplish equalization between the two at all. The U.S. corporation operating a foreign branch enjoys many advantages not available to the U.S. corporation owning a foreign subsidiary; for example, the depletion allowances, loss deduction, et cetera, and will continue to do so.

Even in this area, the Treasury propagandists have come up with a fine shibboleth: "Eliminate the double allowance. Do not permit both a tax deduction and a tax credit." There is, of course, no deduction. Credit, yes; deduction, no.

G. SUGGESTIONS

We have three suggestions to make with respect to appropriate legislation in this area where, unquestionably, abuses do exist. In conceding the existence of abuses, however, we think it only fair and honest that it be conceded that sufficient law exists today to meet most of such abuses—as the shell corporation or the intercompany loan that, in fact, is not a loan—or downright dishonesty in the failure to report transactions.

First suggestion: Most of the abuses, we feel, are committed by, and are only of any real value to, closely held corporations. We would suggest, therefore, that the Treasury's proposals, as substantially amended, be confined to such corporations.

The publicly held corporations have an obligation and a desire to pay dividends, and, for this purpose, require the remission of profits from abroad. This should be a sufficient guarantee of their performance in this regard.

Second suggestion: This is totally unrelated to the one above mentioned, and is directed toward giving the U.S. corporation, with a number of operating subsidiaries in the various countries of Europe, flexibility in the kind of investment operations permitted in the Treasury's proposals.

To accomplish this, it is suggested that the earnings of one European subsidiary be usable in the business of another European subsidiary. Thus, all the subsidiaries would be treated as one mutually supporting complex.

In addition, and as a refinement, if there is a holding company intervening between the U.S. corporation and the operating subsidiaries, that it have the same privilege, any income not being used in the trade or business of one or more of the operating subsidiaries, without regard to whose earnings they are, being considered as received by the parent U.S. corporation.

Commercially and realistically, an investment in several countries of Europe by a U.S. corporation is a unity; the fact of seperate incorporations being merely a convenience and a necessity as the requirements or provisions of local laws indicate.

As a further refinement, we might suggest that there be a 5-year period of reckoning, inasmuch as investment moves on an annual basis may not be wholly realistic. This total suggestion may, in final analysis, come down to something like absolving a U.S. corporation from the application of these proposals, which import a nightmare of administrative complexities and financial inflexibilities, if, of its total European subsidiaries' earnings, say, 60 percent, are repatriated, leaving the balance for reinvestment—the seed corn of the future.

Third suggestion: More study.

H. CONCLUSION

We ask this committee to keep in mind the fact that——

Senator GORE. What do you mean "more study"? You ought to give us a little duration. You mean indefinitely?

Mr. ADAMS. The more I read on this subject, the more my own eyes are opened to that and I thought I had a long experience with it, Senator.

Senator GORE. Well, you haven't answered my question yet. What do you mean by "more study"?

Mr. ADAMS. I think such a great deal more study is necessary that I wouldn't dare put a time limit on it.

Senator GORE. Thank you very much. I didn't think you would.

Mr. ADAMS. We ask this committee to keep in mind the fact that—

(1) The foreign trade of the United States—wherever that trade can profitably go—is of paramount importance to the economic health of this country.

(2) Foreign trade is highly competitive and the U.S. foreign trader should not be hindered in the competition, nor should his maneuverability be limited, particularly when his competitors are being subsidized.

(3) The main interest of the U.S. businessman in earning money abroad is to be able to translate that money into as much U.S. money as possible. Sometimes this is done by an immediate remittance of earnings, and sometimes, in the judgment of the U.S. businessman, who is best qualified to judge, it can be done better by further investment and a later remittance of earnings. But remittance is inevitable (as is the day of reckoning with the U.S. tax gatherer).

(4) A big thing for the U.S. foreign trader is involved in the subject proposals. On the other hand, a proper appraisal of the real figures involved will show, we feel certain, that there is very little, if anything, in the proposals as far as the U.S. balance-of-payments problem or U.S. taxes are concerned.

(5) Where abuses do exist—and they always will in the tax area with rates as high as they are—these should be corrected. This should be done on a selective basis, though, the abuses being clearly spelled out, and not on the Herodian principle contained in the present proposals. It is believed that there are adequate provisions in the law to cope with most abuses, particularly with the advent of I.R.C. section 6038 which will bring to light many type situations heretofore undisclosed and unknown.

We respectfully submit that the best interests of the United States clearly lie in more foreign trade every place, not less, and any legislation which hobbles such trade is surely bad legislation. We urge the committee to view these proposals with disfavor.

A perceptivity of the great destiny of the United States in the foreign trade field, which is only possible, not inevitable, dictates that course.

Thank you.

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

You mention that American business abroad, that the competitors are being subsidized; would you elaborate on that?

Mr. ADAMS. I beg your pardon, sir?

The CHAIRMAN. Would you elaborate on that? You state that the competitors of American competitors abroad are being subsidized.

Mr. ADAMS. I had reference, sir, there to the tax treatment which a British business, let us say, operating outside of Britain receives. It is not subject——

The CHAIRMAN. You mean subsidized by other countries, not by this country; is that it?

Mr. ADAMS. That is correct; yes, sir.

The CHAIRMAN. Senator Gore?

Senator GORE. You stated that under the provisions of the pending bill your company would be required to pay approximately an additional $2 million in taxes.

Mr. ADAMS. That is correct.

Senator GORE. Standing alone, that figure might appear shocking. But when viewed against the fact which appears from your 10–K form, it is not so shocking. Your company showed a net income of $80 million in 1960.

Now, as I have examined numbers of financial statements, consolidated and otherwise, there appear to be a few clearly identifiable earmarks of tax avoidance schemes.

I have not detected a single one on your statement. In fact, your consolidated statement of your operations, both foreign and domestic, showed you paid a tax rate of almost 50 percent in 1960.

Isn't that correct?

Mr. ADAMS. I believe that is; yes, sir. Of course, the $80 million you refer to was before tax, and so far as I am concerned we are not engaged in tax evasion or tax avoidance or any games at all.

Senator GORE. I have not alleged that you are. I think some people are, but I have not seen anything to indicate that your company is.

Now, in view of this fact, I wonder if you would explain to the committee the sources of the $2 million additional tax liability.

Would it come from the gross-up or where?

Mr. ADAMS. It comes half and half. Half from the gross-up, and half from the imputing of earnings abroad to the domestic parent.

Senator GORE. Which subsidiary?

Mr. ADAMS. It is this Swiss holding company setup that we bought into. We did not set it up ourselves.

Senator GORE. So, then one-half would come, if I understand you correctly, from the gross-up provisions, and one-half from increased tax liability due to the activities of your Swiss subsidiary?

Mr. ADAMS. Right.

Senator GORE. If your company did not have so many other subsidiaries, if its operations were not so great and profitable, if you had only one subsidiary, and that was the Swiss subsidiary, and you had only an income of $2 million, one of which remained in Switzerland, then you would have an identifiable earmark. But since this Swiss subsidiary is such a small part of your overall operation your overall tax rate is approximately 50 percent. That raises an interesting question about your Swiss subsidiary.

How long have you owned it?

Mr. ADAMS. About—well, when you say how long have we owned it. Actually, it was an investment made 20 years ago, but it didn't become a controlled situation until 5 years ago, and even then we didn't take control over it until we acquired even more shares and so I should say it become—we exercised control for the first time about about 3 years ago.

Senator GORE. Would you identify the Swiss subsidiary?

Mr. ADAMS. It is Knorr.

Senator GORE. What were its total assets, what was the total of its assets, at the time you acquired control and started using it in your management 3 years ago?

Mr. ADAMS. I couldn't tell you that, Senator; actually expertises are being made to determine how much should be paid for the last bit of shares that we are acquiring, and those figures have run all over the lot. I am not familiar with them right now.

Senator GORE. Could you give me an estimate, an order of magnitude?

Mr. ADAMS. I just would be guessing right now, if I did.

Senator GORE. Would you give me an estimate of its profit accumulation in the past 3 years.

Mr. ADAMS. Let me say that these Swiss, these subsidiaries of this Swiss holding company were postwar enterprises engaged in by this Swiss company, so that there hasn't been very much accumulation because they have all just been starting up since the war, and there have been rather large losses.

It has only been within the last 2 or 3 years that they have become profitable situations, and exactly what their profit is, I don't know.

Senator GORE. Well now, if I may make a deduction from the fact that this bill would require you to pay an additional $1 million taxes on your Swiss subsidiary, I must conclude that it has been substantially profitable in the last——

Mr. ADAMS. It has, yes, indeed.

Senator GORE. Would it be reasonable to conclude that you are just a little late in moving in on the tax haven operation?

Mr. ADAMS. I thought I had explained we bought into this situation. We did not set it up. We don't even consider this——

Senator GORE. Whether you set it up or bought it, it is there, and you have been using it for 3 years, and you have accumulated some millions of dollars in profit.

Have you remitted anything to the United States from the Swiss subsidiary?

Mr. ADAMS. In 1961, we had total foreign earnings of some $22 million, and I believe we remitted $21 million to the United States, so I assume that the Swiss subsidiary must have paid a substantial part of its earnings, too.

Senator GORE. I am not asking you for assumptions.

Do you know whether or not any of the profits, the profits of the Swiss subsidiary, have been remitted to the United States?

Mr. ADAMS. I don't know as a fact, but I believe it is so.

Senator GORE. Would you supply this for the record?

Mr. ADAMS. I would.

(Mr. Adams subsequently submitted the following information:)

Earnings since 1957 (the year in which we received control of the Swiss subsidiary) was $6,800,000. The dividends to us were $5,300,000.

Senator GORE. Overall, your consolidated statement looks very good, I congratulate you, sir. You have a successful business. You have made enormous profits and by and large you have paid your taxes on those profits.

But this one isolated tax haven operation, which is a comparatively new venture for you, has not, according to your own statement, been paying, I think, the taxes which it should pay, and it is for the pur-
new venture for you, has not, according to your own statement, been
laboring.

Now, the tax consequences of this bill to your company would not appear to be of severe consequence. You paid the tax of many millions of dollars at the rate of approximately 50 percent, and this bill would perhaps bring you to around the 52 percent mark, so I don't really think you present a picture here of disastrous tax consequences. You understand perfectly well, from your operations in the high tax countries, the tax consequences would be very small indeed. It is in the third country operation when this bill would be effective, and you have a classical setup now, although you have just recently started using it, perhaps with some vigor. You have a Swiss holding company with subsidiaries in various other countries.

It is a combination of the tax deferral privilege—though you don't accept that term, we understand what we are speaking about; you understand what I am speaking about when I use the term.

Mr. ADAMS. I do, yes, indeed.

Senator GORE. It is a combination of the tax deferral, and the tax haven where the abuses arise. I am glad that this is only a small part of your operation, but I am afraid you might be tempted to enlarge the operations of your Swiss subsidiary unless the law is changed, as many other companies are already doing.

Mr. ADAMS. I can only comment to that, Senator, that $2 million is a lot of money to us. It is a great deal of money to us.

Senator GORE. Well, it is a great deal of money, but when measured against $80 million income it is not as large as it would be for some of the smaller companies.

Mr. ADAMS. Well, I just repeat, the $80 million figure you refer to is before tax, and $2 million looms large in this company's calculations and in the minds of the many small stockholders (one-half the shareholders of this company own less than 50 shares of stock) to whom this company belongs. Furthermore, so far as I am concerned, there is absolutely nothing reprehensible about the operations of our Swiss holding company. I have already told you that of $22 million of foreign income that we earned last year we have brought back $21 million. I think in the preceding year we earned $18 million and brought back $14 million. It just seems to me economically wrong, where we have been able in connection with this Swiss subsidiary to take money out of a high tax foreign country into low tax Switzerland, and use that money in developing our business, that we should not be permitted to do that.

That is the economic way to do it because all it does is make more money available in the long run to bring back to this country.

Senator GORE. Well, it also lessens the amount of tax you pay to this country, if the profit winds up in Switzerland. It means—well, this is what we are after.

You say there is nothing reprehensible; I say there is nothing illegal. The party which is guilty of being remiss is, it seems to me, the Government of the United States, in permitting this kind of law of law to remain on the books.

Thank you very much.

The CHAIRMAN. Senator Bennett?

Senator BENNETT. No questions.

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

The next witness is Mark H. Berens of the Brunswick Corp.

Is Mr. Berens here?

Take a seat, sir, and proceed.

STATEMENT OF MARK H. BERENS, ATTORNEY, REPRESENTING THE BRUNSWICK CORP.

Mr. BERENS. Mr. Chairman, I am Mark H. Berens, a partner in the Chicago law firm of Mayer, Friedlich, Spiess, Tierney, Brown & Platt.

My testimony today is in a dual status. First of all, generally from the viewpoint of an attorney with experience in international investments and operations in advising a number of clients, and in particular on behalf of Brunswick Corp., which through foreign subsidiaries, conducts manufacturing, trading, and operates bowling centers in 21 foreign countries.

My testimony constitutes the first portion entitled the summary, and highlights a more complete statement which, with your permission, I request be inserted in the record.

The CHAIRMAN. Without objection your detailed statement will appear in the record following your oral presentation.

Mr. BERENS. My presentation is confined to the controlled foreign corporation provisions of proposed section 13 of the House bill, with

some commentary on the proposed amendment to section 482, which I think is mechanically impracticable and will bear most adversely on enterprise that assembles abroad, thereby encouraging them to manufacture or procure abroad.

I favor in principle the other foreign income provisions of the bill, including grossup provision, except that I believe that the scope of section 16 is too broad.

The Treasury Department supports section 13 for four reasons:

1. To help improve for the next several years our balance of payments;
2. To make the income tax burden neutral between investment in the United States and investment in other developed countries;
3. Through such neutrality, to relatively encourage additional domestic investment; and
4. To increase Federal income tax revenues, at least for the next several years.

In my judgment it is improbable that the proposed legislation will appreciably achieve any of these commendable objects sought by the Treasury, but rather is likely to create unintended adverse effects that will counterbalance the desired benefits should they, contrary to my expectations, be fulfilled.

Balance of payments effect: Tables A–6 and A–7, of exhibits presented by the Treasury to this committee estimate that the legislation will favorably affect our balance of payments by an annual average of $125 million lasting only 8 years, an extremely modest result for legislation which is so complex and controversial and such a departure from our existing law and the tax laws of all other principal commercial countries.

However, it seems to me unlikely that the legislation will affect the balance of payments even that much. The basic attractiveness of investment opportunities in the developed countries will not be changed by the legislation, so that American capital will continue to flow to such opportunities unless the legislation effectively deflects it.

But the legislation does not affect investment in foreign branch operations; nor in countries where the effective income tax rates normally are about 52 percent, which include most corporate activities in Canada, the United Kingdom, France, and Japan, and to a lesser extent, Germany; nor does it affect foreign investments in which American interests do not hold voting control. Most significantly, it does not inhibit portfolio investments which, over the last 5 years, have averaged almost $1.4 billion per year, on a sharply rising trend, of about 15 percent per year.

Thus, the legislation does not create neutrality between domestic and foreign investment, but inhibits only American controlled investments in the developed countries. The result to be expected is no significant decline in foreign investment, but a substitution of joint venture with foreign investors and portfolio investments for American controlled investment.

For analogous reasons I believe the legislation would have less effect than expected in inducing dividends by controlled foreign subsidiaries.

Neutrality: Under the conditions just described, the attempt to make our income tax neutral between domestic investment and investment in developed foreign countries cannot succeed—even if

neutrality at the source of investment is to be preferred to neutrality at the market where the capital is employed.

So long as income tax rates affect the availability of capital to an enterprise, and thus indirectly constitute a genuine cost of doing business, the competitor with a higher effective income tax rate will obtain less of the market than he would were he paying the same income tax rate as do his competitors in the same market.

For the most part the legislation will not create effective neutrality between domestic and foreign investment, because American capital can readily be invested in developed foreign areas without substantial interference by the legislation, in such form as to actually achieve marketplace neutrality. On the other hand it will have an unfair and adverse affect on small concerns, exporting businesses, and established offshore enterprises who are not so readily in a position to participate in attractive foreign markets by entering joint ventures.

Moreover, I find it disturbing that the proposed legislation is not truly neutral between domestic and foreign investment, but in several major respects will subject the income of controlled foreign corporations to higher effective rates of tax than domestic income.

An inexplicable burden upon such foreign income under the bill is the failure to attribute a loss of a controlled foreign corporation to the domestic shareholders, just as income is attributed. This means that a domestic shareholder could pay at an effective rate of substantially greater than 52 percent in a given year if one foreign subsidiary has a loss and another has attributable subpart F income. The same thing can happen over a period of years with a single foreign subsidiary because of the absence of any loss carryovers or carrybacks in computing subpart F income.

Secondly, the numerous and valuable elections permitted under the code to domestic corporations, including their foreign branches, would be unavailable to controlled foreign corporations or their shareholders. This, of course, includes LIFO inventory accounting, a very important election.

Thirdly, and of particular significance is the absence of any deferral of income of controlled foreign corporations which could not be remitted because of exchange control limitations or corporate law restrictions that exist in many civil law countries.

Let me interpolate an example of this latter type of restriction. In most of the civil law countries a corporation is not permitted to pay any dividend even though it has earnings until it has accumulated an earned surplus equal to 50 percent of its paid-in capital.

It is not a valid justification for this lack of neutrality, contrary to the bill's own premises, to contend that foreign operations can be conducted through branches of domestic corporations. Nontax reasons often require operations be by a local corporation, examples being pharmaceutical production, food processing, and others which need special licenses. Another nontax reason is the subsidies that are given by foreign governments, such as Japan, to investments in that country, which must be through a domestic corporation of the particular country.

DOMESTIC INVESTMENT

Even if the legislation would deter investment in developed areas, which seems doubtful, it does not follow that funds not so invested offshore will be invested domestically, as hoped by the Treasury.

An investment anywhere depends on the investors' appraisal, in light of risks, of whether the profit prospects justify the use of capital in one way in preference to other alternatives. The low rate of domestic growth in recent years under conditions of inadequate employment and relatively low interest rates is a telling reflection of investor opinion on domestic opportunity.

If this is compared to the situation in most of the developed countries where there has been a high rate of economic growth coincident with full employment and high interest rates, it does not seem likely that a limited measure like this will overcome fundamental domestic investment sluggishness.

Incidentally, the Treasury's estimate of additional domestic capital of $125 million per year to be made available by the bill represents less than four-tenths of 1 percent of the average domestic private (nonresidential) investment for the last 5 years.

Thus, for a doubtful and small domestic investment stimulation, the legislation, if effective in deterring foreign investment, simply would mean an abandonment of what otherwise would be the American investors' share of valuable foreign markets, which now, particularly in the European Common Market area, give the greatest opportunity for long-range achievement.

REVENUE EFFECT

If the foregoing analysis is correct, the Treasury estimate of increased tax revenues from the proposed legislation is unduly optimistic, especially because American-controlled enterprises will not be stimulated, as they now are, to avoid foreign income taxes through so-called tax haven operations.

It also seems likely that foreign countries will utilize their primary ability to tax income at its source; the consequence of this will be that a portion of the tentatively increased U.S. tax revenues will be sopped up by greater foreign tax liability eligible for the U.S. foreign tax credit. Consider the example here of the State pickup estate taxes to fully use the Federal estate tax credit.

Even if the intended benefits of the legislation are achieved, they will be accompanied by a number of inherent adverse effects which I believe are serious enough to question whether the legislation is in the overall national interest.

1. As has been pointed out by many witnesses, the legislation will make American-controlled investment in foreign areas less competitive than foreign-controlled investment. A detriment of about 5 to 25 percentage points of tax rate will exist for any American-controlled corporation operating in all but about a half dozen of the developed countries.

Much more acute will be the competitive detriment to American-controlled international trading, leasing, and servicing companies, and international exploiters of intangible rights, who will be competing with foreign-controlled counterparts subject to income tax at

rates seldom over 15 percent. It is these so-called tax haven companies which are the principal developers of U.S. export trade.

I do not understand the reason for creating this serious competitive disadvantage, particularly when virtually all foreign service activities, including utilities, and most foreign manufacturing, leasing, and trading operations, do not supplant domestic enterprise, facts which are partially demonstrated by the Treasury statistics presented to this committee, which disclose that oversea investment increases net exports from the United States.

I also find it difficult to understand why we would promote minority American investment abroad inasmuch as American-controlled foreign corporations have assisted our foreign policy, such as by inducing cooperation in foreign areas with strategic goods embargoes against the Soviet-Sino bloc.

American-controlled corporations also mean American management controls, and an opportunity to demonstrate the actual working of our economic system in foreign areas.

2. Correlatively, the bill severely limits the operational flexibility by American enterprise abroad by compelling it to arrange its affairs in such a way as to mitigate its tax impact.

Such inflexibility, which is primarily directed to multicompany operations, will circumscribe the ability of American enterprise to solve foreign currency exchange, customs, import licenses, turnover taxes, and foreign income tax problems, and will thereby increase the operating cost (as well as the income tax cost) of doing business, and thus itself will make American enterprise additionally less competitive. Here again it is the smaller enterprise abroad that will have the least flexibility, especially those who are attempting to establish a toehold abroad.

3. If the legislation is effective, the Treasury concedes that it will damage our longrun balance of payments, and unless this detriment is not to become permanent, this legislation must be viewed as temporary, an almost unique approach under our income tax law in recent years.

Moreover, its estimated short-term advantage on the balance of payments of $125 million for 8 years is a fraction of the Treasury's own estimate of the long-term detriment.

4. Although the legislation surely is not likely to be very objectionable to major competing countries such as Germany, Japan, the United Kingdom, and France, it is likely to raise questions in Italy and Belgium, where it limits American participation in their tax holiday investment programs, as to why their less developed areas are less deserving of assistance than those of other nations.

5. The immense complexities of the legislation will introduce unparalleled difficulties and costs of administration. Determinations concerning control, source, and destination of goods; whether intangible rights were "substantially" developed in the United States; whether earnings were invested in "substantially" the same trade or business; and whether investments in qualified property are "ordinary and necessary," will usually be difficult and frequently be virtually impossible.

To this must be added the staggering problems of annually calculating subpart F income and the earnings and profits invested in quali-

fied property of a foreign corporation under concepts of U.S. income tax law. Compounding these are the choice of the correct exchange rate to use for converting foreign funds to U.S. dollars when multiple exchange rates exist.

Our exhibit A is a detailed compilation of administrative and technical difficulties of section 13, many of which appear to be inherent in any approach similar to this section.

If, as the Revenue Service has publicly asserted, it has difficulty effectively administering the present law, it is hard to see how it can hope to uniformly administer this legislation to the end that all taxpayers affected by it are treated equally. But, unless there is equal treatment, there is not equity nor neutrality. This equity problem is acute because of the difficulties of offshore auditing.

6. Extensive and otherwise necessary litigation would be caused by the legislation because of serious constitutional doubts already pointed out by others, because of the immense difficulties of factual application, and because of probable conflicts with some provisions of our tax treaties.

7. The legislation would have the unusual effect of causing greater hardship to established foreign investment, created under a long-continued tax system, than future foreign investment, which can more easily be arranged to avoid its impact.

8. The legislation would limit the ability of funds earned in developed areas to be reinvested, without income tax, in less developed areas. Similarly, the imputed royalty provisions for U.S. source know-how will hit hardest in the less developed areas.

9. The provisions imputing income for the exploitation abroad of U.S. source inventions and know-how will perversely induce a greater amount of research abroad.

10. The requiremetns (to avoid subpart F income) that merchandise not be traded betwen controlled affiliates and that it be substantially produced in the country in which it is sold for ultimate consumption will inevitably induce more procurement and manufacture from local foreign sources.

It seems relevant in judging the wisdom of the proposed legislation to compare it with how other major commercial nations tax income from foreign sources. As shown in detail in part XVII of my detailed statement and exhibit B, no other major commercial nation taxes unremitted dividend income to domestic shareholders (other than in personal holding company situations), nor do any have any legislation inhibiting the use of international trading, leasing, servicing, and licensing companies.

Many give special tax preferences to foreign business income. Almost all of these nations have much larger per capita external investment and per capita export trade than does the United States. Moreover, their tax systems persisted through balance-of-payments crises far worse than we are now experiencing.

I should like to now point out several specific problems this bill creates for Brunswick Corp., which problems are not unique and which we believe are unintended.

Because of exchange control, customs, and turnover tax problems, the Brunswick organization is forced to lease rather than sell its automatic pinsetter in certain countries, which leasing is most effectively

done by a single entity serving a number of countries. The bill makes such rentals subpart F income even though the leases are not to affiliates. We think such rental income should be treated no differently than income from sales to unaffiliated persons, or, for that matter, from sales to affiliated persons.

To develop the European market for American style tenpin bowling Brunswick has commenced financing customers' purchases of equipment from it, and to this end, has established an international finance company similar to that of domestic customer finance companies. As such, it will be competing with commercial banks, both foreign and domestic, whose income under the bill will not be subpart F income. We are unable to see why the income of financing organizations, which directly promote U.S. exports, should be treated adversely to that of competing banks.

Although Brunswick does not operate any bowling centers in this country or Canada, as part of its attempt to promote bowling in Europe, it will operate numerous bowling centers there through local subsidiaries. Under Secretary Dillon's proposal to this committee to extend the application of section 13 to all income earned by controlled corporations in developed countries, such income would be classified as subpart F income and will be immediately taxable to Brunswick Corp., even though the operation of such bowling centers cannot compete in any sense with economic activity in the United States. We find it difficult to understand the wisdom of accelerating tax liability in any situation such as this, involving the rendering of services in foreign areas.

Most of Brunswick's exports are in the form of finished goods for sale to foreign customers. However, because of foreign import licenses, exchange control, and customs problems, it ships automatic pinsetter components and bowling lane bedstock for assembly and installation abroad. The application of proposed section 482(b) to Brunswick will necessitate extraordinarily difficult and burdensome calculations.

I do not mean to indicate opposition to the principle of 482(b), which would substitute a pricing formula instead of an income formula as is now in that section. I think, however, that it will be a much more workable approach if the pricing formula were based on a ratio of domestic costs to foreign costs related to the particular export, rather than based on domestic assets to foreign assets.

With three exceptions, none of the foregoing conclusions will be changed should all income of controlled foreign corporations in developed nations be subject to immediate U.S. income tax as proposed by Secretary Dillon. If that should be enacted, there will be slightly less complication in administering the legislation, but the competitive position of controlled American business abroad will be much more seriously affected, as would our longrun balance of payments.

It seems to me that there exists an exceptionally strong case for caution in taxing unremitted earnings of controlled foreign corporations, which are genuine operating entities. The bill would overturn a 40-year-old system of taxation, under which considerable foreign investment has been made, and would be unique among nations. The Treasury states in its presentation to this committee that important economic data pertinent to the legislation is rudimentary or not avail-

able. Experienced international investors, businessmen, and advisers, including accountants and lawyers, unanimously, so far as I know, believe that the legislation will not achieve the benefits it seeks, but on the contrary will severely hamper the ability of American-controlled investment to compete in most of the developed nations, which are and for the near future will be the best foreign markets. I do not think legislation should ignore such qualified opinion.

I strongly urge that section 13 be deleted from the bill except for the problem of offshore insuring of American risks.

In part XX of my statement I recommend a series of alternative solutions to some of the problems toward which section 13 is directed—if legislation is in the opinion of this committee to be immediately adopted concerning these problems. Underlying each recommendation is the object of preserving the ability of American business to fully participate in foreign markets, which section 13 as now drafted would not do.

Let me add that one of my proposals is quite similar, in fact almost identical, to that made by Senator Javits earlier this morning, and that is to delete all of section 13 in favor of an extension of the provisions of 531 to foreign income.

In fact by chance, I agree with all his provisions subject to one additional suggestion: under section 531 there now is a presumption that a holding company is unreasonably accumulating surplus. This applied to a foreign holding company, I think, would create an unintended effect, because the intermediate foreign holding company misnamed, I believe, a tax haven company and misidentified as a sham tax avoidance operation, performs a function in permitting a great deal of flexibility in conducting foreign operations, such as to avoid exchange control problems of foreign countries. Thus, with that one exception, I would wholeheartedly agree with Senator Javits' proposal as a way of selectively curing a problem that exists today without hurting American competition abroad.

Thank you.

Senator GORE (presiding). Thank you very much, the committee appreciates your presence.

(The detailed statement referred to follows:)

DETAILED STATEMENT

I

The Treasury Department has given four principal reasons in support of its proposal to tax U.S. shareholders on unremitted income of controlled foreign corporations derived from developed countries:

(1) To help improve for the next several years our balance-of-payments;

(2) To make the income tax burden neutral between investment in the United States and investment in other developed countries;

(3) Through such neutrality, to relatively encourage additional domestic investment; and

(4) To increase Federal income tax revenues, at least for the next several years.

To these might be added the purpose of relatively encouraging investment in less developed nations through continuing most of the existing system of taxation to the income earned in such areas.

In my judgment it is improbable that the proposed legislation will appreciably achieve any of these commendable objects. Rather, I believe there is strong evidence that the legislation will create unintended adverse effects that will counterbalance the desired benefits should they, contrary to my expectations, be realized.

II

The Treasury concedes, and the statistical materials it has presented to this committee demonstrate, that its proposals will adversely affect our balance of payments in the long run. Tables A–6 and A–7 show that a favorable balance of payments will only exist during the first 8 years. During these 8 years the Treasury estimates the average favorable balance to be about $125 million annually. This estimate is a net calculation of a decrease in foreign investment, an increase in dividend payments to meet accelerated tax liabilities of shareholders of controlled foreign corporations, and a decline in net exports due to curtailed foreign investment.

It is difficult for me to understand why the Treasury so vigorously seeks legislation which it estimates would improve the balance of payments by such a small amount.

There are convincing indications that the legislation will not affect the balance of payments at all. The attractiveness of investment opportunities in the developed countries, apart from U.S. income taxes on such investment, remain unchanged. Therefore, capital will continue to flow to such opportunities unless the legislation effectively limits it. But the legislation does not affect investment in foreign branch operations; nor in countries where the effective income tax rates normally are about 52 percent, which for most activities includes Canada, the United Kingdom, France, and Japan, and to a lesser extent Germany; nor does it affect foreign investments in which American interests do not hold voting control. Most significantly, it does not inhibit portfolio investments which, over the last 5 years, have averaged almost $1.4 billion per year, on a sharply rising trend. Thus, the legislation does not create neutrality between domestic and foreign investment, but inhibits only American controlled investments in the developed countries. The result to be expected is no decline in foreign investment, but a substitution of joint ventures with foreign investors and portfolio investments for American controlled investment.

Moreover, there will be an introduction of serious but nebulous antitrust problems because of the use of such joint ventures.

To the extent that future investments are not affected by the legislation, there will be no pressure to remit dividends from such investments. As to existing investments which fall within the scope of the legislation, there will be pressure toward increased dividends, but the extent to which this will actually result in increased dividends depends on the appraisal by U.S. shareholders of whether it is preferable to pay the U.S. income taxes on income of a foreign subsidiary with funds from the subsidiary, or to pay such tax liability with domestic funds and leave the funds abroad as retained earnings to capitalize on investment opportunities.

III

The proposition that U.S. income tax should be neutral between domestic investment and investment in developed foreign areas raises a pair of fundamental questions. The first is whether the income tax should be neutral in the place of the source of the capital, or should it be neutral at the place where the capital is employed.

Although arguments can be made on both sides of this question, actually it is almost wholly theoretical. So long as income tax rates affect the availability of capital to an enterprise, and thus indirectly constitute a genuine cost of doing business, the competitor with a higher effective income tax rate will obtain less of the market than he would were he paying the same income tax rate as do his competitors in the same market. But if American capital can readily be invested in developed foreign areas without substantial interference by the legislation, in such form as to achieve marketplace tax neutrality, the legislation will not create effective neutrality between domestic and foreign investment, except to the extent that it inhibits American enterprise, particularly smaller concerns, export operations, and established enterprises, which are not in a position to readily enter joint ventures, from participating in an attractive foreign market.

Expressed differently, if we assume (which we must for analytical purposes) that all other costs are equal, if one competitor in a particular market has a higher income tax cost, he will be less competitive, and thus the American enterprise subject to a 52-percent rate will, in the long run, obtain less of the market than he would were he paying say 40 percent as do his competitors. American capital then has only the choice of giving up part of a foreign market which it otherwise could capture, or to invest in a form unaffected by the proposed legislation. Accordingly, the neutrality of the legislation is illusory.

The second question is whether the proposed legislation is actually neutral between domestic and foreign investment. As now drafted, it most surely is not, but subjects foreign income of controlled foreign corporations in several significant ways to higher effective rates of tax than domestic income.

The most serious and inexplicable discrimination against such foreign income under the proposed legislation is the failure to attribute a loss of a controlled foreign corporation to its domestic shareholders. This means that a particular shareholder can pay at an effective rate of greater than 52 percent in a given year if one foreign subsidiary has a loss and one has attributable subpart F income. The same thing can happen over a period of years with a single foreign subsidiary because of the absence of any loss carryovers or carrybacks in computing subpart F income.

Secondly, the numerous and valuable elections permitted under the code to domestic corporations will be unavailable to the controlled foreign corporation or to its shareholders. These include the investment credit proposed in this bill.

Thirdly, and of particular significance is the absence of any deferral of income of controlled foreign corporations which could not be remitted because of exchange control limitations of many countries, or corporate law restrictions, such as mandatory surplus reserves of a proportion (usually half) of paid-in capital, common in most civil law countries.

The failure of the proposed legislation to provide true neutrality, consistent with its own premises, is not exonerated by the fact that foreign operations can be conducted through branches of domestic corporations, because nontax reasons often demand that an operation be conducted by a local corporation. This is particularly true for pharmaceutical manufacturing, food processing, and other industries which either require special regulation or which are entitled to local subsidies. It is also true that local corporations, even though foreign owned, sometimes are more readily acceptable to their potential customers.

IV

The object of the legislation least likely to be realized, in my opinion, is that the deterring of controlled foreign investment will increase domestic investment by a significant amount. Even if the legislation would deter investment in developed areas, which is doubtful, it does not follow that funds not invested offshore will be invested domestically, as hoped by the Treasury. All investment, no matter where made, depends on the investors' appraisal, in light of risks, of whether the profit prospects, after income taxes, justify the use of capital in one way in preference to other alternative investments. The low rate of domestic growth in recent years under conditions of inadequate employment and relatively low interest rates has been a telling reflection of investor opinion on domestic opportunity. If this is compared to the situation in most of the developed countries, where there has been a high rate of economic growth coincident with full employment and high interest rates, it does not seem likely that a limited measure like this would overcome fundamental domestic investment reluctance.

Incidentally, the Treasury's estimate of additional domestic capital of $125 million per year to be made available by the legislation represents less than four-tenths of 1 percent of the average domestic private nonresidential investment for the last 5 years.

It is also noteworthy that the average corporate return, after foreign income taxes, on all investment in Western Europe and Canada has been 10.7 percent for the period 1953 through 1960, while domestic corporate return, after U.S. income taxes, has averaged less than 7 percent in recent years.

V

If we are correct in our analysis that most future American foreign investment will not be affected by the legislation, it follows that the increase in tax revenues from the legislation estimated by the Treasury is overly optimistic. Also, it appears that the Treasury's calculations on revenue effects have ignored the probability that if earnings in developed areas are subject to immediate American taxation, American controlled enterprises will no longer seek to avoid foreign income taxes through tax haven operations, the result of which will be that a portion of the tentative increased U.S. tax revenues will be sopped up by greater foreign tax liability eligible for the U.S. foreign tax credit. Similarly, it seems that the Treasury has ignored the likelihood that some

foreign countries will take advantage of the situation by canceling tax holiday agreements with American controlled companies, or will increase dividend withholding taxes on remittances to American shareholders, which for some countries would require tax treaty renegotiation or unilateral amendment. We have heard that some Swiss cantons are looking at the proposed legislation as a windfall.

VI

Even if the intended benefits of the legislation are entirely fulfilled it will cause a number of adverse effects which are serious enough, in my opinion, for this committee to hesitate in recommending enactment of such drastic and controversial legislation. The adverse effects, all but one of which will occur whether or not the hoped for benefits are achieved, include the following:

(1) Make American-controlled investment in foreign areas less profitable than foreign-controlled investment;

(2) Impose inflexibility in the structure and operation of American-controlled enterprise abroad, which means less ability to effectively compete;

(3) Create serious long-run balance-of-payment problems;

(4) Risk adverse reactions in some foreign countries;

(5) Introduce unparalleled difficulties in administration and compliance with the new legislation;

(6) Induce much litigation, factual, constitutional, and treaty interpretation;

(7) Affect existing controlled foreign corporations more severely than new investment;

(8) Indirectly suppress investment in less developed countries;

(9) Encourage offshore research and development to avoid the impact of the royalty imputation provisions on the offshore exploitation of U.S. source patents, copyrights, and exclusive formulas; and

(10) Encourage more foreign procurement and manufacture to avoid incurring subpart F income when merchandise is traded between affiliates and is not sold for ultimate consumption in the country where it is deemed to be manufactured.

VII

Economists, businessmen, and investors now generally gree that income taxes directly affect the ability of an enterprise to retain earnings and attract outside capital, and, therefore, profoundly affect in the long run its share of a particular market. In an indirect sense, income taxes become a true cost of doing business. This is particularly evident when enterprises competing in the same market with the same product or service are subject to differing rates of tax on their incomes. For analytical purposes, it must be assumed that all nontax costs are equal, in which event it follows that the enterprise with the lower effective income tax rate will have at least a longrun competitive advantage, through which it can increase its share of the market by greater ability to retain earnings and attract outside capital for expansion of working capital or facilities and for research. In some circumstances it can exploit its tax advantage through lower prices. In most of the developed countries, the effective tax rates (for domestic income) are from about 5 to 25 percentage points below the American corporate rate, which means that if this legislation is adopted, American investors in the long run must either divest themselves of their majority position in foreign corporations operating in developed areas or retain a smaller portion of the market than they would if their tax cost were equal to competitors in the same markets.

This choice is even more acute to the extent that the legislation inhibits use of international trading, leasing, and service companies, or of companies exploiting intangible rights on an international basis. Such so-called tax haven companies must compete with foreign-financed enterprises performing the same type of activities at rates seldom exceeding 15 percent. It is these types of international companies that most effectively have developed U.S. exports in competition with foreign-made products.

One of the subordinate justifications of the Treasury for the legislation is that the curtailment of foreign investment might reduce displacement of American exports which otherwise would be made if it were not for such foreign investments. This argument cannot apply to services, including utilities, which cannot be exported from the United States, but must be performed locally. Likewise, as has been demonstrated by many examples and by commonsense, it does not apply to many manufactured goods, which, because of such

basic factors as labor costs, customs duties, transportation costs, import restrictions, must be manufactured locally for local sale. The choice then is not whether American exports will be displaced, but the proportion of the market that American-controlled capital will occupy in developed foreign countries.

I cannot see that it is in our national interest to induce American investment operating in developed areas to be customarily in a minority position. American-controlled foreign investment has meant greater cooperation of foreign enterprise with American policies, as for example the very noticeable pressure in other countries to cooperate with the U.S. embargo of certain trade with the Soviet-Sino bloc.

Equally important is that American shareholder control of foreign enterprise means American management control. If we believe that our form of capitalistic enterprise is superior not only to the Communist system, but to the old line capitalism still rather prevalent in many Western nations, we ought to be willing to let it display its effectiveness and dignity abroad. This has important value in developed as well as less developed nations.

VIII

The corollary to the preceding adverse effect is the creation of inflexibility of American enterprise abroad. We have mentioned that the legislation encourages minority participation or portfolio investment abroad. Similarly, the numerous provisions of the legislation, particularly those directed against international trading, leasing, and servicing companies, and international exploiters of intangible rights, means that American businessmen must structure their international corporate organization and arrange their foreign operations so as to avoid, to remain as competitive as possible, the higher tax rates imposed by the legislation. Such artificial arrangements are both inevitable and costly, and themselves make American enterprise abroad less competitive. Here again, it will be the smaller enterprises that will be hurt most by such inflexibility.

This compelled inflexibility will not only inhibit competition with foreign controlled enterprise, but will also make it more difficult for American enterprise in foreign areas to meet, without direct Government assistance, Communist economic challenges which portend to become more widespread and disruptive.

IX

Possibly the most obvious adverse effect of this legislation is the long-run constrictions in the balance of payments, an effect which the Treasury's presentation to this committee shows will occur after 8 years. How is it advantageous to solve a short-run balance-of-payments problem in a manner which admittedly will aggravate the same problem in the long run? Such a solution will be particularly detrimental if the curtailment of foreign investment should reduce exports more than the very modest figure estimated by the Treasury.

The dubiousness of this solution becomes more pronounced from the viewpoint of the sources of our balance-of-payments deficit. Department of Commerce sources show that during the period of 1950 through 1960 our total payments deficit has been $25.780 million, classifiable as follows:

[In millions of dollars]

Government:		
Economic grants (including pensions and other transfers)		(26, 397)
Military expenditures		(27, 420)
Net Government capital outflow	[1] (6, 564)	
Income on foreign investments	2, 707	
Net capital deficit		(3, 857)
Net Government deficit		(57, 674)

[1] Including subscription of $1,375,000,000 to IMF.

Private:		
Exports of goods and services, and domestic travel	206,378	
Imports of goods and services, and foreign travel	(174,917)	
Net trade surplus		31,461
Direct private investment	(12,025)	
Income on direct private investment	20,545	
Surplus from direct investment		8,520
Private portfolio investment	(9,497)	
Income on portfolio private investment	3,352	
Deficit from portfolio investment		(6,145)
Net private remittances		(5,445)
Net private surplus		28,391
Unrecorded transactions (surplus)		3,503
Total deficit		(25,780)

If the solution of this payments deficit is to be confined to the private sector, the curtailment through tax legislation of direct (or controlled) private foreign investment does not seem the best choice, inasmuch as it is the only category of capital transactions, governmental or private, which, with the income from it, has produced a favorable payments balance in the last decade.

In appraising the value of American direct investment abroad, it is noteworthy that the Treasury table No. 2 discloses in the period of 1953 through 1960, earnings, after foreign income taxes, on direct investment in all industries in Canada and Western Europe averaged 10.7 percent, and earnings on manufacturing investment in those areas averaged 13 percent. This manufacturing return of 13 percent is higher than the return of 12.5 percent for the same period for the less developed areas of the world. Although we do not have entirely satisfactory figures, this appears to be substantially higher than the average return on foreign portfolio investment.

X

A nebulous but important effect, will be the reaction of foreign nations to the legislation. These will be based on the interaction of the legislation with tax treaty obligations; with other treaty obligations, including OECD and GATT; with international concepts of extraterritorial jurisdiction to tax; and with tax holiday programs in developed countries; the consequence of being classified as "developed" or "less developed" economically; the gradual decline in the foreign scene of American controlled enterprise; and in general the neomercantilism of the legislation and its conflict with long established and well publicized policies of our Government.

So far as our research can determine, the only conflicts of section 13 with the letter of existing tax treaties between United States and any of the developed countries are situations where an individual or corporation has dual residence status or the nationality of a partnership is doubtful. These conflicts will create no serious problem if the rule of section 7852(d) of the code is retained, as asked by Secretary Dillon, whereby treaties override conflicting provisions of the code, although if our Revenue Service is going to litigate these apparent conflicts, as Secretary Dillon indicates, there may be some adverse reaction.

The legislation, we believe, however, putatively is contrary to the spirit of bilateral tax treaties; to the principles set forth in paragraph 5 of article XX of the fourth report of the Fiscal Committee of the Organization for Economic Cooperation and Development, of which the United States is a member and Committee participant; and to concepts limiting jurisdiction to tax recognized by most nations, all of which assume that no nation has jurisdiction to tax income of a foreign corporation that was not derived from sources of the taxing

state. Although the taxation of U.S. citizens, corporations, or residents on unremitted income of foreign corporations is not a tax legally and directly on the foreign corporation itself, nonetheless in substance it is a tax measured by the income of an entity, created under the laws of another nation, over which the United States has no taxing jurisdiction. The Treasury has stated to this committee that such a tax will likely induce the payment of dividends by the foreign corporation which otherwise would not have been paid, and, therefore, the measure is explicitly intended to affect the activities of a foreign entity. Such taxation by indirection does not seem consistent with our treaty obligations or with our national policy of promoting the international "rule of law."

This country has been one of the world leaders in the promotion of free trade epitomized in GATT and by the current tariff legislation sponsored by the administration. Similarly, since World War II it has promoted in numerous ways the free flow of capital among nations by its support of such things as the International Monetary Fund, the European Payments Union, the Organization for European Economic Cooperation, the Common Market, and the Organization for Economic Cooperation and Deveopment. The OECD Treaty, of which the United States is a member, states in article 2(d) some of its principal objects to include:

"pursue their (members) to efforts to reduce or abolish obstacles to the exchange of goods and services and current payments and *maintain and extend the liberalization of capital movements*." [Emphasis supplied.]

It does not seem consistent to simultaneously promote the free movement of goods while inhibiting the free movement of capital, or of encouraging other nations to eliminate as soon as feasible exchange control restrictions, while simultaneously enacting tax legislation which is explicitly an attempt to curtail important capital flows. Such inconsistency seems likely to jeopardize the confidence of other nations in our leadership toward greater economic integration of the Western nations.

Closely related to the foregoing is the tacit proposition in this legislation that certain countries have become sufficiently developed so that we will be justified in curtailing further American investment in them. This is hard to explain when the highest per capita income of any of the developed nations is about 55 percent of our per capita income, and the average per capita income of the developed nations is only about 40 percent of our per capita income. It is also difficult to justify in light of the most economic allocation of the Western World's resources, when interest rates of the developed countries generally are substantially higher than American interest rates, indicating a surplus of capital in this country relative to the remainder of the Western World. Thus, the legislation is calculated to slow the further economic development of certain countries, all our close allies, even though their economic living standards remain far below, and capital needs are much greater than ours.

As we previously mentioned in a different context the curtailment of American-controlled enterprise in the developed countries will reduce opportunities for such enterprise to demonstrate its inherent capabilities and value to people of other nations. American enterprise in the developed nations, as well as in the less developed nations, has done much to build genuine respect and friendship toward our business institutions and methods of operation. Such enterprises have greatly inhibted the ability of Communists and others to misrepresent the actual workings of American enterprise.

It would be an exaggeration to contend that the aforementioned effects of the legislation in foreign nations are going to create unmitigated criticism of our policy. In most countries some of these irritants may be counterbalanced by the approval of the legislation by foreign entrepreneurs, who will significantly benefit by a relatively improved competitive position. This is particularly true of such nations as the United Kingdom, Germany, and to a lesser extent France, Sweden, and the Netherlands, which compete internationally with our industry. Switzerland, and other tax haven countries which have numerous genuine international headquarters, are most likely to view the legislation as a windfall because they will be able to readily renegotiate tax agreements with American-controlled enterprise to increase the local income tax take. Possibly the only countries that will have a serious reaction are Italy and Belgium, whose tax holiday programs for certain depressed areas will be hampered by the reduction of American-controlled capital available. Other countries that might object are ones like Australia and New Zealand which generally welcome all American capital.

XI

The immense complexity of the proposed legislation can only occasion immense and unprecedented difficulty and cost of administration and compliance. The administration of section 13, as now drafted, would require, to mention a few of the worst, regular determinations: whether a foreign corporation is "controlled" at any time during the year; whether a taxpayer directly or indirectly owns 10 percent of the voting power or total value of the shares of a controlled foreign corporation; whether patents, copyrights, and exclusive formulas and processes were "substantially developed, created, or produced in the United States"; amounts of royalties to be imputed to exploitations of such U.S. source intangible rights; whether fees are for services or for the exploitation of intangible property rights; where the ultimate destination of goods is; where certain goods are deemed to have been manufactured; whether earnings are reinvested in "substantially the same trade or business"; and whether investments in property are "ordinary and necessary" to the active conduct of a trade or business so as to be "qualified property." Each of these determinations normally will be difficult and costly, and frequently will be virtually impossible.

To these complications must be added the staggering problems of calculating "subpart F income" and "earnings and profits invested in qualified property" of a foreign corporation within the meaning of U.S. income tax law. Even on an annual basis and with books kept under American accounting practices, this is a most difficult job. It can become unsolvable when it involves determinations of many years and is based on books kept under foreign accounting concepts and practices. If subpart F income and earnings and profits are to be computed under standards of American Federal tax accounting, as a practical matter it requires a separate set of books, but these will not have been kept by a foreign enterprise during the period prior to when it becomes American controlled.

Attached to this statement as exhibit A is a detailed list of technical and administrative difficulties which are a part of section 13 as now drafted, some of which appear to be inherent in any approach such as that of the proposed legislation.

Compounding these practical difficulties is one seldom mentioned, which is the rate for converting earnings and profits in foreign currency to the equivalent in U.S. dollars. This is not the problem of changes in exchange rates from the time the income is earned to the date it is converted; rather, it is the problem of multiple exchange rates. Is the official rate to be used, or the officially approved free rate, or the officially ignored black market rate, or the switch rate?

Apart from the difficulty and costs that these complexities will cause both to the Revenue Service and to taxpayers, the complexity of itself will inevitably preclude uniform enforcement of the provisions. Uneven application or enforcement of tax laws is not tax neutrality nor is it just. This is not a theoretical danger, because the Revenue Service has indicated that it is now having difficulties enforcing the relatively uncomplex existing tax provisions relating to foreign income.

The goal of uniform enforcement is likely to be further frustrated by the difficulties of auditing records located in foreign countries, and this stituation is going to create severe temptations to report a minimal amount of income of controlled foreign corporations through such typical and easy means as expensing capital expenditures, accelerating depreciation, deferring income, and excessively conservative inventory accounting. Such ease of deception is going to give an additional advantage to the unscrupulous, again hardly a gain in true tax neutrality.

XII

Another undesirable effect of the legislation will be extensive and otherwise unnecessary litigation which will follow from the administration of such complex legislation, from the serious doubts as to its constitutionality, and from probable conflicts mentioned in part X with some tax treaty provisions.

It seems quite likely that cases will test the question whether unremitted income of foreign corporations is income within the 16th amendment, as interpreted in *Eisener* v. *Macomber*, 252 U.S. 189, 217, 219 (1920), or collelatively, whether it constitutes an unapportioned tax on property contrary to article I, section 9, clause iv of the Constitution. The fact that losses of controlled foreign corporations will not be attributable to the shareholders will also raise issues under the due process clause of the fifth amendment, and this and the multiple-

tax treatment of shareholders of foreign corporations in developed areas, of domestic corporations, and of foregn corporations in less developed areas, will likely raise issues under equal protection concepts which have been incorporated into the due process clause of the fifth amendment.

XIII

This legislation has the unusual effect of causing greater hardship to established foreign investment than future investment simply for the reason that, with section 367 of the code and section 16 of the bill, it will be much more difficult for an established foreign enterprise to convert its structure and operations to reduce the impact of the legislation. As a practical business matter, an existing enterprise may be very reluctant to divest its holding to a minority position.

XIV

The bill inadvertently also curtails investment in less developed areas. It does this by partially limiting the use of funds from developed areas without first paying full U.S. income taxes. Moreover, in his testimony to this committee, Secretary Dillon has proposed that no funds from developed areas should be available for less developed without payment of U.S. income tax. The provisions prohibiting the international exploitation of intangible rights applies most severely to the less developed countries. Finally, the imputation of income from the exploitation of U.S. source patents, copyrights, and exclusive formulas and processes is going to have the most serious impact on operations in the less developed countries, which must rely heavily on U.S. source invention and know-how.

XV

It should also be appreciated that the subjecting to immediate U.S. income tax imputed income from the foreign exploitation of U.S. source patents, copyrights, and exclusive formulas and processes, pursuant to proposed code section 952(a)(1)(B) and 952(c), will create definite pressures for American enterprise to conduct research offshore.

XVI

Similarly, it should be understood that the provisions in the proposed legislation regarding international trading encourage more foreign procurement and manufacturing abroad so that American controlled enterprise can avoid incurring subpart F income when merchandise is traded between affiliates and is not sold for ultimate consumption in the country where it is deemed to be manufactured. See proposed sections 952(a)(1)(C) and 952(e)(2).

XVII

In adjudging the wisdom of the proposed legislation, it seems relevant to inquire how other major commercial nations tax income from foreign sources. To this end we have done research and have consulted with tax specialists in Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, and the United Kingdom. Although several of these countries have provisions equivalent to our foreign personal holding company sections, none taxes unremitted profits of foreign subsidiaries controlled by citizens, residents, or domestic corporations. None has legislation inhibiting in any way the use of so-called tax haven companies. A number of countries grant additional and important tax advantages to foreign source income. For example, Sweden and the Netherlands exempt income of a domestic corporation earned through an autonomous foreign branch, and Germany, Belgium, Italy, and Sweden tax such foreign branch income at reduced rates. As is well known, the United Kingdom, through its oversea trading company legislation, allows a domestic corporation to be free of tax from foreign source income. Germany permits tax reduction for domestic corporations operating in less developed areas even though such income is not earned through an autonomous foreign branch; it also may reduce the usual tax on dividends from subsidiaries operating in such areas. Japan allows up to an 80-percent exemption for export income. Canada, the Netherlands, and Switzerland exempt dividends from controlled foreign corporations from any corporate income tax liability, and Belgium, Germany and Italy tax such dividend income at reduced rates. In addition, by recent legislation, Ger-

many grants a domestic corporation a deduction in computing its income in an amount equal to one-third of certain foreign investments in less developed areas, which deduction, however, must be returned to income over a 5-year period commencing the third year after the deduction was taken.

Attached as exhibit B is a chart summarizing the taxation of foreign source income, and income tax benefits accorded by other major commercial nations to foreign investment.

The practices of these nations seem particularly significant in light of the fact that the per capita export trade and per capita external investment of each of them (except foreign investment of Japan) is respectively larger than, in most cases several times, our per capita export trade and investment. Moreover, these nations have permitted these tax advantages for foreign investment during periods in which their balance of payments was relatively far worse than is ours now.

In this context, Secretary Dillon has vigorously argued that the proposed tax legislation is no more onerous than the currency exchange controls which limit foreign investment of many of the other developed nations. We believe that the Secretary's sources have failed to distinguish between the letter of the exchange control law and regulations and actual practices under them. While it is difficult to accurately generalize on this point, it is probably fair to say that, except at times of great crisis, the principal commercial nations (with the exception of Japan) have rather liberally permitted external business investment, particularly controlled investment, although they have been very rigorous in curtailing foreign portfolio investment. The pending tax legislation aims in the opposite direction.

XVIII

An interesting standard for judging the legislation is whether it would be constitutional under the commerce clause or either the equal protection or due process clauses of the 14th amendment for a State to attempt to tax its residents or domestic corporations on unremitted income from a foreign corporation (i.e., of another State). Although we are unable to find anything closely in point, reference to the principles enunciated in several lines of Supreme Court decisions regarding both State taxing jurisdiction and State regulation of banking raises some doubts whether a State would be permitted to enact legislation such as this. If the practical principles embodied in the commerce clause and the equitable principles embodied in the due process and equal protection clauses have a validity that transcends the geographical area of the United States, we think that legislation which might contravene such principles should be adopted only with the greatest circumspection.

XIX

It the benefits sought by the Treasury in section 13 are achieved as it expects, they will be accompanied by the adverse effects that we have described. In this event, it is not clear at all that the legislation is beneficial. If, in addition, the legislation fails, as I expect it will, to achieve its intended purposes, the result will be wholly detrimental.

Such possibilities suggest caution in passing legislation as this. Also suggesting caution is the fact acknowledged by the Treasury in its presentation that crucial data regarding the economic effect of American direct private investment abroad is not reliable, particularly as to the net export effect of investment abroad. Also suggesting caution is the fact that the proposed legislation would overturn a 40-year-old system for taxing the income of foreign corporation only when it is remitted, in reliance of which billions of dollars have been invested by American enterprise abroad. Also suggesting caution is that no other nation has seen fit to enact legislation similar to this.

XX

A critique such as this ought to conclude with some positive recommendations.

(*a*) Until more pertinent economic data are available, and some sort of consensus has been reached concerning the effects of the legislation, it would seem wise to delete section 13 from the legislation, except to the extent that it is deemed necessary to retain its provisions pertaining to offshore insurance and reinsurance of U.S. risks, and possibly the exploitation by controlled American corporations of intangible rights, such as patents, copyrights and know-how,

actually owned by a citizen, resident, or domestic corporation. Provisions inhibiting these types of tax avoidance should be approached under section 482, although the offshore insurance problem could alternatively be solved by subjecting premiums to a withholding tax at an appropriate rate on the theory that such premium is gross income of a determinable nature.

(*b*) If more stringent legislation is deemed necessary, the tax acceleration provisions of section 13 should not be applicable to international trading, leasing, and servicing activities, because to do so simply means less American controlled international trade, and an inducement to offshore procurement and manufacture of goods destined for foreign markets.

In all events, the legislation should exclude the operations of controlled foreign commercial financing companies, and similar lending institutions, just as it exempts commercial banking.

The legislation also should provide a greater certitude concerning the classification of less developed nations, particularly as to when the removal of a nation from such classification might occur. We would suggest an approach in terms of the relationship of the per capita national income, or similar standard, either relative to the United States or to other nations. We would couple this with at least a 3-year, but preferably a 5-year, period from the date of an announcement to the effective date that a country was removed from less developed status.

(*c*) A much less desirable alternative approach would be to couple the concepts of section 13 with the enactment of legislation providing for an oversea trading corporation (or group of corporations) with exemption from U.S. tax, so long as substantially all of its earnings were from sources outside the United States, or from the export of goods and services from the United States. Such corporation (or group) would have freedom to reinvest such earnings itself (or themselves) or through controlled subsidiaries or affiliates without payment of U.S. taxes so long as the reinvestment was used offshore in any active trade or business or for the promotion of the export of goods and services from the United States. Protection against excessive deferral of dividends could be provided through an undistributed profits tax along the lines of existing section 531.

The principal advantages of this approach are the granting of adequate jurisdiction to the Internal Revenue Service over foreign business activities, while simultaneously permitting controlled American enterprise to compete on equal terms with foreign controlled enterprise in foreign markets. This approach readily could eliminate the distinction between developed and less developed nations.

EXHIBIT A

ANALYSIS OF SUBSTANTIVE AND TECHNICAL PROBLEMS UNDER SECTION 13 OF H.R. 10650

Section 13 of H.R. 10650 would amend the Internal Revenue Code to provide that certain undistributed income of controlled foreign corporations shall be included in the income of U.S. shareholders in the year the income is earned by the foreign corporation, whether or not it is distributed. The amounts on which U.S. shareholders are taxed may be classified as (1) Subpart F income, and (2) profits considered as being distributed. Subpart F income is, in general, certain reinsurance income, certain patent, etc., income, and certain passive income (dividends, etc.) and sales income unless reinvested in less developed countries. Profits considered as being distributed are the profits of foreign corporations, including foreign manufacturing corporations, except to the extent that such profits are invested in qualified property. Qualified property is limited to property which is ordinary and necessary for the operation of present (but not new) foreign business, or property reinvested in less developed countries.

Section 13 of the bill introduces into the code a body of new taxing provisions (revolving around the concepts of subpart F income and profits considered as being distributed) which are extremely complex and in some respects novel. The provisions contain a substantial number of defects, ambiguities and inequities which will cause taxpayers and the Internal Revenue Service serious difficulties and lead to extensive litigation. While some of the defects can be

cured by improved drafting, others appear to be inherent in any such complex taxing concept.

Some of the problems created by the proposed amendments are described below.

SUBSTANTIVE DEFECTS WHICH MAY CREATE INEQUITIES, HAVE ADVERSE ECONOMIC EFFECTS, OR CREATE ADMINISTRATIVE PROBLEMS

(1) Section 951(a) imposes tax on U.S. persons who own 10 percent or more of the stock of a controlled foreign corporation. Thus, tax would be imposed on persons who may, in fact, have no control over the policies of a foreign corporation because they own a relatively small percentage of the stock of such corporation.

(2) Section 951(c) provides that a U.S. person who is a qualified shareholder in an electing foreign investment company (a company which has elected to distribute 90 percent or more of its income) shall not be required to include in his gross income for such taxable year the subpart F income of such company. However, it would seem that such a shareholder would be taxed under section 951(a)(1)(B) on any increase in earnings invested in nonqualified property for such year. Since section 1247 provides that an electing foreign investment company must distribute at least 90 percent of its earnings, which would therefore be taxable to the shareholders, it seems inequitable that the shareholders should, in addition, be subject to taxation under section 951(a)(1)(B) on any retained amounts which are invested in nonqualified property. This would be particularly true as to any year in which the foreign investment company liquidates qualified property.

(3) Sections 952(a)(1)(B) and 952(c) create a distinction between patents, copyrights, and exclusive formulas and processes having a U.S. source and those which do not have a U.S. source. Income from U.S. source patents, copyrights, and exclusive formulas and processes is treated as subpart F income and subjected to tax. This distinction would have the effect of encouraging research abroad in order to avoid the punitive provisions of this act as respects patents, etc., of U.S. origin. We do not believe it is desirable to create a tax climate which encourages business to do its research work outside the United States.

(4) Section 952(a)(3) provides that the subpart F income "shall not exceed the earnings and profits of such corporation for such year." While helpful, this provision is not sufficiently broad to avoid inequities and double taxation, as shown by the following examples:

Example 1

Subpart F income (before taking into account section 952(a)(3)	$5,000
Corporate losses from other foreign activities	(6,000)
U.S. source income	4,000
Total earnings and profits for the year	3,000
Amount taxed to corporations because of its U.S. source income	4,000
Amount taxed to U.S. shareholders (assuming section 951(b) is inapplicable)	3,000
Total amount subject to U.S. tax	7,000

Example 2

Corporation A (a U.S. person) owns 100 percent of corporation X, which in turn owns 100 percent of corporation Y, both X and Y therefore being controlled foreign corporations. In 1963, Y has $1,000 of subpart F income which is taxed directly to A. In 1964, X has subpart F income of $2,000, other types of losses of $1,000, and a dividend from Y of $1,000. It is clear under section 956(b) that X's subpart F income does not include the dividend from Y. However, except for this dividend, Y's earnings and profits for the year would have been $1,000, and the amount of subpart F income taxable to A would have been limited to this amount. However, because of the $1,000 dividend from Y (which has previously been taxed to A), X's earnings and profits for the year would be $2,000, and thus the entire subpart F income would be taxed to A. In other

words, for the 2 years A would be taxed on $3,000, even though the consolidated earnings of both X and Y were only $2,000.

(5) No adjustment appears to be made in connection with the subpart F income calculation under proposed code section 952(c) for rentals or royalties actually paid by the controlled foreign corporation to its U.S. parent as a result of "use or other means of exploitation by the controlled foreign corporation" under section 952(c)(3). The effect appears to be that even though the controlled foreign corporation has paid a completely fair rental or royalty for the use of a U.S. patent, its U.S. parent corporation which has received such royalty or rental income will also have subpart F income equal to the fair royalty or rental income for such patent, thus resulting in double U.S. taxation to the U.S. parent. In this connection, it should be pointed out that proposed code section 952(c)(2), which provides an adjustment for expenses, does not appear to provide relief from such double taxation. Proposed code section 952(c)(2) provides that such expenses shall not include "any production, manufacturing, or similar expenses incurred in the use or other means of exploitation of such property or rights" and royalty or rental payments by the controlled foreign corporation to its U.S. parent would seem to be within this exception.

(6) The definition of "foreign base company sales income" contained in proposed code section 952(e)(2) would appear to be deficient in the following respects:

(*a*) In order to meet the less than 20 percent test of sections 952(e) (2) and (6), with resulting exemption from tax, or to avoid the exceeds 80 percent test of section 952(e)(6), which results in full taxation, foreign companies would be encouraged either to (i) curtail their purchases from their U.S. parent, or (ii) expand their foreign production operations. Either alternative would tend to decrease U.S. exports. The second would also tend to move additional capital abroad in order to finance the production of items previously produced in the United States. Thus, it would seem that the bill might have an adverse effect on both our balance of payments and our domestic employment.

(*b*) The accounting problems involved in determining the amount of income derived from sales of those items which give rise to foreign base company sales income would be unduly burdensome and, in many cases, impossible. In this connection, it should be noted that a given product (which does not, in itself, constitute a product manufactured by the controlled foreign corporation) might contain some components purchased from a related entity and others purchased from outside sources. Furthermore, a given component might be purchased from both sources and identification might be impossible.

(*c*) The "use, consumption, or disposition" test contained in section 952(e)(2)(B) would present considerable difficulties and, for many companies, would be virtually impossible to apply. The test would seem to apply if, at any time, any use, consumption, or disposition of the property takes place outside the country in which the foreign subsidiary is created or organized. A given article might be used in several different ways in several different places during its life. For instance, a piece of luggage sold by a foreign subsidiary organized in country X to a resident of country X might be used on a vacation in country Y. Similarly, a piece of construction equipment might also be used in many different countries. A component part sold by a controlled foreign corporation to another company for incorporation into a completed product and resale, would appear to be used by the second company and also by the ultimate consumer of the completed product. By the same token, any given article might be sold (i.e., disposed of) several different times and in several different countries in the chain of distribution from the controlled foreign corporation to the ultimate consumer. It would seem to be impossible for a controlled foreign corporation (let alone, the U.S. shareholders) to make the required determination. In this connection, it should be noted that the required information must be known at the end of the corporation's taxable year.

(7) Under section 952(e)(3), the income of a foreign corporation whose principal activity consists of owning and leasing a plant to a related foreign corporation would be considered foreign base company income. For local property tax reasons, separate foreign corporations frequently own plants operated by related foreign manufacturing companies. Under this section, the income of the real estate company will be taxed to U.S. shareholders, whereas this would not have been the case if the foreign manufacturing company owned its own plant. Here again, this bill places foreign corporations owned by

U.S. interests at a disadvantage, since they cannot operate and finance foreign plant expansion in the same method as other foreign concerns.

(8) Proposed code section 952(e)(5) provides that the income of banks and corporations controlled by banks is excluded from the term "foreign base company income." It does not seem equitable to deny this treatment to other lending institutions and loan companies, including finance companies established by manufacturing companies to finance the purchase of their products.

(9) Proposed code section 953(b)(2)(A) provides that the term "qualified property" includes money or property located outside the United States which is ordinary and necessary for the active conduct of a qualified trade or business. Innumerable difficulties will be experienced in determining what is "ordinary and necessary" for a particular business on a property-by-property basis. In this connection, it should be noted that withdrawal of any money or other property, particularly from less developed countries, may be blocked. Since proposed code section 953(b)(2)(A) relates to property located outside the United States, it will give rise to numerous troublesome questions as to the "location" of property, particularly intangibles.

(10) Subsections 953(b) (2)(C)(i) and (3)(A)(ii) refer to corporations engaging in business "almost wholly" within a less-developed country. This concept of "almost wholly" appears to be new to tax legislation and undoubtedly would give rise to considerable litigation to determine what it means. Also, the requirement that a foreign corporation operate almost wholly within a less-developed country or countries would, as a practical matter, seem to preclude the use of branch offices outside less-developed countries, and thus restrict their operations. A similar problem exists with respect to the use of "substantially the same trade or business" and "substantially the same U.S. persons" in section 953(b)(3)(A). The House report (p. A–98) indicates the first term is intended to prevent the use of untaxed earnings to "diversify" the business. This could result in unreasonable interpretations, since it might, for example, mean that if a foreign electronic manufacturer diversified its line of products, it would not be engaged in substantially the same business. As to the second term, the House report says that the "substantially the same U.S. persons" test will be satisfied if the new shareholders are "other U.S. persons whose relationship indicates that there has been no substantial change in interest," citing as an example stock acquired by an heir of a deceased owner. This again appears to be an unnecessarily restrictive interpretation. It would seem to indicate that even if 50 percent of a corporation is owned by the identical U.S. shareholders during the 5-year period, the corporation would not be controlled by substantially the same U.S. persons if there was a change in ownership of the remaining U.S. shares.

(11) Because of section 953(b)(5), a controlled foreign subsidiary operating in a less-developed country would have an economic interest in having such country remain economically less developed. Such a controlled foreign subsidiary should receive the benefits of operating in a less-developed country, at least for some definite and substantial period of time. Such an assurance would be consistent with our present foreign policy.

(12) Proposed code section 953(b)(5) purports to give the President the power to effect tax results by means of Executive order. This hardly seems appropriate. The making of laws, as well as the rates and provisions included in that process, are a prerogative of Congress, not the President. This might raise constitutional problems.

(13) Proposed code section 954 defines a controlled foreign corporation as a corporation which is more than 50-percent owned by U.S. persons on any day during its taxable year. This is in contrast to section 951(a), which imposes tax upon the person owning stock of a controlled foreign corporation on the last day of the taxable year. The "any day" provision easily could become a trap, particularly in view of the presence of complex constructive ownership rules. Furthermore, once determined, it would seem that there is no real assurance that such control would continue in future periods. Newly organized corporations may be particularly vulnerable to the "any day" requirement. The "any day" provision also appears in sections 951(b), 954(a), 954(b), and, in certain situations, might impose impossible tracing and administrative burdens.

(14) Proposed code section 954(c) permits a reduction in the percentage ownership in a foreign corporation to which proposed code section 953(b)(2)(C) applies below 50 percent where a lesser percentage is required under the laws of a less-developed country. In many foreign countries, the percentage ownership permitted to foreigners will vary from industry to industry and with the

particular needs of the country at the time the required permits and authorizations to do business are requested. In most instances, there is no specific legislation which determines the ownership which foreign interests will be permitted to acquire, and the extent of ownership is a matter of negotiation with the officials of the foreign government in question. Thus this provision will be extremely difficult to administer.

(15) Proposed code section 955(b)(4), relating to attribution rules, could cause considerable difficulty since, in many cases, it could make it virtually impossible to tell whether or not a given foreign corporation was a controlled foreign corporation within the meaning of proposed code section 954. For example, a foreign corporation X is owned by U.S. corporation A and a foreign corporation Y, each owning precisely 50 percent. This is a very common arrangement in foreign operations and is specifically designed so that neither A nor Y will have absolute control over the operations of X. Yet, X will be deemed to be a controlled foreign corporation if a U.S. person, perhaps a competitor of A, acquires one share in Y directly, or perhaps one share in a company which owns one or more shares of Y. It would seem that unless Y is very closely held, there could be serious risk that X might be a controlled foreign corporation. As a practical matter, U.S. corporation A will have no way of ever knowing whether or not X is a controlled foreign corporation unless, of course, its competitor buys one such share and sees fit to advise it in order to make certain that it has all the disadvantages of subpart F. In this connection, it should be noted that the competitor would suffer no disadvantage since it will own less than 10 percent.

(16) In proposed code section 957 the foreign tax credit allowed in relation to earnings of a controlled foreign corporation included in the gross income of a U.S. person is limited to a U.S. person which is a domestic corporation. While this is consistent with the existing rule of section 902 it does not seem to be consistent with the operation of proposed section 951 wherein other U.S. persons such as individuals, estates, trusts, and partnerships, could also have included in their gross income income of a controlled foreign corporation.

(17) Subpart F purports to tax certain of the income of a controlled foreign corporation, but it makes no provision for losses of such a corporation. This seems highly inequitable. If the U.S. persons are to be taxed on income, they ought to be entitled to deduct corresponding losses. Certainly any losses sustained should be carried forward and used to offset any income in subsequent years before any amounts are taxed to U.S. persons. This is particularly important in foreign operations, for losses can greatly exceed those in the United States. The recent expropriation, without adequate compensation, of assets in Cuba is a good example.

18. The Internal Revenue Code imposes a series of limitations, such as section 367, on the reorganization of foreign structures. It would seem that in view of the vast changes made by the present bill, and the need to reorganize foreign operations as a result thereof, section 367 should be amended to permit, as a minimum, a tax-free liquidation under section 332 of existing foreign corporations.

TECHNICAL DEFECTS WHICH MAY CREATE INEQUITIES, HAVE ADVERSE ECONOMIC EFFECTS OR CREATE ADMINISTRATIVE PROBLEMS

(1) Section 952(a)(1)(C) provides that "net foreign base company income" will not be taxed to the shareholders unless five or less U.S. persons own more than 50 percent of the foreign corporation's stock. It is not clear when this ownership test is to be applied, nor is there any provision for proration of income in the event the relationship should exist for less than the full year.

(2) Proposed code section 952(c)(1)(B) refers to "any U.S. person which * * * owns or controls, or is owned or controlled by, or is under common ownership or control with, the controlled foreign corporation." Control does not seem to be defined for this purpose. A similar problem appears in proposed code section 952(e)(2).

(3) The definition of "foreign base company sales income" contained in proposed code section 952(e)(2) does not make it clear (as it is in the committee report, p. A–94) that it does not apply to the purchase and resale of materials or parts which are incorporated by a controlled foreign corporation into a manufactured product (including certain assembled products). The committee report indicates that this is not deemed to be a purchase and a sale of the same property within the meaning of proposed code section 952(e)(2).

(4) Section 952(e)(4) provides that foreign base company income does not include any income derived from insurance of U.S. risks or income from U.S. patents, copyrights, etc. However, section 952(e)(6)(B) provides that if the foreign base company income (before any deductions) exceeds 80 percent of the corporation's gross income, "the entire gross income shall be taken into account in determining foreign base company income." Thus, it would appear that such insurance or patent income could be included in subpart F income twice—once by reasons of sections 952(a)(1) (A) or (B), and again by reason of sections 952(a)(1)(C) and 952(e)(6)(B).

(5) It is not clear under section 953(a)(2) whether a shareholder's pro rata share of the corporate earnings invested in nonqualified property at the close of the preceding taxable year is to be prorated on the basis of his stock ownership at the close of the current year or the preceding year. If the latter is the case, a shareholder could be subject to tax under this section merely because he increased his stock interest during the year.

(6) It is not clear under section 953(a)(2)(A) whether the earnings invested in nonqualified property at the close of the preceding year could be reduced below zero by reason of distributions during the year to which section 956(c) applies.

(7) Section 953(b)(2)(C) provides that certain investments by controlled foreign corporations in other foreign corporations constitute "qualified property." One of the requirements is that the controlled foreign corporation own 10 percent in its own right and, together with four or fewer U.S. persons, own more than 50 percent of such other corporation. However, the attribution rules of section 955 for determining stock ownership are not made applicable for this purpose. It would seem that this should be done.

(8) Section 954(a) applies where more than 50 percent of voting power rests with U.S. persons. Thus, by its basic terms, ownership of all U.S. persons is aggregated. Assuming a need for constructive ownership of some type, the constructive ownership rules of section 955(a) seem to be more appropriate than the constructive ownership rules of section 955(b). Under section 955(a), the U.S. person is deemed to own any stock held in the name of a foreign entity, and this would appear to be a sufficient safeguard. Section 955(b) contemplates attribution between U.S. persons and therefore logically should not be applicable to section 954, since the five-person rule is inapplicable.

(9) In line 9 of proposed code section 954(b), on page 123, the word "individual" should be inserted in front of the word "residents" in order that resident foreign corporations' property outside of the United States is not included.

(10) Proposed code section 955(b)(1) appears to contain a drafting error in connection with the removal of nonresident alien individuals from the constructive ownership provisions. Section 955(b)(1) provides that stock owned by nonresident alien individuals shall not be attributed under section 318(a)(1)(A). It is significant that section 318(a)(1)(B) deals with adopted children. Thus, under section 955(b)(1), stock owned by a nonresident alien adopted child may be attributed to his U.S. father, whereas stock owned by a nonresident alien child is not. Such an interpretation would be supported by section 318(a)(4) where the reference is made to section 318(a)(1) instead of section 318(a)(1)(A).

(11) Proposed code section 955(b)(3) purports to do away with downward attribution after there has been an upward attribution from a partner, beneficiary or stockholder to the partnership, estate, trust or corporation. Thus, what is meant by "indirectly"? Conceivably, it means attribution from an entity which is owned by the partnership, estate, trust, or corporation in question. If this is the case, this should be clarified so that section 955(b)(3) is not circumvented through the term "indirectly" in sections 955(b)(2)(A) and 955(b)(2)(B).

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Exhibit B

Taxation of foreign income to domestic corporations by selected foreign nations

Country	Taxation of undistributed profits of foreign corporations (not a personal holding company)	Foreign personal holding company type provisions	Taxation of dividends of foreign corporations to domestic corporations	Credit or deduction for foreign taxes	Taxation of business income earned abroad by domestic corporations	Special provisions
(1)	(2)	(3)	(4)	(5)	(6)	(7)
Belgium	No	Yes; of very limited application.	Rate reduced from 31.5 to 12 percent.	Credit proposed	Reduced to 5 to 8 percent, which is ⅕ of normal rates.	
Canada	No	Yes	Exempt, if paid to 25 percent or more corporate shareholder.	Direct credit	Yes; except for wholly exempt foreign business corporation income.	Earnings outside Canada by foreign business corporation exempt. Not available for new corporations.
France	No	?	Same as for domestic dividends, which is full 50-percent rate, unless 20 percent of shares are held, whereupon rate is 12½ percent.	do	Yes; if through autonomous foreign branch, but see column 7.	Agreement with taxing authorities possible to reduce or relieve tax on foreign income not through autonomous branch.
Germany (West) [1]	No	No	Taxable at full corporate rates, but see below.	do	Generally no; but see below.	See below.
Italy	No	Yes; of very limited application.	Same as domestic dividend, which is from 0 to 15 percent under the excess profits tax.	Deduction	Reduced rate of from 0 to 15 percent as compared to approximate usual rates of 28 to 43 percent.	
Japan	No	No	Same as domestic dividends, which generally are free of tax on intercorporate dividends.	Direct and indirect credit.	Yes; but see col. 7	Up to 80 percent of income from exports, foreign royalties, and service fees is exempt.
Netherlands	No	Yes	Exempt, if paid to 25 percent or more corporate shareholder (proposed to apply to 5 percent or more shareholder).	Not necessary under exemption system, but see col. 7.	Exempt	Foreign source dividends, interest, and royalties allowed a deduction of any foreign tax withheld.
Sweden	No	Yes	Exempt, if paid to 25 percent or more corporate shareholder.	Deduction	Exempt if through autonomous branch.	Income from foreign real estate exempt.
Switzerland	No	Yes	Exempt, if paid to 20 percent or more corporate shareholder.	do	Exempt or greatly reduced rates.	Income from foreign real estate generally exempt.

United Kingdom	No	Yes	Subject to income tax at standard rate and to profits tax.	Direct and indirect credit.	Generally yes; but only when remitted, but see col. 7.	Oversea trading company legislation, which permits domestic company to be exempt from British income and profits tax on income earned abroad until it is paid as a dividend to resident corporate or individual shareholders.

[1] Special provisions: Tax authorities may waive partly or wholly German corporate income tax earned through foreign branches or dividends from foreign subsidiaries, if it is helpful for general economic reasons. Tax authorities are authorized to levy a flat 25-percent corporate tax on a German company principally involved in foreign investments, which is a reduction from the usual 51-percent rate. Corporations who invest in less developed countries are entitled to deduct ⅛ of the investment computing income tax for the year in which the investment is made, but such deduction must be returned to income over a 5-year period commencing the 3d year after the deduction.

Senator GORE. The committee stands in recess until 2:30.

(Whereupon, at 12:20 p.m., the committee stood in recess until 2:30 p.m., the same day.)

AFTERNOON SESSION

Senator GORE (presiding). The committee will come to order.

The first witness is Mr. J. D. A. Morrow, representative of Joy Manufacturing Co.

Mr. Morrow, we will be pleased to hear you.

STATEMENT OF J. D. A. MORROW, CHAIRMAN, FINANCE COMMITTEE, JOY MANUFACTURING CO.

Mr. MORROW. Let me thank the committee for this opportunity to be here.

I appear for Joy Manufacturing Co., Pittsburgh, which manufactures mining machinery, construction machinery, oilfield equipment, compressors, both lubricated and nonlubricated for compression of air and gases; a full line of fans and blowers and electrical connectors.

Joy has manufacturing subsidiaries in Canada, Scotland, England, France, South Africa, Australia, and Mexico.

The administration is telling U.S. industry over and over again, "Every effort must be made to expand U.S. foreign trade." That is a statement of public policy. The reasons for that policy are too well understood to need restatement here. That policy should apply to the U.S. Government, as well as to U.S. business. It means that our Government should not place American corporations engaging in foreign trade in a position of disadvantage in competing with their opposite numbers abroad.

This bill before you, H.R. 10650, is inconsistent with that basic principle. Under this bill, the foreign subsidiaries of American corporations that must carry the burden of competing for foreign trade with oversea companies are placed taxwise at a disadvantage compared to British, West German, French, and Italian companies, as well as those of smaller Western European nations. The general rule in these four commercial nations is that income of their foreign subsidiaries is taxed only as to income actually paid to the parent corporation at home. All four of these foreign governments reserve the necessary powers to deal with tax evasions. Our study shows that such powers are exercised. But Congress has already given similar power to our own Internal Revenue Bureau.

H.R. 10650 disregards the requirement that we be kept on an equality with our foreign competitors and aims at equating American foreign subsidiaries with U.S. domestic companies with which they do not compete and which do not make the effort or run the risks of trying to increase U.S. business overseas.

The Treasury attempts to give the impression that foreign subsidiaries of American manufacturing companies are set up largely, or even mainly, for tax reasons. This just is not true. They are set up for sound, practical business reasons, because they see and pursue an opportunity to make money manufacturing and selling abroad.

Let us illustrate the basis for our opposition to this measure by specific references to Joy Manufacturing Co.'s own expenditures and experience in foreign sales and manufacturing.

All export sales of the parent and of its foreign subsidiaries are handled by or through Joy International, S.A., a Panama company with its headquarters in Monaco. Since it pays no corporate income taxes in Panama and no taxes of any moment in Monaco, Joy International is a so-called tax haven company. Ultimately, dividends from Joy International will be paid to the American parent and then will become taxable. In the meantime, Joy International's earnings are put to effective use in expanding Joy's foreign trade and in creating larger future return payments to the United States, to the continuing improvement of our balance of payments.

Our Government is spending annually enormous sums to increase American business with all the free world, but not $1 so expended can equal the results obtained from the expenditure of the earnings of foreign subsidiaries by hardheaded, American businessmen, who must account to their stockholders for profitable results from such expenditures.

Let me add that this is said in no derogation of the capability, and sincerity of the representatives of the Commerce Department abroad, but they are forbidden to sell the product of any single American company. They can only talk in generalities.

You do not sell anything in that manner. You cannot even sell legislation to this committee when you talk in generalities. The committee insists on setting out the specific details.

Sales abroad are made when you talk about a specific machine or installation, which means you name a company. That those representatives of the Government are forbidden to do. To give out information, yes, understanding and help to small companies; but, in general, larger companies engaged in foreign trade know about the trade opportunities they advertise long before the Department of Commerce men can know about it.

Permit us to present some of the business reasons for setting up Joy International:

First, to escape legal liability on the part of the parent company, its officers, and directors for operations abroad if conducted by its own employees. This is a more serious hazard than most American companies realize. It is covered in detail in the appendix hereto.

Another business reason was the financing of our foreign operations. The restrictions of the indenture underlying Joy's $20 million debenture issue preclude the creation of additional indebtedness by the parent company to finance the growth of our foreign subsidiaries. However, those restrictions do not apply to an unrestricted subsidiary.

That is defined as a subsidiary doing business outside the United States and Canada, and doing no substantial part of its business and owning no substantial part of its property within the United States or Canada. Joy International was organized as such an unrestricted subsidiary and, therefore, could incur indebtedness for the purpose of promoting Joy's foreign business activity without transgressing the restrictions of parent Joy's debenture agreement.

To increase the amount of earnings available for such financing by Joy International, that company in 1958 was incorporated in Panama, which levies no corporate income tax, rather than in France or England, so that all its earnings would be available for financing Joy's foreign subsidiaries. The profits have been so used. In addition, Joy International has borrowed substantial sums on its own credit,

which in turn it has loaned to some of Joy's foreign manufacturing subsidiaries to expand their facilities and trade.

It was also clear that because of the differences in the conditions of doing business abroad Joy International should be designed and staffed by experts in that field, with a large degree of independence from the parent company's officers, who are not familiar with the vast and complex conditions of foreign trade. This is spelled out, likewise, in more detail in the appendix.

The fact that these were good business reasons is revealed by the results of Joy International's conduct of Joy's foreign business, as shown by the following exhibit:

STATEMENT OF OVERSEA SALES AND REVENUES FROM OVERSEA SUBSIDIARIES AND INDEPENDENT LICENSES

Ten-year average 1949–58 and fiscal year 1959–61

[Thousands of dollars]

Oversea sales	Prior 10-year average 1949–58	Under Joy International		
		Fiscal year 1959	Fiscal year 1960	Fiscal year 1961
Parent export sales	$10,978	$14,152	$15,717	$16,417
Oversea subsidiaries' sales to customers less parent exports to subsidiaries	8,969	13,507	16,243	21,389
Total global foreign sales	19,947	27,659	31,960	37,806
Engineering fees, dividends, and interest from oversea subsidiaries and independent licensees remitted and included in parent's stated income	363	847	1,018	1,448

This exhibit indicates that Joy International, organized and staffed for the specific purpose of handling and promoting the expansion of oversea sales and profitable operations by Joy's subsidiaries, is eminently successful in achieving that objective. This is no mere shadow or dummy or tax dodge. Here is a carefully organized, expertly staffed, effectively working, international trade organization. Such organizations would be eliminated by the bill before you. We submit that instead, they should be supported and encouraged.

It is charged that investments by American manufacturers in foreign subsidiaries to make their products abroad produce an unfavorable effect on the balance of payments. The facts contradict these statements. Table 1168, page 868, "Statistical Abstract of the United States, 1960," reports direct investments abroad by American companies and the income received here from those investments from 1940 to 1958, inclusive. To 1958, the total of such investments is given as $27,075 million and the income thereon for 1958 as $2,198 million. That table shows the cumulative long-term private investment abroad in productive enterprises, exclusive of U.S. Government investment overseas, together with the favorable annual income from those investments.

But this is only part of the story. The exports generated by these foreign manufacturing subsidiaries are of outstanding importance to the U.S. balance of payments.

The following table gives you an 11-year picture of the operations of Joy, of Joy International, and of Joy's manufacturing subsidiaries abroad.

(The table referred to follows:)

EXHIBIT NO. 1

Joy Manufacturing Co. transactions affecting U.S. balance of payments for 11 years ended Sept. 30, 1961

[Thousands of dollars]

	1951	1952	1953	1954	1955	5-year subtotal	1956	1957	1958	1959	1960	2d 5-year subtotal	1961	11-year total
DOLLAR OUTFLOW														
Investments and advances to foreign subsidiaries	368	478	65	(270)	2,947	3,588	1,698	(13)	(147)	513	1,045	3,096	685	7,369
Foreign dollar expenses (commissions, sales promotion, engineering services, etc. salaries and expenses)	460	655	658	759	816	3,348	982	1,026	1,145	1,439	1,407	5,999	1,507	10,854
Foreign licensee and royalty payments											58	58	135	193
Total	828	1,133	723	489	3,763	6,936	2,680	1,013	998	1,952	2,510	9,153	2,327	18,416
DOLLAR INFLOW														
Export sales:														
To and through subsidiaries	3,224	6,752	6,331	5,827	6,969	29,103	12,739	16,597	11,626	10,731	12,044	63,737	10,430	103,270
To others	4,885	6,274	5,480	4,976	4,168	25,783	7,218	7,551	6,316	5,785	6,317	33,187	8,088	67,058
Total	8,109	13,026	11,811	10,803	11,137	54,886	19,957	24,148	17,942	16,516	18,361	96,924	18,518	170,328
Engineering fees and royalties from foreign sources:														
Foreign subsidiaries	36	8	181	236	237	698	341	550	457	411	740	2,499	1,179	4,376
Foreign licensees	30			65	36	131	137	277	349	283	285	1,331	385	1,847
Total	66	8	181	301	273	829	478	827	806	694	1,025	3,830	1,564	6,223
Dividends and interest from foreign subsidiaries		20	17	74	92	203	172	343	174	221	168	1,078	69	1,350
Total	8,175	13,054	12,009	11,178	11,502	55,918	20,607	25,318	18,922	17,431	19,554	101,832	20,151	177,901
Net favorable balance of payments	7,347	11,921	11,286	10,689	7,739	48,982	17,927	24,305	17,924	15,479	17,044	92,679	17,824	159,485
Approximate U.S. tax	673	1,166	1,135	1,037	1,059	5,070	1,895	2,492	1,909	1,764	2,052	10,112	2,294	17,476
Less foreign tax credit		6	10	38	39	93	73	220	63	140	233	729	265	1,087
Net tax paid	673	1,160	1,125	999	1,020	4,977	1,822	2,272	1,846	1,624	1,819	9,383	2,029	16,389
Retained earnings of foreign subsidiaries	381	807	729	544	676	3,137	1,582	1,731	1,435	817	1,233	6,798	789	10,724

Mr. MORROW. This table shows total 11-year parent company investment and advances to foreign subsidiaries of about $7.4 million, and dollar expenses of operating abroad of $11 million, a total dollar outflow of, roughly, $18.4 million. Please note that these outlays brought $170 million of exports in those 11 years, 60 percent of which went to or through our manufacturing subsidiaries abroad. In addition, payments of $7 to $8 million of engineering fees, royalties, dividends, and interest make a total net favorable balance of payments of $159 million, and the U.S. Treasury collected more than $16 million of income tax from these operations.

Is that showing unfavorable to the U.S. balance of payments? Gentleman, hundreds of other American foreign subsidiaries would present similar results if you had their figures before you.

The business reasons for the establishment of our foreign manufacturing corporations are further illustrated by the next exhibit No. 2.

(The document referred to follows:)

EXHIBIT NO. 2

Joy Manufacturing Co.—Comparative prices f.o.b. factories, certain mining and construction products

Product	USA plants	Western European plants
18-HR loader	$65,300	$65,000, Joy France.[1]
14-BU-8 loader	36,700	$37,000, Joy France.[1] $40,500, ANF France.[2]
FF-211 hoist	3,500	$2,200, Joy France.[1] $1,600, Samia Brasseur France.
R-221 hoist	18,591	$11,816, Joy Britain. $11,900, Pickrose Britain.
No. 12-BF drill	6,900	$6,300, Joy France.[1] $5,100, Craelius France.
No. 22 drill	10,118	$7,283, Joy Britain.
RP-365 portable compressor	14,775	$8,064, Joy Britain. $8,876, Atlas Sweden. $7,602, Broomwade Britain. $7,883, CPT Britain. $8,428, Holman Britain.
K-81 paving breaker	565	$193, Joy Britain. $195, Holman Britain. $190, Ing. Rand Britain.
L-37 rock drill	540	$187, Joy Britain. $190, Broomwade Britain. $186, CPT Britain. $185, Holman Britain.

[1] Joy's French plant is just getting started on making these machines, and costs are not yet shaken down to normal.
[2] Ateliers du Nord de la France. New design, manufacturing routines not yet established.

NOTE.—These are the list prices of these machines, but under the stress of international competition, they frequently are sold at prices below those listed above. These prices may not agree with previously submitted exhibits as no freight, export packing, etc., are included in above list prices. They are f.o.b. plant of origin Mar. 1, 1962. Furthermore, previously quoted prices were as of 1960 dates.

Mr. MORROW. The Joy machines made abroad listed in this table are identical with similar machines made in the United States, even to interchangeability of parts. You will note that, made abroad, they are sold at prices anywhere from 10 to 60 percent below our American prices. From this exhibit, it is clear that many American machines cannot be sold against competing European machines, even if there were no tariffs against them. If we are to sell such machines abroad, we must make them there at costs that match those of foreign competitors.

As soon as an American machine establishes a market in some foreign country, a local manufacturer will quickly copy that machine, knowing that he can sell it for much less than the imported delivered price, unless it is protected by a foreign patent. But American patents in most foreign jurisdictions are good for only 3 years, unless manufacture is begun under those patents. Certain countries will refuse import licenses to any product that is made or can be made within their own territories. Consequently, it has been mandatory upon Joy and other American manufacturers, if they are to hold their foreign business, to manufacture abroad where such conditions obtain.

It is a misstatement to say that this is done to export jobs from the United States, or even that it has that effect. The jobs are already leaving our shores, or are already gone, for the above reasons, before such manufacture is started by an American corporation in a foreign domicile.

On the other hand, every American manufacturer that I know with manufacturing subsidiaries abroad exports a substantial volume of components and materials to those foreign factories for incorporation in their machines and products when made abroad. This is necessary to maintain standardization and quality, so that parts will be interchangeable anywhere in the world and quality reputation can be maintained.

Here is an exhibit that shows the effect of exports from Joy Manufacturing Co.'s Franklin, Pa., plant, chiefly to its oversea manufacturing subsidiaries, of components of Joy machines made abroad. You will note that in 1961, nearly one-third of the employment at Franklin was derived from such exports. The Treasury asserts that such cases are exceptional and not representative and should be disregarded.

Here again the Treasury ignores the facts published by the Department of Commerce, which show that in 1960, out of $18.9 billion of exports, $2.695 billion went to or through foreign manufacturing subsidiaries of American corporations. These are not the statements of private industry; these are the Federal Government's own official figures.

(The document referred to follows:)

EXHIBIT 3

FRANKLIN PLANT

DOMESTIC SHIPMENTS

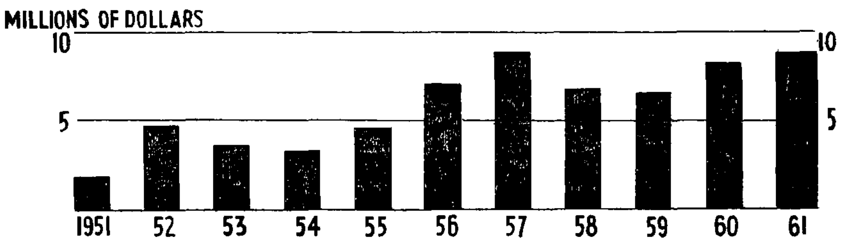
FOR FISCAL YEARS

MILLIONS OF DOLLARS

45 40 35 30 25 20 15 10 5

1951 52 53 54 55 56 57 58 59 60 61

EXPORT SHIPMENTS



Mr. MORROW. The proposed repeal of section 902(d) of the present act should be rejected. This section permits engineering fees and royalties received by a U.S. parent of a foreign subsidiary to be given credit in lieu of dividends for taxes paid abroad, when the parent has an agreement with the subsidiary that for some period of time, it will require no dividends from such subsidiary. This is a valuable provision where manufacturing subsidiaries are established in countries short of dollar exchange, but where prospects of excellent future growth make it advisable to expand plant facilities and working capital. An agreement with the local authorities to plow back all earnings into such foreign subsidiary meets the need of the local country, and, at the same time, the remission of engineering fees and royalties satisfies to some degree the natural and persistent desire of American stockholders for some tangible return from the investment.

The present section 902(d) meets this situation and is particularly helpful in expanding American trade in underdeveloped countries, one of the President's announced objectives.

The so-called gross-up provision of the present bill should likewise be rejected. No foreign industrial country applies such a tax principle to its foreign subsidiaries, so it violates the principle of equality of treatment for American foreign subsidiaries compared with their oversea competitors.

The provision in this bill that parent U.S. companies owning manufacturing subsidiaries abroad must pay annually a tax on the profit earned by such companies should likewise be rejected. No such principle has ever been employed in the United States since the corporate income tax was first established. It is inequitable and a direct attack on the ability of American corporations to expand their oversea operations and foreign trade. Since foreign subsidiaries cannot be taxed by the U.S. Treasury direct, the parent will have to pay the taxes under this provision. But if the foreign subsidiaries are growing and require a large part of their earnings for their own expansion and development, they are in no position to remit funds to the parent to pay corporate income taxes that would be levied under this proposal. Consequently, the burden would fall on the parent companies here, leaving them less money for investment here at home or abroad.

The provisions of H.R. 10650 that are adverse to the employment of American nationals abroad would likewise render it more difficult for American companies to compete in international trade. Employees of British, West German, Dutch, Belgian, French, and Italian companies resident abroad, engaged in selling the products of their respective nations, do not pay their country's personal income taxes on their salaries, though they do, just as Joy International employees do, pay such local income taxes as are levied by the countries in which they are residents. If those provisions of the bill are enacted as written, Joy and other American companies will suffer a disrupting return to the United States of employees now abroad, which could be disastrous to the continuance of their business overseas.

For these reasons, we respectfully urge your committee to reject the provisions of H.R. 10650 that apply to foreign subsidiaries of American companies.

(The attachments to Mr. Morrow's statement with respect to legal liability and independent organization follow:)

LEGAL LIABILITY

A most important business reason for the establishment of Joy International was the serious concern of the parent's directors and officers with regard to substantial legal liability on the part of Joy Manufacturing Co., its directors and officers arising out of its foreign business activities. In 1957, just prior to the formation of Joy International, when Joy had a branch office in Paris, France, the French tax authorities were planning to levy a tax assessment on American Joy Manufacturing Co. on the ground that Joy was "doing business" in France. There was uncertainty as to what percentage of the parent's total income would be held to be taxable in France, but there was definite fear that such percentage would be unreasonably high in relation to the amount of Joy Manufacturing Co. business in France. Both Joy's United States and French attorneys advised that in view of the increased activities of the branch office in Paris, Joy would be held to be "doing business" in France and, therefore, liable to service of legal process in France and to taxation by the French Government. That branch office and all Joy Manufacturing Co. employees were promptly moved out of Paris and reestablished in Monte Carlo, Monaco, which did not levy corporate income taxes.

This potential French taxation caused Joy Manufacturing Co. to have independent legal counsel review in detail the future legal risks to the company if it continued to engage, through its own employees, in business activities throughout the world. It was the opinion of counsel that the increasing foreign business activity of Joy would render the U.S. company subject to the legal and tax jurisdiction of many counties where Joy's employees lived and worked. Counsel concluded that the exposure to the legal and tax jurisdiction of so many foreign countries created a substantial financial hazard. Some of the considerations underlying the opinion of counsel were—

(1) Joy's directors and officers could be required to defend legal actions brought in distant foreign jurisdictions. Thus, the president could be required to appear as a witness in a legal action brought against Joy in a foreign country.

(2) In certain foreign jurisdictions, Joy's directors and officers could be held personally liable for alleged acts of such directors or officers, or for alleged acts and obligations of Joy or its employees.

(3) Joy, its directors and officers, would be subject to the possibility of adverse foreign judgments rendered without the benefit of American due process of law.

(4) Joy, its directors and officers, would be subject to the regulations of many foreign countries, some of whose laws are quite contrary to American constitutional principles.

(5) Joy Manufacturing Co., U.S.A., would be subject to tax levies in many countries, some of which might be based, directly or indirectly, on an arbitrary and unreasonably high percentage of the parent's total income.

For example, the parent's mining machinery and equipment is used throughout the world. If a foreign court were to reach the conclusion, based on strong local emotion, that a defective mining machine had caused a mine disaster, Joy, U.S.A., if subject to the legal jurisdiction of that country, could be held liable for a staggering amount of damages. A judgment for such damages might be enforcible in the United States or in countries where the parent has subsidiaries with considerable net worth.

After careful consideration, Joy's directors and officers concluded that business prudence required the legal insulation of the parent company from the financial risks of extensive foreign operations and that failure to effectuate such protection could constitute a neglect of the interests of the parent's stockholders.

INDEPENDENT ORGANIZATION

In 1957, when the great growth potential of the parent's foreign business became apparent, Joy's directors and officers decided that the organization responsible for supervising the foreign business would have to differ significantly from a domestic division of Joy, U.S.A., in order to realize the potential volume and profit of the foreign market. That organization must—

(1) Have an intimate, up-to-the-minute, accurate and current knowledge of the constantly changing market potential of each country in the world, including its political, social, and economic aspects.

(2) Determine whether the market potential of each country can best be realized by U.S. exports sold through an independent distributor or through a sales and service subsidiary, or by licensing a local manufacturer, or by establishing a local manufacturing subsidiary, or by exports from a foreign manufacturing subsidiary domiciled in a third country.

(3) Obtain and make the most profitable use of local financing or financing from other sources outside Joy Manufacturing Co.

(4) Communicate with customers, public officials and banking authorities all over the world, preferably in their native tongues, and with full knowledge of the local mores.

(5) Have a thorough technical knowledge of all parent Joy products and competitive products, both American and foreign, together with the sales and engineering skill necessary to promote the sale of and supervise the installation, use, maintenance and repair of all parent products.

(6) Provide high quality managerial supervision and business counseling to Joy's foreign subsidiaries, licensees, and distributors.

(7) Protect the business interests of Joy by assuring proper remittance of royalties, engineering fees, and by guarding against the improper use and infringement overseas of Joy's patents, trademarks, trade names, manufacturing drawings, secret technical information, and other proprietary data.

(8) Secure competent key personnel of various nationalities to staff Joy's foreign subsidiaries.

(9) Coordinate the activities of the oversea subsidiaries, licensees, and distributors with the interests of the parent, having due regard to the legitimate interests of the United States and of foreign nations.

Prior to the establishment of Joy International, Joy's foreign business was initially supervised by a vice president with New York offices. As the importance of foreign markets grew, this operational setup proved ineffective because the control was too distant from the factories and customers. The offices were moved to Paris, and the experience of the parent has demonstrated that its foreign operations can best be supervised by personnel working and living abroad.

It was quite evident that the executive officer in charge of the international business organization would have to possess much broader authority and a great deal more discretion than is given a vice president or divisional general manager of the parent and would require the counsel and advice of a separate board of directors with members who were especially familiar and experienced with oversea business. It was wisely decided that such executive officer should be granted, with regard to the oversea business organization, authority, and discretion similar to that possessed by the parent's president with regard to domestic business activities.

These practical business considerations resulted in the formulation of Joy International, a separate Panamanian corporate entity, and the granting to it of a high degree of autonomy.

Without question, most of these same considerations have been convincingly persuasive in leading to the formation of oversea companies by other American corporations, not for the evasion of taxes, but for sound business reasons that cannot properly be ignored in the consideration of this tax program.

Senator GORE. Mr. Morrow, in examining your statement you filed with the SEC, I find you have filed a statement entitled "Totally Held Unconsolidated Subsidiaries," and another one entitled "Joy Manufacturing Co. and Consolidated Subsidiaries."

Now, in your statement with respect to the unconsolidated subsidiaries, you show a profit before taxes of only $1,169,000, and profit after taxes of only $564,000, whereas on the other statement you show income before taxes of $6,341,000, and a net income after taxes of $4,223,000.

Would you explain the disparity between these statements, the reason for the disparity of the profit position of these two operations?

Mr. MORROW. It has been a long time since I looked at that 10-K statement, Senator Gore.

I think the difference there is due to the fact that the parent company is included in one set of figures and is not included in the other.

Senator GORE. Well, I had thought there was another explanation for it, and I suppose I may as well ask you specifically.

The first statement, which shows a very small profit indeed compared with net sales, net sales being in excess of $28 million, and net income being only $564,000, is composed, generally speaking, of subsidiaries in high-tax countries.

Mr. MORROW. That is correct.

Senator GORE. Whereas the statement involving the large profit rather generally includes the subsidiaries located in so-called tax haven countries.

Mr. MORROW. It includes not only Joy International, Canada and Mexico, but it also includes the parent company. None of the four above are in what you call statement No. 1 which includes only the oversea manufacturing subsidiaries.

Senator GORE. Well, the parent company—what was the tax of your parent company?

Mr. MORROW. 1961—the parent company tax, I am thinking of a consolidated figure now—was about $2,200,000, as I recall it, 33⅓ percent.

You are surprised at that low figure? That is due to credits for foreign taxes paid on income received from manufacturing subsidiaries abroad, also from the fact that the income reported included some capital gains on which the tax was only 25 percent, so that in the aggregate it was down to about 33 percent, as a consequence.

Senator GORE. The picture apparently emerging from these statements and your testimony is that the affairs of your company with respect to its oversea holdings has been managed so as to make the operations in high-tax countries show a bare profit, whereas the profit in the tax haven countries is maximized.

Mr. MORROW. No. There is only one tax haven company, and that is Joy International, and that sells the exports of all of these companies, the parent company and the exports from the foreign subsidiaries, the exports of the British company, the French company, south African company——

Senator GORE. That is your Panamanian——

Mr. MORROW. That is right.

Senator GORE. You call that Joy International?

Mr. MORROW. That is right.

Senator GORE. How long has it been established?

Mr. MORROW. Since 1958.

Senator GORE. How much did you invest in this subsidiary?

Mr. MORROW. At the time of incorporation $50,000 was paid in, but we kept the earnings in the company.

The net worth of that company today is about $3.5 million, and it has borrowed about $2 million on its own credit which, in turn, it has loaned to various foreign manufacturing subsidiaries, together with loans from its retained earnings, making total loans by Joy International of about $4,700,000 to Joy's manufacturing subsidiaries.

Senator GORE. From what source did it borrow the funds?

Mr. MORROW. It borrowed them here in the United States.

Senator GORE. From your company?

Mr. MORROW. No, from American banks, but on its own credit, no guarantee by the parent.

So it does not transgress any of the requirements of the indenture underlying our debenture issue.

While we are on that subject of borrowed money, let me say that these foreign subsidiaries have borrowed about $5.5 million of local currency, which is in their business.

Senator GORE. Insofar as the balance of payments is concerned, a borrowing in the United States by Joy International which money, in turn, is invested in third country subsidiaries, amounts to the same thing as if you had made a direct foreign investment.

Mr. MORROW. That loan, Senator, is being repaid at the rate of $80,000 a month or nearly $1 million per year so it is all coming back fairly rapidly.

Senator GORE. Then, to that extent, my statement would necessarily be modified.

Mr. MORROW. Yes, it would to that extent.

Senator GORE. Then, according to your testimony, Joy International has assets now of some $3.5 million.

Mr. MORROW. Net.

Senator GORE. Is that its total holding?

Mr. MORROW. Those are the net assets. Total assets are $5,500,000 and——

Senator GORE. Well, I misspoke myself. When you say "net" you include the net of all of its holdings?

Mr. MORROW. That is right. It does not own these foreign subsidiaries.

Senator GORE. But handles exports to them?

Mr. MORROW. No, it handles exports from them, and exports from the United States parent company wherever they go.

Senator GORE. Which includes to the subsidiaries.

Mr. MORROW. Yes. Some of those, a lot of them, in fact, go to the subsidiaries, but exports also go elsewhere throughout the free world. If you will look at exhibit 1, you will see that the total of exports from the parent company to these foreign subsidiaries amounted to $103 million over the 11 years of that exhibit, which is 60 percent of the total exports of the parent company. The remaining $67 million of exports went to independent buyers.

Senator GORE. How much repatriation of profits from Joy International has there been to the United States?

Mr. MORROW. Well, if you will look at exhibit 1, you will see that over these 11 years there have been engineering fees and royalties from foreign sources, royalties and licenses of $6,223,000.

There have been dividend and interest payments of $1,350,000, or a total of $7,573,000 against a total investment of $7,369,000.

Senator GORE. Well, now, I do not quite understand. Perhaps there is some misunderstanding in terms.

You were questioned last year by Congressman Baker before the Ways and Means Committee, and I read:

> Mr. BAKER. Has it returned any dividends to its parent company?
> Mr. MORROW. Not as yet.

Mr. Baker. What taxes do you pay in Panama?
Mr. Morrow. We do not pay any.

Do you remember that testimony?

Mr. Morrow. Oh, yes, that is correct.

Senator Gore. Then Joy International has not paid dividends.

Mr. Morrow. Not as yet. What I am referring to here is the return flow from these foreign investments.

Senator Gore. No, I asked you about the repatriation of profits from Joy International.

Mr. Morrow. I misunderstood you. There is no repatriation of profits from Joy International as yet. There is a return from these foreign manufacturing subsidiaries all together slightly in excess of the total investment in them.

Senator Gore. How many foreign subsidiaries do you have?

Mr. Morrow. Canada, Great Britain——

Senator Gore. The total.

Mr. Morrow. I have to count them up—eight.

Senator Gore. How many subsidiaries do these subsidiaries, in turn, own?

Mr. Morrow. Well, I included a subsidiary, a Moroccan subsidiary, of the French company in that total. There are seven plus the Moroccan subsidiary of the French company.

Senator Gore. How long have you been president of Joy?

Mr. Morrow. I was president of Joy from September 1, 1940, to January 15, 1956.

I was chairman of the board for a year, and then I retired from those positions but am on the directorate and executive committee, and am now chairman of the finance committee.

I am not an active executive of the company any more.

Senator Gore. Has one of the officials of Joy Co. recently become president of Dresser Industries?

Mr. Morrow. I believe he has. I think that is correct; yes, John Lawrence.

Senator Gore. I find that worthy of notice because, from what I have seen of the statement of Dresser Industries, they have a tax avoidance scheme very similar to yours.

Mr. Morrow. I do not know anything about it.

Senator Gore. You do not know anything about that?

Mr. Morrow. No, I am not familiar with it.

Senator Gore. I am not sure that they have been as successful as your company has.

Mr. Morrow. I hope not.

Senator Gore. Do you seriously contend that you should not pay any tax upon the profits of your organization merely because you export through or by way of a Panamanian subsidiary; do you think that is good policy for this country?

Mr. Morrow. Senator, does this country want exports? If it does, they are going to have to pay for them. They do not just rain out of the sky like an April shower. You work for them. You spend money to get them.

Senator Gore. I am not talking about exports. I am talking about the question of whether you should pay taxes on the profits you make from your exports.

Mr. MORROW. Now I will relate it to the context, the purpose, and the reason we do this. We are promoting the exports of the parent company in the most effective ways that we know how. We have organized a very highly skilled, very expert international sales company.

Senator GORE. Do you seriously contend now that your salesmen can operate more efficiently in selling to Europe out of a paper corporation in Panama——

Mr. MORROW. This is not a paper corporation, just get that out of your head.

Senator GORE. Well, out of a subsidiary in Panama; I guess it is more than paper, it has got $3½ million.

Mr. MORROW. It sure has.

Senator GORE. Do you seriously contend that a salesman operating in whatever way he operates out of Panama representing a company, manufacturing company, in the United States, can be more effective in his approach to customers in the Scandinavian countries than he could if he operated under the direction of an office in New York?

Mr. MORROW. Well, let me correct that statement of yours, first. He does not operate out of Panama. That is merely the location of the incorporation of the company. The headquarters are in Monte Carlo. He is subject to the direction of the president of Joy International.

Senator GORE. How many employees does your Panamanian subsidiary have?

Mr. MORROW. Well, the last time I checked up on it, I believe there were 42.

Senator GORE. Forty-two?

Mr. MORROW. Forty-two.

Senator GORE. What is the annual income per employee?

Mr. MORROW. Annual income of the employee or of the company?

Senator GORE. Of the company.

Mr. MURROW. Well, the company's income is about $1 million a year.

Senator GORE. Then I want to reduce that to——

Mr. MORROW. That is its net profit.

Senator GORE. Then, is what is the net profit per employee?

Mr. MORROW. About $25,000.

Senator GORE. About $25,000?

Mr. MORROW. That is right.

Senator GORE. Give us the net profit per employee of your corporation in the United States.

Mr. MORROW. About $10,000.

Senator GORE. Now give us that figure with respect to your unconsolidated subsidiaries and your consolidated subsidiaries.

Mr. MORROW. I cannot do that, Senator. I do not have those figures before me, I do not recall them.

I want to go back to the question you asked about the effectiveness of the selling of these employees of Joy International.

I will say categorically that they are more effective selling under the direction of the president of Joy International from Monte Carlo than they would be if we were located in New York.

He was located in New York for a number of years, and we discovered that he was out of touch with the foreign markets. The

salesmen are experts; they are picked for their suitability at different locations.

Our Middle Eastern man, for instance, speaks Arabic just as well as the Arabs do.

Senator GORE. What does Arabic have to do with Panama?

Mr. MORROW. Nothing whatever. He does not operate out of Panama.

Senator GORE. All right. Then why are you domiciled in Panama?

Mr. MORROW. Well, in a way that was an accident. We discovered that the French Government was about to tax some portion of the parent company's income because we had an office, the parent company had an office, in France, in Paris, and we were doing business there,

Senator GORE. That was an unbearable thought to you?

Mr. MORROW. It certainly was because we did not know—the French tax authorities can be very arbitrary, and we had no idea what part of the parent company's income they might allege was subject to French taxation.

We checked up with our French counsel, and they said the French authorities had a legal right to do this, and apparently that is what they expected to do.

The next morning we were located in Monte Carlo, moved out of Paris quick, and we said to our attorneys, are we subject to this sort of thing elsewhere in the world. Well, they took a good look at it and said, yes, you are, and subject to a lot more besides.

Then we employed special counsel, Shearman, Sterling & Wright in New York, and got an opinion from them, and if you read the appendix here on this subject you will see what the hazards were that we were running doing business in that way.

Counsel said, "You set up an independent company separate from the parent company to insulate the parent from all these legal hazards of doing business now all over the world."

The lawyers hastily incorporated in Panama. They might have just as well done it in Monte Carlo. We thought at the time Panama would not be such a bad place for headquarters, because we do quite a bit of business in Latin America, but it did not take very long to see that that was the wrong place to be. We could not readily go any place from Panama; so we do not have any office in Panama.

Our South American and Latin American business is handled from Lima, Peru.

Most of our foreign business is over in Europe, Africa, Western Europe, Australia, and——

Senator GORE. I thought you said the Panama corporation was not a paper setup? You have no office there; do you have any employees in Panama?

Mr. MORROW. No, we do not have any employees there. We merely have an attorney down there of record to accept service of process and make reports.

Senator GORE. How much do you pay him?

Mr. MORROW. I do not know. It is not very much, probably $250 a year, a very minor amount.

As I said, there was no real necessity for incorporating the company in Panama at all. That was just——

Senator GORE. I have one other question, and then I must leave for another engagement.

From the statistics I have seen of your company you show a production cost in your consolidated statement of 77 percent based upon the net sales. The figures are net sales, $100 million; production costs, $77 million.

You list, on the other hand, in your unconsolidated subsidiaries net sales of $28 million; production costs of $23.6 million or 84 percent.

Now this would make it appear that your production costs are a great deal higher in the unconsolidated subsidiaries than in the U.S. company and its consolidated subsidiaries.

Mr. MORROW. Temporarily, Senator, that is true.

Senator GORE. Why would that be true? People have been telling us that one reason they were establishing foreign subsidiaries and manufacturing subsidiaries is that their production costs were less. Yours appear to be higher.

Mr. MORROW. Well, that is accounted for by the fact that we have a new factory in France, and the factory was bought——

Senator GORE. Who owns it?

Mr. MORROW. The French company.

Senator GORE. Who owns the French company?

Mr. MORROW. The parent company here, 100 percent.

Senator GORE. Joy International has nothing to do with that?

Mr. MORROW. Not a thing to do with it but sell its products outside of France for export.

Senator GORE. It has not made a profit?

Mr. MORROW. No.

Senator GORE. But Joy International has.

Mr. MORROW. It has.

The British company has made a profit, South African, Australian, Mexican, Canadian, Peruvian; the French company will make a profit, but we had to phase out the manufacture of the products that were already in that factory when we bought it.

We had to agree to continue a diminishing rate of manufacture of those products until the owners could get located elsewhere, and we had to bring in Joy products as we could.

Now, that was a pretty expensive operation, and that company lost money in the process. It is coming out of it now, but for the year you have before you when that loss was subtracted from the profits of the other subsidiaries, it did drop the whole figure down, so it does not look as good as it will a year from now.

Senator GORE. I will say, Mr. Morrow, insofar as I am concerned, it is my opinion that your testimony before the Ways and Means Committee and before this committee has facilitated the passage of this bill and, perhaps, a more stringent form of it than it is now in.

Mr. MORROW. Well, I regret that very much. It should not.

Senator GORE. You, at least, have been frank. Do you tell us that you are operating so as to avoid taxes, and you think that is right and proper?

Mr. MORROW. Not to evade taxes. We are simply living inside of the tax laws as they are.

Senator GORE. I do not say evade; I say avoid. There is a considerable difference. I am not saying at all that you have done anything illegal.

Mr. MORROW. I see. I am sorry, I misunderstood you.

Senator GORE. I just do not understand how the Government of the United States could permit this to continue. You are an American citizen. Your corporation enjoys all the benefits of the American system of government, society, and economy. I think your company and all companies similar, and all citizens similar, should bear their fair share of the defense of this country, the costs of its development, and its security.

Thank you for appearing.

Mr. MORROW. Well, let me say this, in answer to what you said. They do, and so far as these deferred taxes go, that income will come back, taxes will be paid.

In the meantime, that money is being very effectively used to extend our foreign trade, the most effective use of it that can be made.

Senator GORE. Do you know, every taxpayer in the United States could use the money he pays as taxes in increasing the consumption and the productivity of the U.S. economy.

If all taxpayers succeeded as you have in avoiding taxes, this Government simply could not be great—this country could simply not be as great as it is.

Mr. MORROW. Senator, I think you and I would have to have more time to discuss this than we have this afternoon, and when we got through we might not be as far apart as we seem to be right now.

I am looking at it from a hard——

Senator GORE. Perhaps we will have another opportunity, I hope so.

Mr. MORROW. Thank you.

Senator GORE. I hope you understand my remarks are not intended in any way to be offensive to you.

Mr. MORROW. I understand.

Senator GORE. You have been frank, and so have I. I am not sure that all members of the committee share my opinion, but I happen to be in the chair for the moment. Thank you very much.

We will now have a short recess.

(Short recess.)

Senator BENNETT (presiding). The hearings will resume.

Mr. Frank T. Quirk, of the Rubber Manufacturers Association, is next on the list.

Mr. Quirk, Mr. Sidney Lee, of the West Indies Investment Co., has reason to get through and get away. Would it be all right with you if I asked him and called him out of order, or are you in the same fix?

Mr. QUIRK. I have a 5 o'clock plane, Senator.

Senator BENNETT. Mr. Lee, how much time do you need? Is Mr. Lee here?

Go ahead, Mr. Quirk, and we will put Mr. Lee on next.

Mr. QUIRK. Thank you, sir.

Senator BENNETT. At this point let me ask another question, is Mr. Sidney Zagri here?

We will step Mr. Lee up in Mr. Zagri's place then.

Go ahead, Mr. Quirk.

STATEMENT OF FRANK T. QUIRK, ASSISTANT SECRETARY, GOODYEAR TIRE & RUBBER CO., AKRON, OHIO

Mr. QUIRK. My name is Frank T. Quirk. I am assistant secretary, Goodyear Tire & Rubber Co., Akron, Ohio. I appear today on behalf of the Rubber Manufacturers Association, Inc., of New York City. The RMA is a voluntary association of 170 member companies producing all kinds of rubber products and accounting for more than 90 percent of all rubber consumed in the United States.

The Rubber Manufacturers Association, Inc., opposes the enactment of H.R. 10650. We are deeply concerned with the philosophic trend this legislation would establish. The use of tax laws to regulate business procedures is an abandonment of basic principles which would lead to endless litigation over interpretations.

In our opinion, H.R. 10650 has little to recommend it as a measure to raise revenue. It is an unfortunate and untimely approach to changing the basic nature of our economy.

We urge that the whole approach, as reflected in H.R. 10650, be abandoned outright. Instead, substitute a program for eliminating tax barriers to economic growth.

The proposed 7-percent tax credit for investment in qualified assets would inject a system of rewards for expenditures along lines established by preconceived administration standards.

The investment incentive credit in essence is a subsidy and a tax "gimmick." It could develop into outright control over the right of business to invest only with the permission of government "controllers."

The designers of this tax credit amendment to the Internal Revenue Code lose sight of the real motivation for renewing or expanding business facilities. Investment in capital assets is made only when and if the owners are assured of a reasonable return on their investment. An important and necessary assurance is that tax rates and depreciation policy permit an adequate return—an opportunity to make a profit. President Kennedy said earlier this week that profit was essential to economic growth.

Modernization of productive facilities would be better stimulated through effective depreciation reform. Revision of depreciation allowances over the long term would involve less revenue loss than the tax investment credit. The effect on capital formation of this kind of tax credit would be no greater than the release of a comparable number of tax dollars through tax rate reduction. Depreciation reform would avoid the inherent inequities of the tax credit and treat all taxpayers fairly.

The provisions of sections 3 and 4 relating to legislative and business expenses would cripple the rule of "ordinary and necessary" expense deduction that has always been a part of the income tax law. These proposed rules are completely arbitrary, substituting mandatory restrictions by statute and regulation for the traditional business judgment. Our attached supplement comments in greater detail on these sections.

The provisions on taxation of foreign earnings insisted upon by the Treasury Department are based upon a fuzzy, theoretical concept of equalizing the tax on income of domestic corporations which operate

abroad through foreign subsidiaries with their domestic competitors. They ignore the realities of doing business in foreign markets where the competitors are not those with whom we are engaged in the domestic U.S. market but a group of very eneregetic and competent foreign manufacturers of related products.

The American rubber industry now finds that the foreign investments which they have been encouraged to make for many years by national policy are suddenly regarded in important governmental circles as being highly undesirable, detrimental to the American economy, and based upon selfish motives. This concept is anything but an accurate analysis.

Penetration of a foreign market often is possible only by building a plant in that market. No rubber plant has ever been located overseas capriciously or primarily with a view of tax avoidance.

Wholly beyond the questions of taxes and tariffs, the American rubber manufacturer faces abroad a crisscross maze of quota restrictions, import licenses, and many other devices.

It would be an incalculable loss to the United States if the rubber industry and other established industries are prevented by U.S. tax law from continuing to meet foreign competitors on fairly equal terms in seeking to obtain a share of these expanding foreign markets. This committee already has been told of the conditions favoring our foreign competitors.

In many instances, rubber companies have received dividends in this country from their foreign subsidiaries amounting to more than their total current foreign investment. This dividend income has, of course, been subjected to full U.S. taxation.

When domestic rubber companies decide to locate a plant overseas, most of the equipment for the plant is shipped from the United States and is made by American workmen. If further expansion is curtailed by revised tax provisions, not only will the foreign markets be taken over by foreign competitors, but the machinery, equipment, and supplies for their new plants will come from foreign producers.

There are numerous examples in our industry where the annual purchases of replacement equipment, machinery, materials, and supplies to keep foreign plants operating represent more than the total U.S. dollar investment of the same company overseas. These purchases, amounting to many millions of dollars each year, provide work for thousands of people and are advantageous in our balance-of-payments position.

H.R. 10650 is designed to exact more revenue for the U.S. Treasury from economic activity in foreign countries. It is our opinion that such provisions, if enacted, would actually result in retaliation by foreign markets with tax measures designed to discriminate against corporations with U.S. affiliation.

The end result would be that the Treasury of the United States would realize less—not more revenue. This would result particularly from the gross-up provisions of section 11(b) and the controlled foreign corporations provisions of section 13.

In the supplement which we attach for the record, we have included additional comment relating to many of the complex provisions of H.R. 10650 on the taxation of foreign earnings. Also in the supplement are comments on the provisions (sec. 14) covering the sale of de-

preciable property and our comments in opposition to the proposal by the Secretary of the Treasury asking repeal of the dividend credit and exclusion. That supplement is attached, Senator, which we request be put into the record.

Senator BENNETT. The supplement will be made a part of the record.

Mr. QUIRK. Thank you, Mr. Chairman.

(The document referred to follows:)

SUPPLEMENT TO THE STATEMENT OF THE RUBBER MANUFACTURERS ASSOCIATION, INC., ON H.R. 10650, THE REVENUE ACT OF 1962

SECTION 3. LEGISLATIVE EXPENSES

Our democratic form of government has no room for any legislation that hampers the free communication of thoughts and ideas between citizens.

The disallowance of expenses incurred by a corporation in any attempt to inform the general public with respect to legislative matters is an "Iron-Curtain" approach to lawmaking. For many years our Government has realized the tremendous importance of educating foreign people regarding their own governments. It seems rather inconsistent to consider legislation that, in effect, prohibits such dissemination of information to our own citizens. To disallow such expenses would discourage any business from explaining the effects of proposed legislation and expressing its viewpoints to the general public.

The proposed legislation implies that the communication is permissible between business and lawmakers, but is not permissible between business and the general public. Such discrimination must not be legislated. Any ordinary and necessary business expense must be recognized as a legitimate deduction.

SECTION 4. ENTERTAINMENT AND TRAVEL EXPENSES

The proposed legislation destroys the "ordinary and necessary" concept which has been firmly and fairly made a part of our tax structure. The abandonment of this concept under the guise of "loophole" plugging subjects our economy to bureaucratic control and denies business judgment.

Travel and entertainment expenses can be quite adequately handled through firm enforcement of the present "ordinary and necessary" concept. The new concept, "directly related to the active conduct of the taxpayer's trade or business," is an abstract requirement. Salesmanship extends far beyond shoptalk and direct negotiations. Customers choose one product rather than another which may be similar or perhaps identical for peculiar and personal reasons. It is necessary for a businessman to constantly expend ordinary and necessary efforts to sell his product and services. How can this businessman or the Government ascertain under the stress of sales effort whether or not such effort will be considered as directly related?

The proposal recognizes the costs of facilities and club dues if used primarily in the trade or business. Such an arbitrary distinction is without merit. If 51 percent of the expense is business-oriented, the motivating facts would not change if the ratio merely dropped to 49 percent.

Travel expenses must be reasonable under the proposal. Such a requirement is difficult to define in a widespread business community and must be subject to differing definitions by different men. The administration under this proposed legislation promises to be provocative of extended and costly litigation. The net revenue effect, in any event, is picayune when cost of administration and the adverse business effects are placed in proper focus.

SECTION 6. ALLOCATION OF SALES INCOME BETWEEN A U.S. CORPORATION AND A FOREIGN SUBSIDIARY

Amendment to section 482 of the Internal Revenue Code is unnecessary and undesirable. The present language contained in section 482 is sufficiently broad to permit the Secretary or his delegate to make any allocation necessary to properly determine taxable income. Any shortcoming in this area is one of administration rather than one of lack of statutory provision.

The method of allocation which is proposed by section 482(b)(2)(A) is now available to the Secretary if that method is deemed necessary and more accurate than any other conceivable method. We object to including in the code a formula for the Secretary's use for the reasons that this inclusion, by its very presence, would encourage its adoption in instances when another method would be more equitable or when the allocation used by the taxpayer is realistic despite a variance with the formula involved in the code. Even though the proposed amendment contains language providing that "arm's length" prices shall be used where available, the Ways and Means Committee's explanation places such emphasis on the formula that we are led to the conclusion that use of the formula will undoubtedly be carried to the extreme.

Moreover, this section fails to provide that any income allocated to the domestic corporation will be considered from foreign source for purposes of limitation on foreign tax credit. This could actually result in the taxation of income twice; once when an allocation is made, and again when a dividend is received in a later year if no offset is allowed against foreign income for the amount so allocated.

SECTION 11. THE GROSS-UP OF FOREIGN INCOME

Section 11(b) of H.R. 10650 would add a new section 78 to the Internal Revenue Code. This new section would apply the so-called gross-up principle in computing the credit for foreign taxes by including in the gross dividend an amount equal to the foreign tax deemed paid by the domestic corporation receiving the dividend. The full U.S. income tax is then computed on this grossed-up amount.

The gross-up proposal is not in harmony with the principle of basing U.S. tax liability upon income. The proponents of gross-up have advanced the argument that gross-up will remove an advantage companies have when operating through foreign subsidiaries compared to companies operating with foreign branches. These arguments ignore completely the fact that the selection of a branch operation is availed of only when other operating advantages, such as utilization of operating losses and foreign exchange fluctuation, outweigh the considerations favoring the alternative of operating by use of a subsidiary.

It has been thought for over 45 years that the long-existing foreign tax credit provision equalized at least in part inequities between a foreign subsidiary-type operation and a foreign branch-type operation. Now we find H.R. 10650 would put an end to this partial equity and produce an absolute inequity despite the claims of its opponents.

Moreover, section 11(b) of H.R. 10650 would completely disregard the existence of a corporate entity created under the laws of a foreign government. It would look through such legal corporate entity and attempt to impose a tax on the domestic U.S. parent on income earned abroad by the foreign subsidiaries which could never be returned to the parent as dividends since it had rightfully been taken by the foreign government as tax.

We submit that this raises a serious constitutional question, and we trust that this committee will give it thoughtful consideration.

As "gross up" will increase U.S. revenue only where foreign tax rates are lower than our own, such countries may logically be expected to increase their own effective tax by a form of withholding tax so that they and not the United States will receive the additional revenue. We would expect this to be done in each foreign country without cost to its own national corporations, inevitably resulting in discrimination against those corporations which were affiliated with corporations based in the United States. The unfortunate and, in our opinion, inescapable result of enacting section 11 will be to severely reduce U.S. earnings and tax revenue from foreign sources because more of such earnings and taxes will be trapped and retained by foreign governments.

SECTION 13. CONTROLLED FOREIGN CORPORATIONS

The proposed section 13 of H.R. 10650 is suggested in an attempt to curb abuses in a limited number of cases, completely ignoring corporate entities and legitimate expansion of trade and commerce. Section 482 on allocation of income and sections 367 and 1941 of the 1954 Revenue Code pertaining to transfers contain all the legislation which is needed to enable the Secretary to curb said existing abuses. If, however, it is the belief of this committee that additional legislation is needed to end the so-called tax haven form of operation, the amendments to the Code should be directed only to that target and not spread in a way that would affect legitimate operations.

Proposed section 13 would, by its definition of nonqualified property, prohibit growth of a new controlled foreign corporation out of earnings in economically developed countries and seriously impede further growth out of earnings by those which are now established. Qualified property, as defined in this section, appears to exclude funds accumulated for future expansion and for the replacement of assets where inflation has resulted in replacement cost exceeding original cost. Prudent business judgment would require this accumulation against need.

In explanations and discussions relative to this section of the proposed bill, its advocates have used such terms as "tax deferral" in referring to what is nothing more than respect for corporate identities. If foreign trade and commerce is bad for this country, it should be abolished by direct legislative action and not by amendments to the Internal Revenue Code.

SECTION 14. GAIN FROM DISPOSITION OF DEPRECIABLE PERSONAL PROPERTY

We are fully aware that our deficient depreciation structure for tax consideration is a deterrent to growth and technological progress. We also clearly realize the seriousness of our national economic situation. There is little, if any, debate against a basic revision upward in depreciation rates as is now being promised by revising Bulletin F. It is an acknowledged fact that a certain amount of "creeping" inflation exists in our economy. It is impossible for us to reconcile these basic principles with the present proposal to tax as ordinary income the gain from the disposal of depreciable assets.

The ultimate effect of such legislation is very apparent; prudent businessmen will be reluctant to dispose of productive machinery if an accumulation of substantial gains accompanies the disposition and the resulting tax would consume most of the proceeds.

There is no doubt that the disposition of used or obsolete equipment is always prerequisite to replacement and modernization. There is also no doubt that such replacement is constantly made with more expensive new equipment. Encouragement of business to purchase and intall new and modern equipment will not result from this proposed legislation. The influence of inflation upon both the proceeds from the disposition of obsolete and inefficient equipment and upon the cost of the new equipment required to replace it must not be ignored.

SECTION 16. GAIN FROM CERTAIN SALES OR EXCHANGES OF STOCK IN CERTAIN FOREIGN CORPORATIONS

Section 16 is another example in which the proponents of the bill seek to ignore corporate entities and discourage the operation of controlled foreign corporations. If an individual as a stockholder owns 10 percent of the stock in a domestic corporation, any gain upon liquidation will be treated as a capital gain. If, however, a stockholder owns 10 percent of the stock of a controlled foreign corporation, this section would exact tax at ordinary income rates. This is clearly an act to promote discrimination.

Accumulated corporate earnings of a domestic corporation may be transferred to its domestic parent either tax-free upon liquidattion or by divided prior to liquidation and be subjected to only the intercorporate dividend tax of not more than 7.8 percent. The present Code and regulations now discriminate against the liquidation of foreign corporations by subjecting gain to capital gain rates and dividends prior to liquidation to the full corporate tax rate.

If gains upon sale or liquidation of such stock investments are to be taxed at higher rates by the United States, we may expect foreign countries to seek means of securing the tax benefit for themselves by discriminatory taxes upon such sales or transfers as the increase in value will be looked upon as arising from economic activity in their countries. If this is done, and in our opinion the retaliation to the enactment of this section would be swift and sure, another source of revenue to the U.S. Treasury will be cut off.

SECTION 21. TREATIES

One of the most surprising and indefensible provisions of H.R. 10650 is the one contained in section 21 which would make inoperative section 7852(d) of the Internal Revenue Code (relating to treaty obligations) where it would otherwise apply to provisions of H.R. 10650.

This provision cannot help but have its effect on other countries which were party to those tax treaties which are now in force. If Senate approved treaty provisions can be nullified so lightly by this country, other countries can do likewise. Parties to treaties, each acting independently, could in this way completely destroy the treaty by ignoring its provisions in their own country.

Tax treaties entered into in good faith by our country are relied upon in making business decisions and should be adhered to without exception until amended by negotiation and agreement between the United States and the other country party thereto. Our country, noted for its fairness and generosity in foreign affairs, should not destroy this climate of good will by arrogant and unilateral abrogation of treaty provisions entered into only after serious and prolonged negotiation.

DIVIDED CREDIT AND EXCLUSION

We oppose the proposals of the Secretary of the Treasury in the area of the dividend credit and exclusion for they would not promote equity between taxpayers and would not promote economic growth.

It is generally agreed that there is a substantial measure of double taxation on distributed corporate earnings. It is an inescapable fact that taxpayers who receive dividends are worse off, from a tax point of view, than taxpayers who receive wages, interest, rents, or royalties. Equity capital is the most difficult to obtain, the most essential to an expanding economy and the only form of capital subjected to a double income tax. When all economists agree that we should increase our rate of growth, it is not the time to discriminate further against stockholder investment.

The argument that its "benefit is highly favorable to the taxpayers in the upper income groups" is irrelevant. Relief from double taxation of dividend income should naturally go to those who receive the income. Such credit should not be evaluated by the economic status of the recipients; an inequity is no less an inequity if it is imposed on a person already overburdened by excessive tax rates. Not only is the argument irrelevant, it is also incorrect in fact. The tax credit amounts to 20 percent relief of the dividend tax at the bottom of the tax bracket, whereas the relief is less than 4.5 percent for the taxpayer at the top of the tax bracket.

Senator BENNETT. Just one comment: you say—

The effect on capital formation of this kind of tax credit would be no greater than the release of a comparable number of tax dollars through tax rate reduction. Depreciation reform would avoid the inherent inequities of the tax credit and treat all taxpayers fairly.

By that are you pointing out that this benefits the man who has a program of improvement right now, but the man who got busy a year ago and brought his plant up to date is left out?

Mr. QUIRK. That is right, Senator. Actually, many millions of dollars, I presume, have been spent in 1962 wholly and with no regard to this type of legislation, and the retroactive effect of this would be an outright windfall to those people in that respect.

In other words, we feel that the much needed and long overdue reform of the schedule F depreciation allowances is the basic approach and is the sound approach, and not in—I think we have used the word tax "gimmick"—in reference to the investment credit idea.

Senator BENNETT. I am inclined to feel that before we legislate in this field we should at least have a look at the proposed improvement in the depreciation schedules.

Mr. QUIRK. I am very happy to hear you say that.

Senator BENNETT. So we are not working in the dark.

Mr. QUIRK. I am very happy to hear you say that, Senator.

Senator BENNETT. I think you would agree with me.

Mr. QUIRK. Completely.

Senator BENNETT. Thank you very much, Mr. Quirk.

Mr. QUIRK. Thank you.

Senator BENNETT. I have no colleagues to question you further.
Mr. QUIRK. I do not know whether that is fortunate or unfortunate.
Senator BENNETT. I think you should be happy, under the circumstances. [Laughter.]
Now, Mr. Lee, we will be very happy to hear you.
Did Mr. Zagri come in?

STATEMENT OF SIDNEY LEE, PRESIDENT, WEST INDIES INVESTMENT CO.

Mr. LEE. Thank you, sir.
My name is Sidney Lee, and I am president of the West Indies Investment Co., Christiansted, St. Croix, in the W.S. Virgin Islands.
I will address my remarks to section 18 of the Revenue Act of 1962, H.R. 10650.
Heretofore the gross estate of a decedent for estate tax purposes (sec. 2031 Internal Revenue Code) did not include real property situated outside the United States.
Section 18 of the Revenue Act of 1962 proposes to amend the Revenue Code so as to include real property situated outside the United States.
The Virgin Islands, which are a territory of the United States, will be greatly affected by section 18. It is respectfully suggested that section 18 be altered so as to exclude any change in the status of real property in the U.S. Virgin Islands.
The Virgin Islands, which are a possession of the United States, present a unique problem which should be considered separately from that relating to other "foreign real property."
Investment in the Virgin Islands does not involve any drawing of dollars from our country, does not bring about any loss of gold, and does not affect our balance of payments.
As a possession of the United States, it is important that these islands do not lag behind in their economic and cultural development.
The Virgin Islands are relatively small. They have a population of only about 31,000 people. The language, customs, and traditions, and culture are not dissimilar to those of the continental United States.
The economy of the islands is based on agriculture and tourism. Agriculture is waning and becoming progressively less significant. This is due to the lack of water supply and to the economic problems attending a manually harvested sugarcane crop. Tourism, at best, is transitory. It is affected by the vagaries of long distance transportation, by the publicity given to any political unrest and militancy in the Carribbean, and greatly affected by any adverse comments on the business outlook in the United States.
An important way for the Virgin Islands to develop is to attract, from among cruise boat tourists and other vacationers, a number of continental U.S. residents who will invest in the Virgin Islands and build there. In our favor to accomplish this is our most attractive climate and scenic beauty.
We have problems, and among our problems are—

1. Our long distance from continental United States.
2. With only 15,000 total inhabitants on an island, construction is relatively difficult and can be expensive.

3. The shipping costs and problems of distribution to a small population makes the basic cost of living high. It is said in jest, but is nevertheless a fact, that in the Virgin Islands the luxuries are cheap, while the necessities are expensive.

4. The other Caribbean Islands under British, French, and Dutch flags offer attractions and inducements to tourists and colonists.

The Virgin Islands have a limited supply of water and other resources. Efforts are made to foster industry but there is no large labor supply and no sizable local market for products.

There has been much publicity given to the Caribbean area. There is a good potential for the Virgin Islands. We have made accomplishments in getting people to the islands, but we desperately need more time to get on our feet.

Many visitors are fascinated by the attractions of the Virgin Islands. But they also weigh the risks of long-range involvement. We have to provide an incentive to induce people to invest in the land and help develop the islands.

One such incentive has been the exemption from estate tax of the investment in real property. Right now there are perhaps hundreds of people contemplating an investment in the Virgin Islands. The removal of the incentive at this time has a greater adverse psychological effect than if the advantage had never existed.

The land, particularly in St. Croix, is to a large extent in bush and in weeds.

We need people and we need investment. When people buy land in the islands and visit or move to the islands, they bring some of their capital with them. They spend money buying their food in the islands; hiring labor to build their homes. They may discover a needed business or service that is not in existence. Before long, they are contributing energy, initiative, and capital.

All this helps replace capital taken out by the Danes when we bought the islands in 1917.

And it has a multiplied effect in stimulating and building the economy from which the Virgin Islands and the U.S. Government receive their taxable income.

The cost to the U.S. Treasury of making this incentive available is relatively small. On the other hand, the continued availability of this incentive will bring to the Virgin Islands the people and investment to make the islands self-supporting; to develop living standards that will be a credit to our country; and in the long run be of significant benefit to the U.S. Treasury.

There are but about 75,000 acres involved in St. Thomas and St. Croix, some of which are Government owned. Much of the acreage is owned by developers in corporate form, and hence not affected by the estate tax.

In summary, the cost to the U.S. Government as a so-called tax haven would not be comparable to the benefits the Virgin Islands and the U.S. Government would derive by continuing unchanged the exclusion of real property in the Virgin Islands from the gross estate.

Although we feel that the public interest would be best served by excluding all real property in the Virgin Islands from the coverage of section 18, the Congress may nevertheless feel that in principle all tax

havens should be restricted. In this event, we suggest consideration of an alternative, to wit, the exclusion from the gross estate of real property in the Virgin Islands limited to $100,000 per individual.

Senator BENNETT. Do you have many individuals in the Virgin Islands who hold $100,000 worth of real estate?

Mr. LEE. Well, "many" is a relative term, but it is not unusual for people to come to the Virgin Islands to buy 2 or 3 acres of land, to build a home, and in real property——

Senator BENNETT. If we put such a limitation in, and I interpret the limitation to mean that only those that have more than $100,000 invested would find their property above $100,000 subject to the estate tax.

Mr. LEE. Yes.

Senator BENNETT. If we were to put such a provision in, how many people would we catch?

Mr. LEE. Well, you would catch anyone who was buying land in the Virgin Islands as a tax haven.

As I see it, we have 75,000 acres total; we have the Government owning 5,000 or 6,000 acres, we have in corporate form a large percentage of what is there. So in total if you have 30,000 acres worth in bulk a few hundred dollars to a few thousand dollars an acre, we do not have very much money.

The inducement is tremendous to build up the islands. Why I am thinking of the possible limitation is that it may be in mind that someone will not come down to build a home or build a nice-sized home, but will pour money into the islands as to avoid inheritance taxes.

Senator BENNETT. I have the impression from what you have been telling us that there are very few people, if any, owning more than $100,000 worth of real estate at the present time; so, to say it another way, wouldn't this provision of excluding the first $100,000 virtually exclude all real estate in private hands in the Virgin Islands today?

Mr. LEE. Yes.

Senator BENNETT. Yes, I would think that is true.

Well, thank you very much, Mr. Lee. I hope you are able to meet the time pattern that you have to meet. We appreciate this testimony. I think this is the first testimony we have had on this particular problem.

Some day I hope to get down to the Virgin Islands.

Mr. LEE. It will be our pleasure.

I might just add a sentence because of your remark about the first time it has been mentioned. We are in an anomolous position for inheritance tax purposes. We are considered as foreign real estate. In general, people feel that the Virgin Islands belong to the United States, and it is not foreign property, so it may well be that it could be missed in the overall picture, and I think it is entirely distinct and different, and certainly should be considered.

Senator BENNETT. Mr. Stam reminds me that we had another witness, whom I did not hear, who called our attention to this particular problem.

Mr. LEE. I appreciate being allowed the time to appear before the committee.

Senator BENNETT. Thank you.

Mr. Nathan McClure, the American Chamber of Commerce of Venezuela.

I will be happy to hear your testimony.

STATEMENT OF NATHAN McCLURE, TREASURER, AMERICAN CHAMBER OF COMMERCE OF VENEZUELA; ACCOMPANIED BY ROBERTS CHAPIN, CHAIRMAN, TAX COMMITTEE

Mr. McClure. My name is Nathan McClure. I am a director and treasurer of the American Chamber of Commerce of Venezuela, and my colleague is Mr. Roberts Chapin, chairman of its tax committee. We are both U.S. citizens and partners in U.S. international public accounting firms. We have both been residents of Caracas for many years.

The chamber we represent has a membership of some 300 persons, representing 100 companies, most all of which are owned in whole or part by U.S. persons and corporations; these companies employ several thousand U.S. citizens in Venezuela and a much greater number of Venezuelan citizens.

We have come all the way from Caracas to express to you the opposition of the members of our chamber to the foreign income provisions of H.R. 10650. We do this with full respect for the viewpoints of the Treasury and with appreciation of their knowledge of the subject and their dedicated zeal to explore every avenue of possible tax revenue for the good of our country. We give our testimony only to contribute, positively, in a small way, to an understanding of some of some of the realities of doing business in a foreign country, a thing on which we think we can speak with some authority.

We are in accord with those witnesses who have testified that—

(1) Foreign income of foreign companies controlled by American interests should be taxed only when brought home and at no more than at the present time;

(2) There is no need for complicated formulas to determine selling prices between controlled companies;

(3) The taxing of U.S. citizens who are bona fide foreign residents working in Venezuela is not realistic;

(4) The proposed changes are harmful to American and Venezuelan business in Venezuela; and

(5) The imposition of the proposed taxes could hurt our resident citizens in their cooperation with the Venezuelan people in trying to provide for Venezuela some of the things it needs for a decent and dignified life and which are contemplated in the Alliance for Progress.

We have prepared and desire to submit separately a memorandum containing our detailed views on these matters.

Senator Bennett. I have a copy of that supplementary memorandum and it will be included in the record at the conclusion of your testimony.

Mr. McClure. Thank you.

First, we think that the Treasury has not clearly and unequivocally demonstrated that anything has happened to cause the abandonment of our former foreign tax policies. Its arguments on the subject of balance of payments have been refuted by qualified experts. Its im-

positions on foreign service give us serious doubts as to its awareness of the problems of that field, particularly as its opinions seem to be based on less than 500 examples out of some 20,000 returns.

We testify that foreign service in Venezuela does subject our bona fide resident business citizens and companies to circumstances different and more hazardous than at home, and different even than in other foreign countries, and we think these circumstances must be carefully weighed if real equity is to be done.

Venezuelan service requires extra compensation to overcome the extremely high costs of living varying between $6,000 to $15,000 a year; more than in the United States, it necessitates learning and working in a new language; it requires learning and conformity with different economic, tax, and legal philosophies; it subjects us to different living conditions, to customs problems, to unstable moneys; to expensive and frequently uncompensated travel; and to lesser protection of our lives and property. It separates our people from the benefits of living in the United States, from their families, from voting, from participation in governmental matters, from the type of education to which we are used, and from being first-class citizens.

Foreign subsidiary corporations are exposed to different tax systems and commercial laws; to higher customs duties, to more restricting economic and social philosophies; to unstable monetary and political systems; to a lesser trained labor and technical force with different attitudes; to antagonistic social groups; to less developed communication and transportation systems; to highly nationalistic opposition; to competition with nationals of other countries having lesser taxes on their take-home profits; and to different types of markets.

Our companies in Venezuela do not receive the benefits of the United States guaranty programs which would, in some measure, but only partially, reduce the hazards of our service; hazards which have been experienced by our nationals in Cuba, for example, and to some extent by us in Venezuela in the recent quasi-devaluations of currency. To us these hazards are real; they live with us day by day. They are not to be dismissed as something that happens in novels. No profit is definitely made to a U.S. company until all of its investment and profits are free of this overpowering hazard.

Furthermore, our Venezuela-American businesses bring benefits to our country in permitting otherwise marginal volumes of production; in introducing to our people good ideas developed by Venezuelan and other foreign peoples; in broadening our appreciation of Venezuelan and other foreign cultures, in aiding the good people of Venezuela and our State Department in combating false politico-social doctrines; and in carrying out our noble concept that peace in the world depends upon a dignified life for all people.

The Treasury seems to neglect all of these hazards and benefits of foreign service.

In limiting the exemptions on personal earned income, it particularly overlooks the extremely high cost-of-living part of our compensation which is not income at all. It also neglected the peculiar employment situation in Venezuela for Americans.

Actually a tax on a North American employed in Venezuela is not a tax on the employee; it is a tax on the business that employs him.

This is because no American ever goes into Venezuela service unless he can get more "take home" pay (after taxes pay) than he can get in the United States. If you reduce the present "take home" pay by additional tax, the employer, Venezuelan or American, must make good the deficiency to keep or replace this important man. This is not the situation in the United States where the tax is equal on all incomes of the same level.

Many of these people work for companies with important Venezuelan interests. Taxing these employees, taxes our Venezuelan friends. In addition, our companies are constantly under pressure to keep salary scales for Americans at a comparable level with those for Venezuelan citizens. The increase for Americans, caused solely by U.S. tax policies, will result in a snowballing effect on Venezuelan economy, and will be used by the Communists to claim, wrongfully of course, Yankee interference.

In its arguments for increasing the tax on foreign business income by means of the gross-up system, and through the speedup of paying tax on income not yet received, the Treasury Department also overlooks some of the realities of the situation. For instance, it espouses the theory that high taxation does not retard business activities. Nothing in our long experience as accountants in preparing business budgets and planning statements would permit us to agree with this conclusion. We both know of cases where increased income taxes have caused serious reductions in expansion and development of local businesses.

The Treasury overlooks the high customs duties in countries such as Venezuela, which, to our minds are alone sufficient to justify the present foreign-tax-credit system, which results in a small reduction in the tax rate on dividends received on foreign investment.

Venezuela supports its government in great part from customs duties, and thereby reduces its income tax. But both are costs of government borne by that business unit and comparable to our income tax. If such costs were called income tax, the resultant credit would be considerably increased and the U.S. tax decreased, even under the Treasury's arithmetic. The present system at least gives some benefits for this. Furthermore, we, in our role as accountants, believe that income taxes are just as much of a cost of doing business as are import duties. Both are deducted by business planners in order to determine net return; both are included in costs when sales prices are computed. Both are costs of the same government. We think this situation has been recognized in the present tax-credit method and we think that to throw out a system that has been in existence for 40 years on the grounds that it represents poor arithmetic is somewhat strange.

Furthermore, the Treasury's method of allocating income between controlled companies will be most cumbersome in practice and is going to cause many controversies with Venezuelan tax authorities, who are also interested in allocating income.

We think also that the Treasury has overlooked the importance to our foreign trade of the tax deferral for corporate income legitimately earned outside the country, and not yet brought home. Such income, no matter what the business form or nationality of the primary owner, or where invested, is, or will be, in buildings, equipment, receivables, land, machinery, tools, etc., physically situated in foreign countries

for the benefits of such countries under the Alliance for Progress. Such things cannot be spent in the United States. Their sales price did not come out of the pockets of domestic consumers and in their present form they cannot buy food or clothing or housing in the United States. We think that the pressures of stockholder dividend requirements will be sufficient to guarantee that the foreign profits will be brought home in regular course and that there is no need of the Treasury Department to interfere with ordinary economic forces. We regard it as completely unjust to collect a 52 percent tax on profits which by local laws, devaluations, confiscations, and destructions may never be realized.

We think the Treasury has overlooked difficulties in connection with the immediate reporting of income realized from patents, copyrights, and exclusive formulas and processes and certain sales income. As accountants we know this is going to be very difficult to administer in foreign operations. The amount of a foreign-based corporation's income attributable to these things could be none or all depending on the attitude of the Treasury Agent, and consequently Venezuelan corporations, would be subjected to expensive examination by U.S. revenue agents, and possibly its officers, including Venezuelan nationals, would be brought into expensive and burdensome U.S. tax litigation.

We are particularly concerned with the effect of the bill, as a whole, on the Venezuelan economy and its unwarranted interference with Venezuelan corporate operations. We cannot help but think that it is the complete antithesis of the philosophy of the Alliance for Progress and will give the Communist party of Venezuela ammunition to claim further interference by Yankee imperialism in the internal affairs of Venezuela.

We are pleased to see that the Treasury has recognized one injustice in the House bill and that it now recommends that the provisions eliminating capital gains treatment on sales or liquidation of foreign investments should not apply to income earned prior to 1963. We think that they should go further and eliminate the whole provision.

We want to tell you, in closing, that if the Treasury Department is successful in damaging U.S. business in Venezuela, it will not only lose revenue from taxes, but it will have to spend many millions if it wants to replace the thousands of American citizens who now act as personal ambassadors of our country. Through our North-American Association, to which all our citizens automatically belong, and related organizations, we bring to Venezuela the dedicated service of those highly trained and broad-minded people. These organizations provide for educational counseling and for scholarships of Venezuelan youth to U.S. schools and colleges; for interchange of journalists between the countries to expand understanding; for training of Venezuelans in English and Americans in Spanish; for textbooks for Venezuelan schools to offset the textbooks given by the Communists; for joint cultural and sports programs; for care, clothing, and human interest of unfortunate children; for equipment for hospitals; for an independent "Peace Corps." And, we are proud to say that we raise the funds for these projects and contribute the labor for them ourselves without any drain on the U.S. Treasury.

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We think that a tax system that has produced such benefits should not be changed.

We have been asked by the American chambers of commerce in Buenos Aires, Mexico, Spain, and Okinawa and the Philippines to submit to you their concurrence in our protestations.

Our chamber has talked with many visiting Senators and Congressmen who have come to Venezuela. They have worked hard at their jobs, and they have left us with a better knowledge of Venezuela. We can testify that they were not "just on a junket."

We hope that you, too, will come and see us in person sometime, and we assure you of a warm welcome.

Senator BENNETT. Thank you very much, Mr. McClure.

You are talking to one committee whose members take no trips.

We are very proud of our chairman, who believes in economy of Government, and one of the programs that is not a part of the Finance Committee pattern is trips of any kind.

(The supplemental statement referred to is as follows:)

STATEMENT OF COMMENTS BY AMERICAN CHAMBER OF COMMERCE OF VENEZUELA SUPPLEMENTING OUR PREPARED ORAL TESTIMONY REGARDING CERTAIN OF THE FOREIGN INCOME PROVISIONS (SEC. 6, 7, 11, 12, 13, 16, AND 20) OF H.R. 10650, THE REVENUE ACT OF 1962

In the following written comments it is not our intention to attempt to cover in detail the multiple effects of the foreign income provisions of H.R. 10650 on American business and citizens abroad. Almost every possible aspect of these provisions has been covered in testimony already presented. Accordingly, our comments are limited to selected phases of the sections of the bill covered by Mr. McClure's prepared testimony, with particular emphasis on the effect of these sections on American business and citizens located in Venezuela, since we, as longtime residents of Venezuela, have an intimate knowledge of the situation in that country. Our basic approach will be to demonstrate why, many times with specific examples, the foreign income tax provisions of H.R. 10650 would, if placed into effect, have manifold inequitable results on legitimate American business operating abroad, and consequently would be a damaging blow to American trade and business in foreign countries.

SECTION 6. AMENDMENT OF SECTION 482

The proposal to incorporate in the code arbitrary rules for allocating income is, we believe, unrealistic and inequitable. The present code section 482 grants sufficient power to the Treasury to reallocate income in cases of abuse, and provides appropriate safeguards, in that the facts and circumstances of each case have to be taken into account. Accordingly, we believe that the proposed change should not be accepted.

Through the establishment of a few vague, arbitrary, and mechanical rules, it apparently is hoped to apply the same or similar bases to all taxpayers in the allocation of income. However, because of the infinite variety of situations among businesses abroad, taking into account the distinct laws of foreign governments, labor policies, risks, customs, and so forth, it is virtually impossible to lay down general rules to be applied to all taxpayers in connection with allocation of income. We believe application of the rules in this section would result in inequities and hardships and involve taxpayers in endless disputes with the Treasury, which would be costly and time consuming for all concerned.

Unfortunately, it appears that the proposed section would encourage the Treasury to allocate income in the manner which results in the most tax, regardless of whether or not the resulting allocation is reasonable or realistic in the light of all the circumstances. Moreover, the Treasury is not bound to be consistent in its treatment of all taxpayers, or even of the same taxpayer from one year to the next; and in all cases in defending his position the burden of proof would rest with the taxpayer. Such a situation would be difficult to endure; carrying on business abroad is so complex and uncertain that any substitutions of

vague, arbitrary rules for the businessman's own informed judgment would have a strong adverce effect on business abroad.

SECTION 7. DISTRIBUTIONS OF FOREIGN PERSONAL HOLDING COMPANY INCOME

This section provides for lowering the foreign personal holding company income requirement from the present 50 or 60 percent to 20 percent; we believe this would have far-reaching unfair consequences. For instance, the scope of the operations of a company engaged in an active trade or business might be reduced during a given year for reasons beyond its control; the company might well then find itself in the foreign personal holding company classification. This would mean that the U.S. shareholders would be penalized by having to pay U.S. tax on their pro rata share of the company's foreign personal holding company income, even though they have not received such income as dividends; in addition, the U.S. shareholders, officers, and directors of the company would be subject to the onerous monthly and annual reporting requirements of section 6035.

In connection with the above, we present an example of a normal situation. Suppose three American citizens and two Venezuelan citizens form a Venezuelan company, each with equal stockholdings, for production of specialized food products. As may happen frequently in Venezuela, a factory is built in an area where housing is not readily available and accordingly the company constructs housing facilities which it rents to its employees. For a number of years the company's annual gross sales are about $1,200,000 and its gross income from operations about $300,000 a year; in addition it receives rental income from its employees of about $50,000. Under these circumstances the company would not be considered a foreign personal holding company, since its rental income is less than 20 percent of its gross income. Now let us suppose that in a given year various factors such as competition, depressed conditions, or poor management result in a reduction of gross income from operations to $150,000. The company releases some of its employees, but rents some of the vacated facilities to others and its annual rental income is $45,000. The company is now clearly a foreign personal holding company. It does not have cash available to pay dividends. Accordingly, although the company is legitimately engaged in the active conduct of a business, and its foreign personal holding company income is really incidental to its business, its U.S. shareholders, officers, and directors become subject to the tax and reporting penalties mentioned at the end of the previous paragraph.

Another example of a situation damaging to an American businessman follows:

John Smith, a U.S. citizen and Jaime Gonzalez, a Venezuelan citizen, own 52 percent and 48 percent, respectively, of the capital stock of Cauchos S.A., a Venezuelan corporation, engaged in Venezuela in the business of furnishing equipment, materials, and supplies to shops which retread tires. Sixty percent of the gross income of Cauchos S.A. is derived from sales of equipment, materials, and supplies, 20 percent from the rental of equipment owned by Cauchos S.A. and leased to shops, and 20 percent from royalties for using the exclusive processes owned by Cauchos S.A. The taxable income of Cauchos S.A. is $100,000, all of which is retained to carry out a modernization program needed by the business. H.R. 10650 would, for the first time, increase the taxable income of John Smith by $20,800 (52 percent times $40,000). There are no personal holding company provisions in Venezuela's income tax law nor any income tax on either undistributed or distributed earnings. Although Smith owns the majority of Cauchos S.A. his net return from the business, by reason of his personal U.S. income tax burden would, under H.R. 10650, be inferior to Gonzalez'. For the same reason, Smith's share of the cost of modernizing Cauchos S.A. is disproportionately higher than that of Gonzalez'. Gonzalez suggests that since the income tax law of the United States precludes Smith from enjoying the benefits of majority shareholder, that Smith should now sell him 3 percent of Cauchos S.A. stock at a nominal price since ownership of these shares results in an economic liability to Smith. Smith, who does not have the cash to pay the U.S. tax, finds the argument difficult to refute and is thus forced to relinquish majority control.

Many other examples could be given which would show that manifestly unfair situations would arise.

SECTION 11. DOMESTIC CORPORATIONS RECEIVING DIVIDENDS FROM FOREIGN CORPORATIONS

The effect of the change proposed in this section is to impose a U.S. tax on dividends from Venezuelan corporations which, with the Venezuelan income tax, would equal the 52 percent U.S. income tax which would apply were the related income earned in the United States. Under the present law, and for many years, the earnings of a Venezuelan corporation owned by U.S. interests would pay a combined tax of less than 52 percent, sometimes as low as around 45 percent, when remitted home.

We believe that it is an unwarranted assumption that the laws in effect for over 40 years are based on an arithmetical error, as claimed by the Treasury. Such laws were simply based on the sound and logical concept of taxing only the profits brought back to the United States in the form of dividends. The laws were carefully designed to limit the foreign tax credit to that portion which might be considered attributable to the dividends received. Moreover, we do not understand the concept that the earnings of a foreign corporation should bear the same tax burden as those of a U.S. corporation, since a foreign corporation is not subject to the laws of the United States. In any case, foreign branches of U.S. corporations have certain tax privileges not available to foreign subsidiaries, since losses may be deducted in the income tax return of the home office and in certain cases the home office may receive the benefits of a "Western Hemisphere trade corporation."

Another reason why it is impossible to achieve equality in the tax burden of U.S.-owned foreign corporations is the difference in tax practices in various countries. For instance, in Venezuela the costs of government are met in far greater proportion than in the United States by high customs duties. In some cases these have amounted to 120 percent of the income tax. If customs duties were assessed as income taxes, the U.S. tax would be substantially reduced or in some cases eliminated by the foreign tax credit.

The Treasury argues that customs duties are indirect taxes passed on to customers and therefore different than income taxes. We contend that both are costs of government; import duties cannot always be passed on to customers; both have an effect on customers' prices; and they cannot be dismissed as of no importance to consider.

It seems to us that this section is simply another example of increasing taxation of American business abroad, with unfair effects on companies which have been organized with the present laws in mind and that it will act as a deterrent to expansion of American business abroad.

The Treasury has recommended to the Senate that the effective date of these provisions should commence on January 1, 1962, without even the 2-year grace period permitted in H.R. 10650; we believe that this would be a particularly harsh retroactive procedure.

SECTION 12. EARNED INCOME FROM SOURCES WITHOUT THE UNITED STATES

Since 1926, the tax law has provided that if a U.S. citizen is a bona fide resident of a foreign country he does not have to pay U.S. tax on his income earned outside the United States. This exemption was designed to further the foreign trade interests of the United States and for 36 years it has served its purpose well. During this period our foreign trade has expanded many times over. It has created jobs in ever-increasing numbers for U.S. citizens, both at home and abroad.

The Congress is now being asked to abandon this long-standing policy. Make no mistake about the effect of the proposal—it calls for abandonment of a principle established by deliberate action of Congress. We are not dealing with some loophole or unintended benefit which crept into the law unnoticed, nor has any evidence of widespread abuse of the policy been advanced. Why, then, is it proposed that the policy be abandoned? Is it to provide additional revenue? We have been told that the estimated revenue gains are insignificant, but we have no doubt that the impact on many individuals on career assignments abroad will be severe. Is it in the interest of some theoretical concept of tax equality? It is submitted that the present rules provide the truest kind of equality—equality among individuals living and working in the same economic and social environment. And are we not to believe that once the policy of 36 years' standing has been abandoned we shall soon have the complete elimination of the earned income exclusion? This would appear to be the logical

extension of the present proposal if credence is to be given to the tax equality theories advanced by the proponents of this measure.

In these days of the "cold war," one cannot separate the economic interest of the United States from national security considerations. The United States must maintain and increase its economic strength—to do otherwise would be to invite the further spread of totalitarian systems of government dedicated to the elimination of freedom. The administration tells us that a vigorous foreign trade is absolutely essential to our economic well-being. Would the Congress, then, be furthering the foreign trade of the United States if it enacts section 12 of the bill? We think not.

The conduct of operations abroad by American private enterprise is a vital part of our foreign trade. And, for the successful conduct of these operations it is almost always necessary to have Americans working abroad. This is so because in the labor forces of most foreign countries there do not exist the required skills in the required numbers. Furthermore, the assignment of some U.S. citizens to work in the country of investment and look after the interests of U.S. shareholders is a practical necessity.

In Venezuela, there is a serious struggle going on between the Communists and the forces of freedom, a struggle whose ultimate outcome is by no means certain at this time. We sincerely believe that the contraction or withdrawal of American private enterprise from that country would seriously weaken the strength of those who are resisting a Communist or Castro-style takeover. We also sincerely believe, and this point cannot be emphasized too strongly, that the enactment of the proposals to limit the foreign income exclusion at unrealistic levels would sooner or later make it extremely difficult, if not virtually impossible, to attract a sufficient number of qualified Americans to work in Venezuela. Some economic incentive is required to make qualified U.S. citizens leave their homes in America to work abroad. Reduce these incentives, and you will not get the employees you need. It has been said that the employer has only to raise salaries to restore the necessary incentive levels. Such a suggestion blithely ignores a host of other considerations which do not permit of such a seemingly simple solution—things like the damage done to competitive position, the principle of equal pay for equal work, and the unfavorable impact on the local economy. All of these considerations would mitigate strongly against a compensatory increase in salaries of U.S. citizens employed by American private enterprise in Venezuela.

At first glance, it would seem difficult to contend that $20,000 and $35,000 earned income exclusions are inadequate and would cause hardship to the individual working in Venezuela. Undoubtedly, to his counterpart in the United States such exclusions would appear to be a windfall. But we must take into account a number of considerations which will show that this is not the case.

The cost of living in Venezuela is extremely high. This is recognized by the U.S. Government in its cost-of-living allowances for Foreign Service personnel assigned there and in the per diem subsistence allowances for Government employees there on travel status. This cost-of-living differential must be reflected in the local salary scales. This produces inflated salary scales which are very low in purchasing power when compared to the same absolute salaries in the United States. Furthermore, the American employee working in Venezuela will usually receive special allowances to defray expenses which are incurred solely by reason of his foreign assignment. These would include such things as home leave travel and costs of sending children to the United States for education.

The limitations would affect most severely senior executives of American companies who are those most qualified to promote the expansion of American business and to develop the best interest of the United States abroad. As a result we believe the limitations would become a serious obstacle to careers in Foreign Service with private enterprise. The useful, and successful man who dedicates his working life to foreign service would, under these conditions, find that after 10 or 12 years abroad the combination of the high costs of educating his children in the United States and U.S. income tax results in a deterioration of his economic position not shared by persons of other nationalities. The effects of these limitations will mean that Americans would fill the temporary jobs and those of lower category, while companies would give preference to non-Americans for the top career jobs awarded by reason of ability and long service. As a result Americans would not be able to compete with non-Americans for these jobs, since the latter would not suffer deterioration in their economic position by reason of taxes imposed by their native country.

For the reasons mentioned, the Treasury's proposal to reduce the exemption to $20,000 in all cases would, we believe, be particularly unfair to a good number of U.S. citizens in Venezuela and we wish to voice strong protest to such a possibility. Moreover, we would like to point out that a temporary transfer back to the United States would be completely inequitable. For instance, suppose a senior employee of a U.S. company has been working abroad for many years, thus entitling him to a $35,000 exemption. He is transferred back to the United States for a special project which lasts a year or two and then he returns to a foreign country. He now receives for the next 3 years only a $20,000 exemption. Accordingly, if his income were $40,000 a year, he would have to include $20,000 in taxable income in each of these 3 years instead of the $5,000 a year he would include if he had not returned to the United States at the request of his company. This aspect would have a damaging effect on the free deployment of skilled Foreign Service personnel.

When all the foregoing factors are taken into account, the proposed ceiling on the exclusion is not only unrealistic, but represents a very drastic and adverse change in the tax position of the individual.

We believe that essentially all of the reasons mentioned above relating to limitations of exemptions apply to the proposal to tax pensions of U.S. citizens attributable to services abroad after December 31, 1962. This would have a particularly unfair effect on persons who have been foreign residents for a number of years, and have little choice but to spend their remaining working life abroad. Their plans for retirement have been based on present laws and since a good part of their pension will very likely be based on their final years of service, and since this part will be subject to U.S. tax, they may have to revamp completely their retirement plans. We admit freely that the previous exemption of pensions from tax was an incentive to having U.S. citizens work abroad. We believe this incentive should be continued.

SECTION 13. CONTROLLED FOREIGN CORPORATIONS

We can hardly imagine any measure which would be more harmful to American business interests in Venezuela than the maze of complicated rules in section 13 which would result in U.S. taxation of American shareholders of foreign corporations controlled by American interests on a substantial portion of their prorata share of such corporations' earnings, even though they may have not received such earnings in the form of dividends. The complications alone are so great that many otherwise potential investors would tend to refrain from making investments in Venezuela, and many existing investors would withdraw at the earliest opportunity. Moreover, the penalties are so great that American companies would not be able to compete on an equal basis with local investors or investors from other foreign countries. We set forth below a number of specific objections:

The most aggravating feature of section 13 is that it would tax income before it is received as dividends in the United States. Such a concept is contrary to any reasonable taxation principle. This concept is particularly harmful to businesses operating in a country like Venezuela where the risks of operation are well known. We have recently had the example of confiscation in Cuba. In Venezuela and many other countries, it is not at all unlikely that paper profits could disappear because of currency devaluation, expropriation, or other factors. In fact, just last month Venezuela had a "de facto" devaluation. To require an American stockholder to pay taxes on paper profits which for any of a number of reasons he may never receive is not only completely unjust, but will strongly discourage any expansion of American business abroad.

In Venezuela the Code of Commerce requires that legal reserves be created from earnings and the labor law requires substantial payments upon termination of services, for which provisions are made from year to year. We assume that neither of these provisions would be deductible in arriving at the U.S. stockholders' prorata share of the undistributed income subject to U.S. tax under certain circumstances. In these cases, since the amount available for dividends would be reduced by these reserves, the U.S. stockholders would be required to pay tax on amounts they could not legally receive, even though it is the policy of the company to distribute 100 percent of its earnings available for dividends.

Article 15 of the charter of the Organization of the American States, signed on April 30, 1958, at Bogotá, reads as follows:

"No state or group of states has the right to intervene, directly or indirectly, for any reason whatever, in the internal or external affairs of any other state. The foregoing principle prohibits not only armed force but also any other form of interference or attempted threat against the personality of the state or against its political, economic, and cultural elements."

Whether section 13 is a violation of the above article is not clear to us, but we have the opinion of an international tax lawyer that that article could be invoked against the application of the proposed measures against controlled foreign corporations organized and operating wholly within other members of the OAS. In any case, section 13 clearly appears to violate the spirit of the OAS charter.

It is fairly common practice for American investors to join forces with Venezuelan investors by formation of a Venezuelan company to carry out an active trade or business, with control resting with the American investors. Some countries require a minimum interest by nationals, and there is indication that Venezuela might do likewise. In any case joint ownership is a very effective way to promote the mutual interest of the United States and Venezuela. The terms of section 13 would frequently create a clash of interests between the two groups of investors, since the American investors would probably wish to receive the earnings in dividends currently in order to have funds to meet the U.S. tax on their prorata share of such earnings, while the Venezuelan investors might wish to have the corporation retain its earnings for future expansion. Should circumstances not be appropriate for immediate investment in a business or trade, it might be desired to invest any excess funds in marketable securities. This would presumably not be "qualified property" and accordingly the U.S. stockholders would be subject to U.S. tax on their share of accumulated earnings.

It would be perfectly normal for a Venezuelan corporation to wish to invest its earnings in any of a wide number of outlets. It may be that a particular Venezuelan corporation, controlled by U.S. interests, but with Venezuelan shareholders, would like to invest its earnings in a new business in a developed country. If it were to do this the U.S. stockholders would be subject to tax on their share of the increase in accumulated earnings. This would frequently mean that dividends would have to be declared in order for the U.S. shareholders to meet their tax obligation. As a result, the corporation cannot develop along normal lines.

At its present state of development the industrialization of Venezuela contemplates the creation of industries destined to serve the Venezuelan market. Venezuela has a population of approximately 7,500,000 and its present income level imposes restrictions as to the size, organization and capitalization appropriate to the type of industry which can successfully be carried on. The contribution of the U.S. businessman in the form of capital, technical knowledge, patents, when translated into the type of enterprise adequate for purposes in Venezuela usually requires a business organization in which it is impracticable to divide licensing from processing and distribution functions. Any tax burden upon the U.S. shareholder by reason of the licensing or use of patents, copyrights, exclusive formulas and processes is a burden which bears heavily upon the success of the whole business within Venezuela and also upon its competitive position vis-a-vis competitors from other countries. An example follows:

H.R. 10650 would have to be applied under measures taken by the Venezuelan Government with respect to the automobile industry. The Venezuelan Government has established a regime which will preclude the importation of assembled automobiles beginning January 1, 1963. Thereafter all automobiles must be assembled in Venezuela, partially from parts manufactured abroad and partially from parts manufactured in Venezuela. The Government's controls will require using through coming years an increasing percentage of parts manufactured within Venezuela. Parts manufactured within Venezuela by a controlled foreign corporation using a U.S. patent, copyright or exclusive process would, under H.R. 10650, create income taxable to the U.S. shareholder at the latter's effective tax rate, whether received in dividends or not. The same parts manufactured by an uncontrolled foreign company generating the same amount of profit would not be taxable in the United States and would be taxable only at substantially inferior Venezuelan rates. The inability of the U.S. shareholder to defer taxation would create an added burden on the business venture and may well result, for various reasons, in making it impossible for his Venezuelan company to compete with an uncontrolled foreign company.

This could result in giving valuable parts supply contracts to non-U.S. businessmen.

Section 13 of H.R. 10650 places suppliers of equipment from the United States to Caribbean customers in an inferior competitive position to that enjoyed by the suppliers in Europe or other countries. For example, suppliers of equipment to the oil production and refining industry located in Venezuela, Colombia, Trinidad, and the Dutch West Indies, for reasons of economy and competitive position, usually find it desirable to incorporate in a single country and do not do so in other nearby countries, although they maintain sales organizations in those countries. The proposed legislation would not affect sales made in the country of incorporation but would attribute sales income to the shareholders derived from sales made in neighboring countries, making same taxable to them at their effective U.S. tax rates under certain circumstances. The cost of creating and maintaining multiple corporations is substantial; accordingly the U.S. suppliers would in certain circumstances either have to incur substantial costs for additional taxes or for additional corporations, both adversely affecting their competitive position. European suppliers would not incur the same penalty.

One of the concepts of section 13 is to impose taxation under certain conditions on U.S. stockholders of foreign corporations which receive so-called passive income. Practically all forms of rentals of property are included under this concept. There are a number of corporations operating in Venezuela and carrying out a legitimate business which, for one reason or another, receive a substantial part of their income in the form of rentals. Such companies include oil service companies which rent equipment to the oil companies here. They have to import the equipment, store it, make arrangements for leasing the equipment, ship it to where it is needed, service it, and sometimes operate it. In another case a substantial part of a company's income here is for the rental of bookkeeping machines. Such company requires the same type of organization that would be needed if it sold the machines to its customers. In neither of the foregoing cases can the rental income logically be considered passive income. Yet section 13 makes no distinction between rentals which are truly passive income and those which are not. Consequently the income of such companies will be subject to the tax requirements of section 13 relating to passive income without any really logical reason.

The effect of section 13 on controlled foreign corporations operating in Venezuela is aggravated over that in many other foreign countries since Venezuelan income tax rates are quite a bit less than those in the United States, except for fairly high incomes. As a result, the foreign tax credit is considerably less than for many other countries. Actually, the Venezuelan income tax rate is not high, because there are substantial other direct taxes, particularly high import duties, so that effectively the total taxes paid in Venezuela may be as high as in other countries, but a smaller portion of such taxes is available for foreign tax credit. The Venezuelan income tax is progressive; examples of effective rates on businesses follow:

	Percent
$300,000	24
$800,000	28
$1,400,000	30
$2,200,000	34

Very few businesses in Venezuela earn over $2,200,000 in 1 year.

One of the Treasury Department's arguments in favor of section 13 is that it will eliminate tax evasion. We believe that the great majority of American businesses operating in Venezuela are legitimate active organizations which have not been formed to evade taxes. Section 13 will penalize the U.S. owners of such businesses in order to reach a very few corporations involved in artificial arrangements to avoid or defer taxation. We believe legislation is not necessary to correct any abuses in the use of foreign corporations. Section 482 provides statutory authority and section 6038 provides the means of obtaining information required.

SECTION 16. GAIN FROM CERTAIN SALES OR EXCHANGES OF STOCK IN CERTAIN FOREIGN CORPORATIONS

The proposal to tax as ordinary income (rather than as capital gains) profits on certain disposals of stock in certain foreign corporations is clearly discriminatory against certain investors and inflicts a hardship upon them as contrasted with investors in U.S. companies. It is particularly unjust because there is no provision to permit deduction of capital losses arising from sale of stock in a foreign company from ordinary income, even though such income also arose from sale of stock in a foreign company. As a result, in many cases tax would be assessed on nonexistent income. This proposed section violates a basic foundation of our tax structure, in that it deliberately and artificially discriminates against a particular class of taxpayer, and for this reason it is unjust and should be eliminated. As an absolute minimum the bill should provide that losses on foreign investments receive the same treatment as gains; that is, that they be deductible from income subject to ordinary tax rates.

SECTION 20. INFORMATION WITH RESPECT TO CERTAIN FOREIGN ENTITIES

The proposed reporting requirements in the bill, when added to the burdensome requirements presently in effect, would be costly and difficult or impossible to comply with. They are discriminatory, in that they would demand much more information to be submitted by investors in foreign countries than by those who invest in the United States. If enacted, the effect of these requirements would be to discourage investment abroad, particularly by small-and medium-sized investors.

The following proposed additional requirements are particularly objectionable:

(*a*) Under the bill, reports are required with respect to an entire chain of foreign subsidiaries and sub-subsidiaries (while the present requirements stop at the second level of corporate ownership) and the range of transactions to be reported is increased.

(*b*) Reports are to be required from individuals, domestic partnerships, estates, and trusts owning shares in foreign companies (in addition to those presently required from corporate stockholders).

Our objections to the foregoing are based on the great cost and difficulty which will be involved in obtaining and assembling the required data.

It must be realized that in practice the management of "controlled corporations" further down the chain of ownership is often very different from that of the U.S. parent company. Particularly in the case of investments by individuals, estates, and trusts, in many cases there simply does not exist an organization to gather the data, nor to enforce keeping the additional records which would be required, and the cost of setting up such an organization would be prohibitive in relation to the size of the investments.

Accordingly, in many cases obtaining accurate information would be virtually impossible, and to attempt to obtain it would impair relations with the management, stockholders, and governments in the foreign countries.

(Discussion off the record.)

Senator BENNETT. Thank you very much.

Now, Mr. Richard P. Butrick of the American Chamber of Commerce of Brazil.

STATEMENT OF RICHARD P. BUTRICK, ON BEHALF OF AMERICAN CHAMBER OF COMMERCE OF BRAZIL, SÃO PAULO

Mr. BUTRICK. Mr. Chairman, I am Richard P. Butrick, a former career minister in the American Foreign Service, now retired.

I have served in many parts of the world, as diverse as Iceland and the Philippines, and my last post was in São Paulo, Brazil. I have thoroughout my career had great admiration for the American communities abroad, and I think nowhere will we find a better or more responsive community than in São Paulo.

These Americans in the São Paulo area were giving technical assistance long before point 4. They were also engaged in the people-to-people program long before that name became popular, and they were also members of a "peace corps" before that became a formalized organization.

Senator BENNETT. May I ask, Is the Chamber of Commerce of Brazil located in São Paulo?

Mr. BUTRICK. There are two chambers of commerce in Brazil, both with the same name, but each having the name of the city after it.

There is the American Chamber of Commerce for Brazil, São Paulo, which I represent, and the other, the American Chamber of Commerce for Brazil, Rio de Janeiro, which Mr. Nave represents.

The American chamber in São Paulo has about 1,700 members, corporate and individual. It is a large organization, a very earnest one. It works very hard for American interests in that area.

I would like to say that, apart from the official and semiofficial American representatives in that area, these private citizens, American citizens, not only earn their income abroad, but that income is produced entirely abroad, which, it seems to me, is a factor that should be considered in this connection.

In other words, their income has no connection whatsoever with the United States.

I should also like to remark that I checked with the Brazilian Embassy yesterday, and Brazilian private citizens in the United States earning their income here are not subject to Brazilian income tax.

Senator BENNETT. Are you subject to Brazilian income tax?

Mr. BUTRICK. As an official, I was not subject to Brazilian income tax, but I did pay American income tax.

Senator BENNETT. And now as a private citizen?

Mr. BUTRICK. I am living here in Washington.

Senator BENNETT. Oh, you are living in Washington?

Mr. BUTRICK. Yes, and subject to the District tax as well as the Federal tax.

Now I will proceed with the statement.

Senator BENNETT. Fine.

Mr. BUTRICK. This chamber, which has registered opposition to the tax bill providing for taxation of earned income of American citizens residing abroad, as per letter addressed to the Honorable Harry Flood Byrd, chairman of the Senate Finance Committee, on June 2, 1961, this being a letter similar to the one addressed to the chairman of the Ways and Means Committee of the House of Representatives, duly recorded in the hearings before said committee, page 3510, still holds the strongest possible opposition to the passage of any tax bill providing for taxation of earned income of American citizens bona fide residents abroad.

And I may add that the chamber addresses itself only to this problem.

Apart from the objections already stated in the letter above mentioned, copy of which is attached, this chamber wishes, in addition, to emphasize the points hereunder, further to strengthen the objections brought out in the letter above mentioned, which involve costs and problems of living abroad.

(1) U.S. citizens legally resident abroad are disenfranchised, but under the new proposed law would be subject to tax. This, then, is taxation without representation.

(2) A citizen resident abroad enjoys little, if any, of the benefits of American Government services.

(3) He is an ambassador without pay that the Government cannot replace except at great expense.

(4) Expenses abroad not covered by companies are high—medical, housing, cars, et cetera, in comparison to the United States of America. Also "hidden" taxes not known in the United States are numerous and add to the general cost. The cost of an "American way of life" abroad is very high, indeed, and many items in it, such as advanced medical care and higher education for children are unobtainable without an expensive trip to the United States. The tax differential thus is cut considerably.

(5) The difference between income taxed and not taxed largely goes into increasing savings in the United States banks where it is available for investments and development purposes, or into the local economy where it has a directly stimulating effect not often achieved by government-to-government loans or grants. The projected new U.S. taxes would seriously reduce these obvious benefits to the economy. The tax differential acts as an incentive for capable Americans to go abroad for business.

(6) Business brings in technical assistance and know-how, benefiting the host country, without the onus that sometimes attaches itself to government assistance. Reduced incentive would certainly result in reduced interest by business. U.S. Government objectives abroad can be attained more easily and efficiently and at less cost by enlisting the aid of responsible U.S. business through creating new and better incentives, not additional burdens.

(7) Taxing American incomes earned abroad will not result in appreciable income to the U.S. Treasury. If they were taxed, foreign countries could raise their own rates on foreigners to the U.S. level, since the incentive differential would be removed, anyway.

(8) Encouraging Americans to work abroad brings American techniques to the countries and tends to help orientate the people of the country toward the United States both in times of war and cold war.

(9) Americans in general are not prone to going abroad to live unless the financial advantages are very worthwhile. These advantages have been primarily extra compensation with no U.S. tax on earned income. The U.S. income tax on part or all of an individual's earned income abroad will definitely be a hardship in many cases and will certainly destroy one of the attractions of living abroad.

(10) A lot of claims have been made in regard to the amount of tax that will actually be collected by the U.S. Government. There are no statistics available, but the consensus is that the annual return of the U.S. Government would be considerably smaller than anticipated, particularly as many Americans will no longer remain and some will be forced to relinquish their citizenship.

(11) At least 20 Americans in this area are independent businessmen who will suffer definite hardships should this tax be applied.

(12) Other countries will claim, and already are claiming, for example, Panama, and I also understand Switzerland, invasion of

sovereignty and rightly so. The tax on companies and individuals resident abroad can be interpreted as interference with other nations' rights.

(13) Approximately 6,000 people in the São Paulo area, U.S. residents, including all members of families, would be affected directly or indirectly if such legislation were to come into effect.

(14) We are told that the success of "Alliance for Progress" depends heavily on private enterprise operating abroad. Taxing earned income will force return of many Americans from abroad and therefore be detrimental to the "Alliance for Progress" program.

Thank you, Mr. Chairman.

Senator BENNETT. Attached to this is the letter that was addressed on June 2 to the chairman, which will also be made a part of the record.

(The letter referred to is as follows:)

AMERICAN CHAMBER OF COMMERCE FOR BRAZIL,
São Paulo, June 2, 1961.

HON. HARRY FLOOD BYRD,
Chairman, Senate Finance Committee,
U.S. Senate, Washington, D.C.

DEAR SIR: The American Chamber of Commerce for Brazil in São Paulo, which represents an overwhelming majority (almost 100 percent) of American industrial, commercial, and financial investment in this area of Brazil, has as its objective the constant improvement of social, cultural, and commercial relations between the United States of America and Brazil, and contributes in a large measure to the growth and progress of this great South American nation. With this objective in mind, it wishes to take this opportunity to register, on behalf of its members, the strongest possible opposition to the passage of the tax bill providing for taxation of earned income of American citizens resident abroad as proposed by the Honorable Albert Gore, Senator from the State of Tennessee.

American business operating abroad has expended a tremendous amount of time, effort, and money to educate and train foreign nationals, so that these people would be qualified to fill positions of responsibility in these American organizations.

This overall effort has met with considerable success, but it does not, and never will, eliminate the necessity for qualified American executives, operating, and technical personnel.

Therefore, the passage of this bill will have an immeasurable adverse effect on the operations of all legitimate U.S. business abroad. The ever-growing community which this chamber represents finds a constantly increasing need for competent and technically qualified individuals for administrative, productive, and financial operations.

To place the burden of U.S. Federal income tax, either in part or in its entirety, on a family living abroad will provide the Federal Government with relatively little in the way of revenue, but it will destroy a major incentive for U.S. citizens to live abroad. Those people now living overseas will find that the financial attraction that they did have no longer exists, and they will eventually return to the United States of America. Recruiting new or additional personnel of the type and quality needed without a very definite financial advantage over employment in the United States of America will become impossible. Therefore, without some incentive for U.S. citizens to go and stay abroad to occupy essential posts, there will be less interest on the part of U.S. investors in going into new foreign ventures, and it is most probable that the income from existing investments would diminish substantially because of lack of U.S. supervision.

No words need be wasted nor historical references recalled to emphasize to American lawmakers that taxation without representation is, and has always been, un-American.

A tax upon permanently situated foreign-resident Americans is taxation without representation, because these citizens are not only unable to vote in their native land, but are required to do without most of the material advantages of American citizenship. Thave no direct recourse to representative lawmakers of their own choosing and all live without most of the amenities which are the privileges of Americans within the borders of the United States of America.

To the best of this chamber's knowledge no nationals of other countries who are resident abroad are taxed on their earned or unearned income derived from sources outside their homeland. Therefore, the U.S. citizen employed overseas would be placed at a distinct disadvantage compared to other foreigners residing abroad.

There are many instances of U.S. citizens living abroad and operating businesses of an entirely domestic nature with no connection with U.S. firms or corporations, who, nevertheless, have a definite pride in their U.S. citizenship. These and many others would be forced, by legislation over which they have no control, to consider seriously giving up their citizenship. This, then, might be called the price of patriotism.

While recognizing the important contribution made by the U.S. Government through foreign aid and technical cooperation programs, publications, etc., toward the furthering of good relations with foreign nationals, it is generally accepted that the most effective means to that end are through the personal contact of American firms, individual employees, and their families established abroad, our most effective unofficial ambassadors.

This contribution to good relations would be seriously impaired by the discouragement to foreign service resulting from the added onus which would be created in connection with the taxation of all income earned abroad by nonresident citizens. In consequence, to maintain the same degree of good will in foreign countries the U.S. Government would have to increase very considerably the amounts allocated to foreign aid and propaganda programs and, even if this were done, it would be impossible to achieve the same results.

It is this chamber's opinion that the proposed legislation can be considered a reversal of a definite trend in the foreign policy of the United States and to be absolutely contrary to its best interests.

Therefore, this chamber, while being in full sympathy with the U.S. Government's desire to protect its fiscal and balance-of-payments position, earnestly requests that the foregoing objections be given full consideration by your committee.

Respectfully yours,

HOWARD I. MASON, *President.*

Senator BENNETT. Thank you very much, Mr. Butrick.

Mr. Nave?

Do the Americans of Rio de Janeiro speak to the Americans of São Paulo?

STATEMENT OF CYRIL W. NAVE, ON BEHALF OF THE AMERICAN CHAMBER OF COMMERCE FOR BRAZIL OF RIO DE JANEIRO

Mr. NAVE. Yes, Mr. Chairman. We are very friendly. We get along quite well together. Even before I identified myself, I believe the good book says the last shall be first. Even though my chamber is the low one on the totem pole, I still insist that our chamber in point of age south of the Equator, in point of importance and quality, is first.

I just have to insist upon that.

I shall now identify myself. My name is Cyril W. Nave. After 36 years abroad, I retired as vice president and general manager of Atlantic Refining Co. of Brazil. On behalf of the American Chamber of Commerce for Brazil, of which I was a director for almost 20 years, and now an honorary life member, I am presenting its prepared statement in respect to taxation of earned income from sources outside the United States by bona fide nonresident U.S. citizens; it is requested this statement be included for the record.

Senator BENNETT. May I ask you, are you currently living in the United States?

Mr. NAVE. Yes, I am living in the United States.

Now, I would like to take just a moment to explain the question you asked Mr. Butrick.

The American Chamber of Commerce for Brazil was so named in Rio because at that time it never could have been foreseen that São Paulo would become such an important city. Therefore, when the U.S. businessmen organized this, they thought they would call it the American Chamber of Commerce for Brazil, covering all Brazil.

Then, as São Paulo commenced to grow years later, it was recognized that they must have a chamber of commerce, and in order that there would be no difference between the two, it was decided to give the São Paulo chamber the same name. I hope that explains that.

Senator BENNETT. Does that fool the Brazilians?

Mr. NAVE. No, Mr. Chairman, I would not say we attempt to fool the Brazilians. They are pretty clever.

Senator BENNETT. It only fools the members of the Finance Committee.

Mr. NAVE. Due to the limited time at our disposition, I shall briefly summarize and support this statement.

Firstly, my chamber opposes the alteration of section 911(a)(1) of the Internal Revenue Code to establish a ceiling upon the portion of earned income by a bona fide nonresident U.S. citizen to be excluded from the U.S. income tax. It is convinced this alteration would bring about higher operating costs for U.S. companies abroad and thereby render them less competitive, or, as an alternative, oblige said companies to employ the services of nationals from those countries which grant tax exemption incentives, and/or retreat to lower quality of U.S. managerial talent abroad. To attempt to offset this exclusion with some form of supplemental compensation would adversely affect the ability of the U.S. employer abroad to maintain local salary standards and integrate the U.S. citizens into the local scene. In those countries where nationalism is so rife, this would create a serious problem.

Secondly, under section 72(f) contributions which employers make toward employees' pensions based upon foreign employment are not taxable to employees when received. H.R. 10650 would eliminate this exemption, alleging it creates discrimination against the employee of the same employer who remains in the United States and is fully taxable on contributions made by the employer. My chamber is convinced there is no such discrimination because the employee who goes abroad forfeits all the benefits of the U.S. high standards of living; upon returning to retire he suffers profound problems of relocation, readjustment, and reintegration into the U.S. community life.

I have just gone through that, Mr. Chairman, and I can tell you that I had to dispose of my home in Rio. I could not possibly relocate within 1 year. I had to pay the capital gains on the sale of my house in Rio as I could not possibly relocate within a year.

Therefore, I got no credit, even though I bought a higher priced house here in the United States, and the financial cost of relocating is nothing as compared to what I will call the emotional adjustment.

It is just not easy after 36 years away from home to come back here and find a place to park for the rest of your life. It is a very tough problem.

Senator BENNETT. I am sure it is.

Mr. NAVE. Furthermore, my chamber finds this proposal in direct conflict with the other proposal in H.R. 10650 which would permit income exclusions of US$20,000 and US$35,000. An employer's contributions to a pension fund for a bona fide oversea employee are, irrespective of the time of payment, a form of compensation for services rendered abroad. If the tax on salary is to be exempted to the extent of the proposed exclusion ceilings, then, logically, the same tax exemption should apply to the smaller pension payments.

Thirdly, sections 2301, etc. of the Internal Revenue Code. Presently real estate situated outside the United States is excluded from the gross estate and therefore exempt from the estate tax. Apparently there have been abuses of this law by citizens residing in the United States. The President has recommended the elimination of this exemption. My chamber feels a few abuses hardly justify destroying the purpose of the law completely. Instead, correct the abuses. Bona fide nonresident U.S. citizens who purchase their homes abroad, who receive no protection whatever from U.S. laws and who in many instances continue to reside in said homes upon retirement, should not be prejudiced merely because of abuses created by U.S. residents.

I would like now to perhaps clarify and fortify my chamber's views from my own long experience in foreign countries. When I went abroad in 1921, one of my first surprises was the large number of Britishers and other European nationals heading and/or staffing our U.S. companies.

As a matter of fact, Mr. Chairman, my own first boss was an Anglo-Uruguayan. Back in those days, when I would travel from Rio south to the Argentine border and north to the Amazon Valley, I would get into Porto Alegre, Curityba, Bahia, Pernambuco, Forta Leza, Maranho, and Para, I would seldom find any Americans. In Porto Alegre, I believe there were four at the time. Curityba, there were none. Bahia, I think we had four or five there, and three or four in Pernambuco.

But a lot of young Britishers were there after the war, a lot of young Germans, they had their clubs already, a lot of young Italians, Frenchmen, they were there. That has all been changed subsequently.

I recall clearly a new president of the then National City Bank of New York, upon assuming his new duties and learning of the large number of non-Americans staffing his bank's foreign branches declared, "If I cannot find enough good Americans to staff our branches abroad, I will close them." And he set out very vigorously to do that, and he did it.

To encourage more and higher grade Americans to come abroad, our chamber in Rio in 1924 launched its first efforts before the U.S. Congress to gain this tax exemption on earned income abroad. The Congress granted this exemption in 1926.

With this incentive or stimulus, it soon became easier to recruit higher grade U.S. citizens for our foreign posts. I can tell you, Mr. Chairman, that since that date not only have we got more and better Americans, but we have been able to set up cultural institutes from Porto Alegre, on the south in Rio Grande do Sul, north to the Amazon Valley.

I believe today we have something like 62 Brazilian-American cultural institutes in Brazil. Almost every one is sparkplugged by Americans. That means that you have rather substantial nuclei of U.S. citizens' colonies in every one of those cities today.

I call to your attention it was under this legislative tolerance, from 1926 to the present day, that the United States has built up its formidable foreign trade empire, an empire which brings back billions of dollars annually from exports and in the form of interest, royalties, and dividends on our foreign investments.

If, in the wisdom of the Congress in 1926, it was desirable to grant this tax exemption as an incentive to foreign trade, is it not far more important today to preserve intact this dynamic U.S. manpower propellant of our growing foreign trade empire? Certainly we have urgent need of more and more dollars to meet our mounting requirements in the world struggle for the survival of our freedom. Not one dollar returns to the United States until we sell something abroad or render a service abroad. The proposals in H.R. 10650, discussed above, are the equivalent of an across-the-board salary cut to those thousands of U.S. citizens abroad carrying on our foreign trade.

That is a pretty serious action, Mr. Chairman.

I recall in 1932 I had to endure an across-the-board salary reduction on my whole staff in Brazil, and I have never had anything to devastate morale like that across-the-board salary cut, and I would hate to see this happen to our foreign trade.

If the U.S. Government aims in combating worldwide communism and the objectives of President Kennedy's Alliance for Progress are to be advanced through the participation of U.S. enterprise abroad, should we risk jeopardizing the high morale of our U.S. business people abroad, one of our first lines of defense abroad, for an uncertain and very, very modest amount of additional tax dollars to be brought into the U.S. Treasury?

My chamber is convinced we do not.

Furthermore, Mr. Chairman, if this legislative tolerance, this incentive to foreign trade, of almost 36 years standing is once breached, will not every future candidate for a foreign trade career take a hard look at such action?

My chamber is convinced said candidates will fear it is not firmly established Government policy to provide incentives for foreign trade, and many will, therefore, elect to abandon a career abroad. Hence, my chamber cannot support this proposal.

Thank you.

Senator BENNETT. We also have a letter from the chamber from Rio signed by R. C. Fallon.

Mr. NAVE. Yes.

Senator BENNETT. And that will be included in the record.

(The letter referred to is as follows:)

AMERICAN CHAMBER OF COMMERCE FOR BRAZIL,
Rio de Janeiro, Brazil.

HON. HARRY FLOOD BYRD,
Chairman, Finance Committee,
U.S. Senate, Washington, D.C.

SIR: The American Chamber of Commerce for Brazil, Rio de Janeiro, has been most interested in income tax legislation proposed during the past year in the Senate and House of Representatives, particularly:

(*a*) The Gore bill, S. 983, introduced in the Senate for the purpose of repealing section 911 of the Internal Revenue Code which grants exemption on earned income derived from sources outside the United States;

(*b*) The proposed tax reforms of President Kennedy in 1961 which likewise included elimination of the exemption in favor of bona fide nonresident U.S. citizens under section 911(a)(1) of the code, as well as modification of section 72(f) regarding employer contributions to pension plans of oversea employees; and finally

(*c*) H.R. 10650, or the revenue bill of 1962, which has recently been passed by the House and sent to the Senate and wherein, among other matters, there are incorporated in modified form the abovementioned changes in the code, together with repeal of code sections 2031, etc., which exclude from the gross estate of a deceased U.S. citizen real estate situated outside of the United States.

Section 911.—It is difficult for our chamber to understand the reasons for the proposed amendment of this section. The motives which convinced Congress in 1926 of the desirability of tax exemption on earned income from sources without the United States of bona fide U.S. citizens, residents of foreign countries, are much stronger today than they were at that time. Congress recognized the benefits of protecting American businessmen abroad. During these critical times all over the world it would seem that our Government would have to rely more heavily than ever on the strength of U.S. business overseas, and in doing so continue to fully recognize and support the principles which prompted it to grant the exemption in the first place.

In order to soften the initial effect on the foreign-based taxpayer, the proposed reform would permit a certain portion of his income to be excluded from taxation (US$20,000 for the first 3 years that he is abroad and US$35,000 thereafter). Nevertheless, the settled rule of full tax exemption would be broken and an initial legislative wedge driven to facilitate the gradual reduction and eventual elimination of such ceilings in subsequent years.

The revenue effect of H.R. 10650 has been estimated in various tables on pages 5, 6, and 7 of the report (No. 1447) of the Ways and Means Committee of the House. These estimates, as given by the Treasury Department and the Joint Committee on Internal Revenue Taxation, show a range of increase in new revenue for the Government from US$5 million for the fiscal year 1963 to US$25 million or US$30 million after all the changes provided for under the bill have had an opportunity to become fully operative. All miscellaneous items relating to taxation of foreign income are grouped together in the tables, and there is consequently on breakdown to indicate what percentage of the total revenue increase would be attributable to the changes to be introduced in section 911. But whatever the percentage of the estimated gain might be, the tax benefit would apparently be minimal and grossly insufficient to justify the sacrificing of a deep-routed tax concept which has served so well as a basis for promoting the interests of the U.S. Government and U.S. business abroad.

U.S. citizens working overseas do not derive and are not in a position to receive the same benefits from Government services as do those at home. Even by establishing the proposed earned income exclusion ceilings, inequities would nevertheless result in view of the wide range of costs of living in foreign countries; and even if compensation should be supplemented with cost of living allowances, the inequities would not be corrected unless the living cost differential were exempted as in the case of U.S. Government employees working abroad.

Further, the granting of supplemental cost of living allowances would adversely affect the ability of the U.S. employer abroad to maintain local salary standards and controls and otherwise integrate U.S. citizens into the local scene, which factor is of prime importance today where nationalism in Latin America and other parts of the world is so rife.

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In Brazil, Venezuela and many other South American countries, labor laws provide that in case of termination of service of an employee the employer is required to make a termination or severance payment in a lump sum based on length of service. The establishment of an income exclusion ceiling would work a considerable tax injustice to U.S. citizens involved in every case where the termination payment placed them over the ceiling in one year, irrespective of the fact that such payment might have been earned over a long period of years.

Section 72(f).—Under this section, as it presently reads, the contributions which employers make toward employees' pensions based on foreign employment are not taxable to the employees when received. This would no longer be the rule under H.R. 10650. Hereafter such employees, upon retirement, would find themselves obliged to pay income tax to the extent of the employer's contributions to their pensions. Such a position is not only unjust but likewise in direct conflict with the reasoning which has apparently been applied by the drafters of H.R. 10650 in allowing for the income exclusion of US$20,000 and US$35,000 under section 911. An employer's contributions to a pension or annuity fund for a bona fide oversea employee are, irrespective of the time of payment, merely a form of compensation for services rendered during his period of employment abroad. If the tax on the services rendered is to be exempted, to the extent of the proposed exclusion ceilings, then under what justifiable theory should the smaller pension or annuity payments, for retirement at the close of the employee's useful years, be taxed?

In the Ways and Means Committee's Report (No. 1447) accompanying H.R. 10650 there is pointed out on pages 54 and 55 that under present law employer contributions toward the pension fund of a bona fide nonresident employee are treated in the same manner as his own contribution and therefore not taxable to him when he draws his pension or annuity on retirement. This is true, states the report, "even though he may be living in the United States next to someone who has worked for the same employer in the United States and is fully taxable on contributions made by the same employer. *To remove this discrimination* the bill provides that contributions by an employer will * * * be fully taxable to the employee when he receives the pension payments reflecting these contributions." (Emphasis added.)

This chamber is firmly convinced that no such discrimination exists. It is obvious that Foreign Service employees retiring in the United States are subject to problems of relocation and reintegration into community life in the United States. The employee in the United States has had, on the other hand, a lifetime to establish himself as a member of the community; there are no problems of purchasing a home, making new friends, readjusting oneself and all that goes with relocation. The domestic employee with long-term financing has been able to prepare himself for retirement in a most natural manner. The person who has worked abroad all his life is at an obvious disadvantage and should equitably be entitled to a tax-free return on employer pension or annuity payments at a time in life when readjustment is more difficult.

Should section 72(f) be amended according to the terms of the bill, then a complete revision and change of pension plans for oversea personnel must be adopted by all companies maintaining such programs, with the result that the cost of American business operating abroad will be proportionally increased.

Section 2031, etc.—The Ways and Means Committee report referred to above states:

"Under present law real estate situated outside of the United States is excluded from the gross estate and therefore exempt from the estate tax. This is an exception to the general rule that the gross estate of decedents who are citizens or residents of the United States include their entire property wherever situated. The exclusion of real property located outside of the United States from the estate tax base has been specifically provided for in the code since 1934 * * * The President in his tax program recommended that this exemption be eliminated on the grounds that in recent years this has been a subject of abuse. It was stated that primarily because of this tax advantage, U.S. citizens and *residents* have been induced to make investments in foreign real estate in countries with either no or very low estate or inheritance tax rates." (Emphasis added.)

No figures appear in the Ways and Means Committee report as to what the abuse amounts to in loss of revenue to the Treasury. We can only surmise that it is relatively inconsequential; otherwise statistics would have been furnished.

If U.S. citizens residing in the United States are making a business out of foreign real-estate investments, such practice, if considered abusive, could be

cured easily by modifying section 2031, etc., to such effect. There is no reason, however, to destroy the purpose of sections 2031, etc., completely. Bona fide nonresident U.S. citizens who purchase homes abroad and who in many instances continue to reside there upon retirement should not be prejudiced merely because of abuses created by U.S. residents. In this sense the full repeal of the tax provisions in question would work a definite hardship.

In conclusion, our chamber is convinced that if the proposed tax reforms discussed should become law, the end result would be that American business would find itself obliged to increase its cost of doing business abroad and thereby become uncompetitive, or, as an alternative, employ the services of Europeans from those countries which grant tax exemption incentives. This would mean diminishment of the effectiveness of representation of American business overseas by competent U.S. citizens. If the U.S. Government's aims in combating worldwide communism and the objectives of President Kennedy's Alliance for Progress program are to be advanced through the participation of U.S. enterprice abroad, then under no circumstances should the existing tax principles and incentives mentioned above be repudiated.

Respectfully yours,

R. C. FALLON, *President.*

Senator BENNETT. One more call.

Is Mr. Sidney Zagri in the room?

We had expected that this would close the hearings, but, as usually happens, we piled up a little overflow, and the committee will go into session at 10 o'clock tomorrow morning to hear three or four witnesses who have not yet been heard.

Then the hearings will stand in recess for an indefinite period of time subject to the call of the Chair.

The committee is now in recess for the afternoon.

(By direction of the chairman, the following is made a part of the record:)

LOS ANGELES CHAMBER OF COMMERCE,
Washington, D.C., May 3, 1962.

Re Revenue Act of 1962 (H.R. 10650).

Hon. Harry Flood Byrd, Chairman, and Members, Senate Finance Committee, Senate Office Building, Washington, D.C.

GENTLEMEN: We present herewith for your consideration views of the Los Angeles Chamber of Commerce on several aspects of the Revenue Act of 1962.

In the interest of brevity, we shall not summarize the proposals upon which our comments are submitted, since this would be a duplication of information already before the committee.

Withholding on interest and dividends.—Previously, on April 2, we filed with your committee our opinions with respect to the provisions for the establishment of a tax-withholding system for income from interest and dividends. In that communication we summarized what, in the opinion of this organization, are the serious defects inherent in the proposal. The disadvantages to taxpayers would far outweigh any temporary advantages to the Government. We feel these provisions should be dropped from the bill. (Copy of our April 2 communication is attached.)

Dividend credit, exclusion.—It is our understanding that the Treasury Department is attempting to persuade the Senate Finance Committee to amend into the proposed Revenue Act provisions to abolish the 4-percent dividend tax credit and the $50 exclusion on dividend income now allowed under the Internal Revenue Code, on the basis that rescinding of these credits would increase tax revenues by some $450 million per year.

Foreign competitor nations—England, Japan, West Germany, for example—have largely eliminated double taxation of dividends by liberal tax credits or other means. In the United States no other form of personal income is subjected to this double tax. By discouraging financing through equity securities, the proposed repeal would hamper availability of capital for needed expansions. While upper-bracket taxpayers may receive the greatest dollar benefits from the 4-percent credit, it must be remembered that they carry the major proportion of the dividend tax burden in absolute dollars, and they are the major source of risk capital required by an expanding economy. The Los Angeles Chamber of

Commerce strongly favors retention, not repeal, of the existing 4-percent dividend tax credit and $50 dividend income exclusion.

Proposed investment credit.—With the simplification of the investment credit provisions amended into H.R. 10650 just prior to its passage by the House of Representatives to an across-the-board credit of 7 percent with certain exceptions and limitations, we understand that some business groups have decided to support the proposal. It is the opinion of the Los Angeles Chamber of Commerce, however, that this provision, designed as a subsidy to certain businesses, would constitute a further introduction of special privilege into the tax law which is already far too complex and inequitable and would, in itself, result in practices which would require future corrective action by the Congress.

Most students of the tax law recognize that major reform of depreciation provisions is badly needed. An alternative to the investment credit concept would be enlightened depreciation reform which would allow faster writeoffs based on the classification of the asset, with the taxpayer allowed a limited amount of discretion as to the annual depreciation rate. This would be simpler and more equitable since it would be available to all taxpayers, not just to the relatively few who through force of circumstance would be able to modernize their equipment in years to which the legislation applies.

The Los Angeles Chamber of Commerce urges elimination of the proposed investment credit subsidy on the basis that it is not an adequate substitute for depreciation reform (which should be enacted into law and not be left to administrative discretion), and that the investment credit would introduce further inequities into the tax law.

Taxation of income of "controlled foreign corporations."—In its study of this section of the proposed Revenue Act, the chamber's Federal affairs committee has reached a conclusion that the administration's assertion that the proposals for taxation of "controlled foreign corporations" are required in order to bring about, among other things, a more favorable balance of payments have been effectively disproved as a shortsighted view by many witnesses before your committee and the House Ways and Means Committee. Data have been presented for your consideration which demonstrate clearly that, on the whole, American business operations abroad have contributed toward a favorable U.S. balance of payments. We predict that if the proposed provisions are enacted, the major effect would be to enrich the treasuries of foreign governments. They would be quick to revise their laws so as to raise income taxes without fear of losing the American-owned corporation which could claim such credits against the U.S. taxes that this legislation would impose. Should this happen, the effect of such a change would be loss of revenue rather than the production of the $100 million revenue increase forecast by the Treasury.

Moreover, if passed, these provisions would force American businessmen operating abroad to limit activities and, in many cases, reorganize them merely to maintain their position. This could have the effect of seriously hampering expansion by American enterprises in the foreign field, and would result in significant net revenue losses and injury to our national economy.

The philosophy behind these provisions appears to ignore the very significant fact that American businesses operating abroad are doing so only because for many reasons they are unable to supply foreign markets adequately from this country. They must compete for the same markets sought by foreign enterprises operating in the same area. Accordingly, an American enterprise operating in a foreign market should be allowed to compete on the same basis as its competitors already in that market with the advantages of local ownership and management.

The European Common Market is a good example of a situation where the provisions of this legislation would make it extremely difficult for U.S. corporations to compete with those organized in any one of the Common Market countries.

The Los Angeles Chamber of Commerce urges rejection of these proposals on the basis that they appear punitive in nature and designed to cripple the operations of legitimate U.S. business enterprises which desire to expand in the foreign markets.

Disallowance of certain business expenses.—After careful study of the provisions of H.R. 10651 relating to business expense deductions, the chamber's Federal affairs committee has concluded that they would appear to create additional complexities in the operation of the tax laws and deal unfairly with business taxpayers. The proposed prohibitions against entertainment activity "not directly related to the act or conduct of the taxpayer's trade or business"

would prevent much of the activity that the small taxpayer uses legitimately in furthering business development—or force him to spend funds to maintain and develop his business which he would be unable to deduct in computing his taxable income.

The Los Angeles Chamber of Commerce feels that the proposed limitations on business entertainment contained in the Revenue Act of 1962 would impose new inequities and difficult-to-administer provisions for determining the deductibility of legitimate expenditures for promoting business growth, and that abuses in this area can be corrected in large part by effective enforcement of the existing tax laws.

Liberalized allowancs for lobbying expenses.—We are pleased that there is at least one provision in the proposed Revenue Act of 1962, even though of limited application, to which the Los Angeles Chamber of Commerce gives support—that relating to deductibility of certain types of expenses incurred with respect to legislative matters if in all other respects they qualify as trade or business expenses. But at the same time, our organization sincerely recommends that this allowance be expanded to permit deduction of all expenses of this nature where they are otherwise properly deductible as "ordinary and necessary" and do not violate Federal or State laws.

The Los Angeles Chamber of Commerce has for some time supported the principle that business expenses incurred to defeat or promote legislation should be deductible if the purposes therefor and the methods used do not violate Federal or State laws and the expenses are otherwise deductible under section 162 of the Internal Revenue Code.

The Senate Finance Committee is familiar with the background of this issue. We shall not, therefore, develop it here, except to say that a broader exemption than that provided in H.R. 10650 is of especial importance to business firms operating in California. It is well known that at almost every General Election there is a notoriously long ballot on which questions are submitted to the electorate in the form of constitutional amendments initiated by the legislature, initiatives or referenda. For example, arising out of the 1961 and 1962 sessions of the California Legislature are six State measures on the June 5 primary ballot, including five general obligation bond issues which total $970 million in proposed authoriaztions; and there are twenty-one measures on the November general election ballot plus the possibility of several initiatives which are now in the petition circulating process. In the past, some of the measures submitted have been of such a nature that they had to be fought by the business community in order to protect the solvency of the State and all business enterprises in California. The record of California voters has been remarkably good on such issues. But one reason for this has been the fact that business firms have contributed funds and helped in the campaigns to get the facts before the voters. When convinced that they have the real facts, the people usually make sound decisions.

Arbitrary regulations of the type now on the books, and uncertainties as to their application, make it increasingly difficult for business firms to expend funds on legislative issues in their own interest or in the public interest. The Los Angeles Chamber of Commerce believes that it is only just and reasonable that business enterprises should be permitted to fight harmful legislation or support favorable legislation, as it affects their businesses, and that such expenses should be allowed as a part of the cost of doing business.

Public enlightenment as to legislative problems is desirable and should be encouraged. Where a reasonable relationship exists between the issues and the taxpayer's trade or business, a deduction should be permitted for expenses incurred to inform the public of these issues. While the Los Angeles Chamber of Commerce supports the provision in the House version of the Revenue Act of 1962, it recommends that the legislation be further amended to permit the deduction of all expenses incurred in connection with legislative matters where they are otherwise properly deductible as business expenses and do not violate Federal or State laws.

We are grateful for the privilege of submitting our views and ask that our statement be included in the record.

Respectfully submitted.

HAROLD W. WRIGHT, *General Manager.*

WRITTEN STATEMENT ON FOREIGN INCOME OF U.S. CITIZENS BY THE TAX COMMITTEE OF THE AMERICAN CHAMBER OF COMMERCE, A.C., MEXICO, D.F.

PREAMBLE

We have examined with amazement and dismay the provisions of H.R. 10650, now before the Senate Finance Committee, insofar as they relate to the taxation of income earned abroad by U.S. citizens, and with specific reference to the proposals—

(*a*) To tax U.S. shareholders of a foreign corporation on its undistributed income earned abroad.

(*b*) To require U.S. corporations to include in their taxable income, in addition to the dividend received from a foreign corporation, the amount of tax paid by it on the income out of which it paid both the tax and the dividend—the so-called gross-up provision.

(*c*) To extend the authority of the Treasury to allocate to a U.S. taxpayer actual or estimated additional income arising from sales to or purchases from a related foreign organization.

It has been our understanding that the administration is interested in furthering good relations with foreign countries—especially those of Latin America at this time, per the Alliance for Progress program—and in also increasing the standard of living in at least the backward countries for the purpose of combating international communism. Therefore, it appears to us that if the suggested details of H.R. 10650 are enacted into legislation, exactly the reverse will be the result.

It is time for the elected representatives of the American people to consider seriously problems abroad as a whole rather than by compartmentalizing them into apparently mutually exclusive divisions such as "taxation," "political relations," etc.

Consequently, without going into the technical details of the above-listed proposals of H.R. 10650—we are sure that better qualified witnesses have already done so—may we present for your kind consideration some more universal aspects of the proposed legislation under such titles as—

Foreign investments by American citizens do not reduce tax revenue in the United States.

Foreign investments by American citizens favorably affect U.S. balance of payments.

Elimination of tax exemption of foreign-earned income.

Taxes paid to foreign countries on American investments.

Inadequately considered legislation and its results.

Practical aspects of existing exemptions.

Tax havens.

FOREIGN INVESTMENTS BY AMERICAN CITIZENS DO NOT REDUCE TAX REVENUE IN THE UNITED STATES

In the past it has been a considered, although erroneous, opinion of many people in the United States that, by making foreign investments attractive to American citizens and corporations, we were in fact reducing tax revenue at home. A simple example in Mexico, a country with which we are most familiar, will quickly show that this is not the case. For example, we have in Mexico presently the three largest American automobile manufacturers, who assemble cars there. Due to restrictions on the sizes or values of cars that may be assembled or imported into Mexico, it has been increasingly impossible for General Motors, Ford, and Chrysler to assemble any American-made cars, with the exception of the very smallest. As a result, all three have begun to import into Mexico for assembly increasingly larger quantities of the parts of European cars which they manufacture, or they put on the market. This, in the long run, will increase the income from their Mexican operations. Eventually the profits from that income will be returned to the parent companies in the States and therefore will increase the U.S. Treasury's revenue at some future date. But, if we place these companies at an additional disadvantage by taxing even undistributed profits of their subsidiaries, we will make the operation in Mexico less and less profitable. We already have French, Japanese, and Germans assembling and beginning to manufacture cars in Mexico, and if the American enterprises become less profitable, these foreign competitors will expand to fill the gap and there is a good possibility that one of the Communist countries will

also attempt to enter the Mexican market to the detriment of the United States politically.

FOREIGN INVESTMENTS BY AMERICAN CITIZENS FAVORABLY AFFECT U.S. BALANCE OF PAYMENTS

As a matter of fact, direct American investments in productive operations overseas create a surplus, not a deficit, in the U.S. balance of payments—and the revenue to the United States from such investments results from—

(*a*) Remitted earnings.

(*b*) Exports of American products made possible by the investment.

(*c*) Royalties, fees and other payments for services to the oversea operation created by the invested capital.

Of course not all foreign earnings are remitted to the United States. Some foreign earnings are reinvested abroad for exactly the same normal business reasons as in the United States and not, as some people seem to think, to avoid the collection of U.S. income taxes.

ELIMINATION OF TAX EXEMPTIONS OF FOREIGN EARNED INCOME

Now the recommendation that the tax exemption on earned income of Americans permanently residing abroad be repealed totally or in part, is bound also to increase the costs of American companies operating abroad through the necessity of increasing salaries and attractions in order to induce American management and technical experts to live abroad. The American companies already are at a considerable disadvantage due to higher administrative costs, even under the present law of eventual taxation on profits, which is not generally the case with companies of other nationalities. This additional disadvantage will make it more difficult for the United States to do business abroad.

Politically, the reaction from the foreign countries is bound to be unfavorable. The United States will be losing its best potential source of evaluating these foreign countries' conditions as it will force more and more Americans who have spent many years working outside the United States either to return to the United States or in some cases, to relinquish their American citizenship. We believe no adequate use has been made by the U.S. Government of the professional knowledge of the bulk of American businessmen who have been living and working abroad. This is something for the State Department to consider. We further believe that for example the attempt of the Peace Corps to help foreign countries and introduce better feeling toward the United States, although well conceived, could only complement the excellent work done these many years by professional American businessmen who through their knowledge of the countries and their sympathy with the peoples and the success they have made, as evidenced by the fact that they continue to operate in these countries, are always the best ambassadors, the most efficient representatives of the U.S. Government in the countries where they live and work.

In any event, American businessmen in our opinion are much more valuable basic tools than the enthusiastic but comparatively raw Peace Corps. This does not mean that the Peace Corps cannot do a job, but it can hardly replace relationships and information gathered over many years by our oversea businessmen.

We are astounded that the glib estimate of increased tax collections in the sum of $250 million a year should be considered adequate payment for Americans' political and, eventually to our mind, economic losses that will result from the enactment of certain provisions of H.R. 10650. The gradual withdrawal of American capital which will materialize from the enactment of these proposals will leave a vacuum that will have to be supplied by either U.S. Government loans, which we hope will some day be repaid, or by capital furnished by other nations including those with ideologies unfavorable to the United States.

TAXES PAID TO FOREIGN COUNTRIES ON AMERICAN INVESTMENTS

Although some Americans are not in position to know it, substantial taxes are paid to foreign countries by subsidiaries and branches of American companies. A reduction of revenue to the foreign countries through retraction of American investments would have just exactly the unfavorable repercussions in those countries that our Government wishes to avoid—

(*a*) Creation of more intense anti-American sentiments.

(*b*) Providing additional areas of investment by nations unfriendly to the United States.

Then again the tax systems of most foreign countries are different from the American pattern—a larger proportion of total foreign taxes is collected as non-income taxes than is the case in the United States. In other words, income taxes in most foreign countries are a smaller proportion of the business tax burden than in the United States.

For example, industry abroad in many countries pays high import duties and other border taxes and fees which reach substantial amounts. In many cases, such taxes exceed the income taxes to foreign countries of the companies involved.

Then there are "turnover taxes" in foreign countries, ranging from 25 percent in France to 4 percent in Germany.

None of these foreign taxes, unusual to the American businessman, are included in the foreign tax credits by the United States when profits are remitted as dividends.

INADEQUATELY CONSIDERED LEGISLATION AND ITS RESULTS

In the past various and apparently unimportant measures have been enacted into law by Congress or were put into effect by executive fiat, which have redounded to the tremendous disadvantage of the United States only because they were not considered in the overall picture. Such an action as increasing the duties on certain raw materials is a case in point.

It should be pointed out that in the United States for the taxes that a company or individual pays, he receives police protection, many services and we hope "due processes of law" as well as suffrage and additional benefits. If the American resident abroad or the American companies doing business abroad are subject to substantially similar taxes as his U.S. resident counterpart, he will not be receiving these benefits, which constitute a great additional risk to the one operating outside the United States. We wonder whether adequate consideration has been given this.

It is further to be considered that if the U.S. companies reduce or withdraw their investments abroad, as seems likely if H.R. 10650 is enacted, there will accrue at least temporarily in the various foreign nations an enormous amount of unemployment and unrest, which will make very fertile ground for communistic indoctrination, and there is no doubt that capital from other countries will eventually replace the American capital, with the consequent enormous loss of prestige for the United States.

Now, it does not appear to us that this administration or any other which has the best interests of the United States at heart is really attempting to reduce American influence in the rest of the world and paving the way for repugnant ideologies. However, many of the proposals sent to the Congress in H.R. 10650 regarding taxation of foreign income are in fact directly accomplishing this result. While we can appreciate the need to increase revenues for the Federal Government, we can readily see that the decrease in prestige which we anticipate, and the increase in unrest due to withdrawal of capital, or at least less and a much lower rate of investment abroad, will in a not very distant future place the United States in an even more unfavorable light politically, abroad, than it is in today. It may well result in the losing of a cold war and in increased spending for armaments on a scale vastly greater than the expected revenue to be derived from the passage of H.R. 10650.

We have seen too many examples in the past, as mentioned before, of hasty action which has produced very unhappy reaction in the fields that were not immediately connected with the original action. Consequently, we feel that considerable research should be given to the study and effect of the passage of H.R. 10650, see how it will redound both politically and economically before the Congress votes to approve such tax legislation.

PRACTICAL ASPECTS OF EXISTING EXEMPTIONS

There is a great deal of political prestige to be made by the passage of legislation of this type and certainly the provision for the present tax exemption of $20,000 on earned income for those who stay abroad 17 out of 18 months has been a political football for some time. However, the other exemptions which are presently in the law are soundly based and should even be increased in order to accomplish politically just what the United States must achieve in order

to secure the world for our type of society. The $20,000 17-18 month exemption has much to recommend it insofar as it enables technicians to work at lower salaries abroad than they would necessarily have to earn if this were not the law.

Some American companies need this type of technical assistance to be in competitive position with other foreign rivals. It is undoubtedly true that certain elements have taken advantage of this provision, but it is questionable whether the damage done and the loss in revenue are sufficient to merit the upheaval of exemptions regarding foreign-earned income.

TAX HAVENS

The denomination of "tax havens," which classes them as anathema per se, is something that should be investigated on a logical rather than on an emotional basis. The United States has never in its laws provided a means for companies operating in countries abroad to transfer funds from one subsidiary to another without the payment of taxes in the United States. This situation has forced many large corporations to seek other legitimate and legal means to accomplish this and thus enable them to be competitive. In the long run, funds so protected are drawn back into the United States by the corporations in vastly increased amounts, as they multiply many times in the process of their use. If the corporations themselves do not draw back the funds, at least the American stockholders of these corporations, on their deaths, have to pay estate taxes which reflect the vast increase in the values of the stocks of these corporations through the earnings of these foreign operations.

In fact, we do not believe that the term "tax haven" is correctly understood by a majority of the American public. Such a place is not a Shangri-La—a gangster's hideout—or yet a haven from U.S. taxes. It is just a legal locale where American enterprise is free from foreign taxation, free from taxes of the country in which the "haven" is established but not free from U.S. taxes when any profits are repatriated.

Therefore, critics of tax havens are not finding fault with the laws of the countries in which tax havens are established, but are actually questioning the U.S. tax rule that American companies are not taxed by the United States on earnings of foreign subsidiaries until such earnings are sent home in the form of dividends.

The basic rule is predicated on the concept of U.S. tax law that income is not taxable until it has been received by the taxpayer. Naturally, this concept does not offer any special privilege or preferential treatment. It can hardly be said that the United States is losing revenue through this tax exemption setup. Rather, in the long run, the revenue from one or another type of tax is greatly increased.

CONCLUSION

The tax legislation embodied in H.R. 10650 is amazing, if we may repeat ourselves, and dismaying, especially in view of the competitive situations being faced today by American enterprises in foreign countries—competition from subsidiaries and branches of European and Far Eastern entrepreneurs.

The steady growth of industry in the United States requires its participation in universal industrial growth. It is just as impossible for our domestic industry to remain isolationist as it is for our Government to follow that policy. The world is taking giant strides toward free trade (the various common markets)—toward free transfer of capital—toward free convertibility of currency. Throughout the world there very definitely exists a great competitive challenge in the fields of industry and commerce, involving many, many nations—and when the score is posted, the winners will be from those countries whose foreign-exchange-conscious governments have given strong support to the oversea activities of their citizens—the winners will not be from any country that deliberately practices the old cliche that "kills the goose that lays the golden egg" by strangling the previously successful efforts of its businessmen abroad with ill-considered, ineffectual and vitiating taxation such as threatened by the pending tax legislation of H.R. 10650.

Consequently, we cannot urge too strongly that the Senate Finance Committee report unfavorably on H.R. 10650.

MAY 2, 1962.

Re section 13 of H.R. 10650.

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

DEAR MR. CHAIRMAN: The American Life Convention and the Life Insurance Association of America wish to submit a statement concerning the adverse effects that section 13 of H.R. 10650, relating to controlled foreign corporations, would have on the life insurance business. These organizations have a membership of 306 life insurance companies in the United States and Canada, representing 94 percent of the legal reserve life insurance in the United States.

With respect to the life insurance business, we believe that section 13 should be limited to tax haven operations and the so-called foreign reinsurance gimmick (as defined in sec. 952(b)). We believe that such an approach would correct certain tax deferral abuses without limiting or impairing proper and legitimate worldwide insurance operations.

Accordingly, we are submitting a detailed statement as to the manner in which section 13 affects the life insurance business and our suggestions as to how this section might be appropriately modified so as to correct certain existing abuses without drastically curtailing legitimate life insurance operations.

Respectfully submitted.

AMERICAN LIFE CONVENTION,
GLENDON E. JOHNSON,
General Counsel.
LIFE INSURANCE ASSOCIATION OF AMERICA,
EUGENE E. THORE,
Vice President and General Counsel.

STATEMENT OF THE AMERICAN LIFE CONVENTION AND THE LIFE INSURANCE ASSOCIATION OF AMERICA ON SECTION 13 OF H.R. 10650

INTRODUCTION

Section 13 of H.R. 10650, relating to controlled foreign corporations, directly affects the life insurance business under the following three provisions:

(1) Section 952(e), relating to the items to be included in foreign base company income.

(2) Section 953(b)(2), relating to the definition of qualified property.

(3) Section 952(b), relating to income derived from insurance of U.S. risks (the so-called foreign reinsurance gimmick).

Items (1) and (2), as passed by the House, technically apply to a foreign life insurance subsidiary. We believe that their application to a life insurance company was inadvertent because the stated purposes of the provisions, as contained in the House committee report, would appear to eliminate a life insurance company from the scope of these provisions. It is our belief that these provisions should not apply to a life insurance company. Accordingly, we believe the necessary technical amendments should be made to these sections in order to make them inapplicable to life insurance companies.

It is our position that item (3) should remain substantially unchanged, with only the addition of a de minimis rule in order to prevent section 952(b) from applying to certain unintended situations.

SECTION 952(e). ITEMS TO BE INCLUDED IN FOREIGN BASE COMPANY INCOME

Section 952(e) enumerates the items to be included in foreign base company income. The concept and purpose underlying foreign base company income are best explained in the following excerpt from the House Ways and Means Committee report, page 62:

"The foreign base company income consists of two basic parts: passive investment income, or more precisely "foreign personal holding company income" with certain modifications described below, and "foreign base company sales income."

"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. In such cases there is no competitive problem justifying postponement of the tax until the income is repatriated.

"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. *An exception is also made for income of banks and bank subsidiary organizations since in such cases the receipt of interest and other similar types of income do not result from passive investments* * * *." [Italic supplied.]

As passed by the House, section 952(e) would require the investment income of a controlled foreign life insurance company to be reported currently by its U.S. parent. This is contrary to the stated purpose of the House committee report. Specifically, the House has excepted the investment income of banks on the grounds that this type of income does not result from passive investments. This is equally true of life insurance companies. For the purposes of section 13, the investments of a life insurance company obviously are assets used in its trade or business. These investments are absolutely necessary if a life insurance company is to meet its long-term obligations to its policyholders. Accordingly, it is submitted that a life insurance company should be given equal treatment to that provided another financial institution, banks, with respect to its investment income.

Recommendation.—It is suggested that section 952(e)(5) be amended to exclude the investment income of a life insurance company, as defined in section 801 of existing law, from the term "foreign base company income."

SECTION 953(b)(2). DEFINITION OF QUALIFIED PROPERTY

Section 953 provides, in general, that the increase in earnings invested in nonqualified property may also be taxed to the shareholders of a controlled foreign subsidiary. Section 953(b)(2) defines "qualified property" to be "any money or other property which is located outside the United States and is ordinary and necessary for the active conduct of a qualified trade or business."

We believe that the assets of a life insurance company are ordinary and necessary for the active conduct of the life insurance trade or business within the meaning of this section. There is, however, doubt cast on this view because of the possible classification of a life insurance company's investment income as arising from "passive"-type assets. The assets of a life insurance company, like the assets of other financial institutions, are vital to its operation and should, without any question, be considered as being ordinary and necessary for the conduct of its business.

The question of what is "qualified property" used in an insurance trade or business for purposes of this section is entirely different from that under section 805(b)(4). Section 805(b)(4) of the code, as interpreted by the Treasury regulations, limits the assets used in an insurance trade or business to, in general, the home office building and similar property. The purpose of section 805(b)(4) is to arrive at an earnings rate for a life company. That purpose is not present here. Under section 953, the congressional purpose should be the traditional concept of trade or business which, we believe, would include all the assets of a life insurance company.

In view of the above two questions which cast some possible doubts as to the meaning of property which is ordinary and necessary for the active conduct of a qualified life insurance business, we request that this matter be clarified. This might appropriately be done in either the law or the committee report.

In addition to the need for clarification explained above, a further problem arises as to whether any of these assets might be invested in the United States. The House bill limits the investments in property located in the United States to the following three categories:

(1) Obligations of the United States, money, or deposits with persons carrying on the banking business;

(2) Property purchased in the United States for export to, or for use in, foreign countries; or

(3) Any loan arising in connection with the sale of property if the amount of such loan outstanding at no time during the taxable year exceeds the amount which would be ordinary and necessary to carry on the trade or business of both the lending corporation and the borrowing U.S. person had the sale been made between unrelated persons.

We believe that these limitations unnecessarily restrict the investment policy of a controlled foreign life insurance company, and in addition are detrimental to our domestic economy. It is our belief that these foreign subsidiaries should be permitted to invest in any property located in the United States so long as such investment is completely free from, and unrelated to, the parent company. This approach would permit the subsidiary to choose the most beneficial world-wide investments for its policyholders. It would also enable the foreign subsidiary to compete on equal terms with foreign insurance companies which can invest in the United States free from any restrictions.

Moreover, in view of the great capital needs of our economy, there appears to be no sound reason for preventing a foreign life insurance subsidiary from contributing much-needed funds to our domestic economy. Not only would these investments aid our capital expansion, but they would help in connection with our current balance-of-payments problem. It should also be pointed out that the income derived from these investments would be subjected to tax in the United States and would increase our tax revenues. Thus, there appear to be substantial reasons for modifying the severe investment limitations contained in the House bill.

One other point deserves mention. Because of the great faith the world has in the dollar as a unit of currency, many foreign life insurance companies write contracts which provide for the payment of benefits in U.S. dollars. In order to assure ability to meet its contractual liabilities, the foreign life insurance company invests in the United States to an extent necessary to meet its so-called dollar contract commitments. The limited investments permitted in U.S. property by the House bill do not allow insurance companies sufficient choice and diversification to meet their dollar obligations.

Finally, the investments permitted by the House bill in U.S. property are limited primarily to U.S. Government obligations and deposits in bank accounts. Apparently this is done on the theory that these two types of investments are not subject to abuse. We believe that there are several other types of investments which should qualify under the same theory, such as investments in State and local bonds and securities which are within the jurisdiction of the Securities and Exchange Commission.

In summary, it is our opinion that the investment restrictions contained in the House bill are unwarranted in the case of a foreign life subsidiary . There are a number of ways in which these restrictions might be either eliminated or alleviated. In view of this, we are not in this instance suggesting specific language. We would however, we pleased to work with the staffs of the committee in developing more specific language along the lines suggested above.

SECTION 952(b). INCOME FROM INSURANCE OF U.S. RISKS

The report of the House Ways and Means Committee, page 60, states the purpose of section 952(b) to be as follows:

"2. *Income derived from insurance of U.S. risks.*—Since the passage of the Life Insurance Company Income Tax Act of 1959, which, for the first time in many yeas, imposed a tax on underwriting gains of these companies it is understood that a number of the companies involved have attempted to avoid tax on the gains by reinsuring their policies abroad. In other cases the tax has been avoided by placing the initial policy with a foreign insurance company either controlled by an American insurance company or controlled by other American businesses.

"To meet this problem your committee's bill provides that where a controlled foreign corporation receives premiums or other consideration for reinsurance or the issuing of insurance or annuity contracts on property in, or residents of, the United States, the income attributable to this is to be taxed to the U.S. shareholders as a part of subpart F income.

"The bill also covers the type of situation where the controlled foreign corporation does not hold the policies involving U.S. risks but instead holds other policies which, by arrangement with another unrelated corporation, it has received instead of the insurance involving the U.S. risks, while the unrelated corporation holds the policies involving the insurance on property in, or residents of, the United States."

We hold no brief for the persons who have been engaging in this type of operation and we support this attempt of the Treasury and the Congress to eliminate this abuse situation.

We do believe, however, that section 952(b), as passed by the House, does cover certain situations which were not intended to be covered by that provision. It is our hope that the Finance Committee will amend section 952(b) so that it will cover only the abuse areas and not certain legitimate cases. We believe this may be accomplished by use of a de minimis provision.

As drafted, section 952(b) would apply to the following cases which we do not believe were intended to be covered:

Case 1.—A Canadian life insurance company is wholly owned by a U.S. life insurance company. The Canadian company does not do business within the United States. The U.S. parent does not reinsure with its Canadian subsidiary. The Canadian subsidiary issues a group life insurance contract to a Canadian employer which covers his employees. Several of these employees are residents of the United States. Section 952(b) literally applies to this case and the U.S. parent would be subjected to all the complicated provisions of section 13 of H.R. 10650 in order to pick up several dollars of income which may be related to the insurance of the several U.S. employees of the Canadian employer. It is submitted that this example does not in any way represent any abuse of the existing tax law and it was not the purpose of section 952 to cover this case.

Case 2.—Assume the basic facts of case 1, except that, at the time the group contract was issued, none of the employees were residents of the United States. Later, one of the employees moves to the United States and becomes a resident. At that time, presumably, the parent U.S. company becomes subjected to the provisions of section 952(b). Again it is submitted that this is not an abuse situation which needs correction. In fact, the place where the employee resides is completely out of the control of the insurance companies involved. A variation of this case is where the Canadian or other foreign subsidiary insures the life of an American citizen residing abroad and then this citizen returns to reside in the United States years after the policy has been isssued. This type of case is not an abuse area to which section 952(b) should apply.

In these and other similar cases, the amount of tax involved is not the real issue since the amount of revenue raised would be negligible. The basic problem is the tremendous work required to trace the ownership of a small number of policies. Moreover, under the House bill, this tracing would have to be done each year. The illustrated cases do not in any way present a tax abuse situation, and we do not believe they should be included within the scope of section 952(b).

Recommendation.—It is suggested that the above cases be eliminated from section 952(b) by the use of a de minimis rule. For example, it could be provided that section 952(b) shall apply only to cases where the income from insurance of U.S. risks exceeds *x* percent of the gross premiums or other consideration of the controlled subsidiary. For a foreign life insurance subsidiary, the applicable percentage might be in the neighborhood of 10 percent. Once this percentage were exceeded, then the foreign subsidiary would become subject to the provisions of section 13. This approach is similar in principle to the existing provisions relating to Western Hemisphere trade corporations where the Congress provided de minimis rules, one of 10 percent and one of 5 percent.

MEMORANDUM OF COMMITTEE ON FEDERAL TAXATION OF THE CHICAGO BAR ASSOCIATION, H.R. 10650, THE REVENUE ACT OF 1962

PROVISIONS RELATING TO FOREIGN OPERATIONS

The committee believes that the provisions of the bill dealing with foreign operations have so many technical deficiencies, obstacles to efficient administration and ambiguities that the net effect of the proposed legislation might be just the opposite of that intended by the proponents; i.e., American capital that otherwise might be retained for economic production in this country might tend to flow abroad and domestic employment might be decreased.

SECTION 6

This provision would amend present section 482 of the Internal Revenue Code which now gives the Secretary of the Treasury or his delegate the power to reallocate taxable income among organizations which are controlled, directly or indirectly, by the same interests. The amendment would authorize the Secretary or his delegate to establish a different basis for the reallocation of taxable

income resulting from sales within a related group of foreign and domestic organizations where the taxpayer cannot establish an arm's length price for such sales. Broadly speaking, the amendment would authorize reallocation of taxable income under a formula which would take into account the assets, payroll, and selling expenses in the foreign country and the assets, payroll, and selling expenses of the United States.

The proposed amendment raises many substantial problems, a few of which are described below.

1. In its present form the amendment would create a host of problems, both for taxpayers in their efforts to comply with the law, and for the Internal Revenue Service in administering the law. The Treasury has brought relatively few cases under section 482, and it would seem that this remedy, which has been used successfully where foreign corporations were involved, should be exhausted before legislation such as that contained in the bill is enacted.

2. It is believed that very serious difficulties would be presented under proposed section 482(b)(1) in determining the "taxable income of the group arising from such sales" in the case of the sale of finished products between two organizations, both of which are engaged in related manufacturing activities It is not clear how the taxable income to be reallocated is to be determined, thus leaving open the question of how the income specifically arising from such sales can, as a practical matter, be arrived at. These ambiguities could create significant inequities.

3. Serious difficulties could also be presented under proposed code section 482(b)(2)(A) in determining the assets "used in the production, distribution, and sale of property" in the case of the sale of finished products between two organizations which are also engaged in related manufacturing activities. In many instances, business organizations will be engaged in a variety of manufacturing operations. Under such circumstances it would be very difficult to determine specifically the amount of assets, the share of the payroll, and the specific selling expenses attributable to the production, distribution, and sale of the particular items producing the taxable income to be reallocated. Here again the existence of a number of ambiguities may create inequities under the proposed legislation.

4. Proposed code section 482(b)(1) is not clearly limited to sales between a domestic and a foreign organization, and it is therefore conceivable that a reallocation of taxable income could be made between two domestic organizations (who are related to at least one foreign organization). Furthermore, the Secretary might be empowered to reallocate taxable income derived from intercompany sales between a Western Hemisphere trade corporation and its domestic parent corporation. From the proposed draft and committee reports, it appears that this type of reallocation was not intended. Certainly no reallocation of income between a Western Hemisphere trade corporation and its domestic parent corporation under the provision of section 482(b) is permitted if no foreign organization was a member of the related group, but such a reallocation would be permitted if the related group contained one foreign corporation even though this foreign corporation was not in any way involved, directly or indirectly, with the transactions between the Western Hemisphere trade corporation and its domestic parent corporation.

5. Proposed code section 482(b)(2) proposes to reallocate income between companies based on "that portion of the following factors which is attributable to the United States and that portion thereof which is not attributable to the United States." This should be changed to read "that portion of the following factors which is attributable to each of the organizations involved." The effect of the provision as contained in the bill is to reallocate income as between organizations without regard as to which organization owned the assets or otherwise earned the income. Instead, the organization incorporated or formed under the laws of the country where the assets were located would be the one to whom the income would be allocated. The same problem exists with salaries. This interpretation is borne out at page A40 of the committee report. An example of the problem created by this part of the bill would be the case of a foreign corporation (a subsidiary of a U.S. corporation) that has substantial assets and numerous employees in the United States, as well as assets and employees abroad. In this situation, all of the foreign corporation's U.S. assets, salaries, etc., would be used to reallocate income to the parent U.S. corporation, regardless of who earned the income or where it was earned. As drafted, there seems to be some doubt that the provision would be constitutional.

6. Proposed code section 482(b)(2) sets up an allocation formula that is different from that contained in any of our income tax treaties. All 21 income tax treaties concluded by the United States that are now in force contain specific allocation provisions. This is likely to create international problems for U.S. business, since the provision certainly violates the spirit, if not the letter of these treaties. If the United States takes unilateral action of the type contemplated by proposed code section 482(b)(2), it should not be surprised to find foreign governments taking unilateral action against U.S.-owned businesses.

7. Proposed code section 482(b)(3)(A) indicates that assets should be included at their adjusted basis "or, if such basis is not available in the case of a foreign organization, then their book values, adjusted to approximate their adjusted basis." It would seem that this could result in considerable inequities and difficulties. Foreign figures required to determine "adjusted basis" under the U.S. Internal Revenue Code would not be available due to the differences between foreign and domestic depreciation methods, depreciable lives for assets, different principles as respects the capitalization of various expenditures, and differences in the effect of reorganizations and other transfers. Furthermore, many countries have initial allowances, investment allowances, and accelerated depreciation which are in excess of that permitted under U.S. law. For example, Sweden permits the expensing of certain temporary buildings in the year of construction. France permits special allowances for expenditures, the United Kingdom has special initial and investment allowances, etc. In view of these difficulties, it would seem that fair market value of the assets in question would be more equitable than using adjusted basis. Certainly the taxpayer should have the election of having this used, rather than adjusted basis as set forth in proposed code section 482(b)(3)(A). The use of fair market value would also avoid considerable difficulties as a result of foreign exchange fluctuations over the years. Radical inflation in certain countries has meant that the cost basis of assets, when expressed at cost in local currency and converted at today's rates of exchange, have little resemblance to anything meaningful. Certain high cost parcels of real estate in Germany, for example, which are still worth large sums, would be converted at present exchange to an aggregate amount of almost nothing for the entire property. This is also true of France and Italy as well as in many underdeveloped countries, such as Argentina, Brazil, and Chile.

A further factor which the use of the fair market value tends to avoid is the question of what rate of exchange should be used. The above assumes that the foreign exchange conversion is made at current rates as in the case of the foreign tax credit calculations for amounts received from foreign subsidiaries. Perhaps a more realistic basis would be to convert at the rate in effect on the date, or during the year, the foreign company made its investments. However, due to continually changing foreign exchange rates, this would necessitate, in effect, making a completely new set of books over many, many years for the foreign corporation—all in terms of U.S. dollars. Whether sufficient records would be available to make such a new set of books is in itself questionable, but if available, the work involved would be fantastic. In addition, proposed code section 482(b)(3)(A) would give no recognition to a situation where the stock of a corporation (foreign or domestic) having, for example, appreciated real estate, was purchased at a price substantially in excess of the then "adjusted basis" of the underlying assets. The use of current fair market value would avoid many of the above problems.

8. Proposed code section 482(b)(3)(B) indicates that leased assets should be taken into account, but it is not clear on what basis. These assets would normally not have an adjusted basis under proposed code section 482(b)(3)(A).

9. It would seem that the exception for inventory and stock in trade contained in proposed code section 482(b)(3)(B) is not fair. There would seem to be no reason to discriminate against assets of this type. Most U.S. States that have a State income tax use this in their property allocation factor. In addition, intangible assets should also be taken into account.

10. Proposed code section 482(b)(8)(B) indicates that a portion of the income taxes paid by a foreign corporation will be treated as though they were paid by the related domestic corporation to the extent that income is allocated to such domestic corporation. This is equitable, but it does not go far enough. The proposed code section is silent on the matter, but page 30 of the committee report indicates: "However, the income so reallocated for purposes of the overall or per country limit is not to be classified as foreign income." In many cases this could have the effect of denying the foreign tax credit involved, since

the foreign country would almost certainly have a more normal allocation formula than that contained in proposed code section 482(b)(2). The effect could only be that the foreign country will inevitably tax more foreign income to the foreign corporation than would be allocable to such foreign corporation under proposed code section 482(b) as now written. This would have the effect therefore, not of equalizing the tax on foreign business, but of imposing a double tax (since the credit will, in many cases, not be fully available) on this income. In this connection, it is interesting to note that many countries require that goods being sold in that country are not being sold more cheaply than they are sold elsewhere (such as the Canadian Anti-Dumping Act), and others require that they receive as low a price as is offered anywhere in the world (i.e., India). As a consequence, the pricing of goods cannot arbitrarily be fixed to accord with any artificial rules established under proposed code section 482(b), but will instead have to be at fair prices, with the result that exporters will be faced with double taxation as outlined above, or with loss of markets.

11. Proposed code section 482(b)(8)(B) should be expanded to include reallocation of tax, not only as between a foreign corporation and a domestic corporation, but, in addition, between two or more foreign corporations that are under common control. This is important since otherwise, if one of the foreign corporations is subject to the provisions of section 13 of the proposed bill, there could be a serious question and a possible loss of foreign tax credit through no fault of the company involved. This would also be important as respects the present per country limitation, as contained in code section 904.

SECTION 13

Section 13 of the bill would amend the Internal Revenue Code to provide that certain undistributed income of controlled foreign corporations shall be included in the income of U.S. shareholders in the year the income is earned by the foreign corporation, whether or not it is distributed. The amounts on which U.S. shareholders are taxed may be classified as (1) subpart F income and (2) profits considered as being distributed. Subpart F income is, in general, certain reinsurance income, certain patent, etc., income and certain passive income (dividends, etc.) and sales income unless reinvested in less developed countries. Profits considered as being distributed are the profits of foreign corporations, including foreign manufacturing corporations, except to the extent that such profits are invested in qualified property. Qualified property is limited to property which is ordinary and necessary for the operation of present (but not new) foreign business, or property reinvested in less developed countries.

This provision introduces into the code a body of new taxing provisions which are extremely complex and in some respects novel. In the opinion of the committee, these provisions contain numerous defects, ambiguities and inequities which will cause taxpayers and the Internal Revenue Service serious difficulties and lead to extensive litigation. While some of the defects can be cured by improved drafting, others appear to be inherent in any such complex taxing concept.

Some of the provisions of this section of the bill which might tend to have the effect set forth in the initial paragraph of this memorandum are described below:

(a) Sections 952(a)(1)(B) and 952(c) create a distinction between patents, copyrights, and exclusive formulas and processes having a U.S. source and those which do not have a U.S. source. Such a distinction it is believed might have the effect of encouraging research abroad in order to avoid the provisions of this act.

(b) In order to meet the 20 percent tests of sections 952(e) (2) and (6), or to avoid the 80 percent test of section 952(e)(6), foreign companies would be encouraged either to (i) curtail their purchases from their U.S. parent, or (ii) expand their foreign production operations. Either alternative would apparently tend to decrease U.S. exports. The second would also apparently tend to move additional capital abroad in order to finance the production of items previously produced in the United States.

(c) Under section 952(e)(3), the income of a foreign corporation whose principal activity consists of owning and leasing a plant to a related foreign corporation would be considered foreign base company income. For local property tax reasons, separate foreign corporations frequently own plans operated by related foreign manufacturing companies. Under this section, the income of the real estate company will be taxed to U.S. shareholders, whereas this would not have been the case if the foreign manufacturing company owned

its own plant. Here again, this bill appears to place foreign corporations owned by U.S. interests at a disadvantage, since they cannot operate and finance foreign plant expansion in the same method as other foreign concerns.

(d) Because of section 953(b)(5), a controlled foreign subsidiary operating in a less developed country would have an economic interest in having such country remain economically less developed. Such a controlled foreign subsidiary should receive the benefits of operating in a less developed country, at least for some definite and substantial period of time. Such an assurance would be consistent with our present foreign policy.

The committee has the following additional comments with respect to other portion of section 13 of the bill:

1. Section 951(a) imposes tax on U.S. persons with 10 percent or more ownership, actual or constructive. It should be pointed out that such persons may, in fact, have no control over the policies of the foreign corporation.

2. In section 951(b) there is a reference to ownership determined by "applying * * * 955(b) * * * directly or indirectly." It seems that the words "directly or indirectly" are either redundant or extend the constructive ownership provisions to unascertainable areas.

3. Section 951(c) provides that a U.S. person who is a qualified shareholder in an electing "foreign investment company" shall not be required to include in his gross income for such taxable year the "subpart F income" of such company. However, it would seem that such a shareholder would be taxed under section 951(a)(1)(B) on any increase in earnings invested in nonqualified property for such year. Since section 1247 provides that an electing "foreign investment company" must distribute at least 90 percent of its earnings, which would therefore be taxable to the shareholders, it seems inequitable that the shareholders should, in addition, be subject to taxation under section 951(a)(1)(B). This would be particularly true as to any year in which the foreign investment company liquidates "qualified property."

4. Section 952(a)(1)(C) provides that "net foreign base company income" will not be taxed to the shareholders unless five or less U.S. persons own more than 50 percent of the foreign corporation's stock. It is not clear when this ownership test is to be applied, nor is there any provision for proration of income in the event the relationship should exist for less than the full year. The committee suggests that a specific rule should be provided for determining when the ownership test is to be applied. It is the view of the committee that it would be unduly burdensome to impose tax if the ownership test is met on any day during the taxable year. In this connection see the comments on item 15.

5. Section 952(a)(3) provides that the subpart F income "shall not exceed the earnings and profits of such corporation for such year." While helpful, this provision is not sufficiently broad to avoid inequities and double taxation, as shown by the following examples:

Example 1

Subpart F income (before taking into account sec. 952(a)(3))	$5,000
Corporate losses from other foreign activities	(6,000)
U.S. source income	4,000
Total earnings and profits for the year	3,000
Amount taxed to corporation because of its U.S. source income	4,000
Amount taxed to U.S. shareholders (assuming sec. 951(b) is inapplicable	3,000
Total amount subject to U.S. tax	7,000

Example 2

Corporation A (a U.S. person) ownes 100 percent of corporation X, which in turn owns 100 percent of corporation Y, both X and Y therefore being "controlled foreign corporations." In 1963, Y has $1,000 of subpart F income which is taxed directly to A. In 1964, X has subpart F income of $2,000, other types of losses of $1,000, and a dividend from Y of $1,000. It is clear under section 956(b) that X's subpart F income does not include the dividend from Y. However, except for this dividend, Y's earnings and profits for the year would have

been $1,000, and the amount of subpart F income taxable to A would have been limited to this amount. However, because of the $1,000 dividend from Y (which has previously been taxed to (A), X's earnings and profits for the year would be $2,000, and thus the entire subpart F income would be taxed to A. In other words, for the 2 years A would be taxed on $3,000, even though the consolidated earnings of both X and Y were only $2,000. It is not believed that this effect was intended and it is suggested that corrective measures be taken.

6. Proposed code section 952(c)(1)(B) refers to "any U.S. person which * * * owns or controls, or is owned or controlled by, or is under common ownership or control with, the controlled foreign corporation." Control does not seem to be defined for this purpose. A similar problem appears in proposed code section 952(e)(2). A definition should be included.

7. No adjustment appears to be made in connection with the subpart F income calculation under proposed code section 952(c) for rentals or royalties actually paid by the controlled foreign corporation to its U.S. parent as a result of "use or other means of exploitation by the controlled foreign corporation" under section 952(c)(3). The effect appears to be that even though the controlled foreign corporation has paid a completely fair rental or royalty for the use of a U.S. patent, its U.S. parent corporation which has received such royalty or rental income will also have subpart F income equal to the fair royalty or rental income for such patent, thus resulting in double U.S. taxation to the U.S. parent. In this connection, it should be pointed out that proposed code section 952(c)(2) does not appear to cover this point in view of the phrase "but not including any production, manufacturing, or similar expenses incurred in the use or other means of exploitation of such property or rights" since such payments by the controlled foreign corporation to its U.S. parent would seem to be within the exception.

8. The definition of "foreign base company sales income" contained in proposed code section 952(e)(2) would appear to be deficient in the following respects:

(*a*) The definition of "foreign base company sales income" contained in proposed code section 952(e)(2) does not make it clear (as it is in the committee report, p. A–94) that it does not apply to the purchase and resale of materials or parts which are incorporated by a controlled foreign corporation into a manufactured product (including certain assembled products). The committee report indicates that this is not deemed to be a purchase and a sale of the same property within the meaning of proposed code section 952(e)(2): The committee believes that such provision should be in the statute and not merely in the committee reports.

(*b*) The accounting problems involved in determining the amount of income derived from sales of those items which give rise to "foreign base company sales income" would be unduly burdensome and, in many cases, impossible. In this connection, it should be noted that a given product (which does not, in itself, constitute a product manufactured by the controlled foreign corporation) might contain some components purchased from a related entity and others purchased from outside sources. Furthermore, a given component might be purchased from both sources and identification might be impossible.

(*c*) The "use, consumption, or disposition" test contained in section 952(e)(2)(B) would present considerable difficulties and, for many companies, would be virtually impossible. The test would seem to apply if, at any time, any use, consumption, or disposition of the property takes place outside the country in which the foreign subsidiary is created or organized. A given article might be "used" in several different ways in several different places during its life. For instance, a piece of luggage sold by a foreign subsidiary organized in country X to a resident of country X might be "used" on a vacation in country Y. Similarly, a piece of construction equipment might also be used in many different countries. A component part sold by a controlled foreign corporation to another company for incorporation into a completed product and resale, would appear to be "used" by the second company and also by the ultimate consumer of the completed product. By the same token, any given article might be sold (i.e., disposed of) several different times and in several different countries in the chain of distribution from the controlled foreign corporation to the ultimate con sumer. It would seem to be impossible for a controlled foreign corporation (let alone, the U.S. shareholders) to make the required determination. In this connection, it should be noted that the required information must be known at the end of the corporation's taxable year.

9. Section 952(e)(4) provides that foreign base company income does not include any income derived from insurance of U.S. risks or income from U.S. patents, copyrights, etc. However, section 952(e)(6)(B) provides that if the foreign base company income (before any deductions) exceeds 80 percent of the corporation's gross income, "the entire gross income shall be taken into account in determining foreign base company income." Thus, it would appear that such insurance or patent income could be included in subpart F income twice—once by reasons of sections 952(a)(1)(A) or (B), and again by reason of sections 952(a)(1)(C) and 952(e)(6)(B).

10. It is not clear under section 953(a)(2) whether a shareholder's pro rata share of the corporate earnings invested in nonqualified property at the close of the preceding taxable year is to be prorated on the basis of his stock ownership at the close of the current year or the preceding year. If the latter is the case, a shareholder could be subject to tax under this section merely because he increased his stock interest during the year.

11. It is not clear under section 953(a)(2)(A) whether the earnings invested in nonqualified property at the close of the preceding year could be reduced below zero by reason of distributions during the year to which section 956(c) applies.

12. Section 953(b)(2)(A) might give rise to numerous troublesome questions as to the "location" of property, particularly intangibles.

13. Subsections 953(b)(2)(C)(i) and (3)(A)(ii) refer to corporations engaging in business "almost wholly" within a less-developed country. This concept of "almost wholly" appears to be new to tax legislation and undoubtedly would give rise to considerable litigation to determine what it means. A similar problem exists with respect to the use of "substantially the same trade or business" and "substantially the same United States persons" in section 953(b)(3)(A).

14. Proposed code section 953(b)(5) purports to give the President the power to effect tax results by means of Executive order. This hardly seems appropriate. The making of laws, as well as the rates and provisions included in that process, are a prerogative of Congress, not the President. This might raise constitutional problems.

15. Proposed code section 954 defines a controlled foreign corporation as a corporation which is more than 50 percent owned by U.S. persons on any day during its taxable year. The "any day" provision easily could become a trap, particularly in view of the presence of complex constructive ownership rules. Furthermore, once determined, it would seem that there is no real assurance that such control would continue in future periods. Newly organized corporations may be particularly vulnerable to the "any day" requirement. The "any day" provision also appears in sections 951(b), 954(a), 954(b), and, in certain situations, might impose impossible tracing and administrative burdens. The committee suggests that a less burdensome ownership rule should be developed.

16. In proposed code section 954(b), page 123, line 1, the word "controlled" should be inserted before the phrase "foreign corporation."

17. In line 9 of proposed code section 954(b) on page 123, the word "individual" should be inserted in front of the word "residents" in order that resident foreign corporations' property outside of the United States is not included.

18. Proposed code section 954(c) permits a reduction in the percentage ownership in a foreign corporation to which proposed code section 953(b)(2)(C) applies below 50 percent where a lesser percentage is required under the laws of a less-developed country. In many foreign countries, the percentage ownership permitted to foreigners will vary from industry to industry and with the particular needs of the country at the time the required permits and authorizations to do business are requested. In most instances, there is no specific legislation which determines the ownership which foreign interests will be permitted to acquire, and the extent of ownership is a matter of negotiation with the officials of the foreign government in question. It is believed this matter should be given further study before any legislation is adopted.

19. Proposed code section 955(b)(1) appears to contain a drafting error in connection with the removal of nonresident alien individuals from the constructive ownership provisions.

Section 955(b)(1) provides that stock owned by nonresident alien individuals shall not be attributed under section 318(a)(1)(A). It is significant that section 318(a)(1)(B) deals with adopted children. Thus, under section 955(b)(1), stock owned by a nonresident alien adopted child may be attributed to his U.S.

father, whereas stock owned by a nonresident alien child is not. Such an interpretation would be supported by section 318(a)(4) where the reference is made to section 318(a)(1) instead of section 318(a)(1)(A).

20. Subpart F purports to tax certain of the income of a controlled foreign corporation, but it makes no provision for losses of such a corporation. This seems highly inequitable. If the U.S. persons are to be taxed on income, they ought to be entitled to deduct corresponding losses. Certainly any losses sustained should be carried forward and used to offset any income in subsequent years before any amounts are taxed to U.S. persons. This is particularly important in foreign operations, for losses can greatly exceed those in the United States. The recent expropriation, without adequate compensation, of assets in Cuba is a good example.

21. The Internal Revenue Code imposes a series of limitations, such as section 367, on the reorganization of foreign structures. It would seem that in view of the vast changes made by the present bill, and the need to reorganize foreign operations as a result thereof, section 367 should be amended to permit, as a minimum, a tax-free liquidation under section 332 of existing foreign corporations.

22. There appears to be doubt as to the constitutionality of section 13 of the proposed bill under the principles of *Eisner* v. *Macomber*, 252 U.S. 189 (1920). We have considered the case of *Eder* v. *Commissioner*, 138 F. 2d (2d Cir., 1943) and do not believe that it supports the opposite conclusion.

SECTION 15

Section 15(b)(3) of the bill provides as follows:

"(3) *Holding period of property.*—Section 1223 (relating to holding period of property) is amended by redesignating paragraph (10) as paragraph (11) and inserting after paragraph (9) the following paragraph:

"'(10) in determining the period for which the taxpayer has held trust certificates of a trust to which subsection (d) of section 1246 applies, or the period for which the taxpayer has held stock in a corporation to which subsection (d) of section 1246 applies, there shall be included the period for which the trust or corporation (as the case may be) held the stock of foreign investment companies.'"

As a result of the addition of paragraph (10) to section 1223 the computation of the amount of ordinary income taxable on the sale of stock of a domestic corporation which holds foreign investment company stock takes into account earnings and profits accumulated by the foreign investment company prior to the time the taxpayer acquired his indirect interest in the foreign investment company stock. This seems inequitable and illogical. It results in the same accumulated earnings and profits being taken into account in measuring the ordinary income taxable on successive sales of the domestic company stock. Furthermore, it is inconsistent with the treatment of a taxpayer who holds foreign investment company stock directly. In the latter case only earnings and profits accumulated after the time the taxpayer acquired the stock are taken into account.

It is noteworthy that the House committee report apparently does not contemplate the result here criticized. The report's only comment on this provision states (p. A118):

"The trust certificates or stock are to be treated under section 1223 as held by the taxpayer throughout the holding period for which the trust or domestic corporation held stock in a foreign investment company, *but limited to the period during which the taxpayer held such trust certificates or stock in the domestic corporation.*" [Emphasis supplied.]

The committee finds no such limitation in the bill.

Since it does not appear that the new paragraph (10) added to section 1223 serves any function other than to produce the criticized result, the committee recommends that paragraph (10) be eliminated.

Where capital gain income is retained by a foreign investment company, thus taxed to its U.S. shareholders, and such income is invested in nonqualified property, such income may also be taxed to its U.S. shareholders under section 951(a)(1)(B) if the foreign investment company is a controlled foreign corporation. It would appear proper, therefore, to amend section 15 of the bill to eliminate the possibility of this double inclusion of income.

SECTION 16

1. It would be very inequitable to tax the gain realized from the redemption or liquidation of stock in a foreign corporation as ordinary income to the extent of the foreign corporation's accumulated earnings, in effect retroactively, from as early a date as February 28, 1913. It is suggested therefore that section 1248(a) be changed so as to tax only that portion of the earnings accumulated after December 31, 1962, or the close of the fiscal year of the foreign corporation ending during 1962 as ordinary income.

2. Provisions of section 1248(b) have the effect of taxing a portion of the gain realized on the sale or exchange of stock of a foreign corporation as a dividend. This section should be amended to make it clear that, to the extent of ordinary income so realized, corporate stockholders of the foreign corporation would be entitled to the deemed paid foreign tax credit under section 902.

SECTION 20

In general, the committee believes that this section, relating to information on certain foreign entities, imposes burdensome obligations on those required to file the information returns and, conceivably, complete compliance may be impossible due to the nonavailability of such information to those rerequired to file because of local laws and practices in some foreign countries As the section relates to individual shareholders, the provisions are likely to be extremely burdensome and may trap the unwary. In order to determine whether a shareholder owns 5 percent or more in value of the stock of a foreign corporation, it is provided that shares held by "brothers and sisters, spouses, ancestors, and lineal descendants must be included." This rule differs from the attribution rule which is applicable in the "control" situation. There is no reason given for this difference. The different rules are confusing and should be eliminated. Also, with the increase in the sale of foreign issues in this country, a taxpayer may well have brothers, sisters, or parents (some of whom may be nonresident aliens) holding shares in the same foreign company without him knowing this and yet, together, there is the necessary percentage to require the information return. Furthermore, there undoubtedly will be family situations where one member has no access to information concerning the shareholdings of other members of his family in a particular foreign corporation. For these reasons, the committee believes Congress should require clear and convincing proof of the usefulness of this information to Treasury (and a showing that it will be used) before enacting this particular provision.

If such an attribution rule is necessary, however, we believe it should be drafted so as to eliminate any necessity for continual inquiry concerning the stockholdings of members of one's family. The bill, as drafted, would appear to require a person who has no beneficial interest in a foreign corporation to make a return if a member of his family owns 5 percent or more in value of the stock of such foreign corporation on January 1, 1963, or upon the date when said person becomes a U.S. person. It also appears to require a person who comes within the attribution rule only upon the acquisition of stock by a member of his family to make a return. In such cases there is no beneficial ownership, or change in the person's own beneficial ownership, which would call to his attention the necessity for making inquiry of family members, and continual inquiry would be required. We think that the Section should be amended to provide that, anything therein to the contrary notwithstanding, no return with respect to a given foreign corporation is required under section 6046(a)(3), or with respect to ownership on January 1, 1963, under section 6046(a)(2), of a person who has no legal or beneficial ownership in such foreign corporation, and that no return with respect to a given foreign corporation is required under section 6046(a)(2)(A) and (B) of a person who has not increased his legal or beneficial ownership by acquisition of stock. In cases where this limitation of the attribution rule would apply, except cases where the beneficially interested family member is not a U.S. person, the attribution rule would still require the filing of a return by the beneficially interested family member, which return would provide the necessary information.

Section 20 of the 1962 bill also contains the following sentence:

"The Secretary or his delegate may also require the furnishing of any other information which is similar or related in nature to that specified in the preceding sentence."

The committee believes that this sentence should be stricken because it is unnecessary, but if it is to be retained, it should be incorporated as a new paragraph "(F)" of section 6038(a)(1).

SECTION 21

Section 7852(d) of the Internal Revenue Code provides that no provision of the code will apply where its application is contrary to a treaty obligation. Section 21 of the bill provides that section 7852(d) shall not apply with respect to amendments to the code made by H.R. 10650. This is a departure from the provisions of previous revenue acts and the Secretary of the Treasury, in his testimony before the Finance Committee, recommended its deletion. The Tax Committee of the Chicago Bar Association supports this recommendation of the Treasury.

Statement of W. H. Beckerleg, Post Office Box 4931, San Juan, P.R.—View of Certain New Puerto Rico Industries on the Bill To Amend the Internal Revenue Code of 1954

INTRODUCTION

H.R. 10650, now before the Senate Committee on Finance, proposes several amendments to the Internal Revenue Code of 1954. A large number of the amendments deal with the present code's treatment of foreign income and are an attempt, according to the title of the act, "to eliminate certain defects and inequities."

This memorandum is intended only to discuss certain of the amendments and, very much in particular, their relationship to Puerto Rico, and their impact on the industrialization of this island.

I represent the following firms, all of which have manufacturing operations here in Puerto Rico:

1. Atlas Manufacturing Corp.
2. Jaru, Inc.
3. Star Manufacturing Co., Inc.
4. Trio Knitting Corp.
5. Rio Grande Industries, Inc.
6. Linda Bra, Inc.
7. United Corp.
8. West Manufacturing Corp.
9. Moda Shoe Corp.
10. Sun Manufacturing, Inc.
11. El Dorado Import & Export Corp.
12. Sylvia, Inc.
13. Undergarment Accessories, Inc.
14. Solar Products
15. San Juan Flower Co., Inc.
16. The Tenna Manufacturing Co., Inc.
17. Electro Industries, Inc.

The writer is a practicing attorney who, while born in the States, since 1947 has resided, practiced his profession, raised his children, and participated in this community of Puerto Rico. For 14 years the writer has been associated closely with the industrialization program of Puerto Rico, at first as an attorney for the local government, and later, since 1950, as a private practitioner, engaged for the most part in establishing and representing new industries in Puerto Rico. The rejoicing of the community at its economic growth, the struggle of the businessmen in establishing operations here, and the joint pride of the community and the businessmen over their successes have been known and shared. And while these things do not qualify me as an expert, they urge me to speak out with emotion, if not with ability, on behalf of what we have achieved, and in petition that it not be emasculated.

SPECIFIC AMENDMENTS TO BE DISCUSSED

H.R. 10650 contains several proposed amendments which will affect Puerto Rico if enacted as adopted by the House of Representatives. However, the following seem of particular significance from the viewpoint of new industries in the island:

Section 6. Amendment of section 482 (allocation of income between related foreign and domestic organizations).

Section 11. Domestic corporations receiving dividends from foreign corporations.

Section 13. Controlled foreign corporations.

Section 16. Gain from certain sales or exchanges of stock in certain foreign corporations.

Before attempting to discuss each of the above separately, a brief description of the type of Puerto Rican plant we are here interested in may be useful. Not all new firms, of course, fall exactly within these patterns but a significant number do.

Publicly owned U.S. corporations that have related operations in Puerto Rico generally have established subsidiary corporations to conduct their Puerto Rican operations, and these most frequently are U.S. corporations operating under section 931. On the other hand, family or other small U.S. groups tend to establish in Puerto Rico corporations owned by the same or part of the same stockholders, and these corporations are usually Puerto Rican corporations although there are an increasing number of 931 corporations. Many of these firms have had a grant of tax exemption under Puerto Rico's industrialization program, and these exemptions are now beginning to expire or have already expired in some cases.

These new firms are typically manufacturing firms (there are also hotels) and they are primarily production firms; that is, their principal activity and reason for being is to manufacture a product. They sell their product or a good part of it on the mainland, and many sell their product to a "related" firm on the mainland; the problems of ultimate sales and distribution are not their prime concern. Were there no related ownership and did they not own the raw material, we might call many of these firms contractors, particularly in the apparel industry. However, they differ from the usual contractor in that they ordinarily are more stable, having larger investments in fixed assets (including buildings, which they own or rent under long-term leases), higher administrative costs, and more employees.

The stockholders or owners of these firms are U.S. citizens, for the large part resident on the mainland. However, with practically shuttle air service between the island and the mainland, they are frequently at the Puerto Rican plant. They are supported by management and administrative personnel resident on the island and part of the community.

These firms did not establish themselves in Puerto Rico of their own accord; they were invited, encouraged, and promoted, directly or indirectly, by an aggressively conducted campaign on the part of the government of Puerto Rico to industrialize the island. Such active solicitation of new business has been going on for 14 years, since the original Tax Exemption Act of 1948, and it has been so widely advertised, discussed, investigated, and commented on that it can hardly be considered as carried out without the knowledge of the Secretary of the Treasury and Congress.

In the light of this brief background, the specific provisions of H.R. 10650 will be discussed.

SECTION 6. AMENDMENT OF SECTION 482

Section 482 of the present code relates to the allocation of income and deductions among related taxpayers. It is presently a one-sentence, well-drafted paragraph authorizing the Secretary to make such allocations if he deems it necessary "to prevent evasion of taxes or clearly to reflect the income." The amendment would add a new and long subsection to deal specifically with sales and purchases within a related group which includes a foreign corporation; its approach is to set up a definition of an "arm's-length price" and to indicate methods of allocation in those cases where the price does not fall within the definition, placing the burden on the taxpayer to establish such a price.

In our opinion, the Secretary has adequate authority under the act at present to make allocations and this is admitted in the report of the House Committee on Ways and Means (H. Rept. 1447) at page 28, where it is stated that the administrative difficulties of determining a fair price limits the usefulness of section 482 at it now reads.

If such administrative difficulties in establishing a fair price for sales between related companies do exist in some cases, we still believe the Secretary can require the taxpayer to show that the price is fair without the necessity of the amendment. The amendment seems merely to place in the statute what I understand has been the practice of the Secretary under section 482 as is evidenced by the regulations covering the section.

Since it has been proposed to include a definition of "arm's-length price" in the statute, and as this definition is the key to this entire amendment it bears close scrutiny, and from the standpoint of a typical Puerto Rican manufacturing firm which sells its output to the mainland, the definition is most unfair.

First, by its very name "arm's-length price," the amendment has departed from the concept of a "fair market price" discussed at page 28 of House Report 1447; that the two terms are not equal needs no further statement.

Second, the typical Puerto Rico firm sells to its parent or related mainland firm but rarely sells to any other firm in the same mainland market because it is producing and is geared to produce what that mainland firm needs; likewise, the mainland firm seldom, if ever, purchases from any other Puerto Rican firms because they do not produce what he wants being fully occupied supplying their own customers (who are probably competitors anyway). The result is that an "arm's-length transaction" as defined in the proposed subsection (b)(4)(A) rarely would exist as there are no sales in the same areas involving unrelated persons under similar conditions of sale.

An alternative definition has been proposed in subsection (b) (4) (B) to include sales in other areas under similar circumstances to unrelated persons, but this alternative is loaded with adjustments for quantity differences, marketing conditions and "other relevant factors." Since only the Puerto Rico plant is making sales, every Puerto Rico plant selling only to a related mainland firm is automatically subject to allocation by the Secretary, and this is most of them.

Now, it certainly does not follow that because Puerto Rico firm A sells all of its production to mainland firm B, which purchases in Puerto Rico only from firm A, that the selling price is not a fair market prioce or even on "arm's-length price." It is both possible, and frequent, that the mainland firm will purchase from or be able to establish the prices of unrelated firms located on the mainland. This price, whether actually paid or otherwise established, is the "fair market price" and also the "arm's-length price" of that particular product. And if that price is $1 per unit, can it be said unfair or improper that Puerto Rico receives that price or less?

Assume for a moment, that the dexterity of the Puerto Rican worker, the tax exemption of the Puerto Rican plant, and perhaps the lower labor cost in Puerto Rico allows the plant in Puerto Rico to produce the product for less than on the mainland; should the Puerto Rico plant be obligated to sell its production for less than the mainland?

What the Secretary is proposing in this amendment, as far as many Puerto Rican plants are concerned, is that unless there is an arm's-length transaction, he be permitted to determine the price—and since there could be no arm's-length transactions under his definition between these related plants, the Secretary would step in in every case.

We respectfully submit that the definition proposed is unrealistic and unfair insofar as Puerto Rico is concerned. We propose that if the amendment to section 482 be adopted the definition proposed for subsection (b)(4) be modified to read as follows:

"(4) ARM'S-LENGTH PRICE DEFINED.—For the 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) is sold, purchased, or available in the same or other areas under similar conditions of sale and in transactions involving unrelated persons."

SECTION 11. DOMESTIC CORPORATIONS RECEIVING DIVIDENDS FROM FOREIGN CORPORATIONS

Section 11 of H.R. 10650 proposes to amend section 78 and 902 of the present code to eliminate what is referred to as a double allowance for foreign income taxes. Insofar as Puerto Rico is concerned, the proposed amendment would only affect those U.S. corporations which operate a foreign subsidiary corporation which pays dividends to the parent. Where the foreign corporation pays foreign taxes, it deducts these taxes before it can determine the amount of income available for dividends. The amount of the tax is then allowed as a credit against the U.S. tax of the U.S. parent corporation on the dividend. The amendment would require the U.S. parent to include in its gross income not only the dividend it received but also the foreign tax paid by the subsidiary. A very clear explanation appears on page 50–53 of House Report No. 1447.

The proposal, of course, is an attempt to reduce or eliminate the tax advantages which arise from operating a subsidiary in a foreign country which has lower corporate tax rates than the United States. It is, therefore, more of a policy question than anything else. If it is desirable to encourage U.S. firms to establish operations in foreign countries, it is proper to consider whether some

incentive should be given them to do so. It is generally accepted that foreign operations involve certain risks and inconveniences not present in mainland operations, or, at least, such is the belief. The willingness to accept these risks and inconveniences is no doubt at least partially due to the tax savings under the present code, and to the extent that the savings are reduced, we may expect a corresponding reduction in the acceptance of the risks and inconveniences.

In the case of Puerto Rico, an additional factor is present. Many of the Puerto Rico subsidiaries, which are foreign corporations, operate here under a grant of local tax exemption and are permitted to accumulate earnings during the tax-exempt period which is most attractive from the capital gains standpoint. As many such firms will enjoy their tax exemption after January 1, 1965, the proposal in subparagraph (f) of section 11 will prohibit such accumulations. Subparagraph (f) provides, in effect, all dividends made out of profits accumulated prior to December 31, 1962, shall be subject to the proposed new amendment unless distributed prior to December 31, 1964, and all dividends from profits accumulated after December 31, 1962, are affected irrespective of when made.

The proposed amendment therefore directly and adversely affects the Puerto Rico tax exemption program by penalizing, as it were, the continued accumulation after December 31, 1964. And as this penalty applies, irrespective of whether or not the profits relate to a year prior to December 31, 1962, the effect is retroactive in its effect. The only alternative would be to declare dividends which would be fully taxable at U.S. rates as there would be no Puerto Rico tax on the earnings of the subsidiary because of its tax exemption. Under such circumstances, it is highly doubtful that Puero Rico would continue to attract the new industries it needs to continue its program.

It is respectfully suggested that section 1 1of H.R. 10650 should not be enacted as same would be detrimental to continued investment in Puerto Rico, and, if enacted, that subparagraph (f)(2) thereof be eliminated so that the provision will not be retroactive.

SECTION 13. CONTROLLED FOREIGN CORPORATION

Section 13 of H.R. 10650 sets up a new concept of controlled foreign corporations and provides that the U.S. stockholders thereof must include in their income the undistributed income of the foreign corporation. According to House Report No. 1447 (p. 62 and p. A. 94), the proposed amendment does not apply to income of a controlled foreign corporation from the sale of a product which it manufactures (although if the income were also related to the exploitation of a patent, copyright, or exclusive formula and process the amendment could be applicable). However, the provision also taxes to the shareholders the increase in earnings invested in nonqualified properties.

This section is the most complex of the proposed amendments and as a complete copy of H.R. 10650 has only been available since April 26 (when they arrived at Dr. Fernós-Isern's office here in San Juan), my acquaintanceship is therefore not intimate. Nevertheless, from what I do understand, I gather that while the typical Puerto Rico manufacturing plant's income from manufacturing is not subject to section 13 in any case, the increase in earnings after 1962 are taxed if not invested in qualified properties, which is about the same thing.

From the standpoint of Puerto Rico, the accumulation of earnings and the capital gain treatment mentioned in the discussion of section 11 are made impossible under this proposal, and the stockholders are subject to U.S. income tax, computed I suspect in accordance with the method laid out in section 11, on dividends they may or may not have received. The taxpayer is told, in effect, that if his controlled foreign corporation reinvests its earnings, the tax will not apply. But there is a limit to what you can reinvest in and there is a definite limit in practice to how far you can go before there are no places left for investment—at which time the circle is complete and the proposed amendment is again applicable.

The effect of this proposal will be to discourage new ventures in Puerto Rico except from those firms already established here, and as to them an increase in liquidations before the end of the year is to be expected. Puerto Rico's industrialization program today has arrived at a position where it must show that old firms whose exemption has expired that it is desirable not to liquidate but to continue operating and to convince new prospects that this is possible by the actual functioning examples. More than any other proposal, section 13 will injure our industrialization growth.

It is respectfully requested that Puerto Rico be excepted entirely from this proposal.

SECTION 16. GAIN FROM CERTAIN SALES OR EXCHANGES OF STOCK IN FOREIGN CORPORATIONS

The last provision to be discussed is section 16 of H.R. 10650 which provides that any sale or exchange of stock in a foreign corporation will now be subject to full U.S. taxation instead of the capital gain treatment now available or the tax free reorganization literally available but which the Commissioner of Internal Revenue will not permit (H. Rept. No. 1447, p. 76).

Anything that has been overlooked in the previous sections, is neatly tied up here in section 16 by providing that same shall take effect as of the date of the enactment of the act. This is probably the most unfair part of the entire amendment. It is without question retroactive in effect. Until enacted, the U.S. resident stockholder has had capital gain treatment open to him by sale of his stock in or liquidation of his Puerto Rico corporation. He has perhaps accumulated earnings in complete reliance and in complete accord with the Puerto Rican law and certainly with the full knowledge of the Secretary of the Treasury and the Commissioner of Internal Revenue that there is such a program in Puerto Rico and that a substantial number of U.S. resident stockholders are participating therein. Yet the proposed amendment takes this not into consideration, it is completely retroactive. Not only does it kill the incentive to establish a Puerto Rican operation, but it penalizes those who have.

The penalty, and such it is, is not equitable. The section 931 corporations are not foreign corporations and not affected by the proposal.

It is respectfully suggested that this provision does not merit the attention of the Senate and that because of its obvious unjustness should not be enacted.

STATEMENT BY KENNETH A. LAWDER, TREASURER OF W. R. GRACE & CO., WASHINGTON, D.C., REFERENCE TO H.R. 10650

Our statement has been limited to those parts of the proposed Revenue Act of 1962 which relate to the taxation of corporate income from foreign sources. We particularly wish to stress our views as to the need for supporting the Alliance for Progress with tax legislation which will encourage, not discourage, private investment in Latin America.

First, let me say that we fully recognize and accept the premise that it is absolutely essential that our tax policy and foreign economic policy be coordinated to achieve the maximum overall benefit to the national well-being. It is in this light that we have examined the proposed legislation as set forth in H.R. 10650.

We fully share the concern of the administration with the seriousness of the balance-of-payments problem confronting our country and also concur in the need to eliminate defects and inequities in our tax system where they exist. However, in our view, based on our experience in foreign operations (Grace having been founded in Peru over 100 years ago), the proposed legislation, if enacted as now written, will have drastic and far-reaching consequences on our position in world trade in the years ahead without achieving the announced purposes of the proposed legislation.

Our objection to certain aspects of H.R. 10650 is that the administration, in its attempt to prevent abuses, an objective with which we and every responsible businessman are in full agreement, has proposed changes that are so sweeping in nature that they would seriously interfere with legitimate U.S. business operations abroad to the detriment of our foreign trade. Certainly its results are in real conflict with the longstanding policy of our Government to encourage foreign trade and investments abroad.

In this connection, it is important to distinguish between the abuses indulged in by the few as contrasted with the operations of the many legitimate oversea private investments. Statutory means for ending such tax abuses are already available to the Treasury in the present section 482 of the code. This section permits the Commissioner of Internal Revenue to reallocate income to reflect arm's-length terms in dealings between related interests.

The provisions of section 482 provide the framework within which the Treasury can prevent evasion of taxes through the use of sham foreign corporate subsidiaries or affiliates of U.S. corporations as a vehicle for siphoning off income actually earned or generated in the United States and rightly subject to U.S. tax jurisdiction. To the extent that additional information is required to

effectively enforce section 482, the Treasury will have adequate information available through the new forms 2952 which must be filed by all U.S. corporate taxpayers for each foreign subsidiary, pursuant to the present section 6038 of the code, starting with the taxpayer's return for the year 1961.

Grace does, however, oppose the adoption of new and radical changes in traditional concepts of tax jurisdiction by extension of the Government's power to tax income earned by legitimate foreign business prior to the distribution of such profits as dividends.

The Secretary of the Treasury has in his testimony referred to the "privilege of deferring" U.S. taxes. This concept assumes that the income of the foreign corporation is the income of its shareholders. There can be no deferral of tax, unless without deferral, the tax would be due when the corporation receives the income. Since the income of the corporation is not the income of its shareholders until distributed as a dividend, it is not proper to refer to the "privilege of deferring" taxes. This is particularly true with respect to income of foreign companies, since the U.S. tax law does not apply to foreign companies which do not have U.S. source income.

Our law has never considered the income of a corporation, foreign or domestic, as income of its shareholders, except in order to prevent abuse in the case of a very small number of foreign personal holding companies. This bill, however, singles out all foreign corporations, even though engaged in legitimate foreign operations and not engaged in any abuse, for application of this new and radical doctrine which is completely contrary to our heritage of law and business practice.

If the principle of taxing shareholders on income not received is established as a matter of law, it will have far-reaching consequences to all stockholders, corporations, and financial institutions in the United States. If such a legal principle is sustained then nothing will inhibit the Congress or State legislatures from extending such application to the undistributed earnings of domestic corporations. One can well visualize the inevitable havoc that would be worked upon the finances of individuals and corporations that may not have the resources to pay taxes assessed on unreceived income.

With few exceptions, most U.S. corporations extend their operations abroad to participate in the development of new markets, or to protect a market developed through exports, in competition with foreign-owned companies. All too often there comes the time when it becomes necessary to set up a plant in a foreign country to hold the market that initially was developed through exports, or to penetrate new markets. Experience has demonstrated that when the demand for a product reaches a size sufficient to support economically feasible plants, pressure is exerted by foreign customers—and in many cases by foreign governments—for local or regional manufacturing. It was for these reasons that Grace has found it necessary to set up plants in Western Europe, New Zealand, Japan, Mexico, Brazil, Argentina, and elsewhere.

This pressure does not derive from cost or tax advantages. To the contrary, it is the inevitable preference for a dependable source of supply near at hand over one located thousands of miles away. Furthermore, local governments, particularly in the developing countries, most often take the initiative in promoting the development of local industries to conserve scarce foreign exchange resources for other economic and social needs. This is particularly true in Latin America where the governments of these countries in cooperation with the United States are urgently seeking to develop their economies and raise living standards under the Alliance for Progress.

We in the United States must recognize that we no longer have a technological advantage to hold foreign markets. European, Canadian, and Japanese companies have the technological know-how and capital today to compete effectively in all markets of the free world with U.S. enterprises.

Much has been said about the export of jobs through foreign investments, and an attempt has been made to justify the proposed tax legislation on the assumption that it will deter investments abroad and correspondingly help employment in the United States. There is no convincing proof presented in the record of the hearings before the House Ways and Means Committee or before this committee that our present tax treatment of foreign investments is a primary factor in the investment of U.S. private capital abroad.

After developing a market abroad through exports, U.S. corporations are faced with a hard decision in that they must either establish a plant abroad to protect that market, or penetrate it further, or else be ultimately excluded. Thus, in

most cases, at least, the establishment of production abroad cannot be considered an "export of jobs." When the time is ripe, the market in the foreign country for U.S. exports will be lost; the only question is whether a U.S. firm or a foreign competitor will do the manufacturing in that market.

We submit that it is far more advantageous to the overall interest of the United States to have a U.S.-owned foreign subsidiary participate in these markets and thus generate a flow of dividends from the investments, as well as a market for the export of U.S.-made machinery and equipment, spare parts, raw materials, components and intermediates, than to have these benefits accrue to our foreign competitors, with the inevitable loss of tax revenues to the U.S. Treasury on the dividends from investment and the profits generated by the exports. Equally important is the benefit to the balance-of-payments position generated by the dividends and exports.

Turning now to section 11—the gross-up proposal. This proposal is unwarranted and inequitable. The present method of computing the credit allowed domestic corporations for foreign income taxes paid by foreign subsidiaries has been in effect for approximately 40 years. Although it has been continuously under review by the Congress, it has not been changed for this lengthy period of time. Section 11 would for the first time require U.S. parent corporations to include in their income the amount of foreign income taxes paid by foreign subsidiaries if a credit is claimed under the law for these taxes.

The gross-up proposal should not be adopted because it will not, as claimed by the administration, result in equal and uniform tax treatment for branches and foreign subsidiary corporations. Foreign subsidiaries will still not be given the special deductions accorded branches, capital gains will when distributed be taxed as ordinary income and losses will not be passed through to the parent corporation.

Furthermore, as to the less-developed countries gross-up will provide an additional deterrent to new investment. It is especially significant that the effect of gross-up will be most burdensome to U.S. businesses operating in those countries where the foreign tax rate is substantially less than the U.S. tax rate, as in most Latin American countries. Application of gross-up would, therefore, impose a greater tax penalty on investors in these countries than it would impose on investors in developed countries where tax rates, in most cases, approach closely the rate in the United States. U.S. policy under the Alliance for Progress envisions private investment approximating $300 million annually in Latin America. To impose a further tax penalty in the Latin American area would make such investment less attractive. Certainly, this is not an opportune time to apply gross-up to the less-developed areas, and Latin America in particular, if we are to stimulate the flow of private capital under the Alliance for Progress.

Under the Alliance for Progress the administration has projected private direct investments from the United States on the order of $300 million a year. Last year such investments reached only approximately $200 million and in 1960 a mere $100 million. Private investment is an important part of the overall program of our Government, not only for the stimulus it provides to local economies but also because of the contribution it makes in providing much-needed training in technology and managerial skills for nationals of these countries. Parenthetically, as the Treasury Department pointed out in its testimony, investment in Latin America also can be expected to create a particularly high volume of exports from the United States.

In order to achieve the goals of the Alliance for Progress, it seems to us important not only that our tax laws impose no roadblocks to Latin American investment, but further that they be consistent with and support the steps taken by the Latin American Republics themselves to foster private investment and provide much needed jobs for their peoples.

For a number of years the United States has encouraged, and indeed urged, the Latin American countries to improve their investment climate and to provide specific incentives to attract foreign private capital particularly from the United States. Yet those countries which have offered these incentives to attract private investments have discovered to their dismay and disbelief that, insofar as American investors are concerned, U.S. tax laws negate the very benefits they have provided. Far from attracting new U.S. direct investments, this discovery has caused the affected Latin American governments to wonder how different departments of the U.S. Government can be maintaining such apparently contradictory positions.

If the Alliance for Progress is to achieve the laudable goals that have been established, it will require the active effort of both industry and government. Several of the Latin American countries have passed tax laws aimed at attracting and assisting private investment to develop new basic industry by providing incentives to offset to some extent the considerable risks inherent in such investments and to facilitate their financing. However, under our existing tax laws, the incentives provided by the Latin American countries are of no benefit to the U.S. investor since the U.S. Government, under existing law, collects additional U.S. taxes approximately equivalent to those forgone by the Latin American countries.

This inequity can be corrected either by specific legislation amending the present code or through tax treaties. In one specific instance, with which we are familiar; i.e., Peru, the United States negotiated an appropriate treaty well over a year ago. As yet no action has been taken to submit the treaty for ratification. The Congress is already on record in the International Development Act of 1961 as urging the President to "accelerate a program of negotiating treaties for commerce and trade, including tax treaties, which shall include provisions to encourage and facilitate the flow of private investment to, and its equitable treatment in, friendly countries and areas participating in programs under this Act; * * *."

Turning now to the question of compliance, and in particular section 13, the recordkeeping that would be required is so great that, as a practical matter, it would impose an unreasonable burden on the taxpayer, and the enforcement of the proposed legislation would break down of its own weight. Furthermore, the complicated new rules of section 13 would produce a multitude of problems of a complexity virtually impossible of administrative or judicial solution.

STATEMENT OF MR. GEORGE R. CAIN, PRESIDENT AND CHAIRMAN OF THE BOARD OF ABBOTT LABORATORIES, NORTH CHICAGO, ILL.

Mr. Chairman and members of the Committee on Finance, my name is George R. Cain. I am president and chairman of the board of Abbott Laboratories.

Abbott Laboratories has been engaged in an international pharmaceutical business for some 30 years. We now have subsidiaries in 36 countries. Some of our first ventures abroad were in Latin American countries where we now have successful manufacturing operations in such countries as Brazil, Colombia, Argentina, Mexico, Venezuela, and Peru. We are proud of our efforts in these areas, not only because they are profitable but because we know that they are beneficial to the United States, both incomewise and in helping sell our free private enterprise system. We would be most dismayed now with the passage by Congress of what might appropriately be called a Yanqui stay home bill.

I am making this statement because I am convinced that should the foreign income provisions of H.R. 10650 become law the effects would be detrimental both to our country and to our company.

1. The U.S. balance of payments would be adversely affected.
2. The number of jobs in the United States would decrease.
3. The longrun tax receipts of the U.S. Treasury would decrease.
4. Our company and many others would be rendered noncompetitive abroad.

1. Why would the U.S. balance of payments be adversely affected?

(*a*) The present imbalance is not caused by private U.S. investment abroad but rather by the U.S. aid program and by military expenditures. I would not suggest that these programs be abandoned but why not—

(1) Encourage private enterprise through trade, not aid, to play a greater role in developing weak economies?

(2) Work harder to persuade our allies that they should bear some of the burden of countering the Communist economic offensive in the free world?

(3) Try harder to persuade our allies that they should bear more of the expenses in Europe of defending Europe militarily allowing us to furnish

armament from the United States which would not adversely affect our balance of payments?

Instead of—

Discouraging private U.S. investment abroad? Even the Secretary of the Treasury admitted, in his testimony before this committee, that foreign investment has a longrun (10 to 15 year) beneficial effect on our balance of payments. Even if we agreed to the Secretary's estimate of the 10- to 15-year lag (which we do not—see exhibit I), we wonder with what we will supplant this income in 1972 or 1977 if today we stop investing abroad?

(*b*) The imbalance is not caused by the relationship of our imports and exports. The Secretary of Commerce stated recently in support of the trade bill (H.R. 9900):

"The deficit in our balance of payments arises, not from imbalance in our export and import of merchandise, but from intangible accounts such as oversea military expenditures, payments for economic assistance, tourism of U.S. citizens abroad, and flows of foreign and American capital investment in and out of the United States."

(*c*) Abbott Laboratories with investments in 36 subsidiaries abroad, and hundreds of other U.S. companies, favorably affect the U.S. balance of payments.

For the 5-year period 1956–1960, Abbott's exports from the United States exceeded its imports by $50 million. Abbott also receivd from abroad loan repayments, dividends, and miscellaneous income in the amount of $9.3 million, making a total inflow into this country of $59.3 million.

The total outflow of dollars from this country by Abbott, during the same 5-year period, in foreign investments and loans was only $2.2 million. This gives our country a net favorable balance of $57.1 million.

Abbott's favorable contribution to balance of payments 1956 through 1960

[In millions of dollars]

Inflow:	
Exports less imports	50.0
Dividends, loan repayments, etc	9.3
Total inflow	59.3
Outflow: Total outflow (investments and loans)	2.2
Net favorable balance	57.1

I think it is noteworthy in relation to these figures that the rate of expansion of Abbott's foreign operations has been greater during this same 5-year period than during any other like period since we commenced our international operations. In fact, the average age of our oversea plants is less than 10 years.

Proponents of the foreign income provisions apparently would not understand how a company can expand its foreign operations rapidly with so little outflow of U.S. capital. The answer is simple and is well known to all who have had international business experience. Foreign plants can be and are financed very heavily through the use of locally borrowed money in addition to earnings retained overseas. Thus, we increase our base upon which greater future earnings are built. These earnings redound to the benefit of the U.S. Treasury as well as our own shareholders. This is accomplished without a heavy immediate or long-term drain on U.S. capital.

(*d*) Should these foreign income provisions of H.R. 10650 become law, investments abroad would be discouraged, particularly in less developed countries. More capital for any investments made would have to be supplied from the United States.

The slowdown of U.S. investments abroad would mean—

(1) The export of less U.S.-made machinery and equipment.

(2) The export of less raw and semifinished material and less component parts.

(3) The export of less in the way of complementary product lines which can be better promoted and sold because the foreign manufacturing company has been in existence, is locally staffed, and has an established reputation.

Stopping U.S. affiliates from manufacturing abroad will not increase U.S. exports. It will increase the sale of goods manufactured abroad by foreign-owned companies.

In the pharmaceutical business, there are many products which cannot, because of local legal restrictions be imported from the United States. If a similar product is manufactured locally by others we cannot export to the country. Here are some examples:

Penicillin cannot be exported to Australia.

Pentothal cannot be exported to Australia, France, and India.

Nembutal cannot be exported to Argentina, Australia, France, Philippines, Greece, and Turkey, among others.

U.S. companies do not manufacture abroad if they can legally and competitively export from the United States. U.S. companies do not manufacture abroad for import into the United States if they can manufacture here and compete with products sent in by foreign companies. (See exhibit 11.)

2. Why would the number of jobs in the United States decrease?

If we restrict private U.S. investment abroad, as H.R. 10650 is designed to do, U.S. employment would suffer. I can only fall back on Abbott's experience to substantiate this statement, but I believe it to be typical of U.S. industry in general.

Our foreign investments were not made at the expense of our exports from here, but rather because exports became difficult or impossible, due to trade barriers, tariffs, legislation, or arbitrary decisions protecting or favoring local industry in foreign nations, establishment of local factories and plants by competitors, etc.

It is significant that Abbott Laboratories International Co.'s employment in Chicago, as a result of its increased capital investments abroad, rose 50 percent in the last 6 years.

In addition, a large number of scientists, engineers, technicians, researchers, manufacturing, and other personnel are now employed by our parent company, as a result of our expansion in foreign markets made possible by our increased investment abroad.

Our experience is in conformity to the fact that, as American investments in industry abroad tend to raise the level of U.S. exports, such investments are a positive factor in maintaining and augmenting employment in the United States.

3. Why would the longrun tax receipts of the U.S. Treasury decrease?

(a) Earnings of publicly held companies, which comprise the greater portion of U.S. business operating abroad, cannot be held outside the United States indefinitely. The stockholders will not permit such indefinite retention. They will demand receipt of those earnings as quickly as they are not being productively employed in the pursuit of business abroad.

(*b*) When made available to U.S. shareholders, these earnings will also be taxable by the U.S. Government under present law.

(*c*) If earnings in future years are decreased by present discouragement of U.S. investments abroad, less tax revenue will be available for the U.S. Treasury.

The argument of the Secretary of the Treasury that present investments abroad should be discouraged because there is a 10- or 15-year lag in return could be compared to the position of a man who stops the purchase of food in his household because what his family is eating today was purchased yesterday. True, his cash position will begin to improve and his family may not starve for 40 days.

4. Why would Abbott Laboratories and many other companies be rendered noncompetitive abroad?

(*a*) Income taxes in most foreign countries comprise a smaller part of the total tax burden on business than in the United States. Sales taxes, turnover taxes (25 percent in France), transmission taxes, manufacturers excise, capitalization taxes, property taxes, patrimony taxes, and a host of others are usually much higher in other nations than in the United States, yet our Government allows credit for foreign income taxes only. Already we are at a disadvantage compared to our local competitors to the extent that we remit our foreign earnings annually to the parent company. The net after-tax return on the investment of the U.S. company is less than that of our locally owned competitors. We can use our foreign earnings to expand locally under present U.S. law and temporarily be in a "neutral" position with local competition. H.R. 10650 would remove even this "neutrality" (see exhibit III).

(*b*) As to our foreign-owned competitors who compete with us in third countries, we can presently compete only through the use of foreign-base companies (not sham or paper companies) such as they use. Some of our largest competitors abroad are (1) either Swiss companies or (2) other European companies operating through Swiss subsidiaries.

H.R. 10650 would require that our Swiss trading company (or the parent as its shareholder) pay at least 52 percent on its earnings while our competitors in Europe would be paying at most a 10-percent tax in Switzerland and nothing in their home country until earnings were remitted. One type of German-owned Swiss company can even remit its profits to the parent without the payment of a German tax.

Some advocates of the foreign income provisions contend that H.R. 10650 would not make U.S. companies noncompetitive because—this being an income tax—the fact that a tax must be paid means that the company has already successfully competed. This argument, if carried to the logical extreme, would lead to the conclusion that a company could stay in business even with the imposition of an income tax of 100 percent. This argument is unworthy of comment.

Are the foreign income provisions of H.R. 10650 needed?

1. The President has called for some measures to eliminate "abuses of tax havens."
2. Proponents of this bill have alleged that present law is insufficient to eliminate abuses.
3. Mr. William H. Loeb, Assistant Commissioner of Internal Revenue for Compliance, appeared in an American Management Association program on April 25, 1962, at which he was cited in an Internal Revenue Service news release as having said that "Another area of concern is the so-called sham entities. Internal Revenue has been quite successful in the courts when it has been shown clearly that a particular organization serves no business purpose other than the elimination of U.S. taxes."

In reporting on this same talk on April 26, 1962, the Wall Street Journal stated that "He added that perhaps IRS hasn't yet 'used the full potential' of the law that allows it to reallocate income." The Wall Street Journal also stated that "He added IRS will be helped in this by a 1960 law requiring more detailed reporting of foreign transactions by U.S. taxpayers." The Internal Revenue Service, being the enforcement arm of the U.S. Treasury, should be in a position to speak with authority on whether it is properly equipped with legislation to "prevent abuses of tax havens."

What, if any, effect does H.R. 10650 have on the trade bill (H.R. 9900)?

Abbott Laboratories and, I believe, most U.S. businesses are in favor of the concept of free trade. We welcome the chance to compete freely in world markets. We cannot live and prosper, however, in a situation where the hands of U.S. companies are bound and our foreign competitors are given free license to enter any and all markets, both abroad and here in the United States. This will be the situation if both H.R. 10650 and H.R. 9900 become law.

I respectfully urge this committee not to approve the foreign income provisions of H.R. 10650 which will—

1. Adversely affect the U.S. balance of payments,
2. Decrease the number of jobs in the United States,
3. Decrease the revenues of the United States Treasury, and
4. Render U.S. business noncompetitive with foreign-owned business abroad.

Chart I is based on the figures shown in table I. These figures are taken directly from Secretary Dillon's exhibit III, pages 28–31.

Capital outflow for any year T is plotted against inflow for the year $T+3$. The reason for plotting the data in this manner is to show that a high degree of relationship exists between outflow and inflow 3 years later. Such a relationship would add support to the manufacturing industries' claim that capital invested in Europe tends to produce inflow into the United States in about 3 years.

TABLE I.[1]—*Capital outflow and inflow, U.S. manufacturing subsidiaries, Western Europe*

Capital outflow		Capital inflow [2]	
Year	Millions of dollars	Year	Millions of dollars
1953	−7	1956	135
1954	21	1957	190
1955	36	1958	224
1956	83	1959	298
1957	120	1960	321

[1] Based on data from Secretary Dillon's exhibit III, pp. 28–31.
[2] Inflow is the total of income plus royalties and fees.

CHART I

Capital Outflow versus Inflow Three Years Later
U.S. Manufacturing Subsidiaries
WESTERN EUROPE
Outflow 1953 - 1957
Inflow 1956 - 1960

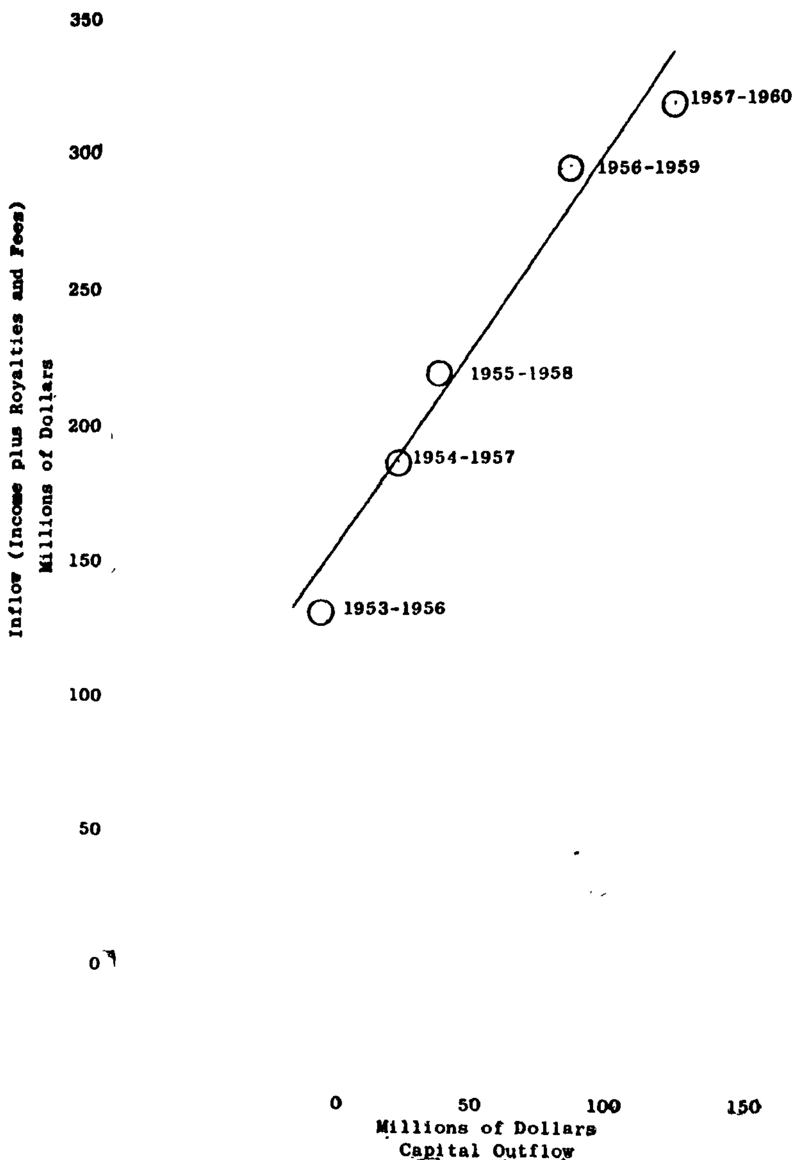

EXHIBIT II

Secretary Dillon has stated as "fact" that one of the primary reasons for investment abroad is the tax deferral incentive. While it may be true that sham corporations have been created because of this tax incentive, these corporations are but a small portion of oversea operations and are not typical of the economy as a whole. In general, investments abroad (as well as domestic investments) are motivated by a host of political, economic, and social factors.

The Secretary has likewise stated as axiomatic that reinvestments of profits abroad are highly correlated with the foreign tax rate, that is, the lower the foreign tax rate the higher the rate of investment. We prefer to treat this statement as a hypothesis to be tested and subsequently accepted or rejected.

Charts II–A and II–B are presented to show what, if any, is the relationship between foreign tax rate and the rate of reinvestment of profits for U.S. manufacturing subsidiaries abroad.

Clearly, for the 2 years portrayed there is no correlation between foreign tax rate and the rate of reinvestment.

Tables II(a) and II(b) show the corresponding figures upon which the two charts are determined.

Assuming independence between foreign tax rate and reinvestment, Mr. Dillon's table 5, page 21, gives quite an erroneous portrayal of the effect of eliminating tax deferral.

CHART II–A

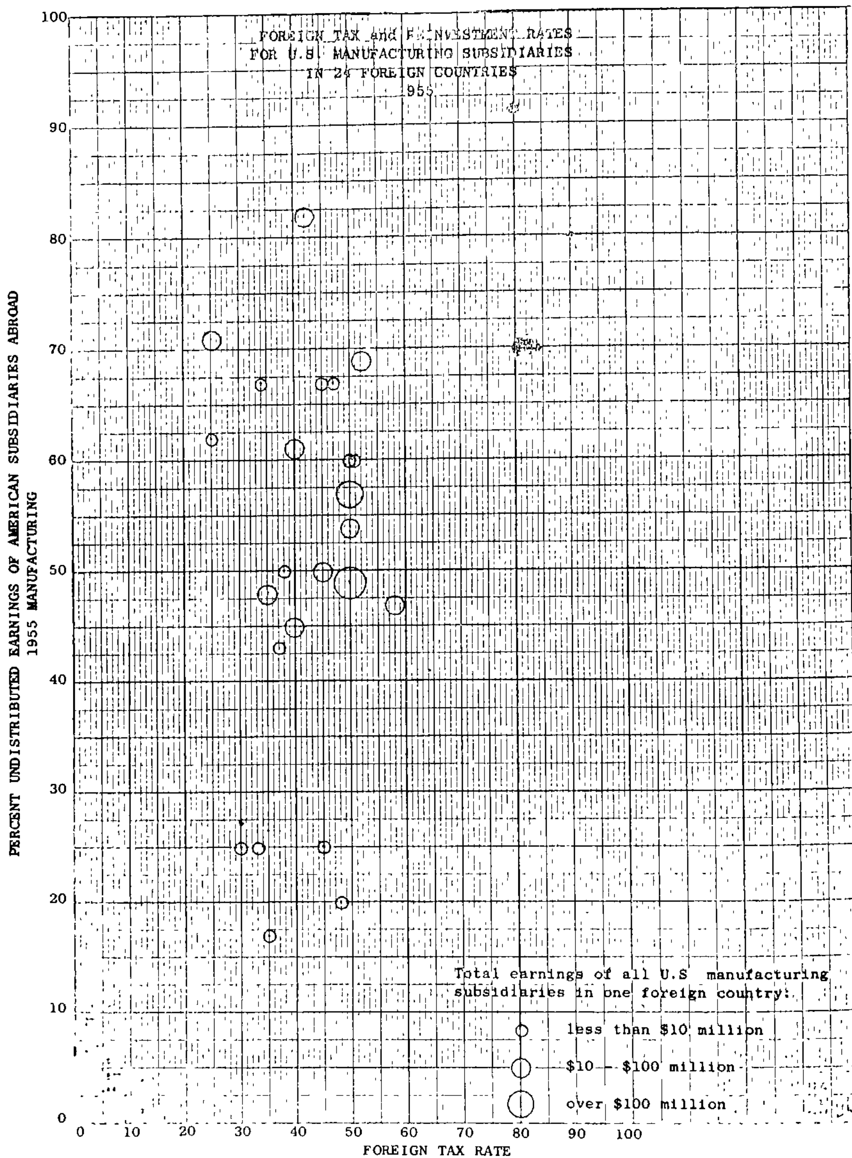

TABLE II (a).—*Earnings and reinvested earnings of U.S. manufacturing subsidiaries,*[1] *1955*

[Millions of dollars]

	Earnings	Reinvested earnings	Percent reinvested
All areas	823	440	53
Canada	336	166	49
Argentina	17	14	82
Brazil	35	25	71
Chile	4	1	25
Colombia	8	5	62
Cuba	6	1	17
Mexico	32	22	69
Panama	3	2	67
Peru	3	.5	17
Uruguay	2	1	50
Venezuela	10	5	50
Belgium	11	5	45
France	28	15	54
Germany	36	17	47
Italy	7	3	43
Netherlands	3	2	67
Spain	2	1	50
Sweden	5	1	20
Switzerland	8	2	25
United Kingdom	161	92	57
Egypt	3	2	67
Union of South Africa	23	11	48
Australia	49	30	61
India	3	2	67
Japan	5	3	60
New Zealand	5	3	60
Philippines	8	2	25

[1] U.S. Department of Commerce, Balance of Payments, Statistical Supplement 1958.

TABLE II (b).—*Earnings and reinvested earnings of U.S. manufacturing subsidiaries,*[1] *1956*

[Millions of dollars]

	Earnings	Reinvested earnings	Percent reinvested
All areas	858	468	55
Canada	393	237	60
Argentina	14	8	57
Brazil	38	27	71
Chile	3	1	33
Colombia	5	3	60
Cuba	5	2	40
Mexico	37	24	65
Panama	2	1	50
Peru	4	1	25
Uruguay	2	1	50
Venezuela	15	4	27
Belgium	11	5	45
France	30	17	57
Germany	33	14	42
Italy	9	4	44
Netherlands	3	1	33
Portugal	2	1	50
Spain	2	1	50
Sweden	5	2	40
Switzerland	7	1	14
United Kingdom	139	61	44
Egypt	2	2	100
Union of South Africa	18	8	44
Australia	41	20	49
India	4	3	75
Japan	10	7	70
New Zealand	4	1	25
Philippines	10	4	40

[1] U.S Department of Commerce, Balance of Payments, Statistical Supplement 1958.

CHART II–B

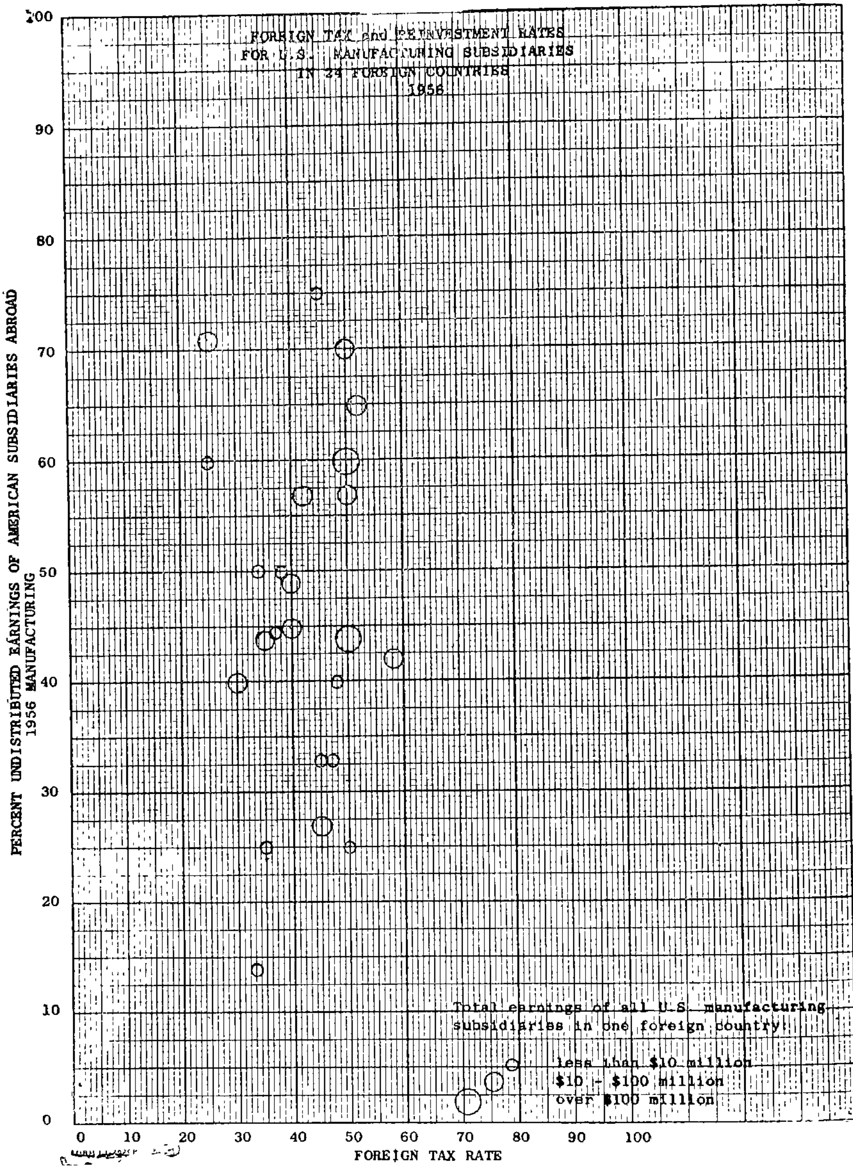

EXHIBIT III

The following table shows both the comparative amounts available for reinvestment and the final returns to a parent company in the United States, and to parent companies in France, Italy, Germany, and United Kingdom, each operating through a Swiss subsidiary, assuming passage of H.R. 10650.

	U.S.	France	Italy	Germany		U.K.
				Swiss Co.	GmbH	
1. Taxable profit	$100.00	$100.00	$100.00	$100.00	$100.00	$100.00
2. Less Swiss tax	10.00	10.00	10.00	10.00	10.00	10.00
3. Total	90.00	90.00	90.00	90.00	90.00	90.00
4. Tax before remittance	42.00					
5. Amount available for investment outside domicile of parent	48.00	90.00	90.00	90.00	90.00	90.00
6. Tax on profit remitted		30.15	15.60	32.40	8.00	28.75
7. Net amount available to parent	48.00	59.85	74.40	57.60	82.00	61.25

AUTOMOBILE MANUFACTURERS ASSOCIATION, INC.,
Detroit, Mich., May 2, 1962.

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

DEAR MR. CHAIRMAN: The Automobile Manufacturers Association submits herewith, for your committee's consideration and for inclusion in the record of the hearings, our views with respect to section 13 of H.R. 10650. This section relates to controlled foreign corporations, which corporations are one of the principal mechanism by which this industry successfully competes abroad with the foreign manufacturers.

Our enclosed brief is in four parts as follows:

1. A general statement, in the nature of a summary;
2. A statement of the economic considerations underlying this industry's substantial investments abroad and an exposition of how such investments have enabled the U.S. automobile industry to contribute nearly $14 billion to the net credit side of the U.S. balance of payments in the past 16 years;
3. A statement of the technical considerations involved in section 13, showing how language intended to tax alleged tax avoidance schemes would in fact have seriously adverse effects on bona fide business operations hitherto regarded as valuable instruments of U.S. foreign policy and vital to the continued economic health of the free countries of the world;
4. Exhibits demonstrating the statistical facts of our presentation.

We trust that if you or the committee would like additional information from us on this serious question, you know we will be happy to supply it.

Sincerely yours,

HARRY A. WILLIAMS, *Managing Director.*

STATEMENT OF AUTOMOBILE MANUFACTURERS ASSOCIATION TO SENATE FINANCE COMMITTEE ON SECTION 13 OF H.R. 10650

I. GENERAL SUMMARY

The Automobile Manufacturers Association strongly opposes enactment of section 13 of H.R. 10650. The principles upon which section 13 is based are so fallacious and the results so foreseeably detrimental to the best interests of the United States in every respect that the association will devote its entire statement to this particular section.

We wish to emphasize that section 13 goes far beyond the correction of abuses concerning tax havens, tax evaders, and sham corporations, the examples so frequently cited in attempting to establish the necessity for such legislation.

We would not oppose reasonable legislation directed toward the taxation of all tax evasion schemes wherever they may exist. Thus, in our view, sec-

tion 6 of H.R. 10650, which would amend Internal Revenue Code section 482 to provide for allocation of income between foreign and domestic corporations, section 20 of H.R. 10650, requiring additional information with respect to certain foreign entities, and the adoption of some valid means of taxing unreasonable accumulations by foreign subsidiaries, would more than suffice to correct any abuses in the area.

Section 13, however, would apply to the income of each and every controlled foreign subsidiary irrespective of whether it is a legitimate manufacturing, assembly, or other operation of a substantial nature. Such an approach represents a complete reversal of our longstanding national policy that encouragement of private U.S. investment abroad is beneficial. It constitutes a manipulation of our tax structure in an attempt to achieve a short-term improvement in our balance-of-payments position. It restricts expansion and diversification. It substitutes the administrative discretion of the Commissioner for the judgment and initiative of private enterprise.

Section 13 would tax U.S. shareholders on earnings of a foreign corporation, whether or not such earnings were distributed. Such an arbitrary and novel approach raises serious questions of constitutional validity and would constitute an eroding influence on fundamental tax principles.

The administration has argued that continuation of the existing tax law artificially stimulates investment abroad, places foreign subsidiaries in a preferred position over domestic corporations, is detrimental to our balance-of-payments position, results in the export of capital and jobs and decreases the export of goods. These arguments simply do not apply to the operations abroad of the U.S. automobile industry.

In 1961, the rapidly expanding automotive markets outside the United States and Canada absorbed, in round numbers, 7 million cars and trucks. These markets are expected to increase substantially in the future. In 1961 approximately 1,400,000 vehicles were produced by the oversea subsidiaries of U.S. automobile enterprises and only 2,500 such units, or less than one-quarter of 1 percent of that total production, were exported to the United States. In the same year the U.S. industry exported some 330,000 cars and trucks from its U.S. manufacturing plants.

The basic consideration in the foreign investment program of the U.S. automobile industry has always been, and continues to be, the necessity to provide the facilities to supply on a competitive basis the vehicles specifically required to meet the demand of oversea markets. Product requirements for the United States and the principal foreign automobile markets are sharply divergent. Design differences are of the same order of magnitude today as they were 30 years ago and it can be expected that these product differences will continue to prevail in the years ahead. The products that are in high-volume demand in foreign markets can only be made available economically from manufacturing sources established abroad because of additional freight costs, import duties and other factors, including local exclusionary practices. For these reasons the U.S. automobile industry must be represented abroad with facilities to compete effectively with increasingly large scale and efficient foreign manufacturers in their own domestic markets and in all other markets requiring product types which cannot be produced economically in the United States.

During the 16 years from 1946 through 1961, the exports of the U.S. automobile industry amounted to more than $17 billion and generated a net export surplus for the United States of almost $14 billion, thus favorably contributing a substantial amount to the U.S. balance-of-payments position. Such sales were possible only as a result of the existence of worldwide sales and service facilities supported primarily by the products produced by foreign affiliates of the U.S. firms and sold in high volume in these markets. Thus, sale of American automobile products abroad is vitally dependent upon investment by U.S. firms in foreign plants.

Essentially, section 13 would impose a tax burden on foreign operations of American automobile companies more onerous than that borne by their foreign competitors. Thus, it would be detrimental to the best efforts that American companies are exerting to participate as effectively as possible in world automotive markets of increasing competitive intensity. Only such participation can produce the long-term foreign source income needed by the United States.

II. ECONOMIC ASPECTS OF AMERICAN AUTOMOBILE INDUSTRY FOREIGN INVESTMENT

U.S. direct oversea investments in motor vehicle assembly and manufacturing facilities are a result of the special demands of oversea markets as well as the policies of foreign governments which penalize imported products as against locally manufactured products.

In the early stages of the automobile industry it was possible for U.S. manufacturers to export fully assembled cars and trucks to meet the relatively limited demand of oversea markets. With the growth of oversea demand the industry continued to enlarge its export business by shipping unassembled vehicles abroad for assembly overseas. This was necessary in order to meet local requirements most economically. During the second half of the 1920's in particular, the industry expanded its oversea assembly facilities substantially to meet the growing competition of oversea producers who enjoyed the natural advantages of location and lower shipping costs. Moreover, it already was apparent that national policies—tariffs, quotas, and special automobile fees—would further insulate the European producer from U.S. competition.

By the end of the 1920's, however, it became evident that although local assembly would greatly assist the continued sale abroad of American vehicles, the preponderance of demand in the principal foreign markets increasingly would be inclined toward product types differing from those developed and manufactured in large volumes for the U.S. domestic market. In 1930, U.S. passenger cars in the low-priced group averaged 108 inches in wheelbase, 180 inches in overall length, about 2,500 pounds in curb weight, and 188 cubic inches in engine displacement. Their average retail price represented 22 percent of national income per household. In contrast, the most popular passenger cars in Europe had an average wheelbase of 95 inches, an overall length of 150 inches, a curb weight of 1,650 pounds, and a low engine displacement. Annual registration fees and insurance premiums in Europe were sharply progressive in terms of engine capacities and these factors, combined with heavy gasoline taxes, kept engine sizes small. Even so, the retail price of such cars, amounting to some 70 percent of national income per household, made them relatively much more expensive to foreign buyers than were the larger, more comfortable, and better performing U.S. cars to American buyers.

The wide gap in retail prices and operating costs relative to consumer incomes and the great differences in driving conditions between the United States and most other countries explained the foregoing differences in product design. Americans who could afford the American-type vehicle did not accept the smaller foreign types in any numbers. The U.S. market thus did not provide a large volume domestic base required for an American product that would compete effectively abroad with the smaller vehicles demanded in those markets.

The worldwide economic difficulties of the early 1930's induced extensive distortions in the pattern of relatively free trade. High tariffs, discriminatory taxes, and other measures were invoked by industrially advanced countries abroad to protect and promote the domestic market interests of their own automobile industries. In the period 1920 through 1924, the four principal oversea manufacturing countries at that time—England, Germany, France, and Italy—supplied an average of 75 percent of their domestic demand, and imported 20 percent from the United States and 5 percent from other sources. In the period 1930 through 1935, however, these countries supplied an average of 95 percent of their own requirements and imported only 4 percent from the United States and 1 percent from other sources. Artificial trade barriers further impaired the export sales potential of vehicles produced in the United States.

The prewar trend continued after World War II with most foreign economies disrupted and seeking to reestablish their competitive bases. The divergence of American and foreign vehicle types persisted, as did increasingly restrictive import quotas, high duty rates, and tax barriers. These measures were taken to conserve foreign exchange and, in the foreign manufacturing countries, to assist their redeveloping automobile industries.

A comparison of the 1962 specifications of the highest volume passenger car model sold in Europe and a typical American small car indicates that the differences in product characteristics that prevailed 30 years ago still exist and that they are of about the same magnitude.

	Typical European-type passenger car		Typical U.S. small-type passenger car	
	1930	1962	1930	1962
Wheelbase ... inches	95	95	108	110
Overall length ... do	150	160	180	183
Curb weight ... pounds	1,650	1,631	2,500	2,558
Engine displacement ... cubic inches	58	73	188	194

Other economic factors influencing demand for passenger cars are shown in detail in exhibit I, attached.

For many years U.S. vehicles have been subject to severe import quotas, exchange controls, highly discriminatory new car ownership and registration charges in a number of important markets abroad. These are factors which, in addition to high tariffs, have greatly increased the cost of an American car to the retail buyer. These charges have substantially impaired the competitiveness in, or completely barred the entry of American passenger cars and commercial vehicles into, those markets. Exhibit II summarizes the principal trade restraints as applied by countries constituting the largest foreign automobile markets.

Different types of retail sales taxes levied at particularly high rates by countries such as the United Kingdom, Australia, and France add a considerable cost burden to American cars competing for sales in those markets. These taxes are particularly onerous since they are computed either on the duty-paid value of the vehicle, or in some instances on this value augmented by a fixed percentage markup. It is to be noted also that the duties in turn are imposed on the cost, insurance, and freight values which are higer on automobile exports from the United States than on imports of comparable products for the American market. The calculation of import duties by foreign countries on the cost, insurance, and freight basis is in contrast to the practice of the United States of applying the duty to the factory cost of production in the source country plus the equivalent of the customary discount from list price in that country.

In recent years an increasing number of countries, which have been large export markets in the past for motor vehicles produced in the United States, have initiated or are currently considering local development of an automobile manufacturing industry to the virtual exclusion of imported vehicles. Continued participation in these expanding markets by the American automobile industry in the future is possible only by investment in the facilities required by the Government-imposed local manufacturing programs.

In this connection it is important to mention a second factor which is in some respects unique to the automobile business. The nature of the product—the expenditure required, its durability, its complexity, and, even more important, its mobility—puts special emphasis on a financially healthy and geographically well-distributed system of dealers to sell, and very importantly, to service the product. This system is a fundamental requirement for building for long-term growth. It can be developed only if volume sales are a reasonable prospect. Investment abroad to provide cars adapted to non-U.S. living conditions and income levels was and continues to be the vital prerequisite to distribution abroad of U.S.-produced vehicles.

In short, the action of U.S. automobile companies in building plants abroad has been taken to assure the competitive position of the U.S. industry in those markets. These investments most emphatically were not a case of replacing exports from the United States by cars produced overseas. The choice was of participating in these markets through local production, or of abandoning them to foreign competition. It was clear even then that unless U.S. manufacturers became a part of those markets, U.S. automotive participation in oversea markets must decline when faced with the natural advantages enjoyed by oversea manufacturers and the protective policies of their governments.

Automotive foreign investment and the balance of payments

In spite of the economic and political obstacles to automotive exports, the value of the industry's exports exceeded imports in every postwar year. In 1959, the year when the volume of new passenger car imports reached its peak, the value of U.S. automotive exports exceeded imports by almost $400 million. For the 16-year postwar period, the American automotive export surplus has totaled almost $14 billion (see exhibit III). This record was possible only because the industry had made the investment abroad which would support an efficient and effective system of distribution. In addition, this investment has produced a substantial flow of earnings to the United States.

In 1961, about half of the free world's cars and trucks—or just under some 7 million units—were produced outside the United States and Canada. Of these, approximately 1,400,000 vehicles, or about 21 percent, were produced by oversea subsidiaries of U.S. manufacturers. That year these subsidiaries exported only 2,500 units, or less than one-quarter of 1 percent, of their total production to the United States. Adding some 330,000 cars and trucks manufactured in the United States for export to oversea countries, some 1,730,000 motor vehicles sold overseas represent the U.S. industry's contribution to oversea automobile trade. About 81 percent of these, produced overseas, presumably would have been supplied by foreign firms if there was no U.S. investment in oversea plants.

The automobile industry's investments abroad have assisted the U.S. balance of payments in other ways, in addition to earnings remitted by the affiliated plants and their direct purchases of assembly components from their parent firms. The manufacturing plants purchase raw materials and other materials as well as components in the United States. These companies also purchase machinery, equipment, and tools from American suppliers. Moreover, the industry's investments, by contributing to improved living standards and a higher level of demand abroad, have added indirectly to income returned to the United States from increased sales abroad of many nonautomotive products.

Private foreign investment by the automotive industry has supported the U.S. Government in its foreign economic assistance programs such as the Marshall plan for Western Europe, and current projects for industrialization of less developed countries. The oversea investment projects of the American automotive industry have been consonant with the economic interests of the countries in which they have been undertaken and have been initiated primarily on the basis of long-term considerations.

There is an important principle involved in this brief account. Free international trade must include uninhibited movement of capital, without regard to national boundaries, as well as the free movement of goods. The value to the United States of a growing volume of exports, competitively priced, is well established. But a key fact that should also be made clear is that increased trade and freedom to invest complement each other—the investment being an essential factor in the ability of an industry or a nation to maintain or enlarge its exports.

Inequitable treatment of U.S. automobile industry in proposed tax legislation

Some proponents of the proposed change in tax treatment claim that its purpose is to insure greater tax equity among American manufacturers. It is held that inequity exists between manufacturers who have foreign subsidiaries and those who have not, because earnings retained overseas are generally taxed by the countries in which they are earned at lower rates than in the United States.

In reality, a foreign subsidiary of a U.S. corporation is taxed at the same rate as its competitors in any particular country. This is obviously equitable within that country. Far from removing a fancied inequity, any change in tax rates that would be applicable only to an American-owned company would represent the creation of a real inequity.

It is no defense against this truth to remark that many foreign countries restrict the export of capital; that governmental permission must be obtained before investing overseas. Once permission to invest overseas is granted, the foreign manufacturer is a vigorous competitor in the country he enters. It would be unfair to make the American-owned company pay higher taxes than such a foreign competitor pays.

To tax the retained earnings of foreign subsidiaries at rates prevailing in the United States would make these subsidiaries less competitive with native companies. Since this would obviously discourage foreign investment by American companies, the proposed bill modifies, but does not eliminate, the new

tax penalty for subsidiaries in so-called less developed countries. The less developed countries are to be determined by Executive decree.

This provision, by itself, almost demolishes the "equity" plea; if it is inequitable to U.S.-based industry for an American-owned company in a "developed country" such as England to be taxed at English rates, would it not be inequitable for an American-owned company in a less developed country, such as Brazil, to be taxed at Brazilian rates? Unless the plea of equity is totally devoid of substance, we have an administration supporting inequitable treatment of American private business as an acceptable and desirable means of promoting the development of economically less developed areas.

A seemingly trivial point but one that will introduce an important element of uncertainty in investor decisions is that there are no generally accepted criteria as to what constitutes a less developed country. The proposed tax legislation lists certain countries which are not to be considered by the executive branch as less developed in any case.

Venezuela is not on this restricted list, but national income per capita is higher there than it is in some of the listed countries. Mexico, which is not on the restricted list, has national income per capita about equal to that of the poorest country among those listed. This raises the question as to when a less developed country is to be classified by the President as being developed. Business planning under such circumstances is impossible. A tax on retained earnings in developed countries would therefore discourage investment in countries that might be nearest to being considered developed, where otherwise investment opportunities might be the greatest, and where additional American capital could do the most immediate good.

Considerations for the future

The American automotive industry's investments in manufacturing plants abroad are made to produce cars, trucks and other products designed for and sold principally in oversea markets. The development and periodic expansion of these plants in the future will be related to the basic purpose of strengthening the participation of American interests in markets outside of the United States. Capacity determination in the American-associated plants in various countries is derived from the best estimate the particular firm can make of the market outlook for its products in the plant country, plus other markets for the specialized foreign-type products.

The U.S. industry, its employees and its shareholders can participate in the expanding oversea markets in the future only if investments are made there to assure the industry the same opportunity enjoyed by competitive foreign manufacturers. This investment is required not only for oversea production but also to insure the continued economical distribution of motor vehicles produced in the United States. It is doubtful if distribution channels could be kept open in many countries with U.S. products only. Without oversea-based plants, therefore, exports from the United States would decline and shareholders in U.S. companies would be deprived of an important revenue source. It is clear that if U.S. direct oversea investments are discouraged by unwise tax policy or other impediments to the free flow of investment funds the U.S. economy will lose an important and rising long-term resource of funds from abroad.

It is not overstating the case to say that this resource will be seriously impaired if U.S. oversea investment is discouraged, for it is certain that other investors outside of the United States will seize the opportunity. And these investors will have distinct advantage in expanding their operations if American enterprises are no longer able to do so on the same competitive basis of reinvesting abroad retained earnings unreduced by the imposition of taxation such as is being proposed by the administration. Primarily, through the reinvestment of earnings and borrowings of foreign capital—thus involving a minimum of actual outflow of capital from the United States—the American automobile industry has provided and will continue to provide the assets abroad necessary to generate a flow of earnings to this country from participation in the principal foreign vehicle markets.

The United States needs both rising exports and a free flow of productive investment funds if it is to make the most of the opportunities that prevail in a free economic world. Both exports and capital investments overseas will be required to maintain the healthy flow of funds that is required. It would be shortsighted to attempt to discourage the enterprise and investment which has contributed so much in the past and can contribute even more in the future to the credit of the U.S. balance of payments.

II. TECHNICAL CONSIDERATIONS

Section 13 would tax currently U.S. shareholders on certain types of income of controlled foreign corporations. This would result, in many cases, in subjecting to U.S. tax a substantial part of conceivably all of the annual undistributed profits of foreign corporations.

Among those items which would be included as currently taxable income of the U.S. shareholder would be: (1) foreign base company income; (2) income from U.S. patents, copyrights, and exclusive formulas and processes; and (3) investments of earnings in nonqualified property.

Each of these provisions, considered in detail below, is subject to extensive criticism because of its seriously adverse effect on bona fide business operations abroad. They generally disregard principles of tax law as well as the laws governing corporate shareholder relationships. They represent an unwarranted intervention by the Government in the investment decisions of business.

Since the enactment of the income tax many years ago, it has been well established that a legitimate operating corporation and its shareholders will be regarded as separate entities. Shareholders are not now taxed on the earnings of the corporation until such earnings have been distributed in the form of dividends. This principle has seldom been disregarded. In the case of "paper" corporations courts have held that where the subsidiary was merely an unnecessary sham or subterfuge, the income of the subsidiary was to be attributed to the shareholder or parent corporation. Similarly, the separateness of corporate entities has also been disregarded under the foreign personal holding company provisions. It must be noted that these provisions were enacted to preclude the use of "incorporated pocketbooks." However, in the absence of any indication of tax evasion, we emphasize that the concept of taxing U.S. shareholders on the profits of foreign corporations is a long step in the wrong direction. If enacted, it would be comparable to subjecting U.S. shareholders to current tax on the undistributed profits of all U.S. corporations.

Foreign base company income

Included as currently taxable income of U.S. shareholders would be "net foreign base company income," i.e., foreign base company income reduced by the increase in investment in qualified property in less-developed countries.

If the foreign base company income is more than 80 percent of gross income, the entire gross income would be currently taxable to the U.S. shareholders; if it is less than 20 percent of gross income, no part of the income would be treated as foreign base company income; if it is between 20 and 80 percent of gross income the foreign base company income would be attributed to the U.S. shareholder.

Under the existing foreign personal holding company provisions the applicable test is 60 percent, or 50 percent in the case of a foreign personal holding company once it has been classified as such. In the case of a domestic personal holding company the test is 80 percent. Section 13 would establish an entirely new test at 20 percent. This 20 percent "floor" is inconsistent with existing provisions, and is so low as to include within its scope those operating businesses which were established long ago without any considerations of tax evasion. Such corporations are often substantial manufacturing operations with subsidiaries which also are engaged in manufacturing. It must be emphasized that operation through the use of sub-subsidiaries is, in many cases, dictated by local and regional marketing considerations and the necessity for centralized management. Enactment of section 13 would undoubtedly stimulate artificial fragmentization of previously centralized operations, thereby increasing administrative burdens and reducing the overall profitability of businesses operating abroad.

The foreign base company income provision would encompass foreign corporations which are clearly engaged in the active conduct of a trade or business but which derive their entire income in the form of interest. For instance, income from financing or credit activities legally or economically required to be carried out by a separate corporation and which are essential to the successful manufacture and sale of automobiles would be taxed immediately to the U.S. shareholders. This result seems unintended and unwarranted.

This section also would provide for the current taxation to U.S. shareholders of income arising to the controlled foreign corporation from the purchase from or sale to a related entity of personal property purchased outside the country where the controlled foreign corporation is incorporated for use, sale, or dis-

position outside that country. This provision would encompass many transactions in which no U.S. parties participate. While the report of the Committee on Ways and Means states that the provision is intended to tax income of a selling subsidiary which has been separated from manufacturing activities of a related corporation merely to obtain a lower rate of tax for the income, it actually seems to go much farther. It could be construed to apply to many operations which are not purely sales activities but actually are manufacturing, such as a subsidiary in Holland with a manufacturing branch in Belgium which substantially transforms property purchased by the Dutch corporation which sells it in a third country.

Foreign base company income subject to current tax would be reduced for amounts immediately reinvested in less-developed countries in (1) stock in another foreign corporation which has been organized under the laws of a less-developed country and substantially all of whose properties are used in a trade or business conducted in less developed countries; and (2) property which is necessary for the active conduct of a business carried on by the controlled foreign corporation almost wholly within less-developed countries. These provisions are so restrictive as to prevent a foreign corporation conducting a legitimate business in developed countries from reinvesting its foreign base company income in such business even though that business produced the income. Furthermore, it appears that these provisions even prevent a controlled foreign corporation which is engaged in widespread operations in both developed and less developed countries from investing in business property in a less-developed country.

The provision for relief from current taxation of foreign base company income if it is reinvested within 75 days after the close of the taxable year in a less-developed country is not practical. This limitation on the time necessary to make the investment decision, as well as to carry it out, is totally unrealistic and unreasonable. It is frequently impossible to determine earnings within such a limited period and, certainly, the decision to invest, particularly in less-developed countries, often entails commitment of funds over several years, not merely on the basis of an annual accounting period, and requires considerably more time to investigate investment opportunities, to negotiate with foreign governments and foreign businesses, and to commit funds for long-term projects. The time required for investment in the United States, considering site selection, contracting and construction, is usually 2 or more years. Even more time would be necessary to accomplish this work in a less-developed country.

Income from U.S. patents, copyrights and exclusive formulas and processes

Section 13 would also include as currently taxable income of U.S. shareholders all income derived from the license, sublicense, sale, exchange or use of U.S. patents, copyrights, or exclusive formulas or processes, reduced by the amount of expenses incurred by the controlled foreign corporation with respect to such income. The income derived from such rights is to be considered as the amount which would be obtained as a gross rent, royalty or other payment in an arm's-length transaction with an unrelated person for the similar use of such rights.

This provision is not limited to the use of such rights in a so-called tax haven manner, whereby such rights would be transferred to a foreign base company for a nominal amount and subsequently assigned or made available by the base company to other foreign affiliates for larger amounts. On the contrary, every domestic corporation would be compelled to ascribe income to such rights developed by it, or even by an unrelated U.S. person, and used by a controlled foreign corporation.

Apparently this result could apply regardless of whether the full rights to such use had been transferred outright many years ago to the foreign corporation at an adequate, arm's-length price. No specific exception is to be made even if the legal life of such rights has expired. The Commissioner would, in effect, become a party to each and every licensing or fee arrangement ever entered into with a foreign corporation, no matter how remote in time, or how fair the terms, when originally negotiated.

Under the ambiguous wording of the bill there appears to be no reasonable limitation on the amount of income which could be attributable to the U.S. parent. If an American manufacturer were engaged in manufacturing operations in Belgium through a wholly owned Belgium subsidiary, the Commissioner might contend that except for the availability of a license from the U.S. parent, regardless of the price paid for such rights, the foreign subsidiary could not have derived any of its manufacturing income. Thus, the end result could be a current U.S. tax on the entire undistributed earnings of the foreign subsidiary, although it is unlikely that such an extreme result would have been intended by the Congress. Such a result would render the American manufacturer noncompetitive as against the local Belgium manufacturer who would be subject only to the Belgium corporate tax rate of approximately 30 percent on undistributed profits. This 22-percent advantage could, and undoubtedly would, render the American manufacturer noncompetitive in the market.

Investments in nonqualified property

Section 13 also taxes currently to the U.S. shareholder that amount attributable to investments in "nonqualified property," which means any money or other property which is not "qualified property." The term "qualified property" means (1) any money or other property which is located outside the United States and is ordinary and necessary for the active conduct of a trade or business which is the same or substantially the same as the trade or business carried on by the controlled foreign corporation; (2) any active trade or business carried on directly by the foreign corporation in a less developed country; and (3) stock acquisitions by the controlled foreign corporation in another controlled foreign corporation if substantially all of the property of such other controlled foreign corporation is ordinary and necessary for the active conduct of a trade or business engaged in by it almost wholly within a less developed country.

These provisions would be applicable for taxable years beginning after December 31, 1962, after which time section 13 would provide, with respect to developed countries, for a 5-year "seasoning" period before an investment, or profits arising therefrom, can constitute a qualified trade or business. Here also, the distinction between "developed" and "less developed" countries would be made the subject of Executive mandate.

These provisions would prevent the free flow of capital without any test of whether or not any element of tax avoidance was present. At least to this extent, it would be entirely inconsistent with objectives of the administration's trade expansion program promoting the free flow of goods. While as previously indicated we would not object to some "unreasonable accumulations of earnings" test, this provision would appear to be more severe with respect to foreign corporations than the unreasonable accumulations provisions presently existing under the Internal Revenue Code with respect to domestic corporations. The domestic provisions are applicable to domestic corporations only if (1) there is an attempt to avoid taxes on the part of the shareholders, and (2) the corporation has accumulated beyond the reasonable or reasonably anticipated needs of the business. Neither of these two limitations would be invoked under section 13. The subjective question of whether a tax avoidance motive exists on the part of the shareholders would be completely absent from a determination leading to taxability under section 13.

Furthermore, the "reasonable or reasonably anticipated needs of the business" test under domestic provisions would in this case appear to be restricted to an "ordinary and necessary" test, to be applied by the Commissioner allowing management little discretion in its investments beyond the minimal use of working capital. Whereas the existing domestic provisions have as their objective the prevention of tax avoidance, the stated purpose of section 13 in this regard is the prevention of diversification of business abroad.

It would seem that this provision would prevent both horizontal and vertical integration of manufacturing activities. For instance, a corporation engaged only in the manufacture of cars in a developed foreign country on December 31, 1962, might thereafter not be allowed, without adverse tax consequences to the U.S. shareholders, to invest in the manufacture of components of the principal automotive product, such as spark plugs, glass, or electrical components, or in such ancillary activities as consumer financing or insurance. It is also doubtful whether the foreign subsidiary could invest in a facility for manufacturing cars in another developed country, since the Treasury has taken the position under other provisions of the Internal Revenue Code that investment in one state in one line of activity constitutes a different trade or business from an investment in another state in precisely the same activity.

The associaion contends that this portion of section 13 severely restricts the mobility, potential profitability, and liquidity of private venture capital abroad. It substitutes the administrative determination of the Commissioner for the initiative and discretion of management not only as to where capital ought to be invested, but also how much is required.

It is apparent that the complex provisions of section 13 would not only impose an onerous burden of recordkeeping but that their enforcement would be difficult and proportionately very expensive to the Treasury. Also noted as objectionable are the lack of provisions for deduction of losses from foreign operations or for currency devaluation after the income has been taxed.

CONCLUSION

The American automotive industry does not go abroad to avoid taxes; it goes abroad to become or stay competitive with foreign manufacturers. It does not reinvest earnings abroad to avoid U.S. taxes, but to realize potential profits for the United States. Furthermore, it is well established that investments in profitable enterprises in other countries, whether developed or less developed, are mutually beneficial to the economies of the United States and of the countries of the free world. It is almost self-evident that a restrictive measure of the magnitude of section 13 can have only destructive consequences and therefore should not be enacted.

EXHIBIT I

SELECTED FACTORS INFLUENCING NEW PASSENGER CAR PURCHASES IN PRINCIPAL WORLD MARKETS

(U.S Dollar Conversions at Official Exchange Rates)

YEAR 1961	AUSTRALIA			FRANCE			GERMANY			ITALY			UNITED KINGDOM			U.S.A.		
INCOME FACTORS																		
Average Annual Income of Hourly Rate Employe in Automobile Industry—$		2,792			2,076			1,810			1,694			2,758			6,313	
% of U.S A		44			33			29			27			44			100	
CAR OWNERSHIP AND OPERATING COST FACTORS	Typical European Low Price Car	Highest Sales Volume Car	Typical U S Regular Low Price Car	Highest Sales Volume Car	Typical U S Small Car	Typical U S Regular Low Price Car	Highest Sales Volume Car	Typical U S Small Car	Typical U S Regular Low Price Car	Highest Sales Volume Car	Typical U S Small Car	Typical U S. Regular Low Price Car	Highest Sales Volume Car	Typical U.S Small Car	Typical U S Regular Low Price Car	Typical European Low Price Car	Typical U.S. Small Car	Typical U S. Regular Low Price Car
Car Purchase Cost—$	2,226	2,466	5,751	1,230	4,963	6,334	1,150	3,398	4,113	1,065	4,304	5,704	1,473	5,831	6,310	1,595	2,108	2,614
% of Annual Income	80	88	206	59	239	305	64	188	227	63	254	337	53	211	229	25	33	41
Annual Registration Cost—$	14	19	28	13	35	59	43	85	138	16	162	369	42	42	42	8*	13*	19*
Special Ownership Tax—$	—	—	—	18	30	243	—	—	—	—	—	—	—	—	—	—	—	—
Gasoline Cost:																		
Per U.S. Gallon—$	0.32	0.32	0.32	0.74	0.79	0.79	0.55	0.61	0.61	0.61	0.67	0.67	0.49	0.54	0.54	0.34	0.34	0.34
For 8,000 Miles—$	85	102	160	160	275	395	147	212	305	140	233	335	119	188	270	91	118	170
Average Annual Depreciation Cost, 10 yr Car Life—$	223	247	575	123	496	633	115	340	411	107	430	570	147	583	631	160	211	261
Total Principal First Year Operating Costs—$	322	368	763	314	836	1,330	305	637	854	263	825	1,274	308	813	943	259	342	450
% of Annual Income	12	13	27	15	40	64	17	35	47	16	49	75	11	29	34	4	5	7

*New York State

EXHIBIT II

TARIFF, LICENSE, QUOTA AND OTHER TRADE RESTRICTIONS ADVERSELY AFFECTING PURCHASE COST COMPETITIVENESS OF U.S. SOURCE PASSENGER CARS IN SELECTED COUNTRIES

ARGENTINA

TARIFFS

SUP—Up to 4,180 lbs /value under $1600—$0.09 per lb plus 10% on tariff value

Up to 4,180 lbs /value over $1600—57% on tariff value

Over 4,180 lbs —57% on tariff value

CKD—30% less than SUP tariffs

Tariff Value—Source country list price less 20% plus 10% of that amount

IMPORT LICENSES

From 1950 to Nov 1958 import licenses were not obtainable on a commercial basis. Such limited car imports as were allowed were specific and under exceptional circumstances

SURCHARGES

Effective Nov 1958 following surcharges were added to prevailing tariffs applicable to cars up to 3,300 lbs. at rates from $2.72 to $4 91 per lb Cars over 3,300 lbs. and over $2,000 factory cost are generally prohibited for commercial import. Where exceptions are allowed, the surcharge is $5 45 per lb In no case will total surcharges be less than $2,890

MANUFACTURING REQUIREMENTS

In March 1959 provision was made for the importation of components on a decreasing scale over a'5 year period within which company programs for complete local manufacturing are to be implemented. Failure of manufacturers to meet progressive annual increases in local content will subject them to penalty charges on any imports in excess of the stipulated minimum local content requirements

AUSTRALIA

TARIFFS

SUP—All vehicles up to 10 tons GVW—35% ad valorem except British Commonwealth sources which pay 25% rate

Vehicles 10 tons GVW or more—22½% ad valorem except British Commonwealth sources which pay 12½% rate.

CKD—Components for assembly pay rates from 7½% to 42½% ad valorem except British Commonwealth sources which pay rates varying from zero to 35%.

AUSTRALIA—Cont.

IMPORT LICENSES

Throughout postwar period, imports of vehicles generally, and particularly from the U.S., have been subject to strict government licensing undertaken to conserve scarce dollar exchange and to lend maximum support to the development of a local vehicle manufacturing industry.

SALES TAX

During postwar years sales tax on passenger cars has been levied at rates generally between 30% and 40%, but reduced to 22½% in February 1962. It is computed on duty paid value increased by 20%.

BRAZIL

TARIFFS

SUP—Passenger cars, station wagons and utility vans—up to 3,520 lbs —80% ad valorem c.i.f. over 3,520 lbs.—150% valorem c.i f.

Trucks and commercial vehicles—80% ad valorem c i.f.

Commercial bodies—120% ad valorem c i.f.

Considerable reductions on parts for incorporation in cars with increasing local content.

QUOTAS

Effective Jan. 1, 1958 importation of passenger cars weighing more than 3,520 lbs. and having f o b. port of embarkation value over $2,300 was prohibited. Limited foreign exchange was provided for importation of qualifying cars and made available to importers by auction bidding

IMPORT LICENSES

Import licenses and exchange allocations for the importation of passenger cars during most of the 1950's was governed by over-all balance of payments requirements This involved compensation arrangements tied to Brazilian export commodities and the importation of cars as tourist personal property

MANUFACTURING REQUIREMENTS

A decree issued in Feb. 1957 initiated passenger car manufacturing Companies with approved programs qualifying as to required deletion schedules were given special consideration in the allocation of foreign exchange for vehicle and component imports

FRANCE

TARIFFS

E.E.C.—18% ad valorem, c.i.f.

U.S. and Other Sources—29%

EXHIBIT II—Continued

FRANCE—Cont.

QUOTA AND EXCHANGE ALLOCATIONS

During postwar period until Jan. 1960 U.S. passenger car imports were limited by allocations of dollar exchange in the range of $1-$3 million annually All such restrictions were removed as of Jan 1, 1960.

SPECIAL TAXES

A sharply skewed progressive tax discriminates against ownership and operation of vehicles over 16 fiscal HP which includes all standard size U S passenger cars. For cars under 16 HP the tax is $30 per year. For a new car over 16 HP this tax starts at $203. A 25% value added tax is levied on duty paid value of the car.

GERMANY

TARIFFS

Over 2,000 cc.

1950—Aug. 1957—21% ad valorem, c.i f

Aug. 1957—Jan. 1961—16% ad valorem, c i.f

Jan. 1, 1961—13%

ITALY

TARIFFS

	U.S. Source	E E.C. Source
1,500—4,000 cc.	34.9%	24.0%
Over—4,000 cc	31.4%	21 0%

Import tariffs are levied on the c.i.f. value of vehicles increased by 3%

Other Taxes on Imports

Compensation Tax—8% of duty paid value

Trading Tax —3 3% of duty paid value

Administrative tax—0.5% of c i f. value

QUOTA AND EXCHANGE ALLOCATIONS

From 1950 through 1955 importation of U.S source passenger cars was restricted to those admitted for the annual Turin Automobile Show. Following the Show, these units could be sold in Italy Under this arrangement licenses were granted for the importation of 9 cars per U S make From 1956—1961 total U.S. source passenger car imports were limited by allocations of dollar exchange in the range from $1-3 million annually. On January 29, 1962 quotas for U S source passenger cars were replaced by automatic licensing.

SPECIAL TAXES

A sharply skewed progressive annual registration tax based on fiscal horsepower ratings greatly increases the operating costs of U.S. source passenger cars. A Fiat 600, the volume car sold in Italy, costs $16 for annual registration Annual registration fees for a typical U S. small car and a typical U.S regular low price car are, respectively $162 and $369.

MEXICO

TARIFFS

SUP—Up to $1,920 official valuation*—25%—36% of valuation
$1,920—$2,400 official valuation*—92%—95% of valuation
$2,400—$3,200 official valuation*—106%—109% of valuation
$3,200—$4,080 official valuation*—103%—150% of valuation
Over $4,080—duties increase by 300% on that part of value in excess of $4,080

CKD—Up to $1,920 official valuation—3%—6% of valuation
$1,920—$2,400 official valuation—13%—16% of valuation
$2,400—$3,200 official valuation—19%—20% of valuation
$3,200—$4,080 official valuation—26%—28% of valuation
Over $4,080—duties increased by 90% on that part of value in excess of $4,080
*Official valuation is list price f.o b. factory plus 10%

QUOTAS

Import allocations granted on basis of a percentage of the 1959 amount of foreign exchange used for importation of automobiles. Since Nov 1960 importation of completely assembled vehicles prohibited. Also prohibited are cars having list prices in excess of $4,400 and production materials for deluxe models and items such as power steering, power brakes and air conditioners

MANUFACTURING PROGRAM

Government has received for consideration from assembly industry proposals relative to local automobile manufacturing Program likely to be formulated and initiated in 1962.

U. K.

TARIFFS

30% ad valorem, c.i.f

QUOTAS

1950-54—No U S passenger cars permitted to be commercially imported

1955-58—Annual quotas for American source cars set at 650 units

1959—Annual quota for American source cars set at $4 2 million

Effective Nov. 1959, all quota restrictions on importation of U S passenger cars were removed.

PURCHASE TAX

Rate-wise the high purchase tax—currently equivalent to approximately 46% of retail basic list price—is non-discriminatory, but on U.S. source cars this tax is also levied on the freight, insurance and duty elements of cost. The high duty rate is likewise levied on the freight and insurance costs

EXHIBIT III

U.S. automotive exports and imports, 1946–61

[Values in millions of dollars]

Years	Exports	Imports	Export surplus	Years	Exports	Imports	Export surplus
1946	$544	$1	$543	1955	$1,265	$85	$1,180
1947	1,133	2	1,131	1956	1,387	144	1,243
1948	924	31	893	1957	1,338	335	1,003
1949	759	10	749	1958	1,114	551	563
1950	730	28	702	1959	1,215	844	371
1951	1,212	38	1,174	1960	1,302	626	676
1952	1,016	57	959	1961	1,205	378	827
1953	992	58	934				
1954	1,065	53	1,012	Total	17,201	3,241	13,960

Source: U S. Department of Commerce.

STATEMENT OF WILLIAM D. VAUGHN, PRESIDENT. OVERSEAS MANAGEMENT SERVICES, INC., NEW YORK, N.Y.

My name is William D. Vaughn. I am president of Overseas Management Services, Inc. Affiliated Overseas Management companies in several foreign countries provide services and facilities to U.S. and non-U.S. corporations and individuals participating in international markets. We provide research of foreign markets, determining the feasibility of marketing products therein. We perform corporate planning services for companies which are initiating or revising their international activities. We also provide warehousing in Panama and Belgium, as well as administrative and accounting services.

We do not operate as a foreign-base company. We are local businessmen, and pay local taxes on locally earned income.

It is our function to provide services and facilities to small companies abroad who find it uneconomical to maintain all of the necessary staff and facilities required to operate effectively. We make it possible for a small U.S. exporter to initiate activities in international markets in his own name at a point far earlier in his growth cycle. As a result of these activities, I am acquainted with attitudes and procedures of many U.S. and non-U.S. businessmen with respect to participation in international markets. I believe the proposed legislation regarding taxation of foreign-source income is inconsistent with the objectives of the businessmen who have the responsibility of developing international business for their company, as well as maintaining this country's economic position abroad. It is also inconsistent with the present administration's proposed program with respect to the reduction of duties under the free trade aspects of the bill now in consideration in the Ways and Means Committee.

The companies which utilize the services which we offer in various countries come from both the United States and outside the United States. It is their objective to participate in international markets as effectively as they possibly can in compeition with companies of their own nationality which are probably larger, as well as competitors from other countries. Our warehousing company in Panama has products in its warehouses from U.S. origin but also from foreign concerns, particularly from Sweden and Japan. It is the intent of the owners of this merchandise to bring the product as close and as economically as possible to the market in Latin America. As a result, their selling activity is highly successful. These companies pay only 10 percent of the regular Panamanian tax on income earned from the sale of these products. This proposed legislation would reach into the Panamanian corporation of the competing U.S. manufacturer and in effect wipe out the tax advantage thus made available to not only the U.S. company, but his competitors as well. It is quite obvious that the result of this action would place the American company at a substantial disadvantage over his European and oriental competitors. People from our European office are constantly soliciting business in behalf of our Panamanian warehousing company and report a continued high degree of interest on the part of European companies in the utilization of warehousing facilities in the Colón free zone, and of the advantages offered by the Panamanian tax laws. If the U.S. company should be cut off from this available opportunity, I am certain the

European and oriental competitor, who already enjoys a selling price advantage over the U.S. counterpart, will step in and reap the benefits of a profit accumulation advantage.

This proposed legislation will create particular problems for the smaller businessman abroad. A corporation is no less a corporation because it is small. It is accepted that small business needs help, not a hindrance. And the small corporation is not necessarily a "sham" or a "paper corporation." Many have testified to this committee and to the Ways and Means Committee on how they started small internationally and have grown to a point where they are contributing substantially to the inflow of gold to this country. Proponents of the bill, while repetitively using terminology implying current wrongdoing, have never defined their terminology. There are many other smaller companies today who have all of the ingredients necessary to accomplish a successful expansion record abroad, but their opportunity is threatened by the proposed legislation. If enacted, it will remove the opportunity of the company just getting started and put into the hands of the company which commenced a few years ago the advantage of having created a foreign marketing organization and, in some cases, production facilities. The opportunity of the new smaller company to accomplish this same record will be irrevocably lost.

The opportunity for a small businessman to export through his own foreign subsidiary and thus accumulate capital is the greatest single advantage a small company has to break away from many of his problems not shared by the larger companies. If the Department of Commerce, which is charged with the responsibility of executing a program to encourage small businessmen to export, could offer this opportunity, it would dramatically improve its chances of inducing more companies to export. This legislation effectively removes such an opportunity.

If this legislation is enacted, it will succeed in impairing the opportunity of the U.S. small businessman, and the small or large European businessman will move in, encouraged, and in many cases untaxed, by their governments. Most of the European countries have an active export incentive program and this legislation is going to result in an export discouragement attitude on the part of the very people that the Government is trying to encourage to engage in this activity.

I submit that rather than undertake a legislative and taxing program which would impair the activities of the smaller businessman outside the United States, consideration should be given to a program which would allow utilization of a foreign base corporation for the encouragement of export and accumulation of capital for subsequent investment outside the United States. This investment would provide manufacturing and marketing facilities for a manufacturer to introduce his products in the markets which are not able to accept American-made goods.

The form of this encouragement could be a complete immunity from taxation at any point either to the subsidiary foreign base corporation, or to the parent when dividends are received, on the first $50,000 of annual earned income. A program of this type would not contribute substantially to any reduced income on the part of the Treasury Department. It would further make enforcement of any controls which the Treasury Department feels necessary to apply substantially simpler because no extensive activity would have to be devoted to the company earning less than $50,000 a year. Certainly a program of this type would give a tremendous assist to the Commerce Department's export program.

It is quite apparent that this legislation will further damage existing export from the United States. When enacted, it will eliminate the opportunity of a U.S. company to establish warehousing and marketing facilities close to their markets by taxing the activities of the foreign subsidiary companies so engaged or at least putting these companies in a position where their competitor does not have the same burden of taxation. It will create an opportunity for the foreign competitor to move in on the markets which the U.S. producer has been forced to evaluate with a new set of Government-imposed rules, and will result in a cutback of export activity. At this point the non-U.S. producer of these goods will increase its share of the markets. The non-U.S. producer could be either a non-U.S. owned, or a wholly or partially owned subsidiary of a U.S. corporation, which has been able by virtue of its past performance internationally to establish a manufacturing facility which can ship into third country markets for lower prices.

One of the stated objectives of this legislation is equality of taxation. However, every businessman, whether he owns a business and invests his own money, or whether he is employed to manage another's business, is constantly seeking inequality. He is looking for a better price, a better wage rate, a better product, and lower taxes, in order to more profitably operate. To establish equalizing controls is foreign to his way of approaching business. Further, until such time as a legally imposed social philosophy in this country develops to a point where the individual is no longer in a position to control where he puts his money, the businessman will act consistent with his interpretation of what is best for his business and where he can get the largest possible return for his investment. There is considerable international competition today for the investment dollar. The businessman making decisions with respect to this investment seeks the highest return with the maximum of flexibility and the minimum of risk and control. This proposed legislation apparently quite intentionally seeks to limit the opportunities which the investing businessman from the United States has, and does so under conditions which give tremendous latitude of interpretation on the part of the Treasury Department.

The United States is taxing itself out of the international investment market. There is a strong temptation on the part of the businessman and investor as a result of this approach, and the attitude of the Treasury Department and proponents of this bill, to put funds in investments outside the United States under conditions whereby U.S. corporate tax is not applicable. Certainly the investment of American funds in a foreign corporation which sells a stock issue in this country is typical of this attitude. There should be no reasonable difference between an investor buying shares of a large foreign company which are not taxable by the U.S. Government and a man investing in his own company outside the United States perhaps competing with this very foreign company. The imposition of this tax simply creates a noncompetitive position. The investor with a choice does not want the Treasury Department sitting on the board of directors, or acting as his controller, setting forth where the company's profits are to be spent and how fast. In those cases where a joint venture in a foreign country is feasible and/or even legally necessary, the foreign participant certainly does not want the U.S. Treasury telling him, by way of its control over the U.S. participant, how the books will be kept and how the profits will be taxed or spent. Investors will simply avoid doing business in a way which subjects them to this procedure as set forth in this proposed legislation.

In summary, the proposed legislation is guaranteeing a substantial profit advantage for those companies which are in part owned by U.S. investors and non-U.S. investors, at the expense of existing U.S. companies which have in the past risked their money, in some cases at the request of this Government.

This legislation will inhibit the small manufacturer from ever getting started abroad on a basis which gives him a chance to accomplish that which has been related to this Commission and to the Ways and Means Committee by various companies which several years ago started by way of a foreign-base corporation.

It will force investment capital to seek means to legally move abroad beyond the reach of U.S. corporate tax. It will alienate those countries and even U.S. possessions which have tried to help themselves by helping American business. The legislation will accomplish the gain of some revenue to the United States immediately at the expense of revenue in the future. This legislation will result in the pursuit of all manner of combinations designed to minimize taxes because the premium for success made possible by the legislation justifies the effort, inconvenience, and expense.

Control for the sake of control, as is apparent in this legislation, will force the investment dollar away from the United States. The result of that will be the feeling that still more control is needed and the only available step after this one is virtual exchange control.

Statement of Col. James W. Roberts for the National Association of Wholesalers

My name is James W. Roberts. I am chairman of the Government Relations Committee of the National Association of Wholesalers, 1725 K Street NW., Washington, D.C. I am a drug wholesaler, chairman of the board of the Henry

B. Gilpin Co., of Washington, Norfolk, Va., Baltimore, and Dover, Del. The National Association of Wholesalers is a federation of 37 national commodity line wholesale associations representing a membership of over 15,000 merchant wholesale establishments. We will confine our statement to comments on three sections of the pending tax credit bill, H.R. 10650. We are interested in (1) the tax credit proposal itself, section 2; (2) the sections having to do with taxation of cooperatives, section 17; and (3) section 3, having to do with the deduction of ordinary and necessary business expenses incurred in testifying or otherwise attempting to influence legislators or voters on Federal, State, or local legislative matters.

THE TAX CREDIT PROPOSAL

The wholesale industry has for many years been advocating a change in our tax laws to provide a tax credit or adjustment, based on the reinvestment of earnings principle. It is our firm belief that today's perilously high tax rates fall much heavier on the Nation's smaller, growing businesses than on their larger competitors. We believe this is true in all types of businesses, manufacturing, distribution, and service businesses. We believe that the Nation's future growth and the increased productivity that we hear and read so much about these days is to a large extent dependent on the vigor and stability of the small- and medium-sized independent businesses of the Nation, still the backbone of our economy. We believe that the possibility of new business formation and growth is as important, if not more so, than any other single factor to the continued growth in our economy and the productivity of our American workers.

We would particularly like to call the attention of the committee to the fact that in the last few years, for the first time in the history of the world, a society, the American economy, has become so affluent that it now usefully and productively employs more people in the distribution and service trades than in manufacturing and production combined. We would suggest that this is a significant fact that bears careful examination and consideration by the Congress and particularly the members of this tax-writing committee.

We commend the administration and the Treasury Department for the recommendation to the Congress of tax reform legislation that embraces the philosophy of a tax incentive to reinvest business earnings in expanded plant and facilities—for developing a formula that we believe will stimulate growth in some segments of the economy. We must express our regrets, however, at the lack of understanding of the problems of the fastest growing, and only recently but most certainly the largest employing, segment of the economy—the distribution and service industries. Today's high tax rates fall very heavily on these segments of the economy, just as heavily as on the producing and manufacturing industries. An even larger percentage of the distribution and service industries are small and medium sized, and thus burdened more heavily and retarded in the growth potential more stringently by today's high tax rates than is true in other segments of the economy.

It is for these reasons that we feel compelled to point out to the committee that the formula in section 2 of H.R. 10650 almost completely ignores the needs of the distribution and service segments of the business community. In distribution, especially wholesaling and retailing, the vast majority of the funds required to start a business and to expand it—make it possible for it to grow and prosper—must be invested in inventory and receivables, not in plant and equipment. In wholesaling, for example, it is estimated that only about 15 percent of all business investment is in plant and equipment. The balance of approximately 85 percent is invested in inventory and receivables.

The formula for measuring the amount of the tax credit for reinvestment of earnings that is proposed in H.R. 10650 is based entirely on reinvestment in equipment, mostly personal property as defined in the bill. The stated purpose of the bill is to increase the productivity of the American economy—to make it more competitive in the world markets. In our opinion, too many economic planners forget or ignore the fact that "nothing happens until something is sold." The most efficient economical mass-production system in the world is absolutely useless unless and until it is backed up by an equally efficient economical mass distribution system. It is the "miracle of mass distribution," every bit as much as the "miracle of mass production," that has made the American economy the envy of the world. It is our miraculous distribution system that has made the product of a small Vermont factory available and uniformly

offered for sale in the far corners of this Nation and the world. It is this availability of the products of our factories and farms that has made possible our tremendous increase in production and productive capacity and our miraculous growth in consumption and thus our increased standard of living.

It is, then, a combination of mass production efficiency and mass distribution efficiency that has made our past national economic growth possible, and it will be as equally so in the future as in the past. If the distribution and service segments of the economy are to be permitted to grow and expand, if they are likewise to be permitted to increase their productivity and improve their efficiency, they, too, must have available to them the tax incentives necessary to lighten their tax burden, especially the smaller, growing firms. Their growth capital needs are to a minor extent, met by the tax credit provisions of H.R. 10650. But, to realistically meet their growth capital needs on an equal basis with the producing and manufacturing segments of the economy, credit must be given for increased investment in the inventories and receivables necessary to the expansion of their business. Inventory and receivables are just as necessary to the healthy growth and increased efficiency of the distribution and service trades as plant and equipment are to the manufacturing and producing firms in the Nation. And, increased efficiency and expansion of the distribution and service trades of the Nation is just as important, if not more so, to the future growth of the Nation as a whole as increased efficiency and expansion in production and manufacturing capacity, for "nothing happens until something is sold."

The wholesale industry approves the basic philosophy of the tax credit provisions of the pending bill. We cannot approve of the formula by which the amount of the credit is measured. We urge your committee to consider the addition of at least increased investment in inventory, as well as equipment, to adequately meet the needs of the most important distribution segment of the economy. We would suggest the substitution of the formula provided in S. 2,, pending before your committee and unanimously recommended by the members of the Senate Small Business Committee and many other Members of the Senate. The adjustment percentage deductions provided in S. 2 could and should be revised to meet the tax credit formula in such a way as to incur no addition of revenue loss to the Treasury.

TAXATION OF COOPERATIVES

The National Association of Wholesalers and the wholesale industry has long advocated the full taxation of cooperative corporations just as all other corporations are taxed. Nothing less will ever bring equal opportunity for business growth and expansion in the marketplace, as between cooperative and private business competitors.

The Congress has long considered this matter and continuously rejected the principle that co-op corporations make profits, just like any other business and should be taxed on those profits like any other business.

The 1951 law change was, at the time of its enactment, believed to be completely lacking in effectiveness to accomplish its stated objectives, that of placing at least a single tax either on the co-op corporation or on the patron. The courts later proved this to be the case and the provisions of H.R. 10650, section 17, with respect to taxation of cooperatives or their patrons, will to all intents and purposes, prove to be just as ineffective.

We have subscribed to the statement of Mr. Brady O. Bryson before your committee on this subject. We will not further belabor the point here, therefor, except to point out that consumer cooperatives will escape taxation completely, or can if they so elect, under the proposed legislation. It is consumer co-ops that compete directly with many of our good, independent merchant retail customers. We protest, vigorously, this plan to continue to force them to face completely tax-exempt competition, while a form of relief, at least, is offered to competitors of the so-called farm cooperatives.

We would be derelict in our duty, also, we feel, if we did not point out that dealer-owned or retailer-owned, or even wholesaler-owned co-op corporations will, for all practical purposes, remain tax exempt, if they so choose, under the provisions of the proposed bill. Even though some of our members are beneficiaries of such legislation, we, and in most instances, they feel that it is an unjustifiable advantage. The only equitable solution is full taxation of competing businesses, regardless of the form they elect to operate, on the same

basis. The least that we feel the Congress should do at this time is to follow the suggestion of Mr. Bryson, and tax everything that is retained and not paid out in cash or the equivalent of cash. We strongly urge your committee to consider amendment of the pending bill to so provide.

COST OF BUSINESS EXPENSES

The National Association of Wholesalers urges enactment of legislation to permit the deduction of any business expense which is necessary and desirable to conduct a business as long as the specific activity is lawful. The current restriction on the deductibility of expenses which pertain to legislative activity is no more warranted by the facts than similar restrictions would be on expenditures for judicial proceedings.

The future of virtually every business is strongly influenced by the laws passed by the Congress, State legislatures, county commissions, and city councils. It is both necessary and desirable that business taxpayers be kept informed of actions being taken by these bodies and that the viewpoint of business be adequately presented to these legislative bodies. Frequently, this is the only way the members of these bodies are advised of the economic impact of proposed laws and regulations.

We also believe that the determination of what is ordinary and necessary business expense should remain the judgment of the taxpayer and not the hindsight judgment of Government tax officials who have neither the responsibility nor experience for operating the business involved. Business taxpayers also should have the right to inform the public or any segment of the public about any aspect of their business including the impact of existing laws and regulations or proposed laws and regulations, and the manner in which such laws would affect the prices charged and services rendered to and for their customers. These expenses should be recognized irrespective of the medium which the taxpayer uses to make his views known.

The wholesalers wholeheartedly support the provisions of S. 467 sponsored by Senators Kerr and Hartke. This measure would present a clear congressional intent which tax officials can follow in order that taxes may be imposed with an even justice on all taxpayers, thus eliminating inequities which are bound to arise and which have arisen in the past through the varying judgments of different tax officials. It would also restore to business the ability to speak to legislative bodies without penalties which current court decisions and Internal Revenue practices now place on taxpayers.

The National Association of Wholesaler surges this committee to give favorable consideration to this proposal.

We wish to express our appreciation to the committee for the privilege of making this presentation.

PHILADELPHIA, PA., *May 2, 1962.*

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
Senate Office Building, Washington, D.C.

DEAR SENATOR BYRD: In response to your recent letter I appreciate the opportunity of presenting my recommendations for inclusion in the record of the current hearings by your committee on the revenue bill of 1962, H.R. 10650.

It is unfortunate that simplification of methods and procedures in the collection of Federal income taxes is so difficult to attain, and that instead the system becomes more complicated and cumbersome. There is a point where lack of simplification becomes unnecessarily costly to the taxpayers, businesses, and the Federal Government because improper methods are used.

Inasmuch as we are expanding the Federal tax system to accommodate the filing of more than 100 million tax returns and related information returns of more hundred millions, simplification becomes much more important. The use of automatic data processing to process the avalanche of tax forms will add tremendous costs to administration of Federal tax collection. It therefore is very essential that the system be both efficient and economical.

The present system of withholding tax on salaries and wages is unnecessarily costly because multimillions of refunds must be made each year because of overwithheld taxes. The Federal Government has in its possession vast sums of money improperly collected from taxpayer who cannot be located to receive their refunds. It is a great injustice to the taxpayers to withhold an excessive amount

of tax from their income or earnings and then not pay it back to them because of a faulty system.

To avoid this unnecessary imposition on the taxpayers under the proposed system of withholding tax on dividend and interest income, the greatest effort should be made to prevent overwithholding by the payors. It is expecting too much to require that taxpayers who are not subject to tax and do not owe tax must file claims for refund to get back the money they should have received in the first place. There will be many cases where the taxpayers will be deprived of that portion of their income forever, and it is wrong to withhold tax from them if they do not owe it.

The following specific recommendations should apply with respect to the withholding of tax on dividend and interest income:

1. Tax should be withheld only on dividends paid to individuals and partnerships.

2. No tax should be withheld in the case of dividends paid to any corporations, trusts, estates, regulated investment companies, personal holding companies, institutions, and governmental agencies. Because of ample auditing procedures, Federal and otherwise, as well as voluntary compliance for those groups, it would appear to be entirely unnecessary to apply withholding to such dividends.

3. Exemption certificates should be permitted for all taxpayers regardless of age or other reason if they certify that they believe no tax will be due on their total income. If provision is made for reporting on information returns all cases where tax was not withheld by the payor there should be no difficulty for the Government to determine if any taxpayer did not pay all of the tax due.

4. With respect to interest on savings accounts in banks or other financial institutions, no tax should be withheld unless the amount of tax applicable is up to a certain minimum fixed by regulations of the Secretary of the Treasury. It should be provided that if the interest income is a small amount it would be permissible to not withhold tax until the interest income totaled the prescribed amount, or unless the account is closed. If the minimum refund is fixed at $10 then it might be provided that no withholding under $10 tax should be made.

The greatest consideration should be given to the prevention of unnecessary work by payors of dividends and interest in the withholding procedures because the time involved in calculating, reporting, paying, and later refunding a substantial amount of tax withholding will represent a tremendous cost to the corporations, banks, and other, as well as the Government, on account of the billions of transactions affected.

I shall be pleased to submit further details if desired.

Respectfully submitted.

JOSEPH A. SCHAFER,
Certified Public Accountant.

R. J. CAHILL & CO.,
Panama City, Republic of Panama, May 3, 1962.

Re H.R. 10650.

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

DEAR SENATOR BYRD: Although I am vitally interested in all aspects of the pending tax legislation H.R. 10650 as it effects taxation of foreign corporations, I did not petition to appear before the Finance Committee. Actually I came from Panama only to observe the hearings and to assist where possible my good friend the Honorable Jose D. Bazan, Vice President of the Republic of Panama, who is here in Washington representing the interest of the Colon Free Zône with regards to this tax legislation.

However, during the course of these hearings I noted that no one made a complete statement regarding the effect that section 16 would have on a private U.S. businessman who owns all or part of a foreign corporation.

This provision would work most serious injustices on such citizens. This, by far, is one of the most serious defects of the entire bill. Because there are thousands of Americans who would be affected if this particular section of the bill is enacted, I feel that I must, in their behalf as well as my own bring this matter to your attention.

Therefore, I prepared a statement regarding this subject and I beg your forbearness in permitting me to submit it at such a late date.

In closing I wish to express my admiration of the way you have handled this hearing despite all the complexities which such a tax bill entails.

With my hearty appreciation and good wishes, I remain,

Sincerely yours,

RICHARD CAHILL.

STATEMENT SUBMITTED BY RICHARD CAHILL ON SECTION 16 OF H.R. 10650

Mr. Chairman, my name is Richard Cahill. I am president of R. J. Cahill & Co., S.A. of Panama City, Republic of Panama.

I am appearing as a private U.S. citizen who owns his own foreign business enterprise. I wish to point out that there exist thousands of U.S. citizens like myself who reside abroad and who are the owners, in whole or in part, of a business in corporate form which would be classified as a controlled foreign corporation under section 954 of the proposed law. The architects of H.R. 10650 completely overlooked the unfair consequences this bill would have on such U.S. citizens.

If section 16 in the bill is enacted, a U.S. citizen who owns all or part of such a foreign business will not be allowed capital gains treatment on the sale or liquidation of his stock at the time when he wishes to retire. Instead, the gain derived from such a sale would be included in his gross income as a dividend. Such a person would be required to pay the normal income tax plus surtax. For example, a person who sold his business at a $300,000 gain would pay approximately $250,000 in tax. A similarly situated individual who disposed of stock in a U.S. corporation at a gain of $300,000 would pay a tax of only $75,000. Obviously, in this case the U.S. citizen who has built up a business abroad is being unjustly penalized.

I wish to give one actual example of the hardship section 16 would cause.

A U.S. citizen has been a respected resident of Panama for over 25 years. He and two other Americans own and operate an automobile agency incorporated under the laws of the Republic of Panama. The business has grown steadily in spite of many difficulties and hazards inherent to most Latin American countries. The automobile agency has paid Panamanian taxes on its income regularly since its organization and the individual owners have drawn only a modest salary on which they have paid personal Panamanian income taxes. The remaining profits earned by the agency have been plowed back into expanding the business. After 25 years of hard and diligent work the automobile agency is now successful and prosperous.

One of the individuals who owns about a third of the business has reached the age of retirement and intends to sell his interest in the business. His major asset after 25 years of hard work is the one-third ownership of this business. If section 16 of the proposed law is enacted this individual would only be able to keep after taxes $1 out of $6 of the sale price of his stock. This is tantamount to confiscation of the man's life savings.

Mr. Chairman, I am taking this opportunity to bring this matter to the attention of the Senate Finance Committee and respectfully request in the spirit of justice that the committee take steps to have modified or eliminate entirely this inequitable section.

CHAMBER OF COMMERCE OF THE UNITED STATES,
Washington, D.C., May 3, 1962.

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

DEAR SENATOR BYRD: The attached memorandum, dealing with the constitutionality of sections 13 and 21 of H.R. 10650, is submitted for the record under permission granted by your committee when the national chamber testified on April 3. (Pp. 467–501 of pt. 2 of printed hearings.)

The memorandum has been prepared to deal specifically with problems of international comity which would be created by adoption of these sections in their present form.

Sincerely yours,

THERON J. RICE,
Legislative Action General Manager.

Memorandum Concerning Certain U.S. Tax Proposals and Their Conformity to the International Obligations of the United States With Regard to Switzerland

Question I. (a) Is a company a juridical entity separate from its shareholders?

Conclusions

A. GENERAL REMARKS

1. With regard to juridical personality, Swiss law separates companies into two categories: those which possess juridical personality and those which do not. The following are considered to possess juridical personality:

"Sociétés anonymes" (SA), "sociétés à responsabilité limiteé" (SARL), "sociétés en commandite par actions," and "sociétés cooperatives."[1] A holding company, which is generally established in the form of an SA is not a special juridical form of corporation.

2. These "societes," with the exception of the "societe cooperative," which is an enterprise whose purposes are economic but not commercial, may be classified under the general and rather vague denomination of "company" of Anglo-Saxon law, as that term is used in the various "companies acts."

3. The SA makes the clearest separation between the two subjects of distinct rights of the shareholder and of the company. Shareholders are never personally liable for the debts of the company.

4. The fact that Swiss law confers juridical personality on these types of companies carries with it the consequence that they become subject to rights that are distinct from those of their shareholders or participating members. All the qualities of a new subject of law, as defined in articles 52–55 of the Swiss Civil Code (CCS), have been conferred upon them. They possess the capacity to assume obligations as well as to acquire rights. In particular, their assets are distinct from those of their participants. As regards the responsibility of such persons with respect to the company's assets, however, particularly in the case of dissolution, this is treated differently from one company to another.

B. THE TAX LAW RELATING TO THE COMPANIES

There is a fundamental difference between the system of taxation imposed upon companies which possess juridical personality and those which do not. In this respect, the tax law follows the distinction effected under the private law between such two categories of companies. As a general rule, Swiss tax law does not construct a juridical tax personality where the private law would not recognize juridical personality. The converse of this proposition is also observed and, where the private law confers juridical personality to companies, the tax law treats them as having this quality. Furthermore, Swiss tax law follows faithfully the terminology of the private law, the terms which one finds in the tax law being generally those defined by the private law.

Question I. (b) Can the shareholders be required to pay tax on income derived by and belonging to the company before it is distributed to them?

Conclusions

(*a*) The participant may be taxed only upon revenue distributed. This goes to the very heart of the tax upon distributed revenues.

(*b*) In no case may the participants be taxed before such revenue has been distributed to them.

Question II. Are the foregoing principles inherent in the income tax convention between your country and the United States?

Conclusions

The CDI (the convention between Switzerland and the United States for the avoidance of double taxation on income, dated May 24, 1951) implicitly recognizes the principle of the juridical distinction between the taxable entities, which are the object of the convention, and the physical or moral persons who form them.

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[1] These four terms are translated in the Martindale-Hubbell Law Digests, vol. IV, chapter of Switzerland, as follows: "Shareholder corporation"; "limited partnership corporation"; "general and limited partnership shareholder corporations"; and "cooperative corporations." A competent description, in English, of the structure and functions of each of the entities noted may be found here.

This appears, in the first place, in article III of the CDI which envisages the fiscal subjugation of the enterprise. If it is exploited by a collective entity, to which the convention recognizes fiscal juridical personality, such entity will be the effective subject of eventual taxes.

The United States could not tax American shareholders on accumulated or undistributed profits of the Swiss corporation. Such a course of action would have the effect of circumventing, by the means of the rights accorded to the United States by article XV(1)(a) of the CDI, the dispositions of article VI(1) of the CDI, and thus deprive the convention of a great part of its effect. An interpretation leading to another result would be abusive. It would result in multiple taxation, a consequence which the present convention is precisely designed to avoid.

The preceding discussion results in the following conclusions:

1. Existing American taxes which strike down accumulated or undistributed profits are not applicable, in principle, to Swiss collective entities.

2. To tax the shareholders on the accumulated or undistributed profits of a Swiss company could constitute an abusive interpretation of the convention.

Question III. (a) Under the said income tax convention should the United States tax a company resident in your country on business income not allocable to a permanent establishment in the United States, or on dividends or other income not attributable to United States sources?

Conclusions

In order to qualify as being Swiss, an enterprise must be exploited by a subject of Swiss law.

1. *The taxation of industrial and commercial profits.*—By the terms of article III(1)(a) of the CDI:

"A Swiss enterprise shall not be subject to taxation by the United States in respect of its industrial and commercial profits unless it is engaged in trade or business in the United States through a permanent establishment situated there."

By virtue of article III(1)(a) of the CDI, a Swiss enterprise may be taxed on its industrial and commercial profits only if it has a permanent establishment in the United States. The concept of a permanent establishment, as defined by article II(1)(c), is considerably more narrow than the expression "engaged in trade or business."

If a Swiss enterprise possesses a permanent establishment in the United States, it may be taxed not only on its industrial and commercial profits, but on the totality of its revenue received from the American source.

To the extent that new taxes were introduced which would tend to bypass the prohibitions created by the CDI, particularly by article III thereof, such taxes would be contrary to the CDI.

2. *The tax on dividends.*—The tax on dividends is partially regulated by article VI of the CDI. A maximum percentage is foreseen for the rate of tax withheld by one of the contracting states on dividends arising in its own territory and which are paid to a person domiciled in the other state, or to a collective entity of such other state. These restrictions apply only if the person or entity in question does not have a permanent establishment in the former state.

Question III. (b) Does the so-called saving clause in said tax convention (which says that each government may tax its citizens, or residents, or corporations on the basis of all items of income taxable under its laws, regardless of any contrary provision in the convention, subject to granting a credit, exemption, or other relief from double taxation), permit the United States now to include in the basis of its tax, on its citizens, residents, or corporations all or part of the income of a company resident in your country from sources therein or elsewhere outside the United States before it is distributed?

Conclusions

Referring to above considerations set forth in connection with questions II and II(a), the following answers may be given:

1. *Taxes on undistributed profits are directed against the companies themselves.*—(a) The saving clause of article XV(1) is not applicable. This is for two reasons:

(1) The entities envisaged would be, according to the definition given by the convention itself, "Swiss" and not "American." Furthermore, the saving clause applies only to American nationals, to persons domiciled in the United States or to U.S. corporations.

(2) It is inconceivable that article XV(1)(a) of the CDI could confer upon one of the contracting states the right to exercise provisions of its internal law which are contrary to the convention.

2. *Undistributed profits taxes on companies domiciled in Switzerland which affect the persons who participate in them (the proposed legislation concerning accumulated earnings tax and the taxation of specific items of income from sources outside the United States).*—As regards taxes constituting a disguised income tax on the profits of companies which, in fact, violate the prohibitions or limitations of the CDI: the same answer applies, mutatis mutandis, as that given under point I(a), supra.

Question III. (c) Would the imposition of the tax described in (a) conflict with the spirit and principles of said tax covenant?

Conclusions

The application of article XV(1)(a) of the CDI to justify a national legislation is not permissible if it goes contrary to article III of the CDI. Any legislation violating the principle laid down in article III would constitute an illicit international act because of nonconformity with the CDI.

Question III. (d) Could your Government retaliate by including in the taxable income of shareholders resident in your country a proportionate part of the undistributed income of a corporation organized in the United States?

Conclusions

It should be stated that the taxation of corporations through their shareholders is a concept foreign to the philosophy of the Swiss system of taxation.

Question III. (e) and (f)

(e) Would your Government object to the de facto invasion by the United States of its jurisdiction over the resident company through the United States demanding balance sheets, profit and loss statements, and other information concerning the transactions of the resident company with companies in third countries in order to determine the basis of the proposed tax?

(f) Would your Government permit U.S. revenue agents to examine in its territory the books of resident companies?

Conclusions

International doctrine and practice recognize that each state has exclusive jurisdiction within its territory. This doctrine is also recognized by Swiss and American jurisprudence. There are only two exceptions recognized to this doctrine:

A state may exercise certain acts within the territory of another state, particularly acts of constraint—

1. if an international convention so permits; or
2. if, in time of war, it occupies a portion of the territory of the other state.

The Swiss jurisprudence on this matter is relatively abundant, since Switzerland jealously guards the principle that its territorial sovereignty be respected. This attitude has already provoked several discussions with the U.S. Government. The Swiss attitude has been increasingly reserved in recent years.

(*a*) The answer to question III(f) is negative.

(*b*) Question III(e), on the other hand, requires a more detailed reply.

1. If the information described in this question were requested from the Swiss Federal Tax Administration ("l'Administration Fédérale des Contributions"), the competent authority referred to in article XVI(1) of the CDI, the United States would be met with a refusal, for three reasons:

A law on the accumulated earnings tax and the taxation of income from sources outside the United States, as presently contemplated, would be contrary to the CDI.

The taxes on undistributed profits are not envisaged by the CDI.

Even if such taxes were envisaged by the convention, it would be impossible to provide information of this type to the U.S. Government, because article XVI(1) of the CDI may not be interpreted "so as to impose on either of the contracting states the obligation to carry out administrative measures * * * which would be contrary to its sovereignty, its security, or its public policy * * *."

This point of view is confirmed by the fact that Switzerland refuses to give to the American authorities similar information, necessary for the application of existing American legislation, providing for taxes on undistributed profits (secs. 531–537, 541–547, 551–557 of the Internal Revenue Code of 1954). Such an exchange of information would be contrary to Swiss public policy.

2. If the described information were requested directly from the company against which the new proposed tax is designed, such a procedure would meet the same objections from the Swiss Government. It is immaterial if the request for information comes from an American diplomatic or consular official or directly from an American governmental agency.

The requests for information would not only be contrary to the convention, but would run also counter to general international law. Kelson has observed that—

> "The restriction (of the domain of territorial validity of the internal legal order) refers * * * to the coercive acts provided by the national legal order and the procedure leading to these acts." (Op. cit.)

3. Article 271 of the Swiss Penal Code provides that—

> "He who, without authorization, undertakes upon Swiss territory on behalf of a foreign state acts which replace public powers, He who undertakes such acts for a foreign party or another foreign organization, He who supports such acts, shall be punished by imprisonment and, in serious cases, by solitary confinement with hard labor."

This disposition would be, without doubt, applicable to American officials who would attempt to carry out the acts described. Theoretically, it even applies to the American authorities who, from the United States, would send questionnaires to the collective entities domiciled in Switzerland. In effect, article 7 of the Swiss Penal Code provides that—

"A crime or misdemeanor is deemed to be committed at the place where the author acted as well as at the place where the result is felt.

"An attempt is deemed committed at the place where the author acted as well as at the place where the author intended the result to be felt."

In the present case, the questionnaires sent from the United States would manifest their effect in Switzerland.

Article 273 of the Swiss Penal Code, which is designed to protect the interests of Switzerland against economic espionage, may also be applicable in cases of this sort.

Swiss legislation concerning bank secrecy could also be relevant in this connection.

Question III. (g) Presupposing that the United States has ample authority under its law and its tax convention with Switzerland to allocate to the U.S. parent corporation profit diverted to the subsidiary in your country by transactions which enable the subsidiary to derive therefrom more income than an independent enterprise would receive, is the Swiss Government bound by said tax convention to assist the United States in reallocating to the U.S. parent corporation income so diverted to the subsidiary?

Conclusions

1. *The question at issue.*—One must know to what extent Switzerland is obligated by the convention to aid the United States to levy a tax in the case of diversion of revenue from an American to a Swiss enterprise.

2. *Article IV of the CDI.*—This provides that in all cases where a subsidiary profits from its parent company to the extent that the latter creates more favorable conditions than would be available to an independent company, the parent company may be taxed on the revenue it failed to realize in such transaction but which would normally have accrued to it in other conditions.

3. *Help from the Swiss side.*—It is believed that such conclusions may be made pursuant to articles XVI and XVII:

(*a*) Concerning the information necessary for the execution of the convention, article XVI of the CDI is applicable. One must, however, except situations where the giving of such information would be contrary to Swiss sovereignty, to public policy, to administrative practice, or to penal dispositions of Switzerland concerning secrecy in commercial, industrial, and professional matters.

(*b*) To the extent that the foregoing would create a difficulty or a doubt with regard to the interpretation or the application of the CDI, the competent authorities of the contracting states could have recourse to the friendly procedure provided in article XVII.

Question III. (h) If the subsidiary in your country derived income (1) from selling to customers in third countries goods purchased from the U.S. parent or an affiliated company in a third country; (2) from licensing patents for rendering technical assistance to affiliated companies in third countries; (3) from interest on loans to, or (4) dividends on shares in such companies, does the United States have the right under the laws of your country or the tax convention with the United States to levy a tax based on such income before it is distributed to the U.S. parent?

Conclusions

Reply to question III (h) within the framework of the convention:

(*a*) *The question at issue.*—The issue raised is to know if, pursuant to the convention, the United States (the state of which the shareholders are nationals) may tax such shareholders upon revenue of a subsidiary company domiciled in Switzerland.

(*b*) *Article III of the convention.*—Article III of the convention states that a Swiss enterprise may not be taxable by the United States for its "industrial and commercial profits" if it has no permanent establishment in the latter.

1. There is no doubt that the companies in question are Swiss enterprises within the purview of the convention.

2. Furthermore, there is no doubt that such companies do not possess a permanent establishment in the United States of America. This is basic to their type of activity, which envisages third states.

3. It must be concluded that article III of the convention is applicable to revenue accruing from the commercial transactions contemplated under (1) and perhaps to the revenue realized from technical services provided to affiliated companies in third countries which would not be considered as being personal services.

But article III certainly is not applicable to revenue accruing from the licensing of a patent, from interest on loans or to dividends paid on shares of affiliated companies in third countries. Such revenue is expressly excluded from the definition of "industrial and commercial profits."

However, articles VII, VIII and XIV contain the principle that such income from other than industrial and commercial profits shall be taxed in the country of the beneficiary of such income. It would be considered against the spirit of the convention to admit such an exemption for income from American sources and not to admit it when such an income is derived from third countries. It may therefore be concluded that the United States has no right to tax such other income derived by the Swiss company from sources outside the United States.

Reply to question III (h): Such a tax would be, as a general rule, contrary to Swiss tax law, since the taxation of undistributed profits of a company through its shareholders is not a recognized approach.

Question III. (i) Would your government assist the United States in collecting such a tax?

Conclusions

1. *No convention concerning tax assistance.*—There is no convention concerning tax assistance between Switzerland and the United States. Moreover, one may not imply the existence of such an obligation upon Switzerland. It should further be noted that it is a general principle of the Swiss Government not to conclude such conventions.

2. *Article XVI* (v) *of the CDI.*—Nevertheless, article XVI (1) declares that the authorities of the two States shall exchange such information as is necessary for carrying out the provisions of the convention.

May one conclude from this an obligation of assistance?

It is believed that the answer must unquestionably be negative. In effect, the exchange of information in the present case may not be considered as being useful for carrying out the provisions of the convention. It would concern information relating, in principle, to a violation of the convention or, more or less, to acts not falling within the scope of the convention.

Furthermore, it should be noted that article XVI(3) of the CDI prohibits the exchange of such information which is contrary to the sovereignty, the public policy, or even to the administrative practices of one of the two contracting states. There is no doubt that the information requested would be contrary to Swiss public policy.

Finally, there would be a problem whether the giving of such information would violate Swiss penal law. Article XVI(1) expressly states that information which would reveal any commercial, industrial, or professional secret could not be exchanged with the American authorities.

Question III. (j) If the bill were enacted and if the U.S. shareholders voted to distribute income of a company resident in your country in order to pay the tax, excluding income set aside in reserves required by law, but including profits needed for reinvestment in its business, and thus harmed the interests of minority stockholders resident in your country, would your government object in their behalf?

Conclusions

(*a*) Article XVII(2) of the CDI permits the competent authorities of the contracting states the possibility to settle by mutual agreement difficulties or doubts arising concerning the interpretation or application of the convention. To commence this procedure, it is not necessary to point out a concrete case of double taxation. Thus, an abstract question may be the object of such procedure which is, besides, optional.

From the foregoing, it may be seen that Switzerland could use the procedure of article XVII(2) of the CDI in order to raise the question of the incompatibility of the proposed new American legislation with the CDI.

(*b*) With regard to collective entities created or organized within the framework of the Swiss judicial system, article XVII(1) of the CDI provides the possibility to inform the Swiss authorities of any concrete act of the American or Swiss fiscal authorities which results in double taxation contrary to the dispositions of the convention.

If the Swiss authorities consider that the grievances raised by such entity are worthy of consideration, they shall take up the matter with the competent American authority in order to reach an equitable avoidance of the double taxation in question.

The normal rules relating to diplomatic protection do not apply to this procedure, since such contracting states may act in favor of the collective entities created or constituted under its law. It is only in the case of the failure of the friendly procedure described above, and within the framework of a diplomatic intervention or a further judicial or arbitral procedure, that the general rules of international law relating to the protection of corporate entities and commercial societies will become relevant.

Question III. (k) Would your Government consider as extraterritorial the basing of a U.S. tax on a local company's income from sources in your country or third countries?

Conclusions

Articles VI and VII of the CDI have the effect of protecting beneficiaries of dividends and interest accruing from American sources, who are domiciled in Switzerland, from progressive American taxes on revenue.

All the more, the United States may not impose progressive income taxes upon income received by the beneficiaries domiciled in Switzerland of dividends and interest paid by a non-American collective entity, although such dividends and interest may stem indirectly from an American source.

It follows that the so-called extraterritorial taxation of dividends and interest is, in principle, forbidden by the convention. Moreover, this prohibition is valid for Switzerland.

The draft law for the taxation of certain items of income from sources outside the United States, and for taxing the annual net increase in earnings, as it would, result in an abusive interpretation of the convention and would constitute an effort to introduce so-called extraterritorial taxation, which is prohibited in principle by the convention.

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Question III. (l) Would your Government consider as discriminatory the basing of a U.S. tax on a local company's profits from selling or licensing to persons in third countries, and from other perfectly normal transactions, but not on certain income from manufacturing in your country?

Conclusions

1. *The convention generally forbids taxation by the United States of Swiss enterprises not having a permanent establishment in the United States.*—It is irrelevant whether the income stems from manufacturing or from other sources (e.g., commercial transactions, license fees, or dividends). It is likewise unimportant that this income originates in third countries or only from transactions in Switzerland. The prohibition to tax is general.

2. The fact of taxing certain categories of income and not taxing others would appear discriminatory to the Swiss Government. Indeed, this procedure is not at all justified by the text of the convention.

However, it should be added that the argument based on the fact that the draft law is discriminatory is not of great practical importance. The contemplated tax is contrary to the convention. This is sufficeint, and it is unnecessary to go any further.

Question III. (m) Would the introduction of a U.S. tax on the basis of a part or all of a local company's income be considered as the creation of a new form of double taxation contrary to the principles of the tax convention between your country and the United States?

Conclusions

The taxation of accumulated earnings and of certain items of income from sources outside the United States by the United States is contrary to the convention at the moment it constitutes an indirect method to reach income, the taxation of which is restricted by the convention, Article III of the CDI which prohibits the taxation of certain enterprises is particularly relevant in this connection. These prohibitions and restrictions have been established precisely with a view to avoid double taxation, as indicated in the very title of the CDI.

It is thus concluded that a law, conforming to the present draft, would introduce a form of double taxation contrary to the convention to the extent that it attempts to circumvent the prohibitions and restrictions contained therein.

The fact of taxing the persons who participate in these companies instead of the companies themselves, with the purpose of satisfying the conditions imposed by article XV (1)(a) of the CDI changes nothing. Furthermore, it has been emphasized that this article may not be interpreted as permitting a tax prohibited by another provision of the convention.

Question III. (n) If the United States introduced such a tax, would your Government denounce the convention?

Conclusions

1. *Denunciation of the convention.*—"It is recognized generally in international law that a state may withdraw from a bilateral treaty when the other party has violated the provisions thereof. But it may also demand that the treaty be maintained and that the other party execute the obligations to which it is bound." (Guggenheim, Traite de droit international public, I, 117.)

Switzerland and the United States are subject to the obligatory jurisdiction of the International Court of Justice. Thus, Switzerland possesses a judicial means to require the United States to execute its international obligations.

2. In general, all taxation of shareholders of American nationality on income of a Swiss corporation would be contrary to Swiss law and even to Swiss public policy. In view of this prohibition, the Swiss authorities could, justifiably, lodge a complaint against the United States of America within the framework of general international law, in view of the fact that the dispositions of Swiss public policy may not be violated by American legislative or administrative measures and that the Swiss company, as well as the shareholders of Swiss nationality, may be prejudiced thereby.

McDermott, Will & Emery,
Chicago, May 3, 1962.

Hon. Harry Flood Byrd,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.
(Attention: Mrs. Elizabeth Springer, clerk, Committee on Finance).

Dear Senator Byrd: I would like to call to your attention a few additional points regarding section 16 of the revenue bill of 1962 (H.R. 10650), as I understand that to date these may not have been covered by the testimony or written material presented to the committee.

Section 16 of H.R. 10650 treats the gain realized by certain U.S. shareholders from the redemption, liquidation, sale, or exchange of stock of a controlled foreign corporation as ordinary income to the extent indicated in this section. In the case of individuals, this section has a punitive effect. Take, for example, the case of a married individual who holds 20 percent of the stock of a foreign corporation with accumulated earnings of $2 million. If he sells his stock at a gain of $400,000, assuming that he has no other income, his tax would be $313,640 (an effective rate of 78.4 percent). If he were single, his tax would be $338,820 (an effective rate of 84.7 percent). In addition, he would receive no foreign tax credit.

It should also be noted that the elimination of the retroactive effect of proposed section 1248(a) by substitution of a current date for the date of February 28, 1913, and/or the insertion of a current effective date from which earnings and profits would be taxed as ordinary income under proposed section 1248(b) would not eliminate the punitive effect of this since future earnings will still be so taxed.

It is therefore suggested that gain realized by individual shareholders be eliminated from the provision of section 16. If this is not acceptable, then, as an alternative, it is suggested that individual shareholders be either entitled to continue to treat gain of the type described in this section as capital gain without the option of paying the alternative (flat 25 percent) tax thereon, or taxed at a flat rate (i.e., 50 percent) on such gain. Another possible alternative would be to give individuals a credit for taxes paid by the foreign corporation.

Proposed code section 1248(c)(3) eliminates from the ordinary income treatment amounts previously taxed to the U.S. shareholder under 951. In the case of foreign corporations which have U.S. source income which is taxed in the United States (i.e., as a result of plants or other permanent establishments here), it appears logical also to eliminate the amount of U.S.-taxed income under section 1248(c). If this is not done, the same income will be taxed twice as ordinary income.

Respectfully submitted.

R. E. Murphy, Jr.

(Whereupon, at 4:20 p.m., the hearing was adjourned, to reconvene at 10 a.m., Friday, May 4, 1962.)

REVENUE ACT OF 1962

FRIDAY, MAY 4, 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 Paul H. Douglas, presiding.

Present: Senators Douglas (presiding), Talmadge, Williams, and Carlson.

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

Senator DOUGLAS. The committee will come to order.

Our first witness this morning will be Senator Joseph S. Clark of Pennsylvania.

Please proceed, Senator.

STATEMENT BY HON. JOSEPH S. CLARK, U.S. SENATOR FROM THE STATE OF PENNSYLVANIA

Senator CLARK. Mr. Chairman, thank you for giving me the opportunity to make this statement before the committee today.

My purpose is to lend support to the administration's position that deductions for luxury business expense account expenditures be sharply limited, and, in the case of entertainment expenses, disallowed entirely.

As Secretary Dillon pointed out in his testimony before this committee last month, the strengthening of the expense account provisions in section 4 of the House-passed bill, as recommended by the administration, would yield an additional $125 million in revenue. With the budget balance for fiscal 1963 very much in doubt, this potential source of additional revenue must not be overlooked.

In my opinion, section 4 of the bill needs strengthening in two principal regards: to prohibit deductions for entertainment expenses and to place quantitative dollar limits on deductions for expenses of wining and dining business prospects and for meal and lodging costs during business travel.

(1) ENTERTAINMENT EXPENSES

I support wholeheartedly the Treasury's position that "the cost of business entertainment, including club dues, and the maintenance of entertainment facilities (such as yachts and hunting lodges) be disallowed in full as a tax deduction."

The "Study on Entertainment Expenses" prepared by the Treasury Department and submitted to Congress in April 1961 and the documentation presented by Senator Douglas in a floor speech on May 26, 1961 (Congressional Record, pp. 8500–8514) provide overwhelming proof of widespread tax abuse in this area.

Cases cited in these sources show instances in which the expenses of entertaining guests at nightclubs, country clubs, theaters, football games, horse races, prizefights, hunting lodges, and on fishing, yachting, and similar trips, both here and abroad, have been held deductible.

For a particularly outrageous case of milking the Federal Treasury, I would like to refer the committee to case No. 17 in the Treasury study in which a roadbuilding equipment company was allowed entertainment deductions totaling $30,654 over a 2-year period, including $13,750 for liquor, $6,700 for club expenses, including dinners and cocktail parties, $2,000 for season football tickets, and $5,650 for "convention expenses." This legalized tax evasion should not be permitted to continue.

At a time when the taxpayers of this country are supporting an annual $50 billion defense outlay, it is not too much to ask the expense account aristocracy of America to pick up the full tab for their lavish entertainment expenditures and stop unloading 52 percent of the cost on Uncle Sam.

The language in the House bill ruling out deductions for entertainment expenses unless they are "directly related" or "used primarily" in the conduct of the taxpayers' business is not an adequate safeguard against existing abuses. While it adds a new requirement to the present "ordinary and necessary" business expense requirements of the code, and the Ways and Means Committee has attempted to give precise meaning to the new requirement in its report (pp. 19–21), the new standards suggested are still too vague and entirely insufficient. Outrageously lavish entertainment expenses would continue to be fully deductible, if the additional proof of relationship to the taxpayers' business were supplied.

I submit that there is no valid reason why a taxpayer should be permitted to deduct half of his entertainment expenses at nightclubs and theaters or on yachts or at hunting lodges, even if he can prove, to use the words of the House report, there is a "proximate relation between the expenditure and his trade or business."

The U.S. Government, with all of its foreign and domestic commitments, can ill afford to continue to pay the major share of the expenses of wealthy business taxpayers at the Stork Club or at their country duck-shooting retreats under any circumstances whatsoever.

(2) MEALS AND TRAVEL

Secondly, I urge the committee to restore the quantitative standards originally suggested by the Treasury and write into the bill dollar limits for the amount of money that can be deducted for expenditures on food and drink for business customers and potential customers and other specific limits for the maximum allowable deduction for meal and lodging costs during business travel.

The original administration suggestion that $7 per meal, including drinks, per customer, be the allowable deduction limit seems to me to be overly generous, if anything.

The $32 maximum deduction suggested for per diem cost of food and board while traveling for business purposes is exactly double the sum permitted by statute for those who work for the U.S. Government. Is this really going to impose an undue hardship on the business community? I suggest not.

The standard of "reasonableness" suggested in the House bill for deductions in this area is far too vague to be useful, either for conscientious taxpayers who want to comply with the letter of the law or for Internal Revenue Service representatives faced with the task of auditing returns which claim suspiciously large expense account deductions. The adoption of reasonable but specific dollar limits is the only way tax abuse in this area can be stopped effectively.

In his tax message to the Congress in 1961, recommending passage of the bill before the committee, President Kennedy stated:

In recent years, widespread abuses have developed through the use of the expense account. Too many firms and individuals have devised means of deducting too many personal living expenses as business expenses, thereby charging a large part of their cost to the Federal Government. Indeed, expense-account living has become a byword in the American scene.

Let me urge the committee to put an end to tax abuse in the expense account area by adopting the amendments recommended by the administration.

For your consideration, I have prepared the text of a suggested rewrite of section 4 of the tax bill. This amendment reflects the original position of the Treasury Department, modified in certain respects to conform with some of the language adopted by the House of Representatives. With the permission of the committee, I would like to have the amendment printed at this place in the record.

(The amendment referred to follows:)

[H.R. 10650, 87th Cong., 2d sess.]

AMENDMENT Intended to be proposed by Mr. Clark to the bill (H.R. 10650) to amend the Internal Revenue Code of 1954 to provide a credit for investment in certain depreciable property, to eliminate certain defects and inequities, and for other purposes, viz: Strike section 4 of the bill, appearing from line 10 on page 27 to line 11 on page 34, and insert in lieu thereof the following:

SEC. 4. DISALLOWANCE OF CERTAIN ENTERTAINMENT, ETC., EXPENSES.

(a) DENIAL OF DEDUCTION.—Part IX of subchapter B of chapter 1 (relating to items not deductible in computing taxable income) is amended by adding at the end thereof the following new section:

"SEC. 274. DISALLOWANCE OF CERTAIN ENTERTAINMENT, ETC., EXPENSES.

"(a) EXPENDITURES FOR ENTERTAINMENT, ETC., EXPENSES.—No deduction otherwise allowable under this chapter shall be allowed for any item—

"(1) with respect to an activity which is of a type generally considered to constitute entertainment, amusement, or recreation, or with respect to a facility used primarily in connection with such activity, or

"(2) with respect to any facility to the extent such facility is used for entertainment, amusement, or recreation.

"(b) CLUB DUES AND GIFTS.—No deduction shall be allowed under section 162 or section 212 for any expense—

"(1) CLUB DUES OR FEES.—For dues or fees to any social, athletic, or sporting club or organization (except dues or fees paid by a professional athlete for the use of athletic facilities essential to the conduct of his trade or business), or

"(2) GIFTS.—For gifts made directly or indirectly to any individual to the extent that such expense, when added to prior expenses of the taxpayer for gifts made to such individual during the same taxable year, exceeds $25.

For purposes of paragraph (a), the term "gift" means any item excludable from gross income of the recipient under section 102 which is not excludable from his gross income under any other provision of this chapter.

"(c) SUBSTANTIATION REQUIRED.—No deduction shall be allowed—

"(1) under section 162 or 212 for any traveling expense (including meals and lodging while away from home),

"(2) for any item with respect to an activity which is of a type generally considered to constitute entertainment, amusement, or recreation, or with respect to a facility used in connection with such an activity, or

"(3) for any expense for gifts,

unless the taxpayer substantiates by adequate records or by sufficient evidence corroborating his own statement (A) the amount of such expense or other item, (B) the time and place of the travel, entertainment, amusement, recreation, or use of the facility, or the date and description of the gift, (C) the business purpose of the expense or other item, and (D) the business relationship to the taxpayer of persons entertained, using the facility, or receiving the gift. The Secretary or his delegate may by regulations provide that some or all of the requirements of the preceding sentence shall not apply in the case of an expense which does not exceed an amount prescribed pursuant to such regulations.

"(d) EXCEPTIONS TO APPLICATION OF SUBSECTION (a).—Subsection (a) shall not apply to—

"(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 and not primarily to promote good will, except that such allowance shall not exceed $7 a day for any individual.

"(2) FOOD AND BEVERAGES FOR EMPLOYEES.—Expenses for food and beverages (and facilities used in connection therewith) furnished on the business premises of the taxpayer primarily for his employees.

"(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 of wages).

"(4) REIMBURSED EXPENSES.—Expenses paid or incurred by the taxpayer, in connection with the performance by him of services for another person (whether or not such other person is his employer), under a reimbursement or other expense allowance arrangement with such other person, but this paragraph shall apply—

"(A) where the services are performed for an employer, only if the employer has not treated such expenses in the manner provided in paragraph (3), or

"(B) where the services are performed for a person other than an employer, only if the taxpayer accounts (to the extent provided by subsection (c)) to such person.

"(5) RECREATIONAL, ETC., EXPENSES FOR EMPLOYEES.—Expenses for recreational, social, or similar activities (including facilities therefor) primarily for the benefit of employees (other than employees who are officers, shareholders or other owners, or highly compensated employees). For purposes of this paragraph, an individual owing less than a 10-percent interest in the taxpayer's trade or business shall not be considered a shareholder or other owner, and for such purposes an individual shall be treated as owning any interest owned by a member of his family (within the meaning of section 267(c)(4)).

"(6) EMPLOYEE AND STOCKHOLDER BUSINESS MEETINGS.—Expenses directly related to business meetings of employees or stockholders.

"(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).

"(8) ITEMS AVAILABLE TO PUBLIC.—Expenses for goods, services, and facilities made available by the taxpayer to the general public.

"(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.

For purposes of this subsection, any item referred to in subsection (a) shall be treated as an expense.

"(e) INTEREST, TAXES, CASUALTY LOSSES, ETC.—This section shall not apply to any deduction allowable to the taxpayer without regard to its connection with his trade or business (or with his income-producing activity). In the case of a taxpayer who is not an individual, the preceding sentence shall be applied as if he were an individual.

"(f) EXPENSES OF TRAVELING AWAY FROM HOME.—

"(1) FOOD, BEVERAGES, AND LODGING.—No deduction shall be allowed under section 162 or section 212 for any expense for food, beverages, and lodging for any individual while traveling away from home to the extent that such expenses for any day exceed $32.

"(2) ALLOCATION OF TRAVEL EXPENSES.—In the case of any individual who is traveling away from home in pursuit of a trade or business or in pursuit of an activity described in section 212, no deduction shall be allowed under section 162 or section 212 for that portion of the expenses of such travel which under regulations prescribed by the Secretary or his delegate is not allocable to such trade or business or such activity. The limitation of paragraph (1) shall be applied before making the allocation required by this paragraph.

"(g) TREATMENT OF ENTERTAINMENT, ETC., TYPE FACILITY.—For purposes of this chapter, if deductions are disallowed under subsection (a) with respect to any portion of a facility, such portion shall be treated as an asset which is used for personal, living, and family purposes (and not as an asset used in the trade or business).

"(h) REGULATORY AUTHORITY.—The Secretary or his delegate shall prescribe such regulations as he may deem necessary to carry out the purposes of this section, including regulations prescribing whether subsection (a) or subsection (b) applies in cases where both such subsections would otherwise apply."

(b) TRAVELING EXPENSES.—Section 162(a)(2) (relating to trade or business expenses) is amended to read as follows:

"(2) travel expenses (including amounts expended for meals and lodging) while away from home in the pursuit of a trade or business to the extent allowable under section 274(f); and".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to taxable years ending after June 30, 1962, but only in respect of periods after such date.

Senator DOUGLAS. Thank you very much, Senator Clark. The next witness this morning is Mr. Daniel O. Dechert of the American Chamber of Commerce of Milan.

Mr. Dechert, we are very glad to welcome you.

STATEMENT OF DANIEL ORVILLE DECHERT, ON BEHALF OF THE AMERICAN CHAMBER OF COMMERCE FOR ITALY AT MILAN

Mr. DECHERT. Mr. Chairman and gentlemen, I appreciate very much the opportunity to make a few remarks to the committee.

Senator DOUGLAS. Yes.

Mr. DECHERT. The present statement is made on behalf of the American Chamber of Commerce for Italy, the main office of which is at Milan, the industrial center of Italy.

The chamber has 2,900 members, including many prominent and distinguished American businessmen who play an enormous role in the furtherance of our foreign trade, in the maintenance of American prestige in the European Common Market, and in the continuation of good will for this country abroad.

The chamber has branch offices in Rome, Genoa, Naples, Turin, Florence, Bologna, and Padua. The consternation which the passage of H.R. 10650 by the House has caused to it is unprecedented.

This statement concerns portions of H.R. 10650 having to do with the proposed increase of the taxation of foreign income in American control, immediate or ultimate.

The bill has been prompted by the President's tax message of April 20, 1961, more than a year ago. The narrow margin by which it passed the House under heavy Executive pressure implies wide misgivings as to its wisdom.

It is supposed to ease the drain on the dollar, and to remove claimed inequities in Federal taxation of income from foreign as compared to domestic sources.

It is suggested that the measures proposed will not produce the desired results and that if enacted they will prove most harmful to the economic and political interests of the United States and will, in addition, cause hardship and injustice to many American individuals and organizations.

It has been indicated by statistics of the Department of Commerce that the net annual private American outflow of capital for investments abroad is greatly exceeded by the annual inflow of income on our private foreign investments.

The net inflow of dollars in this connection has reached, according to the report of the Department, a total of more than $8 billion for the years 1950–60, or an average of more than two-thirds of a billion dollars a year for the period.

This seems clearly not to take into account the huge annual purchases of equipment, parts, supplies and other articles by foreign corporations controlled by American shareholders.

Many of these articles would not be bought from abroad if the buying companies were not controlled by Americans having preference for various American products and close relations with American producers or exporters.

Mr. Herbert Feis, a former economic adviser to the State Department, in an article in the Virginia Quarterly Review for the spring of 1961, entitled "The Gold Outflow," said the following:

> In fact the inflow to us of proceeds from past American long-term foreign investments and loans exceeds new outlays substantially.

Of course a particular sum sent over to a foreign country for investment will not yield repatriated income from some years as great in the aggregate as such sum.

On the other hand, if sums going out for investment are heavily curtailed, as they would be by the present bill, there will be a flight from the dollar by persons in the developed countries having American holdings who will wish to fill the investment gap created by the reduction of American investments abroad, particularly in the countries which are members of the European Common Market now enjoying such phenomenal industrial growth.

In a short time, it is likely that the drain on the dollar will be increased, particularly in those developed countries investments in which the bill is contrived to reduce.

Consequently, those provisions of the bill relating to foreign income seem in truth designed only to remove alleged inequities or to produce additional revenue.

The revenue would be minute when compard to the total of current internal revenue receipts and the size of the national budget. The Treasury's estimate of the increment to be expected from this part of the bill is the more optimistic official one. It anticipates only $145 million more.

The Joint Committee on Internal Revenue Taxation expects only a hundred million. The increased cost of administration of the highly complex and revolutionary dispositions of the bill concerning foreign income will be very heavy.

It is submitted that the provisions should not be adopted merely because a small partial offset is needed to a loss of revenue from the adoption of the investment credit for investment in certain depreciable property, if this measure is to become law, but only if they are meritorious in themselves.

Whatever theoretical inequities may exist in the mammoth system of taxation that of necessity bestrides the country, it is hard to expect that so huge a complex be ideally just from the standpoint of categories of taxpayers and of income.

For example, we have the exemption from income tax on interest on the obligations of the States and their subdivisions, the exclusions from income of portions of dividends, and of items of value received in corporate reorganizations, all for special reasons recognized by Congress.

One may also note the percentage depletion for oil.

Only a few years ago, apparently after the international drain on the dollar had already started,[1] the House Committee on Ways and Means said the following in its report accompanying H.R. 8300 of 1954, which, as modified, became the Internal Revenue Code of 1954. (H.R. 8300, 83d Cong., 2d sess.) (H. Rept. 1337, 83d Cong., 2d sess., pp. 74–75):

> Your committee recognizes that firms doing business abroad may be competing with other enterprises which have lesser taxes to bear, and that such firms may be assuming certain risks that do not prevail in domestic business ventures.
>
> It is also impressed by the fact that the present U.S. tax approach tends to induce heavy foreign taxation of American enterprises.
>
> Accordingly, your committee has incorporated changes in the bill designed to correct this tendency, to eliminate certain inequities in the present tax treatment of foreign income, and to offset some of the factors adversely affecting foreign investment by giving special tax treatment to business income from foreign sources.

H.R. 8300, as drawn by the House, would have accorded a 14-percentage-point favorable differential tax rate to domestic business enterprises actively engaged in significant economic activity abroad, similar to that granted to Western Hemisphere trade corporations (see sec. 923, H.R. 8300 (House version) and report of Ways and Means Committee thereunder).

Under that bill, domestic corporations doing business abroad through a foreign branch of the corporation instead of a subsidiary could exercise an election to defer tax on the profits of the foreign branch in a manner similar to the deferral already provided for for-

[1] See account in New York Times of Tuesday, Apr. 24, 1962, of speech made the previous day at Buenos Aires by Mr. Harold C. Linder, President of the Export-Import Bank, in which he states that the United States has lost about $8 billion in reserves in the last decade.

eign subsidiaries (see secs. 951–958, H.R. 8300 (House version), and report of Ways and Means Committee thereunder).

Also, U.S. enterprises operating abroad would have been given the option to take a credit for foreign taxes on principal, where more advantageous instead of a credit for foreign income taxes. (See secs. 901, 903, H.R. 8300 (House version), and report of Ways and Means Committee thereunder.)

It is submitted that the provisions of the bill which would tax holders of 10 percent or more of the stock of foreign corporations controlled by American persons are ill advised.

They will place such corporations at a competitive disadvantage with other corporations in the same country not subject to the pressure of paying dividends to give their shareholders the money with which to pay a new American tax on putative dividends not received.

This will result in many foreign corporations going out of American control at the very time that the administration is making strenuous efforts to increase our foreign trade.

Some American corporations will distribute their shares in foreign corporations to their own shareholders in such a way that no shareholder owns as much as 10 percent of the foreign company's stock, and in other cases control will be yielded to foreign interests, whether or not the American company retains a substantial minority interest.

In some cases strong foreign minority groups will become dissident when they realize that accumulations of earnings not recognized by the American Treasury as necessary for the business will be attributed pro rata to American shareholders, forcing the declaration of dividends to replenish their own pockets in connection with tax liability on presumed distributions.

Since European and Latin American countries commonly issue bearer shares of stock which are voted by him who presents them at the meeting without the need of a proxy if he is not the owner, how will many foreign corporations and their shareholders know whether there is American control?

If a 10-percent U.S. shareholder subsequently decides years later that he thinks there was American control in a long-past year, consider the quandary in which he is placed.

Various foreign corporations whose shares are listed on the New York or other domestic stock exchanges will probably withdraw their registration because they will not wish to have complications with their shareholders and our Government as to whether or not they are controlled foreign corporations.

The bill has grave international complications for a nation which is dedicated at the top to the promotion of foreign trade. It is at least in violation of the spirit of the tax treaties, and is calculated to cause ill will and reprisal abroad by foreign governments, no principal one of which has as yet sought to adopt similar measures.

I may add that the provisions for imposition of U.S. estate tax on foreign real estate owned by a U.S. decedent, seem to be of such a nature that they will be treated by foreign governments as in violation of certain treaties to which this country is a party.

Tax deferral in the case of corporations foreign to these countries but controlled by shareholders in them is recognized as normal.

After so many years of negotiation and adoption of these treaties by the United States with more than 20 foreign countries in a program which is continuing, it is startling to find in the bill a unilateral provision that the section of the Internal Revenue Code (7852(d)) giving dominance to the treaties in case of conflict between them and any provision of the bill will not apply.

The question is raised of the extent to which the Senate Committee on Foreign Relations and the State Department have been consulted in regard to this aspect of the matter, and whether the effects of the bill have been frankly explained to principal foreign governments.

The bill takes no account of currency restrictions preventing the conversion of earnings into outside money in some foreign countries, nor of legal rules, contractual obligations, and foreign tax considerations which present foreign corporations from distributing all of their profits. It also makes no allowance for fluctuation during the year of the values of foreign currencies when measured against the dollar.

The bill, by providing that its stringent provisions in respect of the taxation of amounts received from sales and exchanges of shares of stock in controlled foreign corporations shall apply from the date of enactment will probably cause a rush of dispositions at a sacrifice for tax considerations. This does not seem to be the time for American business to withdraw from foreign enterprises under the pressure of acts of its own Government.

The limitation of the measures concerning controlled foreign subsidiaries to the "developed" countries relates with a few exceptions to those very countries which already have high taxes, often both upon corporate profits and the distribution of dividends, with the combination frequently making the rate of their taxes on corporate income above the American rate.

In view of this aspect of the problem, it is earnestly suggested that there be a full study of what revenue would in fact be produced by the new measures.

The provisions defining the proposed new "subpart F income" which would be taken into computation in determining whether 10 percent or more U.S. shareholders are subject to tax on undistributed profits of controlled foreign corporations seem to be quite arbitrary and unorthodox in their extended definition of income from U.S. patents, copyrights and exclusive processes.[1]

They are calculated to cause such items in the future to be sold to strangers by American persons, where they are to be employed abroad.

The transfer to foreign subsidiaries of American interests of exclusive processes has been one of the most important elements in the development of American business abroad.

Also, many technical laboratories would as a consequence of the enactment of the bill be transferred from the United States to foreign nations. The language concerning "income from insurance of U.S. risks" is also unorthodox, and will result in international insurance of such risks by foreign companies not under American control.

The provisions in respect of "net foreign base company income" would oblige American companies to form foreign corporate subsidiaries for each foreign country of substantial operation.

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[1] The provisions strangely do not mention trademarks.

In the countries of the European Common Market, and perhaps elsewhere, this may be very uneconomical and undesirable.[1] The inducements in the bill to cause money in foreign subsidiaries controlled in America to shunt accumulated earnings from "developed" countries of incorporation or operation into "undeveloped" ones would seem to be indirect official pressure on these foreign companies to make private investments in various nations, whether old or new, where the climate in respect of foreign private investments is less propitious, and where risks of creeping expropriation de facto or other risks not covered by the guarantees of our governmental agencies would hover over the investments.[2]

As to the provisions in the bill for new methods of reallocation, not of income and deductions, et cetera, but of taxable income, in cases of a group of organizations under common control one or more of which is foreign, these seem to me unnecessary. The Commissioner has an ample vehicle through which to offset the abuses of diversion of net income in these cases to the detriment of the Treasury in the existing provisions of section 482, and of the judicial rules disregarding the entities of sham corporations.

The British have had the longest and most complicated experience in international trade, and their income tax laws go back to the 18th century. Yet their section comparable to section 482, which is section 469 of the United Kingdom Income Tax Act of 1952, as amended, relates basically only to readjustments of sales prices, commissions, et cetera, and not to net income.

The proposal treating as a dividend the gain of U.S. shareholders from redemptions and liquidations of controlled foreign corporations seems to be highly discriminatory when compared to the capital gain treatment intended to be still accorded to shareholders of other corporations.

A particularly objectionable element of the proposal lies in the fact that the dividend treatment would be imposed on the recipient's proportionate share of all earnings and profits of the foreign corporation accumulated since February 28, 1913, for example, since the first enactment of our present continuous income tax legislation. This would be very harsh surprise legislation ex post facto and its justification is hard to find.

Also highly discriminatory is the proposal to treat the gain of U.S. shareholders in sales and exchanges of stock in a controlled corporation as gain from a noncapital asset to the extent of the recipient's proportionate share of the earnings and profits of the foreign corporation accumulated during the period the stock was held by him.

Here again there is great discrimination which in many cases would be of retroactive effect to a date years before the bill was even contemplated, and again justification is difficult.

Another harsh feature of the proposals in regard to redemptions, liquidations, sales and exchanges by the 10 percent or more U.S. shareholders of stock in a controlled foreign corporation is that the arduous new rules would apply if the foreign corporation is a controlled

[1] The provision allowing an inexperienced Treasury man capriciously to decide what accumulated earnings are necessary in the foreign business seem unwise.

[2] As to "underdeveloped" areas, no discretion appears to be left in regard to portions of developed nations not separated by the sea, so that underdeveloped Sicily would be eligible for the tax inducement, but not southern Italy, although both are officially recognized in Rome as distressed areas requiring vast public funds for rehabilitation.

foreign corporation either at the time of the sale or exchange (including those in redemption or liquidation), or at any time during the 5-year period ending on the date of the sale or exchange.

The proposal also seems to be very harsh which would require the U.S. shareholder recipient to establish the earnings and profits of the foreign corporation to be taken into account under the redemption, liquidation, sale or exchange under the pain of having all gain considered as a dividend in the case of a redemption or liquidation, or a gain from a noncapital asset in the case of a sale or exchange.

In operation, this, of course, would mean that the earnings and profits to be taken into computation must be established to the satisfaction of the Commissioner in accordance with American concepts of the term, usually differing from foreign concepts.

Apart from the general inadvisability of the provisions proposing these penal levies on U.S. holders of 10 percent or more of a controlled foreign corporation's shares, this latter proposal seems to be quite impractical, and should be replaced if passage of the other provisions is inevitable by some paragraph permitting the foreign company, to the extent permitted by foreign law, to certify its accumulated earnings and profits under standards applicable to it.

Another harsh provision is the one that the various dispositions of a controlled foreign corporation's shares just mentioned shall be subjected to the penal levy where the transaction occurs after the date of enactment of the bill.

This proposal alone is calculated to cause a rush of distress disposals by U.S. shareholders of shares of stock in these foreign companies at the present time if they believe that these dispositions are likely to become law.

The provisions of the bill, if enacted, would cause an enormous additional volume of bookkeeping by controlled foreign corporations, because American concepts of income and deductions, which would be controlling, often do not coincide with foreign ones.

It seems that they would also impose indirectly on foreign corporations the obligation to furnish for their U.S. shareholders information which, although available from corporations in this country cannot be given under more secretive rules of foreign corporate law.

All in all, while there may be some merit in the bill, such as the exclusion from American tax against U.S. shareholders of certain foreign personal holding companies of income that is not passive,[1] the bill seems to ignore quite fully the reasonable postulate that since foreign operations in general entail greater risks, and are peculiarly vital to the welfare of the Nation in our present closely knit civilization, they merit the benevolent eye of the legislature, and not an effort to achieve a theoretical armchair fiscal equality.

The American Chamber of Commerce of Italy is particularly concerned with section 12 of the bill relating to income from sources without the United States.

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[1] While the proposed abolition of the temporal limitations of the 5-year throwback in regard to accumulation distributions of foreign trusts, and of kindred limitations, probably has considerable emotional appeal to the generality of the public, it is unfair unless coupled with similar changes in respect of accumulation distributions from domestic trusts so as to catch tax which the Treasury has not collected in respect of them. The difference is merely one of degree. The provision is very severe which would make the abolition of the limitation of the 5-year throwback rule apply to distributions made in taxable years of foreign trusts beginning after the date of enactment of the bill. Here again we seem to have exaggerated ex post facto treatment.

Almost no other developed foreign country taxes the foreign-earned income of its nonresident citizens. Yet the primary function of section 12 would be to amend section 911 of the Internal Revenue Code by placing a new limitation in dollars on the amount of the annual exclusion of the earned income for work done abroad of the U.S. citizen who is a bona fide resident of one or more foreign countries for a prescribed period now required to include an entire taxable year.

Legislation exempting from Federal income tax the earned income from foreign sources of the nonresident citizen has existed in some form as a fixed policy of the Congress since the adoption of the Internal Act of 1926, some 40 years ago.

The House Report (H. Rept. No. 1, 69th Cong., 1st sess.) stated expressly that the provision as originally drawn by it was "to take one further step toward increasing our foreign trade."

For many years there has been excluded from Federal taxation, without limitation of amount, the earned income from foreign sources of the U.S. citizen who is a bona fide resident of one or more foreign countries for a period including an entire taxable year.

In 1942, under the heavy pressure for internal revenue receipts provoked by the country's entrance into World War II, it was proposed that the exemptive provision be repealed.

However, the Senate Committee on Finance refused either to repeal the exemption or to provide a ceiling on it in the case of the nonresident citizen.

It said in part (H.R. 7378; S. Rept. No. 1631, 77th Cong., 2d sess.):

> Your committee has adopted a provision which it is believed will effectively terminate the abuse of this section but at the same time will not unduly penalize our citizens who are bona fide residents of foreign countries.
>
> It provides that if such citizens establish that they are bona fide residents of a foreign country during the entire taxable year their earned income from sources without the United States will be exempt. If they have been residents of a foreign country for 2 years or more, this same treatment will be accorded them for the year in which they return to the United States.

In 1943, abuses were guarded against by the addition of a limitation on the meaning of the term, "earned income."

It was provided that the term did not include that part of the compensation derived by the taxpayer for personal services rendered by him to a corporation which represents a distribution of earnings or profits rather than a reasonable allowance as compensation for the personal services actually rendered.

In the case of a taxpayer engaged in a trade or business in which both personal services and capital were material income-producing factors only a reasonable allowance under regulations as compensation for the personal services rendered by the taxpayer, not in excess of 20 percent (since raised to 30 percent) of this share of the net profits of such trade or business, was allowed to be considered as earned income (sec. 107, Revenue Act of 1943).

In 1951, the exemption was expanded at the instigation of the Senate Committee on Finance mainly through the addition of a provision exempting from tax the earned income from foreign sources (later limited to a rate of $20,000 per annum) of the U.S. citizen who was physically present in a foreign country or countries, even if not resident therein, for 17 months in a period of 18 consecutive months.

In this connection the committee said in part, speaking of the unlimited exemption of the nonresident citizen (S. Rept. 781, 82d Cong., 1st sess.):

> Section 116(a) of the code exempts from income tax citizens of the United States who are bona fide residents of a foreign country with respect to income earned outside the United States.
>
> This provision is intended both to encourage citizens to go abroad and to place them in an equal position with citizens of other countries going abroad who are not taxed by their own countries.

Nothing in any of the foregoing shows any belief by this committee, that there should be a ceiling on the amounts of exempt earned income from foreign sources of the U.S. citizen who is truly a bona fide resident of a foreign country for the prescribed period.

Yet section 12, by amending section 911 of the present code, would place the foreign resident on the same level as the citizen who is merely physically absent for 17 out of 18 months by limiting his exemption to $20,000 a year (to be computed on a daily basis) except that after the citizen has been a resident of a foreign country for 3 consecutive years his exemption would mount to a maximum of $35,000 a year computed on a daily basis.

There is the further new limitation that amounts of deferred compensation for foreign personal services will not be exempt if paid more than 1 taxable year after that in which the services were rendered.

Section 12 would also exclude from exemption any amount received as a pension or annuity although referable in whole or in part to foreign residence, and any amount includible in gross income in connection with a nonexempt employees' trust, and so forth.

The adoption of these provisions would deviate measurably from the long-fixed congressional policy, on which scores of thousands of American citizens employed abroad in our foreign commerce have relied for years, that all their foreign earned income be exempted in the case of the U.S. citizen in reality having a foreign residence taken up in good faith and maintained for at least 1 taxable year.

With the constant decrease in the purchasing price of money that has ensued since the end of World War II, both at home and abroad, great numbers of our citizens residing abroad receive more than $20,000 or more than $35,000 a year or their equivalents in foreign money, for their foreign personal services.

To tax at home the excess of their foreign compensation over this figure exposes them to the vagaries of the operation of the credit for foreign income taxes paid or accrued,[1] and makes no sufficient allowance for the comparatively greater variety of foreign taxes not creditable as income taxes which those individuals in many cases have to pay abroad.

Those nonresident citizens affected by these provisions of the bill will feel that, having no representation therein, they have been abandoned by a Congress which for years has in effect, through the un-

[1] See, for example, *U.S.* v. *Rogers* et alii (C.A. 1941), 122 Fed. (2), in which the estate of the late Will Rogers was denied any credit at all for foreign taxes paid to Great Britain as an additional assessment for a prior year because the decedent had no longer had any income from Great Britain in the year of payment of the tax. Consider also the existence of different concepts of income and of income taxes between the United States and foreign countries, and the rule that the U.S. concept controls in application of the credit. See *I. Motland* (D.C.N.D. Ia., 1961), 192 Fed. Supp. 358; *Biddle* v. *Com.* (1938), 302 U.S. 573; *Keasbey & Mattison Co.* v. *Rothenstein* (C.A. 3, 1943), 133 Fed. (2d) 894,

limited exemption, encouraged them to go abroad in what up to now has been considered the interest of American foreign trade.

Many of them may return home with resulting detriment to such trade from the loss of capable and highly paid personnel, or will simply become citizens of the foreign country of residence to rid themselves of the recurring annual tax complication which would be imposed on them after protracted service abroad in foreign lands in reliance on a stability of attitude shown to them by Congress since 1926, and now recommended in part for the scrapheap.

Since the lightning upward surge of the European Common Market, it would seem that we should all the more encourage our citizens particularly to live in that area in connection with enormous American trade having new difficulties of competition, to say nothing of Latin America and the various new countries with which the administration wishes to foster our commerce.

In summary, all in all, the provisions of the bill involving increased taxation of foreign income appear to have so little merit, to be so contrary to other fixed policies of the Nation, and so inimical to our foreign relations as an attempt at regressive legislation, in the international field, that it is earnestly suggested that all such provisions be promptly scrapped.

Senator DOUGLAS. Thank you very much.

Senator Talmadge?

Senator TALMADGE. No questions.

Senator DOUGLAS. Senator Carlson?

Senator CARLSON. No questions.

Senator DOUGLAS. I wonder if an attaché of the committee would give to the witness a copy of part 1 of these hearings.

Mr. DECHERT. Thank you very much, Senator.

Senator DOUGLAS. I would like to ask you some questions.

Mr. DECHERT. I beg your pardon, sir?

Senator DOUGLAS. When you receive this volume, I wonder if you would turn to page 222.

Mr. DECHERT. Yes.

Senator DOUGLAS. Page 222 has a table——

Mr. DECHERT. Yes.

Senator DOUGLAS (continuing). Which lists individuals claiming exemption of $100,000 or more in 1959 or 1960 as bona fide residents of a foreign country, showing countries of residence, occupation, and amount of income excluded from tax in each year.

I find two cases cited so far as Italy is concerned. One is case C–29–J, an executive, who, in 1960, claimed exemption on an income, earned income of $145,321——

Mr. DECHERT. Yes.

Senator DOUGLAS (continuing). As earned——

Mr. DECHERT. Yes, sir.

Senator DOUGLAS (continuing). And paid no tax.

And C–47–J, a director, whether that is a movie director or not, I don't know, who claimed exemption in 1960 on $161,000.

May I ask you, what is the income tax in Italy?

Mr. DECHERT. Well, I think I have it here, I had it here a minute ago. It is a little less than ours. I think it is customary in Italy for a person living there to declare less than their true income and when the return is audited——

Senator DOUGLAS. May I ask what the rate is in Italy?

Mr. DECHERT. The rate is around, I think, 40 percent in the average case. I think the combined——

Senator DOUGLAS. Well now, you are a director of the American Chamber of Commerce in Italy and you pay income tax in Italy, do you not?

Mr. DECHERT. No, Senator. I am a tax lawyer in Washington.

Senator DOUGLAS. Well, your members pay.

Mr. DECHERT. Yes.

Senator DOUGLAS. They pay income tax in Italy. What is the basic income tax?

Mr. DECHERT. Well, the basic income tax, I think, is what is called a tax on movable wealth which is actually a tax on income from movable property.

Senator DOUGLAS. Yes.

Mr. DECHERT. And added to that there is a complementary tax.

Senator DOUGLAS. What is the rate?

Mr. DECHERT. I think the combined rates in the average case are somewhat under our American rate.

Senator DOUGLAS. Very much under our rate, are they not?

Mr. DECHERT. I don't think, too much. I have the rate in my supplemental statement which appears at the end of my testimony.

Senator DOUGLAS. Is it true that in Italy, and I think you implied this in something you said before, that very few people declare their real income?

Mr. DECHERT. Well, I think that is generally true, yes, in Italy, France, and certain other continental countries. I may say, Senator, I understand that the local Italian municipal family taxes are quite high. For example, I was told yesterday about an American citizen living in a large Italian city whose income is equivalent to $50,000 a year and who pays a family tax of $15,000 a year. That is nearly one-third, in other words.

Senator DOUGLAS. If you will look at this table, you will find a large number of people connected with the moving picture industry who say they are bona fide residents of Switzerland.

Mr. DECHERT. Yes.

Senator DOUGLAS. Case C–9–J.

Mr. DECHERT. Yes. I have it.

Senator DOUGLAS. An actor, 1959, claiming bona fide residence in Switzerland and getting exemption on $156,000 income.

Case C–21–S, an insurance agent in Switzerland, claiming exemption on $155,360; case C–24–S, an actor, claiming exemption on $105,145 in 1959; $144,900 in 1960, and then the two cases which I have previously introduced into the record, C–33–B and C–33–S and C–24–S.

Mr. DECHERT. Yes.

Senator DOUGLAS. An actor in 1960 claiming an exemption on $1,099,791 and a housewife declaring an identical income down to the last dollar and presumably, therefore, the wife of the actor, with combined incomes, therefore, the $2,200,000 paying no American income tax.

A cartoonist in Switzerland, claiming exemption, and obtaining exemption on $110,315.

A sales agent in Switzerland, case 44, C–44, claiming exemption of $127,344 in 1960.

A motion picture producer in 1960 claiming exemption on $102,750. I introduced quite a few cases in the record the other day that income tax on high incomes would probably not exceed 15 percent.

Is the common gossip in Italy that these people are nominal residents in Switzerland but come down to Italy to enjoy the night life of Rome?

Mr. DECHERT. I haven't heard any discussion of that point, Senator. I go to Italy about once a year but I don't stay——

Senator DOUGLAS. Pardon?

Mr. DECHERT. I say I go to Italy about once a year, but I don't stay too long.

Senator DOUGLAS. I see.

Mr. DECHERT. I practice in Washington, in New York, and Virginia.

Senator DOUGLAS. You practice in Washington?

Mr. DECHERT. Yes, sir.

Senator DOUGLAS. But you are not resident in Italy?

Mr. DECHERT. No. I think, Senator, in answer to your first question, I might say that I believe in many cases the combination of the two Italian income taxes that I mentioned, the tax on the income from movable wealth and the complementary tax on income when added to the heavy family taxes levied annually by the large Italian municipalities, may cause a combined tax rate of that kind in excess of our American rate, and has happened to many individuals.

Senator DOUGLAS. In other words, they pay higher taxes abroad than they do here. If they pay higher taxes abroad this is credited against the American tax, isn't it?

Mr. DECHERT. No, Senator——

Senator DOUGLAS. Is not the general provision under the tax treaties that taxes paid abroad are credited against taxes which would otherwise be due in this country?

Mr. DECHERT. Only if they are recognized by this Government, I think, Senator, as income tax.

Senator DOUGLAS. Don't we recognize the Italian income tax?

Mr. DECHERT. Yes, we recognize the Italian——

Senator DOUGLAS. Are not the payments under the Italian income tax recognized as offsets against an American tax which would otherwise be levied?

Mr. DECHERT. Yes, they are, Senator, but I think the Italian family tax levied by the municipalities, which is very heavy, is not so recognized.

That has been ruled, as I understand it. I was informed yesterday of an American citizen in a large Italian city who has an income of about $50,000, and he has been subjected to annual family taxes by a large Italian municipality of about $15,000 a year which would not be credited over here.

Senator DOUGLAS. In this country, you can deduct State and local taxes from your income in order to arrive at taxable income.

Mr. DECHERT. Yes, but the deduction——

Senator DOUGLAS. Do you mean to say that local foreign taxes cannot be deducted?

Mr. DECHERT. No, I didn't mean to say that, not if they are recognized as being on the taxpayer, but I say they are not recognized over here as income tax. In other words, only deductible, not credited.

Senator DOUGLAS. Then this reduces the amount of net taxable income.

Mr. DECHERT. That is true, yes.

Senator DOUGLAS. Therefore, they are credited——

Mr. DECHERT. In that sense.

Senator DOUGLAS. To the individual's account.

Mr. DECHERT. In that sense that they are deducted against the gross income. They are not credited directly against what otherwise would be the American tax.

Senator DOUGLAS. If they lived in this country, they would be subject to State and local taxation, and this also would be deducted, so no heavier burden is being heaped upon them by living in a foreign country than would be the case if they lived in this country, isn't that correct?

Mr. DECHERT. I think that the noncreditable levies which would be only deductible or wouldn't be deductible at all, may be much heavier.

For example, I understand, Senator, that in France, there is a sort of sales tax of about 22 percent——

Senator DOUGLAS. I am speaking of Italy because you are representing the Chamber of Commerce of Italy.

Mr. DECHERT. Yes.

Well, to the extent that the burden of the tax, of the levy, is on the taxpayer I think it would be deductible. I don't think the mere fact it is foreign——

Senator DOUGLAS. Then their net income after paying taxes were the sums that I have mentioned, and they are exempted completely from the American income tax and pay income taxes which are, in practice, a lower percentage, so that your claim that the taxes are higher in Italy than in this country doesn't really hold water, and if they were higher you would not be asking for a change in the provisions of this bill.

Mr. DECHERT. No, I merely meant to say in some individual cases, I thought that the combined burden of the Italian taxes might be greater.

Senator DOUGLAS. You know nothing about this case of people claiming to be residents of Switzerland but in reality enjoying the pleasures of the Via Veneto?

Mr. DECHERT. No, Senator.

Senator DOUGLAS. You do not?

Mr. DECHERT. I realize that Switzerland has lower Federal income tax, but also certain cantonal taxes that we fail to take into consideration, because there are more than 20 cantons in Switzerland, and they are heavier than the Swiss Federal tax. When I made the statement a minute ago that I thought it was customary for people living in France or Italy I should have mentioned that by audit of the foreign tax agents the income is usually increased so they end up with paying a tax on as much or actually even more than they have earned.

The agents simply come in and increase the declaration of gross income almost automatically and decrease the deductions in Italy.

Senator DOUGLAS. So that the foreigners in Italy are really heavily taxed?

Mr. DECHERT. Yes, that is my understanding, Senator.

Senator DOUGLAS. And heavily taxed in Switzerland?

Mr. DECHERT. I think they may be when you take into consideration the cantonal taxes as well as the Swiss Federal tax.

I don't have all the cantonal rates.

Senator DOUGLAS. We have computed the rates for Zurich.

Mr. DECHERT. Yes.

Senator DOUGLAS. And in Zurich the combined Federal and local taxes or combined taxes would be approximately 15 percent.

Mr. DECHERT. Well, Switzerland may be an exception.

Senator DOUGLAS. But, in general, American residents abroad are groaning under the heavy strain of foreign taxes?

Mr. DECHERT. Well, I don't know, I wouldn't say they were precisely groaning but I would say they are suffering from a combination of direct and indirect taxes which is very heavy.

Senator DOUGLAS. The degree to which they groan this will be an offset of American taxes and diminish to that degree the taxes which they pay to this country, so in effect if they pay heavier taxes abroad than they do at home, this would mean there would be no American tax.

Therefore, this danger that you speak about in the last pages of your paper would be nonexistent.

Mr. DECHERT. I didn't mean the danger related to all American citizens abroad.

Senator DOUGLAS. Now, your testimony, though, was general in nature although you represent an Italian group. Are you interested in the Venezuelan situation?

Mr. DECHERT. Yes, I would be, Senator.

Senator DOUGLAS. Here is an actress who claims residence in Venezuela, and in 1959 she got an income of $996,200, said she was a bona fide resident of Venezuela. I never thought that Caracas was such an enjoyable place as to make one a permanent resident of that city.

Do you think that is quite right?

Mr. DECHERT. Well, that may be an exceptional case in which there is not a bona fide foreign residence.

Of course, the Commissioner there has certain authority as well as the courts in that the statute must be satisfied providing the taxpayer, U.S. taxpayer, must establish to the satisfaction of the Commissioner that he has been a bona fide resident of a foreign country for a period of at least 1 entire taxable year.

Another point that I wished to make if I haven't done it, Senator, is that I think it is quite uncommon for the principal countries to tax at all any of the earned income of their nonresident citizens. I am speaking now of Great Britain and other major nations.

Senator DOUGLAS. Well now, it is notorious that Great Britain has tax loopholes, it is notorious that Englishmen can escape taxation by going to the Bahamas, I believe that the Channel Islands are exempt from taxation.

I am not quite certain about the Isle of Man. This accounts for the presence of affluent Englishmen in these areas.

Well now, do you think that we should permit these tax havens to exist?

Mr. DECHERT. Well, I think, my own personal view is, that basically when an American citizen becomes a true resident of a foreign country he shouldn't be taxed on the income he earns over there. I think our

concept of world taxation of the income of a U.S. citizen is an exceptional one.

Senator DOUGLAS. Does he claim any rights as an American citizen? What about the diplomatic protection we give to him?

Mr. DECHERT. He gets diplomatic protection and he is also taxed.

Senator DOUGLAS. Shouldn't he pay for the privilege?

Mr. DECHERT. He is taxed on his unearned income very clearly.

Senator DOUGLAS. Yes, but also on the earned income.

Mr. DECHERT. It is a hard thing to say. It is my own opinion that the income should be exempt as I have said in this statement, because he will be taxed over there.

Senator DOUGLAS. Here is a man who claimed residence in Lebanon in 1959, and had an income of $151,167 which was exempt. There were some troubles in Lebanon a few years ago, and American marines were ordered there and were stationed there.

Mr. DECHERT. I recall.

Senator DOUGLAS. Don't you think that American military forces furnish protection to these people as well as American diplomacy?

Mr. DECHERT. Yes, I do; but, on the other hand, I think when an American citizen goes abroad, he goes into a strange land, frequently a land where a foreign language is spoken, the customs are different, he has to adjust himself, he is subject to taxes there, and in many of these countries the taxes are quite heavy and I think that is the other side of the picture.

Senator DOUGLAS. I have lived in Italy.

Mr. DECHERT. Yes.

Senator DOUGLAS. I love the country, I have never regarded it as a hardship to live in Italy.

Mr. DECHERT. I don't know whether I would personally, either. I am very fond of the place, too.

Senator DOUGLAS. Yes.

To go there and be exempt from taxation or to be taxed at lower rates would seem to be a great thing. Might it not draw to Italy income which might better be left home for the United States?

Mr. DECHERT. I say in some cases it is a combination of direct and indirect taxes, indirect taxes not being deductible, where the burden is not falling on the taxpayer——

Senator DOUGLAS. I think this committee will have to go into a study of the comparative burden of taxes abroad and in this country.

But certainly there is American diplomatic protection accorded to our citizens; isn't that true?

Mr. DECHERT. Oh, yes, it is accorded to them. Of course.

Senator DOUGLAS. And American military protection.

I think—was it 1905 that Theodore Roosevelt uttered the slogan: "Perdilaris alive or Raizuli dead"?

Mr. DECHERT. Yes.

Senator DOUGLAS. And they got Perdilaris back and he was a somewhat dubious American citizen but he was returned, and about the same time Miss Ellen Stone, a Congregational minister, was captured by the Bulgarian bandits, and Theodore Roosevelt got her back, and other American Presidents have defended American citizens abroad.

Mr. DECHERT. Yes.

Senator DOUGLAS. So when you go there you have a feeling it is not only the diplomatic power but the potential military power of the United States which can protect you, and yet these people pay no taxes on their earned income.

Mr. DECHERT. I think a further question is it has been our policy to encourage American citizens to go abroad because it is believed where they go abroad they foster our American trade.

Senator DOUGLAS. Well, it is a real question of whether we don't pay a too high price for this. I know the Attorney General has been urging Americans to go abroad in recent days, but this was not as permanent residents but as temporary missionaries.

Mr. DECHERT. Yes, I know. My point is that this seems to have been a fixed policy of the Congress, Senator, since 1926 to grant this tax benefit.

Senator DOUGLAS. Yes, but I mean the policy of Congress can change. Conditions change, Congress sometimes makes mistakes. You should grant——

Mr. DECHERT. Oh, yes.

Senator DOUGLAS. To us the same power of altering our course which you claim as an attorney or as a citizen or as a family man.

Mr. DECHERT. Of course, I realize that.

But my further point is I think we need more than ever today to encourage our American citizens to go abroad.

Senator DOUGLAS. So we should not heap any heavier burdens on them than those under which they are staggering at present?

Mr. DECHERT. That is correct.

Senator DOUGLAS. Yes.

Mr. DECHERT. I mean American competition with the European Market companies is very much more difficult today, with the easing of the tariff barriers between the members of the Common Market.

Senator DOUGLAS. Would you suggest that we create an order and decorate these people who leave our shores and escape American taxation as recognition of the heavy burden that they bear?

Mr. DECHERT. No, Senator, I wouldn't recommend that.

Senator DOUGLAS. You would not.

Mr. DECHERT. No.

Senator DOUGLAS. But you don't want to have them taxed?

Mr. DECHERT. I think we should still encourage our citizens to go abroad in this critical time. I think we need more than ever to encourage our foreign trade and this is one way to increase it.

I should like to submit for the record a brief submitted to the House of Representatives Committee on Ways and Means and the Senate Committee on Finance in connection with the President's message of April 20, 1961, and two supplemental statements.

Senator DOUGLAS. Without objection. Thank you very much.

(The material referred to follows:)

BRIEF SUBMITTED TO THE HOUSE OF REPRESENTATIVES COMMITTEE ON WAYS AND MEANS AND THE SENATE COMMITTEE ON FINANCE BY THE AMERICAN CHAMBER OF COMMERCE FOR ITALY, MILAN, IN CONNECTION WITH THE PRESIDENT'S MESSAGE OF APRIL 20, 1961

The President in his message to Congress of April 20, 1961, proposes to impose substantial new tax burdens on American business abroad and upon American individuals residing abroad.

The stated purpose of the proposed legislation is to ease the balance of payments deficit and to provide additional revenue for the U.S. Treasury, estimated at $250 million.

It is the position of this organization that the measures proposed will not produce the desired results either with regard to the balance of payments problem or as to revenue and that if enacted they will prove most harmful to the economic and political interests of the United States and will in addition cause hardship and injustice to many American individuals and organizations.

Our comments upon the various proposals are based upon the official explanations of the proposals supplied by the Treasury to the House Ways and Means Committee on May 3, 1961.

A. PROPOSALS FOR ELIMINATION OF SO-CALLED TAX DEFERRAL OF SUBSIDIARY OPERATIONS IN INDUSTRIAL COUNTRIES AND TAX HAVEN CORPORATIONS

In his message the President refers to the fact that American shareholders in a foreign corporation are taxable only upon dividends received as a privilege. The truth is that they are now treated in this respect in exactly the same way as shareholders in American corporations. The use of the word privilege in itself presents the matter at the outset in a biased light, so far as the shareholder is concerned. It is of course correct that the foreign corporation itself is not subject to American income tax upon its profits made outside the United States, but this in inevitable in the nature of the case. In most cases it is no great advantage to the corporation since it is subject to foreign corporation taxes which are often in total as high or higher than U.S. taxes. (Although they often take other forms for which incidentally compensation in America by means of the tax credit system is not available.)

In reality the present law regarding the taxation of interests in foreign corporations actually contains some discriminations since certain privileges available to shareholders in U.S. corporations regarding tax-free exchanges and dividend credits do not apply to them.

Still it is true that certain kinds of income can at present be accumulated in corporations, both U.S. and foreign, without the shareholder being under an obligation to pay income tax upon it unless it is distributed. The proposed legislation would eliminate this possibility so far as foreign corporations in "developed" countries are concerned by the following provisions:

1. When a group of 10 or fewer American shareholders (whether corporate or individuals) own 50 percent or more of the capital shares of a foreign corporation, they would have to pay U.S. income tax on their share of the corporation profits whether distributed or not.

2. When any American shareholder (corporate or individual) owns 10 percent or more of a new foreign corporation, even if the shareholder does not have control he would be similarly liable. In previously incorporated organizations the rule will be applied only when American interests have control.

Tax credit is to be allowed to the American corporate shareholder for foreign income taxes paid by the foreign corporation against this tax, as well as for foreign taxes upon dividends in accordance with present rules, subject to one amendment relating to the method of calculation.

Now let us examine the consequences of these proposals:

So far as the balance of payments is concerned the purpose of the legislation will only be accomplished if profits are in fact repatriated to the United States in the form of dividends. But it is a matter of common knowledge that no well-run corporation can afford to distribute 100 percent of its profits. Even if a static position only is to be maintained, corporations must retain a substantial part of their profits as reserves in order to be able to have funds available to adapt to changing conditions. If growth is desired even larger reserves must as a rule be retained.

In addition to these business considerations many foreign corporations are prevented by currency restrictions, legal rules, contractual obligations, and foreign tax considerations from distributing all of their profits. Last but not least many foreign corporations in which American interests exist are real associations between American and foreign businesses in which the other partners would be unwilling to agree to total distribution of profits both for sound business reasons and for foreign tax reasons.

Therefore in most cases it will not be practical or possible to proceed to actual distribution of all of the profits. But if such distribution cannot be made the possession of the shares of such a company will become an intolerable burden

to the American individual shareholder and to corporate shareholders in all countries where the corporate income tax rates are lower than in the United States when calculated by American standards. The more money the foreign company makes, the greater the American tax liability, but unless distribution can be made to pay these taxes the money to do so must come from the American shareholders' own funds.

Obviously the result in many cases will be the sale of the foreign shares and the vesting of control in foreign interests. Since the sale will in many cases be more or less a forced one, the price will be poor. Of course the proceeds of sale will in some cases be returned to the United States (although there is no certainty of this) and to that extent the balance-of-payments situation will be improved. Many foreign corporations controlled by Americans have substantial minority or 50 percent foreign interests and here only a few shares need be sold to give up control, so the sums involved may be small. In any event the return of capital to the United States will soon be offset by the effect of the diminishing influence of the United States in foreign industry. Foreign companies which Americans control are much more likely to buy American goods, employ American personnel, and popularize American ways and methods both in business and outside of business than those controlled wholly by foreign interests.

Although it is impossible to estimate the effect which giving up control and influence in foreign business organizations will have upon the balance of payments and upon American influence over the forthcoming years it is a matter of commonsense that it will be great.

In our opinion this is not the time for American business to withdraw from foreign enterprise and retire back into its own shell, yet this will in many cases be the effect of the legislation proposed. The activities of legitimate private American businesses abroad are, in our belief at least, as useful to the welfare of the United States as Government good will and cooperation programs. American business organizing ability, with its talent for good public relations, its tradition of good treatment of local employees and the fine quality of its products is a force which America needs in the world struggle today. Forcing it to withdraw from foreign areas is as shortsighted a policy as could be imagined.

Of course not all American interests in foreign businesses will be liquidated as a result of this legislation. The consequences of the legislation in connection with those which remain must be considered.

The measure is limited to "developed" countries. With a few exceptions these are the very countries for the most part which already have high taxes. Very often they have taxes both upon corporate profits and upon distribution of dividends. Although in many countries the present corporate income tax rates may be lower than the U.S. rates, the additional distribution tax will very often bring them above the American rates. In order to make a serious estimate of the revenue which might result from this measure it would be necessary to estimate the amount of income which would be included in U.S. returns subject to the various different corporate and individual rates in the United States and then break down the foreign sources of such income and analyze them according to the foreign tax rates and foreign dividend distribution rates. Adjustments would have to be made for the difference in structure of the foreign tax laws since each foreign country's tax is levied according to its own definition of income and according to its own system of deductions for business expenses, depletion, amortization and other adjustments and the taxable undistributed income according to the proposals will be based upon taxable income according to American conceptions.

Of course it is not possible for this organization to make such a study but we can give a few examples to illustrate what may happen in certain countries, which are believed to be of particular interest in this connection.

1. *Switzerland.*—At present the Swiss federal corporate tax rate is only approximately 8 percent of all corporate income. Apparently considerable revenue might result from the President's proposal when applied to American owned corporations here. But closer examination reveals that in addition there are cantonal (state) income taxes which vary greatly. In some of the most important cantons, Zurich and Basle, for example, these taxes run to around 25 to 40 percent of income. In addition there is a federal dividend tax of 25 percent (reduced, it is true, by treaty with the United States to 15 percent for Americans). The American shareholder would have to be in a bracket over 55 percent for any revenue to result to the United States after deduction of credit for these taxes. Even in a canton like Geneva, considered to be a "tax haven," local cantonal taxes vary upon the type of income from nothing on

income from foreign investment to 7 percent on foreign business transactions to over 25 percent on Swiss business transactions. If an average rate of taxation in that canton is taken to be only 10 percent of net income, the total tax to American shareholders on corporate income from a Geneva corporation would still amount to well over 45 percent. No great revenue will result to the U.S. Treasury upon distribution of such income after tax credits have been allowed.

2. *France.*—Here the corporate income tax rate is 50 percent. There is a distribution tax of 24 percent on dividends (reduced by treaty for U.S. shareholders to 15 percent). Clearly, no revenue can result from this source except in the situations where taxable income by local definition is greatly inferior to the company's income according to American definitions. Since French depreciation and other allowances are generally more limited than American, such cases will be rare. They might arise in connection with income of Algerian and other French oversea sources, and perhaps as a result of special tax free, or low tax, revaluation of capital assets. The cases, however, will be rare where the United States can obtain revenue from preventing its citizens from profiting from the very limited advantages allowed to French taxpayers in connection with these items. Incidentally, according to the French corporation laws, not all of the income of French corporations is permitted to be distributed.

3. *Great Britain.*—The rate of approximately 15 percent plus 40 percent will normally leave nothing after the credit is taken for the American Treasury.

4. *Italy.*—Here, it is true, the corporate income tax rate is only 41 percent of net income. There is at present no distribution tax. An American corporation in this 50-percent bracket may perhaps have some tax to pay under the proposals on its share of the profits of an Italian corporation in which it owns shares. Even here, however, care should be taken in estimating the income involved. Italian taxes on the income of corporations are, it is true, based in theory upon net income after legitimate business expenses have been deducted, but administrative practice in Italy is such that minimum assessments are often made to reach a percentage of total sales varying with the type of business involved, regardless of actual bookkeeping profits. In other words, deductions are limited to an overall percentage of gross income in many cases. Certain deductions which would be allowable in America for employee fringe benefits, for example, are not allowed at all. Thus the total rate on net income as defined in the United States may very well exceed in practice the American rates. Nothing will be available from Italy in these cases.

We conclude that the congressional committees whose responsibility it is to examine these proposals will probably find, if a thorough study is made, that very much less revenue will result from them than is supposed by the President. In any event, the committee should insist that a detailed adequate study be made in the light of existing tax legislation in other countries involved of the probable results of these proposals before reaching a decision the consequences of which will be far reaching so far as American business and economic relation abroad are concerned.

But even though the legislation will not, it may be feared, achieve the results desired, it may be expected to have other consequences which can be appreciated without a special study merely by an intelligent consideration of the situation involved.

The administrative burden of the proposed legislation upon such American private interests as remain in business abroad and upon the Treasury Department will be great. American shareholders in foreign corporations covered by the law would have to prepare and maintain two separate sets of tax records and accounts; one for the tax purposes of the foreign country in which they are located and the other for the purpose of calculating the tax due and the credit allowable in accordance with American rules and practice. Since the net income of the corporations involved, as defined by U.S. standards, will be the basis of the tax, records of gross income will have to be kept according to American definition, so will records of all deductions and allowances. In view of diversity of rules relating to the calculation of taxable income in different countries there is probably no case where these records will suffice for foreign tax purposes. Depreciation and depletion allowances and inventory adjustments owing to the variety of rates will have to be calculated twice. So will allowances for expenditures on employee fringe benefits, travel allowances, and many other items too numerous to list. Management of the corporation the shareholders of which are affected by the legislation will not only have the burden of keeping these multiple records, thus increasing their administrative expenses, but in making policy will have to consider not only the tax regulations of the countries in which they are

doing business but also those of the United States. All of this will put them in a position where competition with foreign organizations, not similarly burdened, will become increasingly difficult. Essential decisions will be more difficult to make and will take longer to realize, and competitive advantage will be lost.

In order to assure that the law is properly administered the Internal Revenue Service (which should perhaps be renamed if the bill is passed) will have to audit the records of foreign corporations when they can be made available, and will need a staff of agents familiar not only with American but also with foreign tax laws spread out over the entire globe, with the exception of the Communist countries. This will apply to the so-called "underdeveloped" countries too, since American-owned corporations in those countries must also be checked to make sure that they qualify for the exemption.

These remarks apply to the situation where actual control of the corporations, the undistributed income of which is to be taxed, is in the hands of American taxpayers, but the proposed legislation also includes shareholders of corporations when as little as 10 percent of their shares are in American hands. It is hard to believe that the administration is serious in proposing to tax such income. How can an American shareholder of a foreign corporation possibly obtain the information needed, let alone influence the company's policy in connection with dividends and other matters when he only has 10 percent of the stock? Here the legislation is obviously intended to prohibit American corporations and individuals from owning substantial minority interests in foreign corporations. It must also be intended to prohibit American individuals from owning any participation majority or minority of more than 10 percent since they do not enjoy the tax credit on undistributed profits. It really is difficult to see why such prohibitions should be enacted. If their real object is to prevent the free flow of capital outside the United States, perhaps it would be better to admit it and to enact foreign exchange controls of some sort.

It is true that the proposals exclude from their scope minority participations in foreign corporations organized previous to the enactment of the legislation. If it is desired only to protect existing interests it would seem more reasonable to use the date of acquisition of the stock as a test rather than that of the formation of the corporation which is often artificial yardstick. But it seems clear that minority interests should in any event be totally excluded from the operation of the law if enacted.

It would be unfair not to admit that in some countries, and under some circumstances, corporations owned partly or entirely by American interests are not accumulating funds at lower rates of income tax than would be the case were they operating in the United States.

It seems certain, however, that little benefit to the United States will result in most cases as a result of this attempt to get the difference involved into the U.S. Treasury. Many foreign countries already absorb most or all of the difference by means of distribution taxes. If the legislation is enacted more of them will do so.

But it is questionable whether, even if it were possible to attain this end, it would be desirable to do so. Conducting business and investing money abroad involves risks and problems which are not the same as those in the United States. Often taxes and charges other than regular income taxes nullify the supposed advantages of lower corporate income tax rates. In addition, doing business abroad involves competition with foreign organizations. If American firms are to keep their position how can they be subjected to conditions which their foreign competitors are not subject to. So far as we are aware no other country subjects the foreign holding of its citizens to this kind of tax. If we try to get American business abroad on a basis of exact equality with American business at home we necessarily will put it on a basis of inequality with foreign business abroad.

The Congress must decide whether American industrial and commercial operations in foreign countries are in the national interest or not. If, as we believe, they definitely are in the national interest, then legitimate organizations, and they are the great majority, must not be burdened to an impossible degree.

As to mere tax avoidance operations, it would be foolish not to recognize that they do exist to some degree, but we believe that a proper application of the existing rules relating to foreign personal holding companies and a proper control of operations between American parent companies and their foreign subsidiaries should be adequate to prevent abuses.

B. FOREIGN TAX CREDIT—DIVIDENDS FROM FOREIGN SUBSIDIARY (GROSSING-UP PROVISIONS)

While in principle the Treasury's proposals here do seem to have some merit, care should be taken, in eliminating this anomalous situation, to avoid requiring taxpayers and American-owned foreign corporations from being forced to keep double tax records.

C. EXEMPTION FOR FOREIGN-EARNED INCOME

The President also proposes to eliminate the present exemptions from taxation on earned income for individuals residing abroad (except in "underdeveloped" countries) and upon persons remaining abroad 17 out of 18 months without a permanent foreign residence.

The object of this legislation is no doubt to prevent an unfair advantage resulting from the fact that American citizens can go abroad on occasions when they expect to earn very large sums for work which can be done outside the United States and by remaining abroad can avoid tax on their earnings. The Internal Revenue Service's explanations of the proposal give examples of earnings of a million dollars by a moving picture actor.

It should be kept in mind, however, that the vast majority of taxpayers using the exemptions contained in section 911 of the Internal Revenue Code are employees of corporations on much more modest salaries, and professional people whose earnings are nothing like those given in the examples. For these people if they are regular residents abroad, particularly in "developed" countries, the legislation would have the effect, in most cases, of subjecting them to higher total taxes than the American residing at home. The reason for this is as follows: The American residing abroad will have to include in his gross income all of his foreign salaries, and professional fees, but in many countries he will not get credit for all of the taxes which he pays. He can only get such credit if the tax which he pays is classified as an income tax. Taxes which are called income taxes in many foreign countries are not so classified by the U.S. authorities. An example is the Italian "tassa famiglia." This tax is assessed every year by the commune in which the taxpayer resides. It is assessed by reference to the exterior appearance of wealth. The cost of the taxpayer's residence, automobile, domestic employees, etc., are taken into consideration in assessing the tax. The taxpayer cannot take a credit for this tax under American rules, although substantial amounts are often involved. Frequently the tax amounts to as much as the regular Italian state income tax.

A similar tax is often assessed in France under the regular income tax law. If income has been assessed in this manner by reference only to rental value, which is sometimes required in the case of foreigners, no U.S. credit can be taken.

Similar taxes exist in many other countries.

But at least the above taxes, since they are incident upon the taxpayer, can be the subject of a deduction from U.S. gross income. But the greatest injustice of this proposed legislation lies in the fact that it does not take into account that tax burdens are split up in different ways in different countries. In France the price of almost every article purchased contains a 22-percent tax. Neither deduction nor credit can be taken by the U.S. taxpayer residing there. Yet it amounts in most cases to an additional 22-percent tax on net income after regular income taxes. This situation prevails in many other countries where indirect taxation is on a scale undreamed of in the United States.

Finally, one other aspect of those proposals should be considered. Tax customs as well as tax laws vary tremendously in different parts of the world. In certain places it is absolutely customary and normal for taxpayers to make low initial declarations of their incomes to local authorities, since the latter are in the habit of making automatic increases in the assessment finally made over the original declarations. As a practical matter, a correct declaration in the first place would lead to an overassessment. Americans in these countries, employing local tax accountants and counselors, usually follow the regular customary pattern set by the people of the country, for justice and approximately equal treatment of taxpayers similarly situated can only be arrived at that way. They cannot be mavericks or crusaders if they expect to get along and live in harmony with communities in which they reside as foreigners. But this legislation will put them necessarily in an embarrassing and difficult position. If they make correct declarations to the United States, they must make similar declarations to the country in which they live, particularly in view of the exchange of information features in most U.S. tax treaties. But if their declarations abroad are

made in the thorough and completely accurate U.S. manner, they will be penalized by the foreign tax authorities. Again the result will be more revenue for the foreign country. Since income tax rates in many of the most developed countries are as high or higher than in the United States, the amount included in the U.S. tax return will mostly be absorbed by the tax credit.

On the whole it seems likely that little revenue will result from this measure. However, Americans will be put at a disadvantage in many foreign countries by comparison with foreign taxpayers similarly situated.

In order to prevent tax avoidance by persons such as moving picture stars not permanently resident abroad, we suggest that the provision whereby a person who has no permanent residence in a foreign country, but only remains absent from the United States for 17 months might be repealed. It is, however, already subject to a $20,000 limitation.

One final remark should be made in connection with this proposal. Americans permanently resident abroad have no representative in Congress since they are not resident in any State. Thousands of these citizens are already subject, therefore, to taxation without representation. These proposals would subject them to much more intensive taxation, yet they will not have the protection against executive abuse by appeal to the legislators of their choice which is granted to their fellow citizens residing in the United States. If this legislation should be enacted, serious consideration should be given to permitting representation in Congress for Americans abroad. Precedent has already been established for it in connection with the District of Columbia. Other countries, too, such as France, have representation in their legislatures for their citizens residing abroad.

D. ESTATE TAX EXCLUSION—FOREIGN REAL ESTATE

So far as we are aware, the U.S. administration is now proposing to make history in levying taxes on land situated in other countries. Sovereign states have for centuries refrained from levying or attempting to levy taxes upon land which forms part of another state.

Apart from the fact that this legislation should be closely examined to determine whether it is a violation of international law or of certain treaty obligations, some practical aspects should be considered. The U.S. estate tax is not an inheritance tax, but an estate tax. In other words, the tax is levied not upon the persons receiving the assets of a person deceased, but upon the estate itself: that is to say, upon the personal representative of the deceased.

Under these proposals the American executor, or administrator if one exists, would be liable for tax upon property upon which he may have no control. If the heirs or legatees of the foreign real estate are American, this situation might not be too serious. When they are foreign, it is really difficult to see how the tax can be collected or what justification there would be for attempting to collect it.

One thing is certain. This is a proposal which will bring little revenue into the Treasury, but it will create much ill will with foreign governments. If it is considered indispensable for the United States to get some revenue, it would be less hazardous to consider legislation along the lines already existing in some foreign countries whereby the foreign real estate belonging to the decedent is not taxed, but its value is taken into consideration in establishing the rate upon the assets located in the United States. Legislation of this sort, although it may be regarded as petty in character, at least has the advantage of not stepping on the toes of other countries in a field in which international law, custom, and tradition are very well established.

CONCLUSION

I. A really adequate study of the proposals would probably reveal that they would produce little revenue and would be more likely to have an adverse effect upon the balance of trade than otherwise.

II. They will cause American influence abroad to diminish in vital industrial, commercial, and financial spheres at the very time when the administration is attempting to increase American influence in foreign countries by other methods, the effects of which are much more problematical than those of the activities of the American business organizations abroad. This will be because the relinquishment of control of foreign corporations by American business organizations will necessarily be the effect of the legislation.

III. The proposals to abolish exemptions on earned income cause an injustice to the taxpayers concerned:

(*a*) because they do not take into consideration the variety of foreign tax patterns and cannot therefore give adequate relief against double taxation;

(*b*) because they constitute taxation without representation on a large scale.

IV. The grossing-up provisions are reasonable in principle, but care should be taken to avoid undue accounting burdens.

V. The estate tax proposals are ill considered from a technical standpoint and are of doubtful propriety from the standpoint of international law and relations.

VI. Before reporting on this legislation, the committees, we believe, should insist that a most thorough study of its effects be made by some impartial body. Hearings, we believe, should be held in the principal foreign countries involved, so that the interested parties may make their views known.

Please take note that there is pending Italian legislation, which, if adopted, will result in a further upward revision of Italian tax rates.

SUPPLEMENTARY STATEMENT IN RESPECT OF H.R. 10650 BY THE AMERICAN CHAMBER OF COMMERCE FOR ITALY AT MILAN, THROUGH DANIEL ORVILLE DECHERT, WASHINGTON, D.C., OF THE DISTRICT OF COLUMBIA, VIRGINIA, AND NEW YORK BARS, AND SAMUEL D. MERCER, PARIS, FRANCE, OF THE DISTRICT OF COLUMBIA BAR

REVENUE BILL OF 1962

Section 5 of the bill would change the rule under present section 301 so as to eliminate (by amending sec. 301) the alternative provision now applicable to corporate shareholder distributees of corporate distributions in kind between the inclusion in gross income of the lower of the fair market value of property distributed and its adjusted cost basis in the hands of the distributing corporation insofar as foreign corporate distributors are concerned. In these cases the recipient would be required to include property received in income at fair market value, except for a protanto exception by which the present rule would continue in respect to resident foreign corporations deriving most of their income in a specified manner from sources within the United States, in regard to that part of the distribution attributable to the U.S. income of the distributing corporation.

There seems to be no need for this provision. The amount of revenue which it will produce will be minute, and it represents an unjustified discrimination against American shareholders who have shown the initiative to take the special risks of investment abroad with resulting furtherance, in most cases, of our foreign trade. The procedure seems to be known to the other major nations. The application to these distributions of the credit for foreign taxes would not be a sufficient palliative, because of its vagaries.

Section 6 of the bill would amend present section 482 by adding to it a new subsection (b) aimed entirely at sales of tangible personal property by organizations under common control which are members of a related group that includes one or more domestic and one or more foreign organizations. The word "organization" is not defined, and it is not clear that it includes a sole proprietorship. The provisions of section 6 seem drastic. Under existing law, the Secretary or the Commissioner has the power, in the case of two or more organizations under common ownership or control (either de jure or de facto) whether or not incorporated, whether domestic or foreign, and whether or not affiliated, to distribute, apportion, or allocate gross income, deductions, credits, or allowances between members of the controlled group, whenever he determines that any such action is necessary to prevent evasion of taxes or clearly to reflect the income of any members of the group. This section, of course, is simply designed either to produce transactions like those at "arm's length" between independent persons, or to enable the Commisisoner to force their consequences taxwise. The courts have not hesitated in suporting the Commissioner under a predecessor section to hold foreign sales income of a nonresident foreign corporation from sources without the United States and therefore free from Federal income tax in the hands of the recipient nonetheless taxable here against a transferor under common control who did not sell at an "arm's length" price to the reselling affiliate.

The British have had the longest experience with an income tax, having had one continuously since the 18th century. As subjects of a nation not producing more than about half of her food supply and forced to export in the face of an

international balance of payments extremely hard to square, they have also had the longest and most complicated experience in international trade. Nothing is found in the British income tax law which goes as far as section 6 of the bill. In section 469 of the United Kingdom Income Tax Act of 1952, as amended, the power given to the Commissioners of Inland Revenue, in cases of "sales between associated persons" is to change the selling price of goods passing between such persons as to make it what the goods might have been expected to bring between independent persons so that the like consequences shall ensue as if the property had changed hands between independent parties. The provision is very simply extended to sales commissions by a clause covering the "giving of business facilities." The British are, of course, aware of the existence of "tax haven" countries and of corporations formed in them by British interests. The British income tax section consideration contains no paragraph about a member of a controlled group with "grossly inadequate assets" abroad. The British seem unconcerned with what some American circles now deem to be the inequity of "tax deferral," but to recognize that international networks of business, while paying tax to the homeland on current amounts or realized income, must remain flexible as to when they bring their foreign profits home.

Allocation of taxable income from sales of tangible property based on the factors of the adjusted basis of assets of the group used in production, of compensation of officers and employees concerned with these operations, and of advertising, selling and sales promotion expenses (including technical and servicing expenses) similarly involved is calculated to produce arbitrary results of unforeseeable degrees. The Commissioner seems under the bill to have entire discretion as to whether he will consider other factors including any special risks of the market in which the property is sold. One would not expect him to be very familiar with such risks, and the result might be a tendency to ignore them.

It would seem to be sufficient to add, as the British have done, sales commissions to the gross income or deductions already subject to allocation under the existing statute, provided that in fairness the addition covers also fully domestic groups under common control.

The proposal that there be no allocation of taxable income to a foreign organization whose assets, personnel, office and other facilities not attributable to the United States are "grossly inadequate for its activities outside the United States" seems inadvisable. How will the Commissioner, inexperienced in the local foreign business conditions, know whether the assets, personnel, etc., are grossly inadequate? If the arms'-length price can be established, what more can be needed to avoid abuse?

Section 7 of the bill would amend provisions of the sections of present law concerning foreign personal holding companies. The principal change would be to reduce from 60 percent or 50 percent, as the case may be, to a mere 20 percent, the portion of total world income of the foreign company consisting of those kinds of passive income classified as foreign personal holding company income, the presence of which, combined with the ownership of more than 50 percent in value of the foreign company's shares of stock by five or less U.S. individuals, makes it a foreign personal holding company. Tax on undistributed income of such a company is imposed on the American shareholders as if such income were distributed to them as a dividend. The figure of 20 percent seems to be unwarranted. It is justified by a reference in the committee report to the provisions of the bill (found in sec. 13), by which there would be an attribution to U.S. shareholders of certain undistributed income of controlled U.S. subsidiaries other than foreign personal holding companies where their passive income is as much as 20 percent of gross income. Since the other provisions of the bill seem to cover quite adequately foreign personal holding company situations it seems that the best course for Congress in the interest of simplicity would be to repeal the foreign personal holding company provisions if the other provisions of the bill are to be enacted.

The other change proposed by section 7 of the bill is a modified definition of the term "undistributed foreign personal holding company income"—i.e., the income which is attributed on a pro rata basis as a dividend to U.S. shareholders although not distributed. Under present law such income is entire taxable income with certain modifications, etc., minus the dividends paid credit for dividends paid and consent dividends. Under the proposed modification, if the company's passive income is less than 80 percent of total income, the undistributed income attributable to the U.S. shareholders would be the same proportion of its taxable income (with present modifications) minus the dividends paid credit, as its foreign personal holding company income is of its entire gross income. The principle of this proposal is sound, as it would exclude from

attribution to U.S. shareholders a part of nonpassive gross income. However, the change should be appended to existing law if it is decided to retain the foreign personal holding company provision.

Section 9 of the bill is perhaps the most complicated one from the textual standpoint affecting foreign income. It would increase Federal taxation of accumulation distributions by foreign trusts in respect of U.S. citizens and residents by abolishing in regard to such distributions the 5-year throwback rule. That is to say, the restrictions on taxation as current income of distributions of accumulated income would not be restricted, as in the case of domestic trusts, to undistributed net income of the trust in excess of $2,000 occurring in any of the 5 preceding years. Also, the exemption from taxation intended to be continued in respect of beneficiaries of domestic trusts in cases of distributions to a beneficiary upon reaching the age of 21 years, or to meet emergency needs, or upon reaching a specified age if not more than four such distributions can be made or the distributions are at least 4 years apart, and to a beneficiary upon termination of a trust and final distribution happening more than 9 years after the date of the last transfer to the trust, would be abolished in the cases of beneficiaries of foreign trusts. The new provisions would apply to foreign trusts to which money or property has been transferred, directly or indirectly, by U.S. persons as defined or under the will of a deceased U.S. citizen or resident.

The committee report makes it clear that the intention is to tax all previously accumulated income or distribution to a U.S. citizen or resident, without reference to the 5-year limitation and the other limitations now existing, in contrast to the treatment of accumulation distributions from domestic trusts, and that in general the new provisions are to apply to distributions made in taxable years of a foreign trust beginning after the date of enactment of the bill. There seems to be no reason why the limitations on the tax of accumulation distributions by domestic trusts should not be abolished if such limitations are to be terminated in regard to foreign trusts. There are many cases of domestic trusts in which the Treasury is losing revenue by the limitations on the taxation of accumulation distributions, and therefore no real reason for disparity of treatment appears, since the differences in tax reductions resulting from accumulations in trusts are differences in degree rather than in kind.

Section 11 of the bill concerns the credit for foreign corporate income taxes attributed to domestic corporate shareholders of 10 percent or more of the foreign company's voting stock receiving dividends in the taxable year from the foreign corporation. This provision seems to be based on a theory that no allowance should be made for the greater risks of foreign operation through subsidiaries but that flat equality in regard to the credit for foreign taxes should be achieved by the tax law between the domestic corporation not investing money overseas and the one that takes the greater risks ordinarily involved in the development of American foreign trade. The device adopted by section 11 to attain this supposed equality of treatment is that of the grossing-up into the accumulated earnings and profits of the foreign corporation from which the dividends are statutorily deemed to proceed the foreign income taxes which the foreign corporation has already paid to a foreign government from such earnings and profits—in other words, money which the domestic corporation can never receive because it has already been spent.

The problem which would be cured is said in the House report to arise when the foreign tax rate is below the U.S. rate for the reason that the foreign tax is not only allowed as a credit in computing the Federal tax of the domestic corporation receiving the dividend, but also in effect is allowed as a "deduction," since the dividends can only be paid out of income remaining after payment of the foreign tax. The dividend from the foreign corporation is fully taxable, i.e., not subject to the 85 percent exclusion (except pro tanto in cases of certain resident foreign corporations deriving more than half of their income from the United States). The credit for the foreign tax is limited to the same portion of the tax which the income included in the American tax base is of the total income, under this rule. Where the foreign tax rate is less than the American, there can result an effective rate differential in respect of the dividend of several percentage points below the American corporate rate of 52 percent, which reaches a curious maximum of a little less than 7 percent where the foreign tax rate is 26 percent, thus giving the dividend a tax advantage as compared to foreign branch income. However, foreign branches enjoy certain advantages under U.S. tax law which are denied to subsidiaries. One of the most important is deduction by the American company of losses from foreign operations. It should be borne in mind that operation through foreign branches is not always

practical owing to foreign legal and other conditions. For example, many foreign countries require business to be done by local corporations, particularly where government contracts are involved.

At present many foreign countries attempt to attract needed foreign capital for development by offering attractive rates. The proposal of grossing-up will make it impossible for them to offer such attraction to American capital, and constitutes an invitation to them to increase income taxes on American controlled businesses. The committee should consider that such a provision involves political and economic as well as tax considerations.

Section 12 of the bill would make important changes in present law exempting the earned income of certain U.S. citizens from services without the United States, i.e., for work done abroad or attributable to such work. For many years the earned income from foreign sources of the U.S. citizen who establishes to the Commissioner's satisfaction that he has been a bona fide resident of one or more foreign countries for a period including an entire taxable year has been exempt from Federal tax, except when paid by the United States or one of its agencies. The statute contains a safeguard by limiting the meaning of earned income so as to exclude from it that part of the compensation derived by the taxpayer for personal services rendered by him to a corporation which represents a distribution of earnings or profits rather than a reasonable allowance as compensation for personal services. It also provides that in the case of a taxpayer engaged in a trade or business in which both personal services and capital are material income-producing factors, there shall be under regulations a reasonable allowance as compensation for the personal services rendered, not in excess of 30 percent of his share of the net profits of the trade or business.

Where the U.S. citizen, although he cannot qualify as a foreign resident, is physically in foreign countries for at least 17 out of 18 consecutive months, his foreign-earned income is exempt up to a minimum of $20,000 for an entire taxable year. This is a later statutory addition in supplementation of the rule as to nonresident citizens. Section 12 of the bill would now reduce the exemption for the nonresident citizen until he has resided abroad for 3 years to the maximum amount of $20,000 for any taxable year computed on a daily basis, and put him on a par with the citizen merely absent 17 out of 18 months. Thereafter, the nonresident citizen would be accorded an exemption of a maximum of $35,000 a taxable year computed on a daily basis beginning with that portion of a taxable year occurring after he has been a bona fide resident of a foreign country for 3 years. Although the bill would confirm that for purposes of the exclusions amounts received shall be considered received in the taxable year in which are performed the services to which the amounts are attributable, it contains a new limitation that no amount received after the close of the taxable year following that in which the services are rendered to which the amount is attributable may be excluded, thereby preventing the exemption of much deferred compensation referable to foreign service.

Section 12 also would prevent a spouse having the right under applicable community property law to one-half of the other spouse's earnings from taking in combination with the other spouse an exemption in excess of the limits set for one of them. It would expressly exclude from exemption any amount received as a pension or annuity although referable in whole or in part to foreign residence, and any amount includible in gross income in connection with a nonexempt employees' trust, etc.

All this would be regressive legislation. It would place the nonresident U.S. citizen engaged in foreign trade at a competitive disadvantage with nonresident citizens of other foreign countries whose compensation for personal services is not subject to tax at home. It would mark an amazing congressional turnabout after repeated previous solemn committee remarks about the wisdom of encouraging our foreign trade by inducing U.S. citizens through tax exemptions to take up residence abroad where the implicit assumption has been that they might not do so if fettered by income tax both abroad and at home on their foreign earnings, with only the partially satisfactory credit against the home tax on account of the foreign one. There seems to be no need for this about-face of tiny fiscal significance. It should be kept in mind in this connection that although tax credit is available for foreign income taxes paid, U.S. citizens residing abroad are often subject to a much greater tax burden of a nonincome tax type than is the case of those residing in the United States. For example, in Italy the burden of indirect taxation is very heavy. In addition, local personal taxes, particularly the family tax, which has been held not to be an income tax for American tax credit purposes, are assessed annually in Italy

on the basis of the general standard of living of the taxpayer. Similarly burdensome taxes are levied in France and other countries for which no tax credit will be available. Frequently no American deduction is available by reason of the indirect manner in which the foreign tax is earned. As an illustration, there is such a French tax of 22 percent on almost every article purchased.

Section 13 of the bill would create the controversial controlled corporation. It consists of a proposed new highly complicated subpart of eight sections. The first one, proposed (sec. 951) would require, where a foreign corporation is a controlled foreign corporation on any day of a taxable year beginning after 1962, that every U.S. person (defined elsewhere in the bill as meaning a citizen or resident of the United States, a domestic partnership, a domestic corporation, and any estate or trust other than a foreign state or trust) who owns, directly, or indirectly, by definition, 10 percent or more of the stock of the corporation on the last day in such year in which it is a controlled foreign corporation, include in his gross income: first, his pro rata share of the corporation's subpart F income, and, second, his pro rata share of the corporation's increase in earnings invested in "nonqualified property" for the year, to the extent not excluded from gross income.

A following provision of section 13 defines a controlled foreign corporation as any foreign corporation of which more than 50 percent of the stock (total combined voting power) is owned directly, or indirectly as defined, by U.S. persons on any day of the corporation's taxable year. Another provision excludes from attribution of corporation income any U.S. person who, despite the rules of indirect ownership, cannot be treated as owning on any day of the corporation's taxable year on which it was a controlled foreign corporation, 10 percent or more of the corporation's stock (either combined voting power or total value).

The two new denominations of income of the controlled foreign corporation's income on which the U.S. holders of 10 percent or more apiece of the stock are taxable are defined as follows:

(1) The "subpart F income" is the sum of—

(*a*) Income, if any, derived from "insurance of U.S. risks" as defined in a very extraordinary way;

(*b*) "Income from U.S. patents, copyrights, and exclusive formulas and processes" (as also arbitrarily defined); and

(*c*) "The net foreign base company income" (a very novel concept), but with the limitation that this new class of income is taken into computation only in the base of a controlled foreign corporation in which five or less U.S. persons own, by application of described rules of indirect ownership, more than 50 percent of the stock (combined voting power).

There is excluded from the subpart F income any item of gross income which would be includible in the gross income of a resident foreign corporation except when inclusion is called for by the subpart, and it is provided that the subpart F income of a controlled foreign corporation shall not exceed for any taxable year its earnings and profits for such year.

There follow definitions of the three new classes of income of the controlled foreign corporation that go to make up income which may be attributed to U.S. shareholders.

The first new category of income, "income from insurance of U.S. risks," is defined as follows:

If a controlled foreign corporation receives premiums or other consideration in respect of any reinsurance or the issuing of any insurance or annuity contract—

(*a*) In connection with property in, or residents of, the United States; or

(*b*) In connection with property not in, or nonresidents of, the United States as the result of any arrangement whereby another corporation receives a substantially equal amount of premiums or other consideration in respect of any reinsurance or the issuing of any insurance or annuity contract in connection with property in, or residents of, the United States, then for purposes of the pro rata share of the 10 percent or more U.S. shareholder's subpart F income, the term "income derived from the insurance of U.S. risks" means that income which (subject to certain modifications) would be taxed under existing provisions of law if the controlled foreign corporation were a domestic one required to include its world income of this kind in its U.S. gross income.

This seems to be arbitrary. If income properly allocable to the United States is deviated by artificial arrangements within a commonly controlled insurance group including a foreign member, the Commissioner should exert his present powers under section 482. If it is not so deviated, it has no place in U.S. income

where it is earned by a foreign corporate entity from foreign sources through foreign contracts or otherwise. There is no reason to strike out against such income of foreign insurance companies by attribution to U.S. shareholders simply because of U.S. control.

The second new category of U.S. income, "income from U.S. patents, copyrights, and exclusive formulas and processes," is defined as follows:

The term means the amount of gross rentals, royalties, or other income derived from the license, sublicense, sale, exchange, use, or other means of exploitation of patents, copyrights, and exclusive formulas and processes—

(*a*) Substantially developed, created, or produced in the United States; or

(*b*) Acquired from any U.S. person which, directly or indirectly, owns or controls, or is owned or controlled by, or is under common ownership or control with, the controlled foreign corporation, less cost and the expense allowance incurred by the controlled foreign corporation in the receipt or production of the income described.

As to income from use or other means of exploitation by the corporation, its theoretical amount of gross rent, royalty, or other payment in the hypothetical arm's-length transaction is imposed.

These provisions seem to go far beyond proper concepts of gross income from sources within the United States, and to reach out for indirect taxation of the income of foreign entities that may have no real fiscal contact with the United States. Here again, if section 482 cannot be invoked by the Commissioner, the income should be left alone.

The third category of new income, "net foreign base company income," is defined as follows:

(1) The foreign base company income for the taxable year, as determined by a new provision, reduced by the increase in investment in "qualified property" in "less developed countries" for the taxable year, as determined by another new provision.

The "foreign base company income" means in general the "foreign personal holding company income" (i.e., the passive income, although the controlled foreign corporation is not a foreign personal holding company), with certain modifications and adjustments. The term "foreign base company income" includes "foreign base company sales income" if, for the taxable year, such income is at least 20 percent of the gross income (excluding other foreign base company income). The term "foreign base company sales income" means income, inclusive of profits, commissions and fees, derived in connection with the purchase of personal property from a related person and its sale to any person, or its purchase from any person and its sale to a related person, where—

(*a*) The property purchased is manufactured, produced, grown, or extracted outside the country of incorporation of the controlled foreign corporation; and

(*b*) The property is sold for use, consumption, or disposition outside such foreign country.

If the foreign-base-company income is less than 20 percent of gross income, no part of the gross income of the taxable year is to be treated as foreign-base-company income, but if it exceeds 80 percent, the entire gross income of the taxable year is to be taken into account in determining foreign-base-company income.

The increase in investment in qualified property in less developed countries for the taxable year which goes in diminution of foreign-base-company income in the determination of net foreign-base-company income is an amount by which the aggregate amount of certain stock owned by the controlled foreign corporation in a specified kind of other controlled foreign corporation of a less developed country, plus property and money located outside the United States and ordinary and necessary for the active conduct of a qualified trade or business as defined, held at the close of the taxable year, exceeds the aggregate amount of such property held at the close of the preceding taxable year. Adjusted basis is taken as the value of property, reduced by any liability to which the property is subject.

A trade or business is a qualified one if it (or substantially the same trade or business), either—

(i) is carried on by the controlled foreign corporation outside the United States and has been so carried on by it while 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, or

(ii) is carried on by the controlled foreign corporation almost wholly within a less developed country or countries.

There are also provisions for qualified trades or businesses of foreign sub-subsidiaries.

The less developed countries are negatively defined so as to exclude the developed countries of Europe, and divisions of developed countries not "overseas." For example, Sicily could be included, whereas southern Italy cannot, although both are distressed areas receiving much special help from the Italian Government.

Careful consideration of section 13 of the bill indicates that its effect will be:

(1) To cause Americans to diminish their investments abroad.

(2) To increase greatly the cost and burden of administration in determining what foreign income, judged by differing American standards, has been properly retained for the needs of the business of the controlled foreign corporation, so as not to be taxable against American shareholders.

(3) To put a heavy burden of expense on controlled foreign corporations required to keep additional sets of books in respect of possible liabilities for American tax of American shareholders, differing from the usual foreign books because of different rates of income, deduction, and otherwise.

(4) To make Americans undesirable as coshareholders with foreigners in foreign corporations in cases where American control would otherwise be welcomed, because of the unusual and different tax considerations to which American shareholders would be subject, calculated to result in pressure by them to force the payment of dividends to provide money for taxes laid on them in respect of the foreign corporation's income. This will result both in existing foreign corporations going out of American control and in future corporations failing to come into American control.

(5) To cause confusion as to whether European and Latin American corporations, usually issuing bearer shares, owners of which may be known, are in fact under American control, with resulting uncertainty on the part of American shareholders in respect of their proper position before the Treasury.

(6) To cause various foreign corporations the shares of stock of which are listed on American stock exchanges to withdraw the listings to avoid the possibility of being under American control without knowing it, or of having to keep troublesome extra books because of American control.

(7) To cause exclusive processes, which have been a principal element in the development of American business abroad, to be transferred to uncontrolled foreign companies instead of controlled ones, and research laboratories to be established abroad by international interests instead of in the United States.

(8) To cause retaliations by foreign governments because of the violation by this country of at least the spirit of income tax treaties to which it is a party, or because of the oppressive consequences of indirect American taxation of their own corporations merely because of American control, such retaliations probably taking the form of increased taxation of the companies themselves and of dividends going out to American shareholders, and possibly of restrictions on American ownership of shares in companies formed in certain nations.

(9) Reduce the good will entertained abroad for this country, and the number of capable Americans engaged abroad in our foreign trade.

(10) Place American-controlled foreign corporations at a competitive disadvantage with other corporations operating in the same country but not subject to the pressure of paying dividends to give their shareholders with which to pay the new American tax on foreign corporate earnings.

Section 15 of the bill relates to foreign investment companies. Basically, it would treat gain in the case of a sale or exchange of their stock after December 31, 1962, by a taxpayer who held such stock at any time when the company was such in a taxable year beginning after 1962 as gain from a noncapital asset to the extent of the taxpayers' ratable share of the company's earnings and profits accumulated for taxable years beginning after 1962. The burden is placed on the taxpayer to establish the earnings and profits under penalty of having all gain from the sale of exchange treated as gain from a noncapital asset. These companies are so defined as to be foreign corporations registering in a given way under the Investment Company Act of 1940 or engaged as described in the securities business at a time when under American control. No reason is perceived for this provision. The foreign company will pay U.S. tax on income derived from U.S. sources under present law, and the U.S. shareholder will pay a tax on capital gain on sale or taxable exchange. The proposal is another indirect attempt at exterritoriality in respect of foreign juridical entities.

Section 16 would treat as a dividend the gain of U.S. shareholders from redemptions and liquidations of controlled foreign corporations. This is highly dis-

criminatory when compared to the capital gain treatment which would still be accorded to shareholders of other corporations. Particularly objectionable seems to be that part of the proposal that dividend treatment be imposed on the recipient's proportionate share of all earnings and profits of the controlled foreign corporation accumulated since early 1913. This would be extremely harsh surprise legislation of severe retroactive effect, real justification for which is hard to find.

Also highly discriminatory is the proposal of section 16 of the bill that would treat the gain of U.S. shareholders in sales and exchanges of stock in a controlled corporation as gain from a noncapital asset to the extent of the recipient's proportionate share of the earnings and profits of the foreign corporation accumulated during the period the stock was held by him. The discrimination would in many cases be of retroactive effect to a date years before the bill was contemplated, and again justification is difficult.

Another harsh feature of section 16 is that the proposed rules in regard to redemptions, liquidations, sales and exchanges by the 10 percent or more U.S. shareholders of shares of stock in a controlled foreign corporation would apply if the foreign corporation is a controlled foreign corporation either at the time of the sale or exchange (including those in redemption or liquidation), or at any time during the 5-year period ending on the date of the sale or exchange.

If section 16 is to be enacted in some form despite its general inadvisability, it should be changed so as to take away from the U.S. shareholder the heavy burden of establishing the earnings and profits of foreign companies governed by different concepts of the term. The foreign companies should be allowed to certify their earnings and profits under applicable governing law so as to remove an undue hardship requiring another detailed books and records.

The proposal in section 16 that the new discriminatory treatment be meted out to transactions occurring after the date of enactment will cause a rash of distress dispositions by U.S. shareholders of shares of stock in these foreign companies before enactment if they believe that enactment is likely.

The proposal in section 16 will diminish American foreign investments in the future, at least of the type where Americans have control. This will be a great disadvantage to the U.S. economy in the long run. Foreign-controlled foreign companies will do less business with the United States than foreign companies under American control.

Section 18 seems to be an unprecedented proposal. It would levy U.S. estate tax on real estate abroad owned by U.S. decedents. I would seem to be in violation of estate tax treaties to which this country is a party. If the heirs or devisees are foreign, the tax may be difficult to collect. Enactment of the provision would create much ill will with foreign governments. Sovereign states have refrained for centuries from levying taxes on land situated in foreign countries.

Section 20 would call for very burdensome information in respect of foreign corporations, some of which may not be justified if other provisions of the bill are not passed.

Section 21, by making the provisions of the bill supersede conflicting provisions of tax treaties, seems unwise because it will cause much ill will, at least to the extent that there are any conflicts, on the part of foreign governments who have made compacts with us in pure faith and not expecting unilateral renunciation.

SECOND SUPPLEMENTARY STATEMENT IN RESPECT OF H.R. 10650 BY THE AMERICAN CHAMBER OF COMMERCE FOR ITALY AT MILAN, THROUGH DANIEL ORVILLE DECHERT, WASHINGTON, D.C., OF THE DISTRICT OF COLUMBIA, VIRGINIA, AND NEW YORK BARS, AND SAMUEL D. MERCER, PARIS, FRANCE, OF THE DISTRICT OF COLUMBIA BAR ANSWERING POINTS RAISED IN QUESTIONING BY THE ACTING CHAIRMAN OF THE SENATE COMMITTEE ON FINANCE ON MAY 4, 1962, IN THE COURSE OF TESTIMONY BY DANIEL ORVILLE DECHERT

National taxes in Italy appear to be substantially as follows, according to the latest information available in Washington at the Department of Commerce; dated July 1960:

1. PROPERTY AND LAND TAXES

(*a*) Tax on land (mainly on the "imputed" rent of agricultural land) at a usual rate of 10 percent.

(*b*) Tax on buildings (on actual or "imputed" rent of buildings other than farm buildings) at a rate of 5 percent.

2. INCOME TAXES

(*a*) Tax on income from movable wealth (richezza mobile) applicable to individuals and firms, with rates set according to sources of income, as follows:

1. Income from capital, 23 percent but reduced to 11.5 percent, until June 30, 1962, on interest accruing from bonds issued by corporations (societa per azioni) and partnerships limited by shares (societa in accomandita per azioni).

2. Income from investment of labor and capital combined.

A. Corporations—18 percent on income up to 4 million lire; 20 percent on the part of income exceeding that figure.

B. Noncorporate taxpayers—9 percent on income between 240,000 and 960,000 lire, the first 240,000 lire being exempt; 18 percent on income between 960,000 and 4 million lire; 20 percent on income over 4 million lire.

3. Income from professional practice and from employment.

A. Income from professional activities: (1) Corporations, 8 percent; and (2) noncorporate taxpayers, 4 percent of income from 240,000 to 960,000 lire and 80 percent for the part of income exceeding 960,000 lire.

B. Income of employees: Four percent of income from 240,000 to 960,000 lire; 8 percent for the part of income exceeding 960,000 lire.

C. Progressive surtax (imposta complementore sul reddito)—an income tax on individuals only with rates set according to size of income, regardless of source. The rates vary from 20 percent for taxable incomes of 240,000 lire to 50 percent for incomes in excess of 500 million lire. Annual incomes not exceeding 720,000 lire are exempt. For incomes above 720,000 lire, there is a personal exemption of 240,000 lire and an exemption of 50,000 lire for each dependent.

D. Corporation tax: An annual tax at the rate of 0.75 percent on total capital and reserves and 15 percent on annual profits exceeding 6 percent of the corporation's capital plus reserves. The tax is applicable to foreign firms operating in Italy.

3. ESTATE AND INHERITANCE TAXES

Estates are subject to a progressive tax varying from 1 percent on estates up to 1 million lire to 35 percent on estates over 500 million lire. Inheritance tax rates vary according to the degree of relationship, from a minimum of 1 percent in case of transfers to direct descendants in amounts not exceeding 1 million lire to a maximum of 80 percent in case of transfers to distant relatives or nonrelatives in amounts exceeding 500 million lire. Both estate and inheritance taxes are applicable to property located in Italy, regardless of the nationality or place of residence of either the deceased or the beneficiaries.

4. INDIRECT TAXES

The most important indirect tax is the general transactions (IGE) tax, which accounts for almost a quarter of the Government's total revenue, and is levied on all transactions not specifically exempted by law. Exemptions apply to capital transactions (sales of real estate, stocks and bonds, contraction and payments of debts, etc.), to dividend receipts, to interest on bank deposits, to wages and salaries, to pensions and annuities, to sales of certain types of products and services, and to imports but not to export sales. The IGE tax is collected and paid to the State by the seller, who adds it to the price of the product.

The normal rate of IGE tax is 3.30 percent of the value of the transaction, with a special rate of 1.30 percent for special transactions. There are many other indirect business taxes.

LOCAL GOVERNMENT TAXES

The local governmental bodies (the Provinces and communes) levy a number of direct taxes. These consist of surtaxes on land and buildings and taxes on industry, trade, the arts, and professions (corresponding to the National Government's progressive surtax on incomes, except that the maximum rate is limited to 12 percent).

The major local indirect tax is the consumption tax, levied on a variety of products at various rates established by local authorities within limits set by the state that can be exceeded if warranted by the financial situation of the local government. Consumption taxes apply to goods consumed in the local area whether produced there or brought in from other areas.

PROPOSAL FOR INCREASE OF ITALIAN INCOME TAX RATES, ETC.

There are indirect taxes in Italy which are heavy burdens, but which cannot be credited against U.S. income taxes which American citizens may otherwise rue, because they are not treated by the United States as foreign income taxes or taxes levied in lieu thereof within the requirements of present law. One of these is the family tax (tassa di famiglia), which is related to the outward appearances of a person's scale of living, and can be very heavy.

Also, to the extent that any deduction (other than the personal exemption) is properly allowable to or chargeable against amounts of gross income of the nonresident U.S. citizen excluded from U.S. tax under present section 911, it is not allowed.

The number of December 31, 1961, of the serial publication European Taxation, of Amsterdam, Holland (vol. 1, No. 24), indicated that tax proposals in Italy which would increase income tax rates and surcharges were then in an advanced stage as follows:

1. The surcharge for social welfare (E.C.A.) was to be increased from 5 percent to 10 percent and extended to the complementary tax on corporations (imposta sulle societa).

2. The scheduled income tax on interest (imposta di ricchezza mobile, category A) was to be increased from 23 percent (effective rate 27.77 including surcharges) to 26 percent (effective rate 31.39).

3. The scheduled income tax on industrial and commercial profits (imposta di ricchezza mobile, category B) was to be increased in the higher brackets as follows:

Twenty-two percent (effective rate 33.81) on that part of profits exceeding 10 million lire. (The highest rate at that time was 31.39 percent on the excess over 4 million lire).

Twenty-three percent (effective rate 35.02) on that part of profits exceeding 50 million lire.

Twenty-four percent (effective rate 36.22) on that part of profits exceeding 100 million lire.

4. The progressive surtax (imposta complementare) was to be increased in such a way that 65 percent (effective rate 78.49) was to be levied on taxable income of 500 million lire and more. All rates on taxable income over 3 million lire were to be increased similarly.

These increases were to be applied retroactively from January 1, 1961.

Senator DOUGLAS. The next witness is Mr. Joseph Pechman of the Brookings Institution.

I may say that Mr. Pechman is one of the foremost experts on the American system of Federal taxation. He was for many years with the Treasury and then I believe for some years with the Committee on Economic Development, and he is now with the Brookings Institution. We are very happy to welcome you, Mr. Pechman.

STATEMENT OF JOSEPH PECHMAN, THE BROOKINGS INSTITUTION

Mr. PECHMAN. Thank you, Mr. Chairman.

I am glad to have this opportunity to appear before the Senate Finance Committee to discuss the tax bill recently passed by the House.

Since I have devoted a good deal of my research time in recent years to problems of individual income tax compliance and enforcement, I should like to confine my remarks to a discussion of the proposed system of withholding on interest and dividends.

The views I shall express are my own and do not necessarily represent those of the trustees, officers and other staff members of the Brookings Institution, or of the members of the National Committee on Government Finance, of which I am executive director.

I should like to state at the outset that I am convinced of the need for adopting some system of withholding income tax at the source on interest and dividends.

Eleven years ago, a similar withholding provision was passed by the House, but it was finally defeated on the ground that it should be possible significantly to reduce the amount of underreporting of interest and dividends through ordinary enforcement techniques. In the interim, the Internal Revenue Service has sought and obtained the cooperation of corporations, banks, and other financial institutions in an educational campaign to dramatize the need for improved interest and dividend reporting. Despite these efforts, there is no evidence that the degree of reporting has improved in recent years. Failure to adopt withholding 11 years ago has already cost the Treasury $4 billion or more, and this cost will continue to mount by a factor of $650 million per year, according to current estimates.

I realize that the question of withholding on interest and dividends is charged with emotion. The article in this morning's Washington Post regarding the mail received by Senators on withholding is illustrative of this emotional response. But the members of this committee will recall that the response was even stronger and more extreme when the proposal to adopt withholding on wages and salaries was first discussed more than 20 years ago. In fact, one Commissioner of Internal Revenue opposed the adoption of withholding on wages and salaries.

Nevertheless, the present withholding system is now an integral part, not only of the Federal tax system, but also of State income tax systems and of private business accounting.

Senator DOUGLAS. Mr. Pechman, may I interject?

Is it true that Massachusetts has adopted the withholding system in recent years? In the last 2 years?

Mr. PECHMAN. I am not sure, Senator.

Senator DOUGLAS. What about New York State?

Mr. PECHMAN. I am almost sure New York State has adopted withholding.

Senator DOUGLAS. It did not have?

Mr. PECHMAN. I think more than half the States that have State income taxes now have withholding systems.

Senator DOUGLAS. Would you be willing to submit for the record a list of the States which do have State withholding systems?

Mr. PECHMAN. I would be glad to; yes, sir.

(The information referred to follows:)

Of the 33 States (including the District of Columbia) with general income taxes, 27 have adopted withholding on wages and salaries. These States are:

Alabama
Alaska
Arizona
Colorado
Delaware
District of Columbia
Georgia
Hawaii
Idaho
Kentucky
Louisiana
Maryland
Massachusetts
Minnesota
Missouri
Montana
New Mexico
New York
North Carolina
Oklahoma
Oregon
South Carolina
Utah
Vermont
Virginia (as of January 1963)
West Virginia
Wisconsin

Senator TALMADGE. Would the chairman permit me to ask a question at that point?

Senator DOUGLAS. Yes.

Senator TALMADGE. Does any State have a withholding provision for interest and dividends?

Mr. PECHMAN. No, sir; no State does, and as a matter of fact, I think it would be rather difficult for them to do it.

The wage and salary withholding system was widely acknowledged to have been perhaps the most important and constructive administrative step ever taken in the history of the individual income tax. I have little doubt that withholding on interest and dividends, if adopted, would also come to be regarded as a major step forward in tax administration.

Three major arguments have been advanced during these hearings against the proposed system: (1) withholding is unnecessary because ADP—automatic data processing—will permit the Internal Revenue Service to track down the underreporting and collect the delinquent tax due; (2) withholding will impose heavy costs on those who pay out interest and dividends; and (3) withholding will impose unnnecesary hardships on organizations and individuals not subject to tax. I should like to discuss each of these points briefly.

1. THE RELATIONSHIP OF ADP TO WITHHOLDING

The publicity recently given to ADP has, I believe, given the unfortunate impression to many people that the electronic computer will solve all of the problems of tax administration. It will be a great step forward, and I have little doubt that it will greatly improve the efficiency of tax enforcement. But it should be recognized that ADP is an information system, while withholding is a tax collection system.

As the Commissioner of Internal Revenue and the Secretary of the Treasury have stated, ADP cannot substitute for withholding on interest and dividends any more than it can substitute for withholding on wages and salaries.

In fact, we really do not have a choice between ADP and withholding. Given a withholding system, ADP will certainly close most of the interest and dividend gap. Without withholding, ADP will never, and I want to emphasize the word "never," be able to collect more than a fraction of the total tax due and uncollected from these sources of income.

Consider what exclusive reliance on ADP would mean. It would be necessary first to reduce the filing requirement for information returns on interest from $600 to a much smaller figure and also extend the information requirements to types of interest not now covered by the $600 floor. This is the only way in which the Service can be informed of the amounts paid to individuals. The preparation of the additional millions of information returns by financial institutions—the number would be in the neighborhood of 150 million—would be extremely costly, certainly more costly than all of the additional burdens imposed by the House bill on the same institutions.

After the information returns are received by the Service, it would be necessary to collate the returns by name, and then to match them with the tax returns filed by the recipients. At the present time

it would be physically impossible to complete this matching process; this will be possible only after the ADP system has been installed and this is still several years away.

Even if the matching operation were ever completed, it would be very costly to collect the tax due from delinquent stockholders and interest recipients. Notices would have to be mailed to taxpayers who failed to report the amounts shown on the information returns. The replies to the millions of responses to these inquiries would have to be read to determine who should be sent deficiency notices. Finally, in cases where the taxpayers failed to respond to their notices, it would be necessary to collect the tax through distraint of the taxpayers' property.

I should like to emphasize particularly that relying solely on ADP for enforcement of the tax on dividends and interest would not be simple and inexpensive. The new numbering system will permit the machines to distinguish people with identical names but different addresses, but they will not be able to differentiate cases involving true underreporting from those where the discrepancy can be explained on other grounds.

For example, dividend payments reported on information returns may attribute dividends to a seller rather than the buyer in the case of late transfers of ownership of stock in the corporate records, but the machines will not be able to identify such cases. Notices will be sent to the taxpayers involved, letters of explanation will be received, and then the returns will have to be examined by a competent auditor to validate the taxpayers' claims.

By contrast, consider what would happen if withholding were in effect. In the first place, it would be possible to raise the dividend information return requirement. This alone would save dividend payors a significant amount of money. The reduced number of information returns would then be matched with the tax returns using ADP equipment. But it would not be necessary to mail out notices to all taxpayers with discrepancies, since most taxpayers will have discharged their liability in full through withholding. The ADP equipment would sort out the taxpayers with additional tax liability and notices would be sent only to this relatively small number.

According to the official estimates, the withholding system alone, without ADP, would add $650 million annually to the revenues at a cost of $19 million to the Service. If withholding were supplemented by an information return followup with ADP, the revenue gain would be increased to $700 million, but the cost would go up to $29 million. Relying on an information return followup without withholding would reduce the cost to $26.8 million, but the revenue gain would be cut to not more than $200 million and perhaps less. It should be recognized also that, even if ADP is installed within a few years, failure to adopt withholding would lose revenues at a rate of $650 million per year until the installation is completed and fully operative, and at a rate of $450 million per year thereafter.

As dividends and interest rise these costs will increase. In view of these impressive figures, it seems to me that the case for withholding on revenue and cost grounds is compelling, whether or not ADP is installed in the relatively near future.

2. COMPLIANCE PROBLEMS OF THE WITHHOLDING AGENT

The mechanics of the original withholding system proposed by the Treasury would have imposed no measurable cost on the withholding agent. No statements for individuals were required, nor would it have been necessary to reconcile the amounts remitted to the Government with amounts withheld from individual accounts.

The steps were as follows:

(i) The payor would have withheld 20 percent of the interest and dividends subject to withholding. However, his operations would have been substantially the same as they are today. Instead of paying out 50 cents per share, for example, a corporation would pay 40 cents. And instead of crediting 1 percent interest per quarter on its share accounts, a savings and loan association would credit 0.8 percent per quarter.

(ii) The only other requirement imposed on the withholding agent was to mail a check for the amount withheld four times a year to the Internal Revenue Service. In the case of a corporation paying dividends, the amount to be mailed to the Government would have been computed by multiplying the amount withheld per share times the number of shares outstanding on the dividend date, a computation which can be done on the back of an envelope in 30 seconds, even for the largest corporation in the country. In the case of banks and other firms paying interest, the computation would have been equally as simple—it would have been necessary only to multiply the portion of the interest withheld (0.2 percent in the example given in the previous paragraph) by the amount of deposits outstanding on the interest date.

This simple system was altered in the House to permit children under 18 years of age and nontaxable individuals generally to file exemption certificates with the withholding agent, in order to avoid creating hardships for those who are not taxable.

I shall have something to say about the hardship question in a moment. The additional work required under the House bill of the withholding agent, as compared to the Treasury proposal, is to segregate the accounts among those that are subject to withholding and those that are not. He would then withhold 20 percent only from the taxable accounts. This will cost more than the original Treasury proposal, but I doubt that the cost can be very large. In fact, the system proposed by the House is still much simpler than the system every payor of interest or dividends in the United States has become accustomed to in connection with wage and salary withholding.

It is significant that the only cost estimate presented to this committee during these hearings indicated that the cost of withholding to a bank would be seven-tenths of 1 percent of the taxes withheld in the first year, and three-tenths of 1 percent in each succeeding year. This would be more than offset by the interest financial institutions could earn on the withheld funds which they would retain for periods up to 4 months before making their remittances to the Government.

3. THE PROBLEM OF OVERWITHHOLDING

If withholding is required across the board, without any distinction between taxable and nontaxable recipients, it is obvious that there will be overwithholding. But the fact that there is some overwithholding does not mean that taxpayers will be annoyed or inconvenienced. The Treasury pays out more than $4 billion of refunds each year to roughly 37 million people, yet there are few if any complaints. Among the 37 million recipients of refunds, there are 8 million nontaxable wage earners who have every year between $600 and $700 million withheld from their paychecks—and this group does not complain either. The average refund check for these nontaxable wage earners amounted to $83 in 1959. To have as much as $83 withheld on interest and dividends under the proposed system, an individual would have to own more than $10,000 worth of securities and bank deposits (assuming an average 4-percent yield).

Unfortunately, the available statistics do not tell us precisely what we want to know about those who are likely to be overwithheld under the proposed system. However, we do have some information for the year 1955 which may be derived from the annual tabulations of income tax returns prepared by the Internal Revenue Service.

These data are summarized in the following table:

Nontaxable returns reporting interest and/or dividends	Calendar year 1955		
	Number of returns (millions)	Total interest and dividends (millions)	Average interest and dividends
All nontaxable returns	$1.5	$821	$545
Nontaxable returns with less than $3,000 income	1.3	530	399

Source: Statistics of Income, 1955.

The table shows that, in 1955, about 1.5 million nontaxable returns reported income from interest and/or dividends. The amount of interest and dividends accounted for on these returns was $821 million and the average amount of interest and/or dividends reported was $545. This means that, for the persons represented on these returns, average overwithholding would have been $109 (20 percent of $545) had the proposed withholding system been in effect in 1955 without an exemption system.

I have also shown in the table the same data for returns with income of less than $3,000. Below this point, in other words, there were 1.3 million tax returns in 1955 and they reported average interest and/or dividends of $399. The overwithholding on these returns, which would presumably contain most of the hardship cases, would have averaged $80 per return.

Although it is true that an unknown number of nontaxable interest and dividend recipients do not file returns, the amounts of interest and dividends they receive and hence the potential overwithholding on these incomes must be very small.

Nonfilers have incomes of less than $600 if they are less than 65 years of age and less than $1,200 if they are 65 or older. Under the circumstances, it is a pretty good inference that the income tax popula-

tion probably overstates the average overwithholding by a substantial margin. The figures also indicate that the average amounts of overwithholding on nontaxable low income recipients will be of the same order of magnitude as the average overwithholding on nontaxable wage earners, but of course the number of refunds will be much smaller.

The case for doing something about overwithholding on nontaxable interest and dividends is that the proposed plans involve withholding at a flat rate. Under the wage withholding system, we do provide for exemptions and overwithholding occurs because of part-year employment, fluctuations in wages, and other factors. I agree, therefore, that there is a difference between the two situations. The original Treasury proposal, it seems to me, went about as far as was necessary to relieve the occasional nontaxable person who would be pinched if his interest or dividends temporarily declined by the amount withheld. Under this proposal, nontaxable individuals could claim quarterly refunds and even taxable individuals were entitled to make such claims under certain conditions.

The House bill added the exemption certificates and now we are again faced with the argument that the cost of withholding will be too great for the withholding agent. In other words, we have come full circle.

I conclude that the need for withholding is urgent, but the choice between a system with or without exemption certificates is a close one.

Exemption certificates are needed if the burden of withholding on nontaxables, even with the availability of a generous system of quick, quarterly refunds, is regarded as intolerable.

On the other hand, there is no question that a flat withholding system without exemptions is preferable from the standpoint of simplicity for the withholding agent.

My own preference would have been to begin with a system without exemptions in order to find out how big a problem overwithholding really is, since it is much easier to design appropriate remedies after all the facts are known.

However, I realize that this is a matter of judgment and the committee is in a much better position to make such a judgment than an outside observer like me.

Senator DOUGLAS. Senator Talmadge?

Senator TALMADGE. As I understand it, the present tax bill provides for withholding on pension funds and foundations and other groups that would pay no tax whatever.

Would you recommend that they be allowed an exemption privilege similar to the one that is included in the House bill?

Mr. PECHMAN. If an exemption certificate is allowed for individuals, I would certainly permit pension funds and other nontaxable institutions to use them.

Senator TALMADGE. I have one further question: It seems to me that the greatest hardship that would be involved in withholding would be some individuals who are living almost exclusively on income from, say, social security and a nominal amount of interest and dividend income.

As I understand this bill, it provides for exemption if they have absolutely no Federal taxes to pay, but it does not provide for exemption in the event their Federal tax is nominal.

I would like to have your comment as to what can be done in a situation like that.

Mr. PECHMAN. Under the present bill, under those circumstances, the taxpayer, and he is a taxpayer under the conditions that you stipulated——

Senator TALMADGE. Yes, nominal taxpayer.

Mr. PECHMAN (continuing). The taxpayer would be permitted to file a claim for a refund. He has a refund allowance, which depends upon his total income. He could obtain a refund for—presumably it is a nominal amount—within a few weeks after the amount has been withheld from his check.

As I indicate in my statement, the refund system is permitted not only for nontaxable people but also for taxable people as well.

Senator TALMADGE. Do you think that would, under some conditions, work quite a severe hardship on individuals who were living on this nominal income, and at the same time they would be making interest-free loans to the Government for 90-day periods?

Mr. PECHMAN. I do not think that is a severe hardship, Senator, under the conditions you indicated, because the amounts would be very small. Incidentally, these are the kinds of interest-free loans that wage earners are giving to the Government today, 8 million of them.

Senator TALMADGE. I understand, though you have distinguished some difference, that wage earners can file additional data that illustrate a greater degree of information about their likely taxable income so as to keep the two more in relationship than the interest and dividend income group.

What I am talking about here is a situation where they have a modest income primarily from interest and dividends and possibly all of that modest income is needed to live. While the sum would not be great, as you say, it would still be 20 percent of their income .

Mr. PECHMAN. No, 20 percent of their dividends and interests.

Senator TALMADGE. Twenty percent of their dividends—well, suppose all of their income is from dividends and interest, it would be 20 percent of their total income then, wouldn't it?

Mr. PECHMAN. That is correct, and in that circumstance they would get a refund check in a matter of weeks.

I do not think that the amount that would be withheld, except in very exceptional circumstances, would be burdensome. I think that the overwithholding problem has been grossly exaggerated.

According to the figures, the amounts of overwithholding involved for nontaxable people are not much greater than the amounts that are involved for wage earners. As you pointed out, interest and dividends are generally a supplementary source of income. I have studied income statistics for many years and found that they are very rarely received as the sole sources of income as an individual. An aged person usually has social security or other kind of pension arrangements. Other nontaxable people will have some business income. I just think that we ought to put this matter in perspective.

I don't disagree, Senator, with the decision of the Ways and Means Committee about exemption certificates; I think this is a matter

of judgment. If you think it is necessary to relieve these people of this small inconvenience, and I think it will be very small, by all means go ahead. But I still think that the withholding system is absolutely essential for tax administration.

Senator TALMADGE. Can you think of any reasonable modification or alteration to alleviate the burden of these people who would be paying a very nominal or insignificant tax which would be subject to this 20-percent withholding?

Mr. PECHMAN. I think the House bill goes far enough with respect to those people.

Senator TALMADGE. You and I might consider that insignificant. If they were living solely on that, and a very marginal living at that, withholding 20 percent of their total income for certain periods of time would be very significant if they were depending on it to pay their house rent and their grocery bill.

Mr. PECHMAN. I agree with you. But I don't think the number of such cases is very great. As I indicated, to be overwithheld, $83, which is the average amount of overwithholding for nontaxable wage earners, an individual has to have securities of $10,000. You are not talking about destitute people. Either they have very small amounts of interest and dividends which won't affect their living standard, or if the overwithholding is significant they have a large amount of securities, and are not destitute. With a substantial reserve, such an individual can do without the small amount of withheld taxes for a period of 2, 3, or 4 weeks. I don't think it would hurt them.

Senator TALMADGE. All right, let's get specific.

Let's say that the combined income of this family from interest and dividends would be $5,000, and that it was received totally from dividends and interest. That would mean that they would be withholding quarterly from these people a thousand dollars, wouldn't it?

Mr. PECHMAN. That is correct.

Senator TALMADGE. All right, wouldn't you say that a thousand dollars withheld out of the $5,000 income would be a substantial amount to that particular couple?

Mr. PECHMAN. In the first place, if they received $5,000 of income, they would be taxable to some extent, unless they have——

Senator TALMADGE. They are elderly people and allowed a double deduction.

Mr. PECHMAN. If they are elderly people, they will be subject to some tax. They are not taxable on the $2,400 exemption, the $1,200 retirement income credit, and $500 for standard deduction, which gives them a taxable income of $900 and their tax is $180.

Senator TALMADGE. All right.

Their tax would be $180 a year.

Mr. PECHMAN. That is correct.

Senator TALMADGE. And yet they would have $1,000 withheld from their——

Mr. PECHMAN. They are overwithheld $820 for the entire year. But this is a very extreme case, Senator.

Senator TALMADGE. That is the point.

Mr. PECHMAN. They are overwithheld $820.

Now, these people that receive $5,000 in interest and dividends have $125,000 worth of securities. I think they can wait for 2 or 3 weeks

until the Internal Revenue Service refunds the amount allowed them under their refund allowance.

I don't think you could regard this family as being destitute.

Senator TALMADGE. Under the conditions I have outlined then, it would be an involuntary interest-free loan to the Government under those conditions?

Mr. PECHMAN. Yes, sir, just as 37 million people today give the Government an interest-free loan on the overwithheld taxes they are refunded at the end of each year. There are 37 million such people in the United States.

It should be noted also that you are talking about a retired couple, the husband of whom probably was subject to withholding throughout most of his income-earning career. Most people who receive interest and dividends have been subject to withholding. They know what the withholding system is all about and I am sure they would understand it.

Senator TALMADGE. Let's distinguish that now, you make a good parallel there on salaries and wages and I am aware of the facts on withholding.

But what remedies do they have under existing law on salaries and wages to make their income and their taxation more parallel than they would in the interest and dividend fields?

Mr. PECHMAN. In some respects the law is more onerous for recipients of wages and salaries than the proposed House bill on dividend and interest recipients. If a man is overwithheld on wages and salaries there is no way he can get that back before he files his return at the end of the year.

Senator TALMADGE. It would be annual, not quarterly?

Mr. PECHMAN. That is correct. The proposed bill would give quarterly refunds to interest and dividend recipients.

Senator TALMADGE. All right.

What entry can the employee list to avoid the withholding?

Mr. PECHMAN. Just his personal exemptions, he can list his personal exemption.

Senator TALMADGE. Marital status and the number of children.

Mr. PECHMAN. That is correct.

Senator TALMADGE. And no other?

Mr. PECHMAN. And no other. In addition, the withholding tables take into account the standard deduction.

Senator TALMADGE. Under the bill before us individuals who receive interest and dividends could not file in that manner.

Mr. PECHMAN. They could file—there are two situations. If they expect to be nontaxable they would be in the same situation, or even in a better situation, than wage earners because they can file exemption certificates.

If they expect to be taxable they can file a refund claim up to their refund allowance. This refund allowance takes into account precisely what the present withholding tables take into account for wage withholding. It has been made parallel in that respect. I really do think that the House bill is extremely liberal on this score. It makes it easy for low-income recipients of dividend and interest to get their money back as quickly as possible. As a matter of fact, the bill has gone so far over in the other direction that now the financial institutions are saying that it's just impossible for them to withhold.

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You will recall that much of the early argument about withholding was that it was not practical. Well, you don't make it practical by giving a lot of exemptions and exclusions.

My own feeling is that the overwithholding problem has been exaggerated, that financial institutions can withhold, that the general public wants to pay its tax, and that the vast majority of the people would welcome a system that would permit them to discharge their liability through a withholding system. This is what has been happening for many, many years in the United States under the income tax system.

Senator TALMADGE. I have no further questions, Mr. Chairman.

Senator DOUGLAS. Senator Carlson?

Senator CARLSON. Mr. Pechman, you have had a great deal of experience in the tax field.

What would be the objection to lowering this $600 figure that we have now for reporting dividends and interest?

Why don't we cut it back to $100 or $10?

Mr. PECHMAN. I think the answer to that is even with electronic marvels, a tax administrator, wouldn't want too many pieces of paper floating around. It is very costly to run hundreds of millions of pieces of paper through machines. Furthermore, once having run them through the machines he will have to incur other costs.

Take an individual, for example, who forgets a $5 interest amount that has been credited to his savings account. If we had no withholding and if we required that amount to be reported to the Internal Revenue Service, the machines would compare his tax return and his information return. It would show $5 not reported. A letter would have to go out to that particular taxpayer saying, "You didn't report $5"—or $50, it doesn't matter what the amount is—"So would you mind explaining?"

He may or may not have reported that amount. There are a lot of situations in which he should not have reported. For example, a person who is a trustee for his children may have been indicated as the owner of the interest or dividends.

After these letters go back and forth, suppose the Internal Revenue Service has established that he owes tax on $50 of interest, that is, say, $10. It has got to collect the $10. It is very difficult for the Internal Revenue Service to collect amounts of money due of that size. Today what happens is that many of such small amounts of money that people forget to include in their tax returns are simply not collected.

My own feeling is taxpayers would like to be able to discharge their liability.

You are simply asking too much from administration and even from electronic machines to be able to process the hundreds of millions of information returns.

Senator CARLSON. If we follow your suggestion on an exemption certificate procedure in the bureau, now would we not be in danger of having the same situation prevail on the theory that some of these people, anyone could file these exemption certificates with excessive amounts, what is going to happen then?

You have to go back through all these machinery to maybe find it some day but what happens there?

Mr. PECHMAN. I would welcome an opportunity to be able to check that kind of thing.

Senator CARLSON. Well, wouldn't it be difficult?

Mr. PECHMAN. No, it would not.

In the first place, you are talking about a group of low-income people, people who have a modest amount of taxes, as Senator Talmadge indicated. These people are not going to be fraudulent. They are not going to try to get away with anything. If they file an exemption certificate, for the most part their claim would be correct. To police that, you do not have to police every one of them. All you have to do is to sample one in a hundred or one in a thousand and check up on the sample. You can find out whether there are fraudulent claims in this way.

If the number of fraudulent claims seems to be significant, and I don't think it would be, you can crack down on them. If it is not significant, there is no problem.

But this is a cost of an entirely different magnitude from the cost of running through 300, 400, or 500 million information returns through electronic machines. That is a very costly proposition, Senator.

Senator CARLSON. You state these low-income people would not want to be fraudulent, and I am sure they wouldn't. But you take an individual, as the Senator from Georgia has mentioned, who is going to have $1-, $7-, $800 withheld out of a $4,000 or $5,000 dividend and interest income, he has to live on that, and I am not so sure they are going to get this back as easily as it sounds when we sit around this table. Some of these folks are not so convenient with figures and writing, and I have reason to believe it will cause some real hardships in many instances.

Mr. PECHMAN. Well, when I was in the Treasury, Senator, we were concerned about the same question with respect to wages. There are a lot of people whose wages were withheld on who were not taxable. The answer to your question is that there are 8 million people with wages and salaries who are not subject to tax. They file tax returns and claim refunds every year. Eight million. Not just a few hundred thousand.

The very people whom you are overwithholding on, as I indicated to Senator Talmadge, have been withheld on for many years. They file tax returns; they are accustomed to this.

This is not true with respect to everybody, but it is true with respect to the large majority. And as soon as they are convinced it is not a new tax, and I think it is very easy to convince them, as soon as the people are accustomed to the procedures, I don't think the Government will be withholding funds that properly belong to taxpayers.

In any case, all I can say is that the Internal Revenue Service promptly refunds every year over $4 billion of tax, and instead of being annoyed, the American public regards it as an Easter present around April 15.

Senator CARLSON. Well, Mr. Pechman, I am somewhat familiar with the withholding on salaries and wages. It was my bill in the House of Representatives that brought it about.

Mr. PECHMAN. And, Senator, to your credit, and to the credit of your colleagues, that was the most important administrative action ever taken by the Congress.

Senator CARLSON. I think it was a very salutary provision, and we had to pass it at that time to collect the taxes. But I think there is some difference in this, because we have a withholding with exemptions, family exemptions, and other dependents, and unless we can write this on that same type of basis, I think it will work into real hardships.

Mr. PECHMAN. I think your staff and the Treasury staff could take care of the hardship cases. I think you could take care of them without much difficulty. I think the first decision to make is whether there is a problem, an administrative problem. I am convinced that there is. We are losing a lot of money every year.

If a $650 million price tag is attached to it, I assure you that your staffs can take care of the few hardship cases that you are concerned about.

Senator CARLSON. That is all.

Senator TALMADGE. Mr. Chairman, may I ask another question or two if you don't want to proceed?

Senator DOUGLAS. Go ahead, Senator.

Senator TALMADGE. Mr. Pechman, I want to compliment you on your presentation. You are not only thoroughly familiar with the subject, but you spoke directly to the point.

Would you agree that the majority of the instances where we do not collect all of the taxes on dividends and interest is through negligence or oversight on the part of the taxpayer and not willful?

Mr. PECHMAN. Well, on balance I would say, yes. I think that most people probably forget the amounts that we feel are unreported, particularly interest on bank deposits and savings-bond interest. I remember the last time I went to the bank to cash a savings bond, the savings bank didn't tell me how much interest I had. I had two bonds, and I had to laboriously calculate how much interest I had on those two bonds. It wasn't simple at all.

Senator TALMADGE. If you have to cash it in prior to maturity, it is complicated indeed.

Mr. PECHMAN. That is correct. The average taxpayer is just not familiar enough with the complications. If you withhold 20 percent from the interest of the average taxpayer you have discharged his liability, you have made him an honest man. I think he will feel fine after he gets through with withholding.

Senator TALMADGE. You agree the most efficient way of tax collection is to collect money with the least onerous burdens on the taxpayer by the public generally, would you not?

Mr. PECHMAN. Yes, sir.

Senator TALMADGE. What would be wrong with a system, pursuing further what the Senator from Kansas said, a system of lowering this reporting, and I understand it is now $600; if I collect $600 in interest and dividends an information return is sent to the Government, is it not?

Mr. PECHMAN. That is only with respect to interest. Dividends are $10 or more.

Senator TALMADGE. Ten dollars in dividends and $600 in interest.

Why couldn't both of them be lowered to the equivalent of, say, $10 or some reasonable figure, where the Government would have an information return, and then put an additional report in the individual taxpayer's return where he would have to file it under oath

subject to a fraud or criminal penalty that would make him state affirmatively whether or not he had reported all of his interest and dividend income. The penalty could be made very severe for false swearing or fraud or negligence; wouldn't that accomplish substantially the same result as this complicated program that is outlined in this bill?

Mr. PECHMAN. Senator, I am sorry, I must say that the answer is absolutely not. I am not a lawyer so I can't pass judgment on the suggestion to make it a fraud penalty. My guess is you can't do it. But in any case——

Senator TALMADGE. Why wouldn't you now?

Most taxpayers have a pretty healthy respect for filing a fraudulent return on income and if it were brought to their attention in an impressive way, why wouldn't that collect money that we seek to collect here?

Mr. PECHMAN. He files his present tax returns under penalties, in some cases under penalty of fraud and yet he does not report about a billion dollars of dividends and three billions in interest.

I don't think waving a big stick is going to force taxpayers to pay. What is more, under your system you accomplish two things. First, you create more work for the financial institutions. They have to file all these millions of information returns and that is more expensive than what they have to do under the House bill.

And secondly, you dump these hundreds of millions of information returns on the lap of the poor Commissioner of Internal Revenue. He is always coming in and asking for more money to do his present job and you are going to increase his problems by a factor of 150 million information returns.

I would say that any administrator and any Committee on Appropriations would be foolish, simply from an efficiency standpoint, to expect the Commissioner of Internal Revenue to use his scarce resources that way.

Any dollar that he can spend matching information returns with tax returns would yield a much higher return if it were invested in auditing high-income returns, business returns and so on. To match these millions of information returns would be very costly.

The Commissioner of Internal Revenue has already stated publicly, and the Secretary of the Treasury has testified, that they are not going to be able to use ADP in the way that people suggest it can be used.

I think the most efficient system from everybody's point of view is withholding, supplemented by ADP.

Senator TALMADGE. I have no further questions.

Senator DOUGLAS. Mr. Pechman, can a nontaxable wage earner file an exemption certificate so that there will be no withholding against his earnings?

Mr. PECHMAN. A nontaxable wage earner files a certificate with his employer showing the number of exemptions.

If his wages during any particular week, after being annualized, are below the value of the exemptions plus the standard deductions, there is no withholding during that week.

If his wages exceed on an annual basis the amount of personal exemptions he is withheld on he can't tell the employer, "I don't expect to be taxable during the year." For this reason, for example, young-

sters who are employed during the summertime are subject to withholding. They get their refund checks at the end of the year.

Incidentally, the case of the youngster who has a summer job and who is withheld on during the summer is very similar to the case of his interest and dividends being withheld.

At the time he claims his refund check for the wage withholding he could also claim his refund for interest and dividends. But, of course, under the House bill he wouldn't have to do that at all. Under the House bill he would claim his refund for wages and salaries only.

Senator DOUGLAS. There is no withholding in those cases where the weekly earnings are less than one fifty-secondth of the exemption amounts, is that correct?

Mr. PECHMAN. That is correct, yes.

Senator DOUGLAS. It is only when the weekly earnings are in excess?

Mr. PECHMAN. Yes.

Senator DOUGLAS. And, therefore, the refunds come in part because of irregular employment.

Mr. PECHMAN. That is correct. There are also other reasons. There may be additional exemptions before the end of the year, for example.

Senator DOUGLAS. Yes, I understand.

If I may address a question to the Senator from Georgia.

In the illustration which you gave of the income recipient with dividends and interest getting $5,000, I understood him to say $5,000 a quarter. I would like to ask him if he meant $5,000 a quarter or $5,000 a year.

Senator TALMADGE. $5,000 annually and the withholding would be $250 a quarter, rather than $1,000.

Senator DOUGLAS. It would be withholding of the income at a rate of $250 a quarter; not at a thousand per quarter.

Senator TALMADGE. That is correct.

Senator DOUGLAS. So, therefore, quarterly withholding would be not the $1,000 but $250. I wanted to have the record clear on that point.

Senator TALMADGE. As a matter of fact, one of the members of the staff handed me a calculation which I believe the chairman put in the record several days ago.

In a situation of that type the income would be $5,000 per year, tax liability apparently, according to this, would be $87, the amount withheld would be a thousand dollars.

The excess withholding under those conditions would be $913, excess as to percent of spendable income after tax, 19 percent.

I think that is already inserted in the record, Mr. Chairman, by Senator Byrd of Virginia.

Senator DOUGLAS. Well, would not the refunds, based on the experience with wages, follow the end of the quarter rather closely, Mr. Pechman?

Mr. PECHMAN. Yes, sir.

As a matter of fact, there is another parallel; I think this is still true. Farmers pay tax on gasoline they use on the farm, but they are entitled to file refund claims because they don't use the vehicles on the roads.

The last time I looked at this, I learned that about a million farmers filed refund claims, and we hear no complaints.

Senator CARLSON. That is an annual return?

Mr. PECHMAN. I think that is correct. And I have been told that these refund claims are processed very, very quickly.

Senator CARLSON. I am advised by the staff it is quarterly. I thought it was an annual return.

Mr. PECHMAN. I am glad to be corrected. It is therefore a similar situation. Actually there is no point for the Internal Revenue Service to keep those refund claims lying around. They have every incentive to get them out of the Service.

Senator DOUGLAS. Are those refunds made from the regional offices or from the central office?

Mr. PECHMAN. I would guess they are made from the regional office.

Senator DOUGLAS. From the regional office?

Mr. PECHMAN. Yes.

Senator DOUGLAS. May I ask about the timing of dividend and interest payments. Interest payments are made quarterly, is that not true?

Mr. PECHMAN. Yes.

Senator DOUGLAS. To what degree do the interest payments of savings institutions correspond roughly with the quarterly payments under the income tax?

Mr. PECHMAN. Well, in the case of savings institutions, I would guess that the quarterly amounts are credited to the accounts at the end of the quarter, let's say, for the first quarter it would be on March 31. In some cases they are credited on the first of the following month. But I think in most cases——

Senator DOUGLAS. Now, are the quarters of the savings institutions roughly parallel or closely identical with the quarterly periods of income tax collections?

Mr. PECHMAN. I think they are practically identical.

Senator DOUGLAS. Practically identical?

Mr. PECHMAN. Yes.

Senator DOUGLAS. So how much overwithholding would there be? If tax collection returned to the Government on the 1st of July is in excess of the liability of the individual, and this is withheld, and then a few days afterward the individual can file a claim for overwithholding, for how long a time has he lost the use of this money?

Mr. PECHMAN. Well, you are quite right, Senator.

Senator DOUGLAS. What?

Mr. PECHMAN. The amount of time is small.

As a matter of fact, you just hit on something that hadn't occurred to me before. The individual might receive a refund check before the money has been remitted to the Government by the bank.

Let us assume it is credited on March 31. He files a refund claim on April 1st. He may get his check April 15 or April 25 and the bank doesn't remit that withheld tax until the end of April. So it is conceivable that, if a man files a refund claim promptly, he will get the money before the Goevrnment does.

Senator DOUGLAS. Is it not true that he only has to file a refund claim initially, and that thereafter the matter will be handled by the Internal Revenue Bureau?

Mr. PECHMAN. Yes.

There is no reason why the Internal Revenue Service should handle more than one claim a year. They will automatically make the refund every quarter until he tells them to stop. They will set up a file for him. I don't think this will present any difficulty.

Senator DOUGLAS. Mr. Pechman, would it be too much trouble if you were to prepare a memorandum on the periodicity of interest payments by savings institutions as to when they are normally made?

Mr. PECHMAN. I don't think it would be too much trouble.

Senator DOUGLAS. I know this is too big a job for you to make a survey, but a general memorandum would do.

Mr. PECHMAN. I would be glad to put it in the record.

Senator DOUGLAS. What about dividend payments?

Mr. PECHMAN. My impression is that the majority of corporations pay dividends toward the end of the quarter, there are exceptions, but that is my impression under the circumstances if the dividend payments normally come in March, say the overwithheld dividend recipient will not be out his money for more than a matter of weeks, and it is hard for me to believe there would be much of a penalty.

Senator DOUGLAS. I wonder if it would be too much trouble to prepare a parallel memorandum on dividends?

Mr. PECHMAN. I will combine them in the same memorandum.

Senator DOUGLAS. Yes.

(The memorandum referred to follows:)

It is my understanding that dividends are, as a rule, paid out toward the end of a quarter. On the other hand, in the case of interest, financial institutions usually credit the accounts of their depositors on the first day of the quarter or of the semiannual period.

Senator DOUGLAS. Now, could we fix, say some income limit? Let me preface this by saying, I think we are already bending over backward to give to the recipients of dividends and interest privileges which are not accorded to those in receipt of wages and salaries, namely, complete exemption for the nontaxable, and quarterly instead of annual refunds for those who are taxable.

Now, I don't know that it is necessary, but if a majority of the Members of the House and Senate should have their hearts still bleed more profusely for low income dividend and interest recipients than for low income wage and salary workers, could we assuage their feelings, perhaps by allowing advance refunds for the recipients of dividends and interest whose incomes, let us say, would be less than a given amount?

Mr. PECHMAN. Well, I am sure that would help matters. But I think that you would make the Commissioner of Internal Revenue a very unhappy man if you ask him to refund taxes that are not withheld yet.

Senator DOUGLAS. I know, but we have a problem of getting this bill through the Senate, and without making any reflection on my colleagues, because they merely reflect what is a common popular opinion, the sufferings of a recipient of dividends and interest strikes a much greater chord of sympathy in the breasts of the public and the newspapers and legislators than the sufferings of a wage and salaried worker who is presumed to be less sensitive to financial considerations, and less socially honorific.

Mr. PECHMAN. I don't think this is necessary, but your suggestion is practical. It is just a matter of how far you want to go. There is no question that, by doing this, you will cut the ground from under any argument about hardship, it seems to me.

Senator CARLSON. The Treasury would not be happy and the commercial institutions handling the refund would not be happy.

Mr. PECHMAN. No, that is right, and you can't blame them, Senator.

Senator DOUGLAS. But look at the position that we are being forced into. On the one hand, the people who object to withholding have been saying, "Ah, the poor recipient of dividends and interest will be overwithheld against." So in order to meet their argument we provide for complete exemption for the nontaxables, and give quarterly refunds for those overwithheld against.

Now, I am proposing still another thing, advance refunding.

Senator CARLSON. Prepaid in advance.

Senator DOUGLAS. That is correct.

Now, they say, "You are making it so complicated you can't do it." I submit that the opponents of this provision cannot take both positions simultaneously.

Mr. PECHMAN. I think you are quite right, Senator. I suppose too much water has gone under the dam but I think that, it would have been better to try to withhold without all these additional complications to see what the problems are and then to tailor an exemption system to meet them.

But I still say that the inequity that is now committed against the mass of taxpayers generally by the fact that they don't withhold, and to wage earners in particular, is overwhelming. It now amounts to $650 million a year and it is growing every year. For this reason, we ought to go to great lengths to devise a practical withholding system.

Senator DOUGLAS. See if I am clear in my mind as to the procedure in the refunds on overwithholding.

Do I understand that the first quarter that this system goes into effect the individual files for a refund?

Mr. PECHMAN. That's correct.

Senator DOUGLAS. Do I understand that in the second and third quarter the Treasury sends the form to him?

Mr. PECHMAN. Sends the refund to him.

Senator DOUGLAS. Sends the form or sends the refund?

Mr. PECHMAN. Sends the refund.

Senator DOUGLAS. Mr. Woodworth?

Mr. WOODWORTH. It is my understanding that after the first refund claim is made, the Service sends him a statement inquiring as to whether the refund is as last reported and if he checks off "Yes" then a refund is sent to him.

Mr. PECHMAN. I see.

They do want some validation that the refund claim is still correct.

Senator DOUGLAS. Yes.

Then in the fourth quarter, what happens?

Mr. PECHMAN. At the end of January, he has to file the final return to get his last refund.

Senator DOUGLAS. Yes.

Now, in the next year does this process repeat itself?

Mr. PECHMAN. He has to file, yes.

Senator DOUGLAS. That is initially he files for a refund?

Mr. PECHMAN. That is correct.

Senator DOUGLAS. And then each year follows the pattern of the first year?

Mr. PECHMAN. Once the pattern is begun, and if he remains nontaxable—if he remains in approximately the same situation, he becomes accustomed to the new flow of receipts.

Senator DOUGLAS. Yes, but I mean he has to file each initial form.

Mr. PECHMAN. Each initial form, yes.

Senator DOUGLAS. You have given very valuable testimony, Mr. Pechman.

I would like to ask you some simple questions. You have dealt with all the hard ones.

Mr. PECHMAN. Thank you, sir.

Senator DOUGLAS. But for the sake of the record, I think they should be in.

Is this a new tax?

Mr. PECHMAN. No, sir; it is not a new tax. It is a tax that exists that would be withheld at the source.

Senator DOUGLAS. You know, I have received over 30,000 letters and the letters are still coming in at the rate of between 1,500 and 2,000 a day.

I have made several statements that at least a third of these letters sem to come from people who seem to think this is a new tax. We have made another check and it looks as though perhaps half of the letters in which a viewpoint is expressed come from people who think that it is a new tax.

And I think it is highly important that the public realize that this is not a new tax but merely a better means of collecting an existing tax.

Mr. PECHMAN. I agree.

Senator DOUGLAS. Do you agree with the Treasury estimate that of the $800 million owed but not paid this would collect about $650 million?

Mr. PECHMAN. Yes. I think that it is a good estimate.

Senator DOUGLAS. And you would depend, therefore, upon automatic data processing for helping to collect the other $150 million?

Mr. PECHMAN. That is correct.

Senator DOUGLAS. But you thing the remainder comes primarily from those in the upper income brackets?

Mr. PECHMAN. That is right.

Senator DOUGLAS. And which may be evasion, intentional evasion, rather than unintentional avoidance, is that right?

Mr. PECHMAN. I can't help but come to that conclusion, Senator. A taxpayer who is subject to a higher rate than the withholding rate is not an unsophisticated taxpayer. If $150 million of tax is due, there are an awful lot of people who are inadvertent and careless, who should not be.

Senator DOUGLAS. Where does the money paid by the savings institutions to the Government at the end of each quarter of withholding go? Where does that money go, to the Treasury?

Mr. PECHMAN. Will you repeat your question, please?

Senator DOUGLAS. A savings institution, a building and loan association, or a savings bank will forward at the end of the quarter, you say perhaps 30 days after the end of the quarter, the 20 percent of the payments which it is disbursing, minus such exemptions as are granted.

Would you trace the flow of that money after it leaves the savings institution?

Mr. PECHMAN. Well, I imagine that money will go to the nearest Internal Revenue office.

Senator DOUGLAS. What will the Internal Revenue agent——

Mr. PECHMAN. I see your point.

It will probably be put in the accounts of the very institutions that withheld. They are called tax and loan accounts, I think, an old terminology from the wartime period. Money that is collected by the Treasury is put into the accounts of the private commercial banking institutions in order not to cause an excessive outflow of funds from these institutions on taxpaying days.

Senator DOUGLAS. Are these demand deposits?

Mr. PECHMAN. I don't think they are actually demand deposits. But in effect they are demand deposits. The Government has a policy about not withdrawing them for certain periods of time.

Senator DOUGLAS. Well then, does the Government get interest on these deposits?

Mr. PECHMAN. No; I don't think so.

Senator DOUGLAS. So this is an interest-free deposit.

Mr. PECHMAN. This is an interest-free deposit. That is right.

Senator DOUGLAS. And the banks can loan this money out?

Mr. PECHMAN. It is part of their reserves; they can loan, as you know, several times.

Senator DOUGLAS. You mean that they cannot only loan this money out but they can loan out, say, six times this amount of money?

Mr. PECHMAN. I would have to check that but I think that is right. I am not sure.

Senator DOUGLAS. That this counts as part of the legal reserve?

Mr. PECHMAN. I have to reserve judgment on that, but let me check it.

Senator DOUGLAS. It has been my impression, which is exactly the same as yours, that this counts as part of the legal reserve, as part of the cash reserve, and, therefore, six times as much can be created.

Are you certain of this?

Mr. PECHMAN. I am not certain of it but I think we can check it very easily.

Senator DOUGLAS. I regard you as the greatest expert in the country on this subject.

Mr. PECHMAN. You are very kind.

Senator DOUGLAS. And it is highly important that we clinch this point.

Then the banks as a whole cannot only get interest on the amounts deposited but interest on six times the amount deposited, is that correct?

Mr. PECHMAN. At the maximum, yes.

Senator DOUGLAS. Wouldn't they do pretty well out of this system?

Mr. PECHMAN. I don't think they are going to lose a dime from this withholding system, Senator.

Senator DOUGLAS. "Lose a dime," wouldn't they make money out of it?

Mr. PECHMAN. On balance the banking system will certainly not be worse off.

Senator DOUGLAS. What about the savings and loan institutions, however? Can the Federal Government deposit money in the building and loan institutions?

Mr. PECHMAN. They don't do that, no. I don't think so.

Senator DOUGLAS. So that money will be taken out of the building and loan institutions and put into the commercial banks, isn't that true?

Mr. PECHMAN. That is correct.

Senator DOUGLAS. Money will be taken out of mutual savings banks and put into commercial banks, isn't that true?

Mr. PECHMAN. That is correct.

Senator DOUGLAS. Well, shouldn't we perhaps amend the bill to provide that either, (*a*) that this money can be deposited in the savings institutions from whence it came or in the Federal home loan bank?

Mr. PECHMAN. Well, I think that that would be going a little too far.

Senator DOUGLAS. Might not this assuage some of the opposition of the savings and loan institutions and the mutual savings banks?

Mr. PECHMAN. It seems to me that the savings and loan institutions already get certain tax advantages.

Senator DOUGLAS. Besides, would it not reduce the possibility of additional loan return because if these collections furnish a nucleus upon which the multiplier 6 can be used, wouldn't this half billion dollars collected, $650 million collected, make possible a $4 billion increase in the amount of credit?

If the Federal Government were to issue $4 billion in greenbacks can you imagine how the financial community would complain about this financial practice, Mr. Pechman?

Mr. PECHMAN. I believe we should not carry this example too far.

Senator DOUGLAS. Pardon?

Mr. PECHMAN. Although the example may overstate the case, I do think the major point of your discussion is correct, that the fund withheld will flow initially into the accounts of the commercial banks. To that extent this adds to their reserves and earning power.

Senator DOUGLAS. They will get interest-free resources.

Mr. PECHMAN. That is correct.

Senator DOUGLAS. Not merely on the amounts deposited but on six times the amount deposited.

Mr. PECHMAN. If they are able to loan out that amount, yes.

Senator DOUGLAS. That is if this counts as legal reserves.

Mr. PECHMAN. Yes.

Senator DOUGALS. Mr. Woodworth, can you tell us whether this would count as a legal reserve?

Mr. WOODWORTH. I don't know.

(Mr. Pechman submitted the following information regarding the handling of the tax withheld:)

H.R. 10650 provides that the Secretary or his delegate shall not require the deposit of withheld funds in a Government depository before the last day prescribed for payment of the tax. On the basis of this provision, it is presumed that remittances will be made with the tax return that is required on the 30th day after the quarter in which tax is withheld. However, financial institutions may be permitted to obtain depository receipts on the last day if it is technically possible to do so. If this is the case, then banks would be able to retain the funds for a period of time after the 30 days and make use of those funds in their treasury tax and loan account.

Senator DOUGLAS. There is another idea which is very prevalent in the correspondence that we get.

A great many people seem to think that this 20-percent withholding is not on the interest but on the principal; namely, if they have a thousand dollars deposited in a mutual savings bank or a building and loan institution, that the tax will be $200 on their principal.

Now, to an expert that seems a ridiculous question, but for the sake of the record would you clear that up.

Mr. PECHMAN. Well, it is just not true. If a man has a thousand dollars in the bank and the bank pays 4 percent interest——

Senator DOUGLAS. $40.

Mr. PECHMAN. That is $40 interest. The amount withheld for the entire year at 20 percent would be $8, so it is $8 out of the thousand dollars which is eight-tenths of 1 percent.

Senator DOUGLAS. We found hundreds of letters of people who seem to think that this is 20 percent of the principal.

Mr. PECHMAN. I think this is partly due to the propaganda that has been distributed against this withholding system. Many people are confused by the literature they have been getting. I think it's done a great deal of damage.

Senator DOUGLAS. I am not a bridge player but I will say that in spades. [Laughter.]

Or no trumps.

Well, thank you very much, Mr. Pechman.

Your testimony has been very valuable.

Mr. PECHMAN. Thank you, sir.

Senator DOUGLAS. We have now heard over 200 industry witnesses, 300 more, I am informed by the secretary of the committee have filed statements which will be printed in the record.

I think the committee under the chairmanship of Senator Byrd, and Mrs. Springer, its very efficient clerk, has done a remarkable job in that every witness has been heard on the day he was invited to testify. I want to compliment the chairman and Mrs. Springer and the very efficient staff of this committee, who happens to walk in at the crucial moment, for this extraordinary job in conducting these very elaborate hearings.

I think this is almost a record for a congressional committee. I want to say that the present acting chairman who unworthily occupies the seat of the chairman, has had nothing whatsoever to do with the efficiency of this work.

But it is a great tribute to Mrs. Springer and her assistants and to the Senator from Virginia.

Now, this closes the industry list, list of industry witnesses, and I think no one can complain about the hearing, full hearing which has been accorded to them.

We do expect to ask the Secretary of the Treasury to return for further development because we heard him on the 2d of April, I believe, and a lot of questions have come up since then, a lot of water has gone under the bridge, but the precise date of his testimony, I believe, Mrs. Springer, is not known. But perhaps, maybe sometime next week.

I ask unanimous consent that a statement I made on the floor of the Senate on May 2, 1962, pages 7036 to 7040 be inserted in the record and hearing no objection, this, therefore will be done.

(The statement referred to follows:)

Withholding of the Tax Owed on Dividends and Interest

Mr. Douglas. Madam President——

Mr. Eastland. Madam President, I ask unanimous consent that at this time I may yield to the Senator from Illinois, under the same terms under which I yielded to the Senator from Pennsylvania [Mr. Clark].

The Presiding Officer. Is there objection? Without objection, it is so ordered.

Mr. Douglas. I thank the Senator from Mississippi.

Madam President, during the last few weeks I have received more than 30,000 letters from constituents in Illinois who protest against the withholding provisions for dividends and interest which are included in a tax bill which now is before the Senate Finance Committee.

I find that from one-third to one-half of those who have written the letters seem to think such a withholding is a new tax on dividends and interest. But, of course, that is a mistake. Dividends and interest are income, just as wages and salaries are income; and income is taxable. Dividends and interest are taxable, just as wages and salaries are taxable.

The only difference is that some 20 years ago Congress included in the Revenue Code a provision which causes the basic tax on wages and salaries to be withheld by those who pay them. In other words, that resulted in withholding at the source for wages and salaries; but that has never been practiced insofar as dividends and interest are concerned. In the case of dividends and interest, the recipient is expected to declare the amount so received, in the income tax statement which he files at the end of the year.

The records show that approximately $4 billion of dividends and interest paid out each year is not reported by the recipients, and therefore escapes taxation; and it is estimated that approximately $800 million in taxes is thus avoided or evaded. The fact that this $800 million of taxes is not paid means that the burden on those who do pay taxes becomes correspondingly heavier.

I wish to emphasize that the withholding system that is proposed for dividends and interest does not impose new taxes; it is merely a better means of collecting existing taxes. The very fact that such a large proportion of those who have written letters to me and to other Members of the Senate assume that this is a new tax is an indication of the widespread evasion or avoidance of the taxes now owed on these amounts.

I want to make it very clear that in a large percentage of cases this is a perfectly innocent avoidance. Very commonly, the person who has a deposit in a building and loan association or in a savings institution allows the interest which is credited to him annually to be accumulated as a capital deposit to his account, and it does not pass into his checking account. Many people innocently do not realize that this is income, and consequently do not declare this income upon their income tax statements.

I hope very much that the basic fact that taxes are already owed on these amounts can be conveyed to the public. I am trying to do so in connection with the taxpayers of my own State.

It is estimated by the Treasury that, while not all of this $800 million would be collected by the proposed withholding system, approximately $650 million would be.

This is the most important loophole which the administration is trying to plug in the current tax bill. If this effort should be lost, either before the bill passes the Senate or if it should be eliminated from the final tax bill, there will be very few gains in revenue which can then be distributed either in the form of lower taxes or, as the administration proposes, in the form of an investment subsidy.

I have had prepared a series of questions and answers upon this bill which try to go into the question of the magnitude of the problem and the methods of collection and recording.

We have checked these questions and answers with experts, and we believe the answers to be accurate. They do not cover the entire field. Later I hope to insert in the Record additional questions and answers which will cover further points, but there has been so much misunderstanding that I felt I should not delay further in putting into the Record some material on these basic points, so that a certain degree of popular enlightenment may be carried out.

So, Madam President, I ask unanimous consent that there may be printed in the Record at the conclusion of my remarks a series of questions and answers on the withholding of taxes on dividend and interest.

The PRESIDING OFFICER. Is there objection to the request of the Senator from Illinois? The Chair hears none, and it is so ordered.

(See exhibit 1.)

Mr. COOPER. Madam President, will the Senator yield?

Mr. DOUGLAS. I yield.

Mr. COOPER. I am glad the Senator has made this statement. Like other Members of Congress, I have received thousands of letters on the withholding section of the tax bill. In the last week or 10 days we have answered 2,500 letters. After a time, I realized that many persons, particularly older persons, believe an additional 20 percent tax imposed on dividends and interest will be a new tax imposed upon them.

Some of these persons have sent me letters which they had received from institutions, which could convey the impression that a 20-percent additional tax was being levied upon them. I tried to answer those questions in the letters and give the facts, but I am very glad the Senator from Illinois has spoken on the floor and has made this statement. I think it is very bad that some institutions are leaving the impression that a new tax is being imposed upon people, particularly older persons.

Mr. DOUGLAS. I thank the Senator from Kentucky. As usual, the widows and orphans are being dragged into a discussion of this matter. I wish to point out that all children under the age of 18 by merely filing a statement of their age would be exempt from the withholding provision. Also, anyone over the age of 18 who reasonably believes that he or she would not have any tax to pay can, under the bill, file a withholding exemption certificate with the paying institution, and there will be no withholding whatsoever upon that income.

The Treasury estimates, also, that of the over 22 million individuals who receive dividends and interest, only about 2 million will be overwithheld against. That is only about 1 out of every 10. And of those, only 1 million will be overwithheld against to the extent of more than $10 annually.

It is interesting to note, and I am informed of this by the Treasury, that there are 37 million wage earners and salaried workers who are overwithheld against each year. In other words, 37 million are now overwithheld against in the case of wages and salaried workers—but only about 2 million would be overwithheld against in the case of those receiving dividends and interest.

I have not heard any weeping on the floor or in the mails about these 37 million wage and salary workers who are overwithheld against. It should be further noted that the refunds in the case of wage and salaried workers come only once a year, generally five quarters after the beginning of the taxable year upon which there has been overwithholding. The refunds in the case of recipients of dividends and interest will be quarterly, or four times as rapidly. Therefore, there will be very little loss of interest during that time.

To me it is really extraordinary that people who will not only accept but defend the system of withholding on wages and salaries should nevertheless balk on the withholding tax being applied to dividends and interest. Should not they, in common fairness, be given equal treatment?

As a matter of fact, we are giving easier terms to the recipients of dividends and interest than the revenue law accords to the recipients of wages and salaries. If we eliminate from the tax bill the provision for withholding against

dividends and interest, then, in all fairness, we should eliminate the withholding provision on salaries and wages from the tax code. I shall be sorely tempted to make such a motion. I do not think, in logic or consistency, unequal or superior treatment should be given to dollars received as a result of ownership than is accorded to dollars received from immediate effort.

I think it is about time that some sanity was introduced into a discussion of this measure, and I hope very much the building and loan associations and some of the savings institutions realize just what the issue is and desist from stirring up this mail campaign. I also hope that they will get their facts straight in the information which they give to their depositors.

Mr. COOPER. Madam President, will the Senator yield once more?

Mr. DOUGLAS. I yield.

Mr. COOPER. One of the charges made to me in the hundreds and thousands of letters I have received is that if dividends and interest should be withheld over and above the amount of tax liability, there will be no procedure by which the overpayment may be collected from the Federal Treasury. Will the Senator respond to that statement?

Mr. DOUGLAS. I am very glad that the Senator from Kentucky has mentioned that point. What will happen is that the recipient of dividends or of interest, who believes he has been overwithheld against, can file a statement quarterly and receive a refund without elaborate checking on the part of the Federal Government. There will be spot checks instituted to determine whether recipients are lying, but there will be minimum of auditing of claims. The claims, if made, will be honored without elaborate bookkeeping.

After the first quarter the Treasury Department will actually send to the recipient a form upon which the refund claim can be made for the second, third, and fourth quarters of the year.

The Treasury Department is willing to take such statements on faith because if an untrue statement is made it will represent fraud, and fraud is punishable. There will be a minimum of checking.

I think if these facts were widely known that a great deal of the opposition would disappear. Our tax system is based on the assumption of the honesty of taxpayers. There is only enough checking to try to keep people from straying too far. Sometimes this imposes too severe a temptation for people to withstand. This is why withholding has been so beneficial in the case of those who earn wages and salaries. It would be equally beneficial in the case of those who receive dividends or interest.

There is a further advantage. When there are annual or even quarterly payments, if one waits until the end of the quarter or the end of the year to pay taxes, one may have spent his money. Therefore, the people who work for wages and salaries find it more convenient to have the tax money withheld from each week's pay than to face the payment of the tax at the end of a quarter or at the end of a year.

Although recipients of interest or dividends, on the average, have higher incomes than those who receive wages and salaries, this will also be a convenient method for those who receive dividends or interest. It will enable them to pay taxes on the income as the income is received, and the tax will not accumulate until the end of the year.

We have received estimates that the cost to the paying institution after the initial year will not exceed 30 cents per $100 of tax withheld, or three-tenths of 1 percent.

I am very happy that one or two banks and savings institutions—notably the Franklin Bank of Mineola, Long Island, and a bank on the North Side of Chicago—have taken positions in favor of the withholding of taxes on dividends and interest. I wish the number were larger, but we are grateful to those who have testified.

I congratulate also the association of the bar of the city of New York, which had the courage to come to this city and testify to the same effect.

The savings and loan institutions and the savings banks, in my judgment, already have spent enough on the campaign against the withholding tax to pay all of the administrative costs which they will experience under the act for 3 or 4 years, and they have distributed, unfortunately, a lot of material which is not accurate.

Madam President, I yield the floor, and I thank the Senator from Mississippi.

EXHIBIT 1

QUESTIONS AND ANSWERS ON THE WITHHOLDING OF TAXES ON DIVIDENDS AND INTEREST

1. How many individuals do not report dividends and interest?

	Million
Number of individual tax returns which should include dividends or interest	17.7
Number of individual tax returns which should report dividends or interest but, which do not	6.0

NOTE.—There are no figures available by which to classify these returns as to income groups.

2. Question. What about the widows and orphans and the old people?

Answer. Under the bill, all children under 18 would be exempt from withholding.

Anyone over 18 who reasonably believes that he would not be subject to tax can file a withholding exemption certificate with the paying institution.

In addition, the Treasury estimated that only 2 million individuals of the 22.5 million individuals who receive interest and dividends will be overwithheld against. Of these, only 1 million of them will be overwithheld against to the extent of more than $10 annually.

Of the 1 million in general those with annual incomes of less than $10,000 ($5,000 if single) can claim quarterly refunds up to the amount of their refund allowance which takes into account personal exemptions, retirement income, and deductions.

As as result, opposition to this measure on grounds that it would hurt the widows and orphans is virtually without substance.

3. Question. Won't the wtihholding tax take 20 percent of a person's savings account and return it to the Government?

Answer. No. It will take only 20 percent of the interest on the savings account. This, of course, is already taxable but not paid in the case of millions of people.

For example. If a person has $100 in his savings account and receives $4 interest during the year, the withholding will be 20 percent of the $4 or 80 cents, not 20 percent of the savings account or $20.

4. Why would not automatic data processing be an effective substitute for withholding?

Contention. The Internal Revenue Service is adopting an automatic data processing system and this, coupled with account numbers and information returns, should be used to collect the unreported tax on dividends and interest.

Answer. This contention fails to state than an ADP-information return system would probably be more burdensome on the payers of dividends and interest, would be unworkable in some areas, and would, for a higher cost, recoup only one-third as much of the unreported tax as withholding.

Use of ADP-information returns would necessitate requiring information returns with respect to almost all dividend and interest payments. At present, only savings account interest payments of $600 or more must be reported and no reporting is required in the case of bond interest. Because of the millions of interest payments, the information return requirement would be very burdensome on the payers. Some people have told the Treasury that it would be more burdensome than withholding for many paying institutions.

When an individual purchases a bond between interest payment dates, he is only required to include in income that portion of the interest paid at the end of the period which is allocable to the time he held the bond. The seller is required to report the other portion which was paid him as accrued interest by the purchaser. However, since the paying institution does not know whether a bearer bond has been transferred, it would file an information return showing the full interest payment going to the purchaser. This would mean that a matching of the information return with the purchaser's return would indicate a discrepancy where none exists. As a result, the purchaser may be subject to an unnecessary audit. On the other hand, there would be no information filed as to the accrued interest taxable to the seller. In this area, ADP and information returns would be an unworkable method for enforcing the tax on interest.

Even with an expanded information return system and a complete matching of these returns with the returns of the dividend and interest recipients, not 1 cent of tax would have been collected. There would have to be audit and enforcement followup in each case where a discrepancy is indicated. These

procedures are not economically feasible for the millions of relatively small dividend and interest payments involved. The Commissioner of Internal Revenue estimates that no more than $200 million of the over $800 million annual revenue loss could be recouped through these enforcement procedures. This would be at a cost of $27 million.

For only $19 million, withholding can recoup $650 million each year. In addition, with withholding, the ADP-audit procedures would be left free to recapture most of the remaining $150 million of the yearly revenue loss, since this loss involves dividends and interest received by higher income groups where these procedures can be more economically applied.

One additional consideration is that ADP will not be fully operational until 1966. Therefore, without withholding in the interim, the Government will not even be able to collect the limited $200 million of revenues that ADP and audit would help collect.

5. Some say withholding on interest and dividends isn't necessary.

Contention. Some charge that there is no real need to enact the burdensome procedure for witholding income tax from dividend and interest payments.

Answer. Withholding of tax from interest and dividend payments is a greatly needed reform in our tax structure; one that is necessary for both budgetary and equity reasons.

The most convincing argument for withholding on interest and dividends is told by the figures themselves. On the plus side is the fact that about $18.8 billion of dividends and interest is reported on income tax returns each year. On the other side, however, is the fact that around $4 billion of dividends and interest which should be reported each year is not, either because of inadvertence or an unwillingness to pay one's fair share of tax. This results in an annual revenue loss to the Government of over $800 million. Withholding of income tax from interest and dividend payments will recoup almost $650 milliom of this large yearly loss.

These revenue figures are based on Treasury estimates from data compiled from 1959 returns (the latest data available). They are in substantial accord with the estimates of the prior Republican administration. For example, Mr. David A. Lindsay, former General Counsel of the Treasury, in an address before the Tax Institute symposium on September 29, 1960, estimated that $4 billion of interest and dividends were not reported on tax returns of individuals. To quote him:

"Recent studies have indicated a gap in the amount of dividends paid to individuals and the amount of the dividends reported on individual tax returns of approximately $1 billion, or failure to report about 10 percent of the total amount of dividends received.

"It was also estimated that about $3 billion of interest, which is about one-half of the interest received by individuals, was not reported."

Withholding is important for another reason. It is unfair to those taxpayers who faithfully and accurately pay their full share of taxes to also require them, through higher taxes, to make up the over $800 million of taxes which others fail to pay on their interest and dividends. To have an effective self-assessment system, people must believe that their neighbors are also bearing their share of the taxes. When this belief is questioned, the whole self-assessment system is threatened. Withholding on interest and dividends will be a big step toward making sure that one group does not bear the tax responsibilities of another. In this way it will bolster our self-assessment system.

Withholding is nothing new or novel. It has operated efficiently for many years in helping to collect the taxes due on salaries and wages. There is no reason to believe it is not equally suitable in the area of dividends and interest.

Many people argue that a withholding system is not necessary. They say that the underreporting problem can be solved by taxpayer education. Unfortunately, history shows this is not true. The Treasury and Internal Revenue Service in recent years initiated an extensive educational program to remind taxpayers to report their dividend and interest income. The payers of dividends and interest wholeheartedly cooperated in this program by distributing tens of millions of notices reminding people to report this income. The Government organized a mass publicity campaign, using newspapers, radio, television, and other media. Despite this program, there was no indication of substantial improvement in taxpayer reporting.

6. Some say withholding on interest and dividends will discourage thrift.

(a) Charge that people will withdraw savings:

Contention. If people are subjected to withholding on their dividends and interest, they will sell their stock or withdraw their savings to avoid withholding. This, of course, will discourage thrift.

Answer. It is hard to believe that an individual will forgo any earnings on his savings to avoid having tax withheld from these earnings. For the taxpayer who has been reporting his tax, withholding will merely afford him an efficient method for paying that tax. He would hardly have a motive for withdrawing his savings. For other taxpayers, withholding will result in their paying a tax for the first time. But even for these people, interest or dividends after tax is certainly better than no interest or dividends at all. There is no motive for them to withdraw their savings.

Since withholding would be required with respect to nearly all types of investments available to the average individual, there will generally be no opportunity for him to shift investments to avoid withholding. This is an important safeguard in that it insures that withholding will be a neutral factor when an individual decides where to invest his funds and will not result in giving one type of investment a competitive advantage over another.

(b) Charge that withholding will reduce invested funds:

Contention. Many depositors never withdraw their interest with the result that it increases their savings. The same is true in the case of dividends declared by mutual funds. Withholding will automatically reduce by 20 percent the earnings reinvested by the depositor or shareholder, thereby reducing his savings.

Answer. This is an effect that naturally flows from any withholding system. It would seem, however, that much of the noncompliance occurs in those cases where people automatically reinvest their dividend and interest income and therefore do not receive any cash payments. Many of these people apparently forget or do not bother to check how much interest or dividends have been credited during the year. Therefore, it would seem that withholding is especially important in this area.

7. Answer to objection that there will be massive overwithholding; and that exemption and refund procedures are inadequate and burdensome.

(a) Charge of massive overwithholding:

Contention. The withholding system will result in massive overwithholding.

Answer. It is estimated that 22.5 million individuals receive interest and dividends. Only 2 million of these individuals will be subject to overwithholding and only 1 million of them to the extent of more than $10 annually. Of the latter 1 million, those with annual income of less than $10,000 ($5,000, if single) can claim quarterly refunds of the overwithheld tax up to the amount of their "refund allowance." This refund allowance in effect gives an individual credit for his personal exemptions, retirement income credit, and standard deduction, to the extent there is no other income against which to apply them.

According to Treasury estimates, $3 billion will be withheld on dividends and interest received by individuals, of which only $170 million would be overwithholding. This is a mere 5 percent of overwithholding, as compared to 14 percent in the case of wages. In terms of number of individuals subject to overwithholding, 73 percent of wage earners are overwithheld while only 13 percent of dividend and interest recipients would be overwithheld.

In fact, overwithholding is almost completely avoided by the exemption system. Nontaxable individuals would be eligible to file exemption certificates and, thereby, completely exempt their dividends and most forms of interest from withholding. In addition, 6 million schoolchildren would be automatically exempt from withholding on their school savings accounts.

(b) Charge that individuals will forget to claim their refunds resulting in a windfall to the Government:

Contention. Even though the bill provides for quarterly refunds, many people will forget to claim them with a resulting windfall to the Government.

Answer. Under proposed administrative procedures, an individual would need to initiate only the first quarterly refund claim for the year. The Internal Revenue Service would recompute his "refund allowance" for the second and third quarters and would mail him a partially completed claim for refund on which he would need only enter the amount of dividends and interest he received during the quarter. At the end of the year, the Internal Revenue Service will send each individual who has claimed quarterly refunds a summary statement. For the fourth quarter the refund would be claimed on the individual's regular tax

return which he could file immediately after the end of the year. Although no quarterly claim could be filed for an amount under $10, the individual could cumulate amounts withheld during more than one quarter for purposes of meeting the $10 limit.

8. Charge that withholding of funds from low income persons may cause severe hardship.

Contention. Withholding of 20 percent of dividend and interest payments to low income (but taxable) individuals might cause severe hardship to these individuals who need that money on which to live.

Answer. Most of these individuals would be eligible for quarterly refunds of the over-withheld tax. The individual does not have to wait until the end of the quarter to file his claim for refund but may do so any time during the quarter. For example, an individual who receives all his interest and dividends during the first week of a quarter may file his quarterly refund claim at the end of that first week. Therefore, in many cases, individuals will be without the withheld funds for only a very short period of time. Even if an individual must withdraw funds from his savings to make up for withholding, the net effect is the loss of interest on those funds for up to 3–4 months at the very most. In the case of an individual who receives $500 of interest during a quarter, the loss would amount to only $1 (assuming a 4-percent rate of interest).

9. The charge that lack of withholding receipts will result in fraud.

Contention. There is no requirement that payers of dividends and interest must furnish the recipients withholding receipts (similar to the W–2 receipts in the case of wage withholding). As a result, there will be a great deal of fraud, with the result that extensive audits of records will be necessary.

Answer. There is no area of tax law in which deliberate fraud is not possible. It is known that people claim dependents who do not exist, list charitable contributions they never gave, and claim medical expenses they did not have. Some of this, of course, goes undetected. But deliberate tax fraud is relatively rare. Specifically, deliberate claims for unjustified refunds and credits could never even approach in either dollar volume or numbers of individuals involved the tax evasion currently possible in the absence of a withholding system.

10. Argument that small interest payments should be excluded from withholding.

(a) Generally not subject to tax:

Contention. Small interest payments should be excluded from withholding since they are usually not subject to tax anyway.

Answer. The size of an individual's savings account does not necessarily have any relation to his tax status. For example, an individual could be earning a substantial salary and yet, because of his expenses or other forms of savings, have a relatively small savings account. Since the withholding system has as its major purpose the collection of tax, there is no logical reason to exclude arbitrarily from withholding small amounts which, nevertheless, may very well be fully subject to tax.

In addition, an exclusion from withholding for small interest payments would provide a means by which people could avoid withholding on all of their bank account interest. This could be done merely by opening relatively small accounts in different banks or by opening several small accounts in the names of different members of the family.

Moreover, an exclusion from withholding for interest payments below a specified amount would materially reduce the effectiveness of the "gross-up" system. For example, in some cases an individual may have two savings accounts, one subject to withholding and one not. This could occur, for example, when an individual has a large account for his family's ordinary savings (earning interest above the minimum limit) and a small account (earning interest below the minimum limit) containing savings for a particular purpose, such as a vacation. In such a case, part of the interest received by the individual would be subject to withholding and part would not. This could cause considerable taxpayer uncertainty in applying the "gross-up" system, since part of the interest would be included and part not.

(b) Unclaimed refunds will be large:

Contention. Withholding will result in a large windfall to the Government in the form of unclaimed refunds. As an example, it has been indicated that there are some 32 million bank accounts involving withholding of less than 40 cents, and that many of the depositors in these accounts will not undertake to file either an exemption certificate or a claim for refund with the result that these withheld funds will be a windfall to the Government.

Answer. These figures are very misleading. The 32 million accounts evidently include accounts paying no interest, because they are dormant accounts or accounts where no interest is paid as a matter of bank policy. Therefore, this figure in itself is open to question.

However, even assuming they are correct, it is by no means true that all the withheld funds will be forfeited to the Government. First, many of these small accounts will be automatically exempt through the exemption for all school savings accounts without regard to the filing of exemption certificates. It is estimated that savings accounts of 6 million children will fall in this category.

Second, most dividend and interest recipients, even though receiving small payments, will have other income (such as wages) and, as a result, will owe tax for the year. These individuals are required to file income tax returns on which they will be able to take credit against their tax liability for the dividend and interest withholding. The returns will clearly show that these individuals must report their interest and dividend income and also that they may take a credit or obtain a refund for any withheld tax. There should be no reason for them to forget to take the credit or claim the refund.

Third, even though they owe no tax for the year, many of these receipients will be rquired to file tax returns, because they have more than $600 ($1,200 if over 65) of income. The returns will clearly indicate they are entitled to a refund.

Fourth, many of these individuals will avail themselves of the exemption certificates procedure.

Therefore, after taking into account all those different situations, it seems clear that only a very small number of people will in fact forfeit their withheld tax.

11. The charge that withholding will do nothing to enforce tax on high income people.

Contention. Since the withholding rate is only 20 percent, it will have no impact on the collection of taxes on dividends and interest received by individuals in the higher income tax brackets.

Answer. It is necessary to set a rate of withholding approximating the first tax bracket in order to avoid undue overwithholding on the great majority of recipients. However, with withholding taking care of the tax liability of the great majority of dividend and interest recipients, the Internal Revenue Service will be able to concentrate its ADP facilities and enforcement personnel on enforcing the tax on higher income individuals. It is in this area that the new ADP system will prove very effective in helping to enforce the tax on dividends and interest.

12. The mechanics of withholding.

The withholding procedures to be followed by payers of dividends and interest will be relatively simple. Basically, a payer will perform three steps in performing withholding:

(1) The payer will total up the amount of dividends or interest that is to be paid to persons who have not filed exemption certificates and will deduct 20 percent of this total amount. This 20 percent is the amount of taxes to be withheld.

(2) Each recipient will then be paid 80 percent of the dividend or interest due him. Persons who have filed exemption certificates will be paid their full dividends or interest.

(3) At the end of the month following the close of the quarter in which the dividends or interest were paid, the payer will remit to the Government the 20 percent withheld reduced by any taxes withheld on dividends and interest received by the payer during that quarter. The remittance to the Government will be in a lump sum with no breakdown according to individual recipients.

The following are examples of how these withholding procedures would operate when a bank credits interest to its depositors, and when a corporation pays dividends:

Example 1 (interest paid to depositors):

Bank A credits interest to its depositors twice a year, January 1 and July 1, at a rate of 4 percent annually (2 percent on each payment date). The total interest due depositors on July 1, 1963, is $110,000, broken down as follows:

(*a*) School savings accounts	$2,000
(*b*) Accounts of persons who have filed exemption certificates	8,000
(*c*) All other accounts	100,000

Since school savings accounts and accounts of persons who have filed exemption certificates are exempt from withholding, bank A will credit interest to these accounts in the amount of 2 percent.

The bank will then deduct 20 percent (or $20,000) from the $100,000 of interest due on all other account and credit the remaining $80,000 to these accounts. This means that the bank would credit interest in the amount of 1.6 percent, rather than 2 percent, to each such account. It would not be necessary for the bank to make two computation for each account since it is not required to show the gross interest before withholding.

If the bank reports its taxes on a calendar year basis, it may retain the $20,000 withheld on July 1 until October 31. In determining how much it must remit to the Government on October 31, the bank may take a credit for any taxes withheld on dividends and interest it received. Thus, if $15,000 with withheld on interest and dividends it received during the quarter beginning July 1, it will only be required to remit $5,000 to the Government on October 31.

Example 2 (dividends):

Corporation B declares a dividend of 50 cents a share, payable on April 1, 1963. The total amount of dividends to be paid is $52,000, broken down as follows:

(*a*) Dividends on shares owned by individuals who have filed exemption certificates	$2,000
(*b*) Dividends on all other shares	50,000

Corporation B will then pay the full dividend of 50 cents a share (totaling $2,000) to those individuals who have filed exemption certificates. It will deduct 20 percent (or $10,000) of the dividends payable on all the other shares and pay out dividends at the rate of 40 cents a share. It will not be necessary for the corporation to make two computations with respect to each shareholder since there is no requirement that the gross dividend must be shown.

If the corporation reports its taxes on a calendar year basis, it may retain the $10,000 withheld on April until July 31. In determining how much it must remit to the Government on July 31, the corporation may take a credit for any taxes withheld on its dividend and interest income. Thus, if $2,000 was withheld on dividends and interest it received during the quarter beginning April 1, the corporation will only be require to remit $8,000 to the Government on July 1.

Gross-up procedure for individuals:

Although there is no provision for withholding receipts (similar to the W-2 receipts under wage withholding), a person will easily be able to determine the total amount of his dividends and interest and the amount of withheld tax. This will be done through a simple gross-up schedule which will be a part of the income tax returns and refund claims. For example, assume that an individual receives a dividend of $80. He will then perform the following simple calculations:

(1) Amount of dividend received	$80
(2) One-fourth of this amount (withheld tax)	20
(3) Total amount of dividend ((1) plus (2))	100

From this schedule, the individual would know that $100 is the total amount of his dividend to be included in his income for tax purposes and that $20 of tax was withheld for which he is allowed a credit against his tax liability and a refund of any excess.

Senator DOUGLAS. This meeting is adjourned.

(By direction of the chairman, the following is made a part of the record:)

STATEMENT OF HON. ANTONIO FERNÓS-ISERN RESIDENT COMMISSIONER, COMMONWEALTH OF PUERTO RICO

The government of the Commonwealth of Puerto Rico welcomes the recommendation made by Secretary Dillon to this committee on May 10 that Puerto Rico be excluded from H.R. 10650, so that the existing arrangements relating to the taxation of income from Puerto Rican sources shall remain unchanged by the bill. We feel we should state to the committee the reasons why we have been profoundly disturbed by certain provisions of the pending tax bill, H.R. 10650. These provisions, generally speaking, would have the effect of indirectly subjecting undistributed income, generated in Puerto Rico, to United States tax, at ordinary income rates, either currently or when the U.S. shareholder's

interest is closed out by sale or liquidation. These provisions were designed to deal with problems resulting from the organization by U.S. taxpayers of corporations in foreign nations. Because of the structure of the tax law and the bill, however, they would also be applicable to Puerto Rico. As applied to Puerto Rico, they would have the effect of a sharp, destructive change in U.S. policy with reverberations far beyond the tax field.

Secretary Dillon, in his statement to the Committee on Finance of the Senate, delivered on the 10th day of the current month, had this to say with reference to Puerto Rican corporations and their coverage under H.R. 10650:

"I would recommend, however, that such corporations not be treated as controlled foreign corporations * * *."

During the course of his testimony on that date, Secretary Dillon reiterated that corporations organized under the laws of Puerto Rico and owned by U.S. investors should not be treated as controlled foreign corporations under the bill, so that their present status would remain unchanged by H.R. 10650.

The Commonwealth of Puerto Rico endorses the preceding recommendation and urges the honorable Committee on Finance of the Senate to approve it and to adopt the appropriate amendments to H.R. 10650 to give effect to the same.

The concern of Puerto Rico with respect to the applicability of H.R. 10650 to Puerto Rican trade was predicated on the following:

(1) Puerto Rico should not be regarded in the category of a foreign country as H.R. 10650 proposes to do. Puerto Ricans are, and since 1917 have been citizens of the United States. They share in the common defense; its young men are part of the U.S. Armed Forces, subject to draft like other citizens; Puerto Rico is subject to the coastwise shipping law which increases its freight rates beyond rates which foreign countries must pay; it is within the U.S. tariff system; its trade is in the dollar area and produces no balance-of-payment problem. The U.S. minimum wage laws apply to Puerto Rico. In short, Puerto Rico's obligations to and relationship to the United States are in no way to be compared with those of foreign nations. As this committee pointed out in its report on the Revenue Act of 1950,[1] "* * * Puerto Rico is in a unique position."

In the field of Federal taxation, Puerto Rico has, since its earliest days under the U.S. flag, received separate, special and careful treatment, designed to conform with the pattern of U.S. policy toward it. In the first organic act enacted by the Congress in 1900, and in the second organic act of 1917, Congress provided that the U.S. internal revenue laws would not apply in Puerto Rico. The purpose of relieving Puerto Rican residents from the burden of the U.S. tax was to enable Puerto Rico to develop its own fiscal system and gradually to improve its economic position, so that it could develop its own self-sufficient institutions that would not be dependent upon the Federal Government for support. It is this policy that has been the foundation of Puerto Rico's economic life and development.

For many years the general provisions of U.S. tax laws have defined foreign corporations so as to include Puerto Rican corporations. It is important to understand why this came about. It was not because the Congress regarded Puerto Rico as merely another foreign nation. It came about, on the contrary, as a convenient way to implement and carry out the general policy of excluding Puerto Rico from Federal taxes. The inclusion of Puerto Rican enterprises within the definition of "foreign" first appears in the excess profits tax law of 1917, significantly enacted after the organic act of 1917 which declared Puerto Ricans citizens of the United States and reiterated the exemption of Puerto Rico from U.S. internal revenue laws. The purpose of using the concept "foreign" in that act relating to Puerto Rico, was evidently a matter of drafting technique to make clear that Puerto Rican income was not taxed under the provisions of the 1917 excess profits law.

This treatment, it will be noted, reflected the basic fact shared by Puerto Rico and foreign countries of not being within the U.S. tax area. The provision certainly did not reflect, and could not have reflected, any feeling of the Congress that Puerto Rico and foreign countries were to be equated for all tax purposes. It is under this treatment, that Puerto Rican subsidiaries of U.S. companies have been established and have developed. They have not been subjected to U.S. tax upon their undistributed current earnings. In the case of a sale of stock or assets, the sale is taxed at capital gain rates just as in the case

[1] S. Rept. 2375, 81st Cong., 2d sess., p. 49.

of U.S. subsidiaries. In the event of liquidation, the Puerto Rican subsidiary has also been subject to capital gains tax. These are significant facts that have allowed Puerto Rico's notable economic development.

(2) Puerto Rico is not and has not been a "tax haven." It has no desire to be a "tax haven." Its own tax structure has high rates. U.S. taxpayers who organize foreign companies to engage in owning securities or in diverting from U.S. tax, profits from trading, licensing, or insurance operations, generally organize their operations in Bermuda, the Bahamas, or other countries where there is little or no local income tax. In Puerto Rico such companies would be taxed at such a substantial rate that there would be no advantage to the fugitive taxpayer to locating in Puerto Rico.

(3) The provisions of the bill would seriously impair the progress thus far achieved by Puerto Rico's economic development program so widely known as Operation Bootstrap and its future progress would undoubtedly be brought to a halt. Such program is in part based upon the grant by the Commonwealth of tax exemption for a limited period of time to carefully limited types of enterprises. Under Commonwealth law, only businesses which are engaged in productive activity, specifically manufacturing and hotel operations, are entitled to tax exemption after compliance with rigorous standards applied on the basis of intensive procedure requirements—and no tax exemption or other advantages, are granted to "runaway" industries. Neither does Puerto Rico offer any advantages to holding companies, finance companies, or for any of the gadgets or gimmicks designed to shield profit accumulations from the impact of Federal tax laws.

Puerto Rico fashioned its economic development program, known as Operation Bootstrap, upon the basis of these long-existing fiscal arrangements. H.R. 10650 would now, in effect, alter the fiscal relationships whose foundations were laid in 1900 and which have given Puerto Rico opportunity to sustain and develop its economic life. H.R. 10650, in its present form, does this by subjecting the U.S. shareholders to U.S. tax upon undistributed Puerto Rican income in many situations and by taxing the U.S. shareholder, at ordinary rather than capital gain rates, upon its share of undistributed Puerto Rican earnings, when the U.S. sharholder sells or liquidates its interest. Thus, income generated in Puerto Rico, albeit indirectly, is subjected to U.S. tax. either currently or when the U.S. shareholder's interest is closed out. The consequence is that all incentive for investment in Puerto Rican industries is destroyed.

(4) The value to the United States of Puerto Rico's economic development should not be impaired. Puerto Rico is a showplace for the United States: an example of the spectacular results that can be achieved in accordance with democratic principles in a less-developed area by means of the cooperative effort of governmental leadership and private enterprise.

In the past 20 years, under its economic development program (Operation Bootstrap), Puerto Rico has advanced from a land of poverty and misery to a progressive community of American citizens.

This development in a have-not community is unique in our time. It is the finest—and perhaps the only—example of the use of private investments and skills to revolutionize the economy of a less-developed area. As a result of this development, the per capita income of Puerto Rico has increased from $121 per annum in 1940 to $625 at present. This, however, is still less than one-half of the average income of the citizens of the poorest State in the Union.

The development of Puerto Rico has made it one of the best markets in the world for U.S. products. In 1940, its purchases from the United States amounted to $107 million. Present purchases are in the neighborhood of $754 million. It is now the largest U.S. market except for four nations—Canada, West Germany, the United Kingdom, and Japan—and possibly two others—Mexico and Venezuela. This vital fact is without a doubt largely due to the vigor of Operation Bootstrap. It has been estimated that every U.S. private enterprise dollar invested in Puerto Rico as part of Operation Bootstrap generates more than 50 cents worth of purchases by Puerto Rico from the United States annually.

The Honorable Luis Muñoz Marín, Governor of Puerto Rico, endorses this presentation.

[Telegram]

CHICAGO, ILL., *May 7, 1962.*

Hon. HARRY F. BYRD,
Senate Office Building, Washington, D.C.:

We respectfully submit the following for your consideration regarding Senate Finance Committee hearings on the foreign aspects of the 1962 revenue bill.

Kraft Foods has over 8,500 employees in 10 foreign countries. These Kraft foreign operations are manufacturing and selling food products in competition with foreign firms that have certain tax and other advantages even under present circumstances. Several proposals in the new Revenue Act would serve to give our foreign competition even greater advantages. The Kraft foreign units, for the most part, serve markets that cannot be handled on an export basis from the United States but to the extent that it is economically feasible we are introducing and selling products either manufactured in the United States or produced from raw materials and supplies from the United States. In short, we are not exporting jobs. Rather, we are creating jobs in the United States and, equally important, the bulk of the profits we make in these foreign units is returned to the United States. Specifically, the points that are most serious in putting us at a disadvantage related to foreign competition are:

(1) The section which would consider foreign profits as distributed income for U.S. tax purposes, which would deny validity of bona fide foreign corporations, probably bring on retaliation from other governments and would make it more difficult to maintain necessary working capital requirements in foreign operations controlled by U.S. firms.

(2) The "grossup" provision, which fails to recognize that most foreign countries impose higher sales taxes and other direct taxes on business and lower taxes on profits paid out as dividends than does the U.S. tax system.

(3) The provision which so drastically defines and restricts so-called base companies, which would seriously hamper legitimate business operations in foreign countries merely for the sake of correcting possible abuses by relatively few. The present statutes and regulations are adequate to prevent possible abuses whereas the proposed changes would work a hardship on bona fide business operations and again give our foreign competition further advantage. Our public accountants advise that the provisions of the pending tax bill are so complex that no international business will be able to accurately calculate its tax liability. It is our experience and belief that these provisions will seriously hamper the progress and profitability of American business firms overseas with the direct effect of reducing exports from the United States, reducing U.S. tax revenue and making our balance-of-payments problems more difficult. Your serious consideration of these aspects that would be so harmful to the U.S. international trade and balance of payments will be greatly appreciated.

KRAFT FOODS DIVISION, NATIONAL
DAIRY PRODUCTS CORP.,
J. C. LOFTIS, *President.*

[Telegram]

SAN JUAN, P.R., *May 7, 1962.*

Hon. HARRY FLOOD BYRD,
Senate Finance Committee Chairman,
The Senate, Washington, D.C.:

Puerto Rico Manufacturers Association believes passage of H.R. 10650 without amendments to protect our economy would force immediate liquidation of many of the existing industries in Puerto Rico. Such action would constitute punitive and arbitrary treatment of many U.S. bona fide industrial investments made in Puerto Rico in good faith offering employment opportunities to over 120,000 American citizens. We respectfully urge approval of amendments to H.R. 10650 which will remove this threat to Puerto Rican industry.

ALFONSO VALDES, *President.*

APPLE GROWERS ASSOCIATION,
Hood River, Oreg., May 7, 1962.

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

DEAR SENATOR BYRD: This letter pertains to H.R. 10650, Revenue Act of 1962, and specifically portions applicable to cooperative corporations. We request your consideration of the following points, which represent 49 years experience for this association, and over 30 years for the writer. For your further information, we instituted a test case (*Moe* v. *Earle*), intended to clarify the tax status of members' capital retains, which went through the Portland Federal district court, and the Ninth Circuit Court of Appeals, but was not accepted by the U.S. Supreme Court at the request of the Department of Justice.

It was our contention that cooperative capital retains were properly taxable to members at face value in year of issue, when retained pursuant to a preexisting contract between the patron and his cooperative, and when the patron had been properly notified of the amount of such retain. The courts held that since the retains had no market value, they were not taxable income until redeemed in cash. We do not agree with this decision, and believe the Department of Justice should have appealed the *Carpenter* case, and urged the Supreme Court to accept the *Moe* case.

As to withholding of 20 percent of patronage refunds due members, we are of the opinion that with its new electronic equipment to consolidate income reported from various sources for individuals and corporations, the Internal Revenue Service could adequately determine their total income without resorting to withholding. Dividends, retains, etc., amount to only a few dollars in the majority of instances. Added clerical work of corporations for such numerous small amounts would be tremendously costly, and refunds and other adjustments would be equally burdensome to the Treasury. The cost appears to outweigh the advantages, and public reaction might well cause serious repercussions, since the Treasury would know the amount of taxable income by either method, and it would appear somewhat ridiculous to insist on withholding such small amounts. While we object in principle, we could live with this feature and its unnecessary cost.

The members and patrons consent provisions appear unnecessary, and intentionally or otherwise, to be punitive. Cooperative members are the cooperative. They alone vote, and must provide basic ownership capital if the cooperative is to be able to function. Their contractual relationship is voluntary and may be terminated by them. We see no reason why one or more members should be permitted by law to unilaterally void the financial responsibility portion of their contract, while retaining the profitable portion, at the expense of their fellow members.

In our opinion this consent provision is a direct violation of the long established law of contracts, and to permit one party to void a contract is as illogical and unjust as to permit a citizen to enjoy the services of governmental agencies but to refuse to pay taxes if he does not approve of the actions of his elected representatives. It would be just as reasonable to permit a corporate stockholder to demand redemption of his corporate stock at par, even though the stock clearly did not provide for such action when he purchased it.

To summarize, we believe the tax liability for cooperative retains should be with the patron, at face value, and in the year of retain. We also believe it possible to incorporate this principle in constitutional legislation, without the consent and other needless provisions of H.R. 10650. If a patron does not wish to accept the financial responsibility of cooperative membership he should either not enter into such a relationship, or terminate it if he is unable to secure enough support from other members to change the cooperative policies to which he objects.

We have no particular sympathy for members of any organization, be it cooperative, corporate, union, or governmental who will not use their votes and influence, and then ask someone else to save them from the effects of their own indifference and negligence. It would appear to be a dangerous precedent for Government to deliberately embark on such a program in even this limited field.

Sincerely,

R. D. BARKER, *Treasurer.*

PLAINS COOPERATIVE OIL MILL,
Lubbock, Tex., May 5, 1962.

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

DEAR SENATOR BYRD: Since reference was made to the cooperatives owned and operated by the cotton growers of this area by Mr. Will Clayton and Mr. A. L. Reed from Texas, I am attaching a statement giving information as to our cooperative gin, oil mill, and compress; and I would appreciate it very much if you would have the statement inserted in the record.

Our cooperatives here on the south Plains have grown during the past several years; due, first, to the fact that production of cotton has increased tremedously by pump irigation; and, secondly, our cotton growers have needed the extra $10 per bale that they have made through their cooperatives.

Our associations have been organized wholly by the growers; they are operated by the growers; and the earnings are paid to the growers. We would not support any cooperative that did not pay us cash, if not on a current basis, at least within a few years. Most of our cooperative paper dividends have been returned to us in cash within a period of 5 years.

Per my statement, we have paid income tax on our cooperative earnings, and we believe that the 1951 law should be amended so the growers, who are the owners and the beneficiaries of the cooperatives, would take the dividends of the cooperatives into their income in the year in which the dividends are earned.

Yours truly,

WILMER SMITH,
President, New Home Cooperative Gin.
President, Plains Cooperative Oil Mill.

Mr. Chairman, members of the Finance Committee, U.S. Senate, my name is Wilmer Smith. I live on Route No. 1, Wilson, Tex. This is located on the south Plains, or the Lubbock area of the State. I have an average size farm, and my sole income is derived from farming.

I am the president of the board of the New Home Cooperative Gin and president of the board of the Plains Cooperatve Oil Mill, and I am past president of the Farmers Cooperative Compress. There are 85 cooperative gin associations on the south Plains that own and operate the Plains Cooperative Oil Mill, and 66 cooperative gins on the south Plains that own and operate the Farmers Cooperative Compress. These two firms are located in Lubbock, Tex. There are about 10,000 growers who own the 85 cooperative gin associations.

We organized the Plains Cooperative Oil Mill in 1937, and since that time seed in this area have been bought and sold on a grade basis, and all producers have received the benefit of premiums paid. We operate an efficient mill, selling the products in both the domestic and foreign markets, and, as growers, we have received the benefits from these operations. The Plains Cooperative Oil Mill pays us dividends each year, both on a current patronage basis in cash, and by issuing preferred stock and revolving the oldest outstanding stock. All stock issued prior to 1955 has been paid for in cash, and 40 percent of the 1955 stock has been retired.

The Farmers Cooperative Compress at Lubbock was organized in 1948. The reason for its organization was that the existing warehouses were not able to receive our cotton for days and weeks after it was ginned. We could not sell the cotton until we had a warehouse receipt and a Government grade. Then, too, the existing warehouses were not able to make prompt shipments on cotton sold, which discouraged buyers in our area. We built this first unit solely for the purpose of handling our cotton to the advantage of the grower and the buyer. This has been done.

The Farmers Cooperative Compress has paid all of its earnings toward retirement of outstanding preferred stock. All stock issued prior to 1958 has been retired and 25 percent of the 1958 stock has been taken up in cash.

While it might be possible under the court decisions for cooperative earnings to escape taxation, as a practical matter in this area it has not occurred because the grower would not support a cooperative that was not paying cash dividends within a reasonable time. Our cotton cooperatives of this area were in favor of the 1951 law, and, prior to the court decisions, every grower was taking the dividends of all his cooperatives into his income in the year it was earned.

Since these court decisions, some of the growers have reverted back to the practice of taking the dividends into income when paid in cash; but most of them have continued as they were under the 1951 law.

Our cooperatives have voted repeatedly in favor of a one-tax to the grower on all earnings made by the cooperative in the year in which they are earned, and we hope that the 1951 law will be amended so as to make this mandatory.

Yours truly,

WILMER SMITH.

LAW OFFICES OF DOMAN & ABLONDI,
New York, N.Y., May 7, 1962,

Senator HARRY F. BYRD,
Chairman, Committee on Finance,
Senate of the United States,
Washington, D.C.

DEAR MR. CHAIRMAN: I followed with great interest the hearings conducted by your committee on H.R. 10650, to amend the Revenue Act of 1954. I will address by remarks solely to the foreign income provisions of the bill and particularly to section 13 thereof.

Section 13 introduces the artificial concept of the "controlled foreign corporation." The bill assumes that when there is more than 50 percent American voting power in a foreign corporation, then there exists a common purpose among the American stockholders. Such an assumption is, of course, without rational basis. The following example will illustrate this.

Let us assume that there is a Belgian corporation in which the so-called U.S. group has a 49 percent interest. A foreign group has a controlling 51 percent interest but U.S. citizens or residents own a 2-percent interest in the controlling foreign group. Under the stock ownership rules of the code and of this bill, this Belgian corporation would be a "controlled foreign corporation." The foreign group would not be affected by the proposed section 13, and so far as they are concerned, there would be no reason not to use the earnings and profits of the Belgian corporation for its further growth and investment. In vain would the U.S. group use its vote and other prerogatives to distribute the earnings, if the controlling foreign group chose to act otherwise. The 2-percent U.S. interest in the majority foreign group would have no control over the action of such group. Even though the U.S. stockholders did provenly seek distribution of profits, they would be taxed on their prorated undistributed earnings and profits.

Many other examples could be cited to show that the concept of "controlled foreign corporation" is a fictitious and unrealistic one. The introduction of this concept into our revenue laws could only lead to confusion, constitutional litigation, and reduced participation of American role in international business.

Section 551 et seq. of the code in its present form deals with and covers situations involving passive foreign income items earned by foreign corporations in which five or fewer persons own more than 50 percent of the stock. There is no sound basis for dealing with these persons in section 952 and for singling out small businesses with five or fewer stockholders and to subject them to special tax legislation on their manufacturing and trading incomes.

Section 953 entitled "Investment of Earnings in Nonqualified Property" is also bound to curtail the development and growth of foreign subsidiaries of small American companies which cannot survive after complying with the provisions of said section. The major American manufacturing companies are already in the foreign market, or will be as of December 31, 1962. Under section 953 they can safely continue to use their earnings in the foreign corporate businesses, while new companies to be formed by smaller American companies after said date may not for 5 years use their earnings for working capital, reasonable reserves, payment of debts, and so forth.

The large corporation may well afford the luxury of starting a new foreign business even after December 31, 1962; it could reinvest its foreign earnings instead of distributing them, and then use other available funds to pay tax on undistributed earnings. A small American business, less endowed, could not do this but would have to leave the foreign market to its already entrenched larger competitors if section 953 is enacted. The committee might find that the whole concept of "controlled foreign corporation" as embodied in section 13 should be eliminated from the bill because it could lead to unfair results. If the committee would wish to leave the general framework of section 13,

then for the protection of small business and for the encouragement of new businesses to be started by smaller groups with smaller capital, the following provisions in section 13 should be eliminated:

Section 952(a) (1) (C).

Section 952 (d), (e), and (f).

Section 953.

In section 955(b) the reference to "952(a) (1) (C)."

The present form of section 16 of the bill provides that gain on the liquidation of a controlled foreign corporation, or sale of its stock that is realized by a stockholder owning 10 percent or more of the voting stock, will be treated as ordinary income, and not as capital gain to the extent to which the gain represents earnings and profits. For this purpose all earnings and profits accumulated since March 1, 1913, will be taken into account. Secretary Dillon stated before your committee that a retroactive effect is not desired and that this section might be modified to apply only to earnings and profits accumulated hereafter. Such a modification would certainly be desirable. In absence of such modification, a foreign corporation controlled by American stockholders would be well advised to liquidate before 1963 and transfer its assets to a new foreign corporation to be formed hereafter.

Section 1248(b) in section 16 of the bill is now worded in such a way as to provide for the taxation of the same earnings and profits in the hands of two U.S. persons as a result of the application of both section 1248 and section 951 where the stock has been sold by one U.S. person to another prior to the end of the taxable year. A clarifying modification is desirable.

The suggestions contained in this statement are submitted in the belief that they will contribute to a fair and equitable bill.

Respectfully yours,

NICHOLAS R. DOMAN.

STATEMENT BY JACK MILLER, U.S. SENATOR FROM IOWA

Mr. Chairman and members of the committee, one of the major proposals contained in H.R. 10650, the new tax bill passed by the House, relates to the withholding of income tax on interest and dividends (sec. 19 of the bill).

I am very much aware that the administration claims that a large amount of this income is not being reported and that there is a leakage of revenue properly due the Federal Government as a result.

I am also aware that the administration thinks that the only way to assure efficient collection of this revenue is through a withholding system.

When one suggests that an expanded information return system be used instead of withholding, the answer has been given that even today there are millions of dollars in uncollected tax bills in the files of the offices of the various District Directors of Internal Revenue. The taxpayers know that they owe the tax, but many of them cannot pay it. Moreover, since many of the items owing amount to only a few dollars, the cost of collection (letter writing, personal calls by collection officers, liens, etc.) is out of proportion to the tax involved.

However, this does not necessarily require the Federal Government to go to a withholding system such as proposed by H.R. 10650, with all of the confusion and expense to private business, as well as the Government, which it will cause.

What should be done is to require that everyone who pays interest or dividends must file an information return following the close of the calendar year with the local District Director of Internal Revenue setting forth the amount of interest and dividends paid or credited to the account of each recipient, with a copy to be furnished by the payor to each recipient. Naturally there will be many people who will receive a copy of such information return showing how much dividends or interest they received, but they will not have any income tax return to file or will not have any tax to pay. To this extent, there will be waste motion. But in the case of those people who do have tax to pay, I am quite sure they will think a long time before they will deliberately and fraudulently fail to report the interest or dividends on their returns and pay the tax attributable thereto.

It is no answer to say, as the administration does, that a bank will not have to send a withholding statement to the customer, showing how much was withheld from his interest. As a practical matter of customer relations, the bank will naturally send the customer some information—otherwise the customer will be dissatisfied. So, under the bill, we will end up with both a withholding system

and an information system. We don't need both, and the information return system alone should get the job done.

I recently received a splendid letter from one of my smalltown bankers. His bank is typical of those in the thousands of small towns throughout the United States. It is noteworthy that this banker has made a careful analysis of the steps, personnel time, and postage and supplies needed to comply with a withholding system. I ask consent that this letter with its supporting schedules be incorporated into the record as a part of my remarks.

In conclusion, let me say that I realize there is a problem over the failure to report interest and dividends. It should be emphasized that much of the failure is entirely legal, because the recipient doesn't even have to file an income tax return. Moreover, much of the failure is of no consequence, because even if these items were reported, there would be no tax: The people concerned may have to file a return, but because of exemptions and deductions there is still no tax to pay; or, because of the dividend exclusion, the net taxable dividends is zero. In the case of those people who have failed to report interest or dividends on which, in fact, there would be tax owing, most of this is not due to fraud but due to inadvertence—oversight resulting from failure to keep adequate records, check their accounts, or receive information from the payor. An expanded information return system would fill the gap. Certainly, before resorting to the withholding system, we ought to give a comprehensive information return system a fair trial.

JACK MILLER, *U.S. Senator.*

JEFFERSON STATE BANK,
Jefferson, Iowa, April 21, 1961.

Senator JACK MILLER,
U.S. Senate, Washington, D.C.

DEAR SENATOR MILLER: As you know, I am quite upset and concerned about the possibility of the withholding of income taxes on interest and dividends under H.R. 10650. The more I have studied this problem the more I am concerned about the provisions of this bill insofar as it affects the welfare of our country. At the same time, I have become no less concerned with respect to the increased hardship it places upon my bank.

My opposition stems from the following points:

1. I am not at all convinced that the gap is $650 million. There are other surveys indicating a lesser amount.
2. Electronic data processing equipment and education of the taxpayers can close the gap effectively if the problem is attacked properly through information returns.
3. The heavy burden of additional operating costs to be borne by banks and other interest paying or dividend paying institutions will provide a net cost to the Government far too excessive for the benefits accomplished.
4. The hardships caused savers and investors are such that it will cause serious upsets in thrift habits thereby jeopardizing the source of funds for capital investment or expansion.

Regardless of the moral aspects of the problem, I think the net cost of collection will be much higher under this system than under the present system and especially when electronic data processing is in effect. Just recently I saw that the Treasury Department indicated collection costs would drop from $27 million to $19 million. The difference of $8 million will easily be lost from taxes from banking institutions alone. For instance, as near as I can compute, we will be expending approximately $1,000 more per year to handle withholding. If we are only average in the banking industry, you can readily see that the commercial banks of the United States will be putting out between $13 million and $14 million anually in this regard. Assuming a 52-percent tax status, between $6½ and $7 million of taxes will not be collected as a result of increased operating expenses. Fit this into the picture alongside the dividend paying corporations, the building and loan associations throughout the Nation, and other dividend paying or interest paying institutions, and the cost of collection becomes almost stupendous. Economies of operation cannot be effected, because each unit, whether it be commercial bank, building and loan association dividend paying agent, or whatever, remains a separate unit with no means of

larger operations cutting the cost of smaller operations. I break my cost computation down as follows:

Postage (3 annual mailings to each of 2,184 accounts plus 10 percent repeat mailings. A mailing would be made on each interest-paying date and another requesting exemption certificates)	$288.28
Cost of forms, stationery and supplies, envelopes, etc	144.14
Computation of withholding (60 man-hours per interest-paying date. In our case we pay interest twice annually. Our cost per employee minutes was computed to be 8.27 cents for 1961. This represents salary plus overhead)	583.44
Total	1,015.86

We think our experience is typical of banking throughout the United States.

Our bank happened to be one of the 208 commercial banks included in the survey made by the American Bankers Association early this year. No doubt you have received a copy of this survey. The 208 commercial banks included held 29 percent of the total savings and time deposits of individuals, partnerships, and corporations in all commercial banks as of June 30, 1961. It was amazing to me how closely our figures conformed to the total of the reporting banks and how the proportions were approximately equal. For instance, 65.44 percent of the savings accounts held by the reporting banks received interest during 1961 of $12 or less. In our own particular case 61.4 percent of our accounts received $12 or less. In many other instances our figures compared quite well with the total of the reporting banks. I am enclosing, as a supporting schedule, our breakdown of figures requested in answer to questions three and four of the American Bankers Association questionnaire. This gives you an indication of the scope of our operation and how it compares to the national picture. I am assuming that you have a copy of the association's summary of the survey.

The problem of exemption certificates is a terrific one for our bank. As of the survey date, we had 750 accounts of customers 16 years of age or under. In a great many instances we would be faced with the necessity of running down each account to request that they sign an exemption certificate and certify their age. The problem with respect to the remainder of the accounts is just as awesome, particularly from a public relations standpoint. This battle has to be faced each year because of the necessity of filing a new certificate each year. This is further complicated by the fact that we are increasing the number of time certificate holders. Since interest is paid on time certificates of deposit on the anniversary date of the certificate, all such certificates with an anniversary date in January would mean that we would have to receive these exemption certificates prior to the interest-paying date. You can easily understand the problem we would have in this connection.

I have not even suggested the additional costs which, of course, we have. An interesting parallel might be made to the handling of the U.S. savings bond redemptions here in the bank. During 1961 the cost of redeeming these bonds in our bank came to $617.05. Of this amount $196.05 was offset by remittances from the Treasury Department on a per-item basis. Therefore, our net loss was $421 in our bond redemption activity. This makes no mention of the fact that we have one of our officers who spends about 20 percent of her time helping people with their bond problems such as switching from G- to H-bonds and E- to H-bonds and explaining the relative merits of the various types of U.S. savings bonds, explaining to people why their first checks are not equal to other checks with regard to series H bonds, and counseling with people's tax problems as they rise in connection with the redemption of E-bonds and all the other facets of the savings bond problem. Her salary is about $7,500 per year and the cost of this service that we are providing for the Government is evident. As you can see from my above figures, I have not allocated any cost involved in our people in the bank visiting and counseling, explaining, and justifying (?) the withholding problem to our bank customers. It seems reasonable to me to consider that we will be allocating about $2,000 of direct officer cost in this relationship. This, of course, does not take into consideration the operating costs or overhead in connection with providing the officer with a place to work.

This is an expensive business, not only from the standpoint of the bank but also from the standpoint of the U.S. Government which is going to get that much less in taxes. There is no aspect to this problem which enables the bank to recoup its losses in any fashion. The loss is a loss direct to the bank and direct to

the people of the United States; the costs shared on a 52-percent and a 48-percent basis.

To my way of thinking there is only one answer to the problem. Assuming that the problem of collecting these taxes is as important as the Treasury Department and administration seem to feel that it is, the filing of information returns by the dividend-paying and interest-paying organizations of the country is the only logical answer. With electronic data processing equipment on its way, no citizen could get by without reporting his proper income. We now have in our bank equipment which would provide information returns for one-fifth the cost that we would have incurred 10 years ago. As a matter of fact our cost would be only the cost of supplies to be utilized in connection with our National Cash Register window poster, the operation being performed simultaneously with the posting of our interest plus about 10 percent additional time spent in the posting operation. The expansion of the use of electronic data processing equipment in our larger banks throughout the country would also make this possible in a much more reasonable manner.

Information returns would close the gap 100 percent. There would be, of course, increased costs but these increased costs would be more than offset by the loss of revenue occasioned by withholding.

I have made speeches with regard to this topic locally. My audiences have numbered slightly more than 100. In each case I have found no one who did not think that the correct answer is the use of information returns rather than the withholding of income taxes. I think it is perfectly logical to assume that the voters of this country would favor information returns rather than withholding of taxes. I believe they think that it is the only logical solution and this thinking goes beyond their feeling of frustration and resentment about the withholding itself. Democrats and Republicans feel alike in this respect.

I have heard it bandied about that, just as in the case of withholding taxes on salaries, the cellection problems of the Treasury Department preclude 100-percent collection based on information returns. Since April 1, which was an interest-paying date for our bank, I have kept account of all of the savings accounts closed out, together with the number of savings accounts on which the interest with withdrawn. To date, after 19 days, no account has closed out after receiving the interest. Nine accounts of the 2,184 accounts have withdrawn the interest but left the principal intact. People do not put money in a savings account or purchase a share of stock to await a dividend or interest-paying date and then spend both their principal and interest with the end result that they have no funds to pay income taxes. I cannot see how the Treasury Department could justify its stand that its collection problems make it advisable to withhold rather than to process information returns. I believe our experience in this connection would conform to other institutions of a like nature since our figures compare so well with the A.B.A. summary.

I have not gone into the problems of other aspects such as the withholding of interest being paid on U.S. savings bonds, withholding on other types of Government coupons, and the myriad of other problems which we face not in only withholding the interest but also in collecting the balance from the various agencies and Government representatives. I am sure that you recognize the profound implications and problems faced in these areas. However, if you have any questions and you feel that I can contribute from my own experience with respect to these, I would be very pleased to be of help.

Other than the fact that passage of this bill seems to be a measure of the administration's prestige, I am not concerned with party politics in connection with my objections to this aspect of the bill. I do think that the entire measure contains a rather naive approach to our economic problems in this country.

I am so concerned about this whole situation that I am going to take a very serious look at the justification of this bank engaging in savings bond promotion and servicing of such savings bonds for the U.S. Government.

I am sending a similar letter to Senator Hickenlooper and a copy will also go to Representative Ben Jensen.

Sincerely yours,

THOS. O. COOPER, *President.*

Amount of interest paid	Savings	Certificate of deposit	Total
(a) Less than $12	$3,296.90	$97.84	$3,394.74
1. Accounts of customers 16 or under	1,710.43		1,710.43
2. Accounts of customers 65 or over	222.87	35.22	258.09
3. All other accounts	1,363.26	62.62	1,425.88
(b) $12 to $23.99	3,740.90	651.86	4,392.76
1. Accounts of customers 16 or under	850.30		850.30
2. Accounts of customers 65 or over	680.10	234.67	914.77
3. All other accounts	2,210.50	417.19	2,627.69
(c) $24 to $47.99	5,618.90	1,231.39	6,850.29
1. Accounts of customers 16 or under			
2. Accounts of customers 65 or over	3,635.99	443.36	4,079.29
3. All other accounts	1,982.11	788 09	2,771.00
(d) $48 and over	28,617 70	29,612.84	58,230.54
1. Accounts of customers 16 and under	1,362.20		1,362.20
2. Accounts of customers 65 or over	10,900.48	10,660.52	21,561.00
3. All other accounts	16,355.02	18,952.32	35,307.34
Total interest paid, all accounts	41,214.40	31,593.93	72,868.33

Amount of annual interest paid	Savings		Certificate of deposit		Total number of accounts	Dollar balance
	Number of accounts	Dollar balance	Number of accounts	Dollar balance		
(a) Less than $12	1,330	$212,709.10	10	$3,332.98	1,340	$216,042 08
1. Accounts of customers 16 or under	690	110,353.48			690	110,353.48
2. Accounts of customers 65 or over	90	14,379.13	4	1,199 87	94	16,579 00
3. All other accounts	550	87,955 21	6	2,133.11	556	90,208 32
(b) $12 to $23.999	220	143,836.60	41	27,187.33	261	171,023.93
1 Accounts of customers 16 or under	50	32,694 06			50	32,694.06
2. Accounts of customers 65 or over	40	26,149.49	15	9,187.44	55	35,336 93
3. All other accounts	130	84,993.05	26	17,999 89	156	102,992.94
(c) $24 to $47.99	170	216,739 40	41	46,507.60	211	263,247.00
1. Accounts of customers 16 or under						
2. Accounts of customers 65 or over	60	140,252.07	15	16,742.74	75	156,994.81
3. All other accounts	110	76,487 33	26	29,754.86	136	106,242.19
(d) $48 and over	210	920,000.00	162	1,000,809 27	372	1,920,879 27
1. Accounts of customers 16 or under	10	43,795.33			10	43,795.33
2. Accounts of customers 65 or over	80	350,454.66	58	360,291.34	138	710,746.00
3. All other accounts	120	525,820 01	104	640,517.93	224	1,166,337.94
Total, all accounts	1,930	1,493,355.10	254	1,077,837.18	2,184	2,571,192.28

LAW OFFICES OF PETER B. ATWOOD,
Chicago, May 7, 1962.

SIR: Enclosed is memorandum which I have prepared analyzing H.R. 10650 so far as it relates to foreign corporations.

A careful study of the bill indicates some shocking results. This memorandum is intended to be helpful to you in your review of this legislation, and I appreciate your courtesy in considering it.

Sincerely,

PETER B. ATWOOD.

MEMORANDUM REVIEW—PROPOSED 1962 REVENUE BILL RELATING TO CONTROLLED FOREIGN CORPORATIONS

PREFACE

Our examination of H.R. 10650, revenue bill of 1962, so far as it relates to controlled foreign corporations, reveals some shocking results which we believe require serious consideration.

In short, this bill destroys in one single piece of legislation the lifetime work and savings of thousands of American shareholders in closely held foreign corporations, with no real, substantial benefit to the U.S. Treasury. Even if the U.S. Treasury is improved, it is not the function of tax legislation to destroy important economic units or to create havoc with such shareholders.

In general, too, these provisions, including those contained in section 9 relating to foreign trusts, are an invitation to fraudulent practices. They encourage, stimulate, and invite fraud. However, this memorandum objectively reviews the bill in relation to its impact on the affected foreign corporations and their shareholders.

I. SECTION 16—GAIN FROM REDEMPTION, SALES, OR EXCHANGES OF STOCK IN CONTROLLED FOREIGN CORPORATIONS

In the case of a controlled foreign corporation (more than 50 percent voting stock ownership by U.S. persons), this section would deny capital gain treatment to shareholders upon the redemption, sale, or exchange of their shares (in the case of 10 percent or more shareholders). This provision is effective upon enactment of this bill. In other words, the affected shareholders must now dispose of their shares in anticipation of a possible confiscation of the value of their holdings on passage of the bill. These are high stakes to gamble. There is not time to sensibly dispose of shares of closely held foreign corporations.

Take the case of a company organized in Switzerland with four equal U.S. shareholders. This company has been in business for many years. If the shareholders decide now to sell 50 percent of their holdings and thus have less than the required percentage to be classified as a controlled foreign corporation, these results occur:

(1) There is a 30-percent tax in Switzerland on the gain realized by the U.S. shareholders. Hence, no tax is turned into the U.S. Treasury, as the U.S. taxpayers will get a credit for the Swiss tax paid. (The U.S. treaty with Switzerland limits taxes on dividends to 15 percent, but a liquidating distribution may not be a dividend within the meaning of the treaty.)

Other countries are likely to see the light of day on this boon to their coffers, and pass similar legislation.

The Swiss people benefit from this provision—not U.S. taxpayers.

(2) If less than all of the U.S. shareholders' shares are sold, any foreign shareholder in the transaction mentioned above can blackmail and beleaguer the U.S. shareholders by threatening to sell his shares to a U.S. citizen or resident alien so that more than 50 percent of the shares will again be held by U.S. persons and thus come within the ban of these new tax provisions.

(3) The loss of such shares by U.S. persons will render useless the existence of such foreign corporation, with the result that just that much less foreign business takes place. As an economic proposition, there is a loss of U.S. revenue from many sources with no benefit whatsoever to the U.S. Treasury.

All we have accomplished is to destroy the investment held by U.S. persons.

(4) Section 16 covers not only a sale or redemption of stock, but also an exchange. Therefore, should the U.S. shareholders want to merge or enter into a plan of reorganization with a U.S. corporation or other foreign corporation, they must pay a present tax (calculated at ordinary tax rates) on the exchange, with no money resulting from the transaction to pay the tax.

This, in effect, nullifies section 367 relating to exchanges with foreign corporations, without so stating in the bill.

Furthermore, if the exchange is attempted before possible passage of the bill, the Internal Revenue Service must approve the plan before it may be treated as a nontaxable exchange. Anyone who has had even a small acquaintance with the progress of an application for ruling with the Internal Revenue Service (especially in this limited field) knows that it takes too long to get such a ruling to gamble on its issuance before passage of this bill.

Thus, the taxpayer is deprived of the exchange route to avoid this section 16 and its destructive force.

II. SECTION 13—CONTROLLED FOREIGN CORPORATIONS

In the case of 10-percent U.S. shareholders of a controlled foreign corporation, the earnings of such corporation are taxed to them, whether or not distributed, measured by what is called subpart F income and earnings invested in nonqualified property.

Subpart F income consists of:

(1) Income derived from insurance on U.S. risks on property or persons;

(2) Income derived from U.S. patents, copyrights, and exclusive formulas and processes which were developed in the United States; and

(3) Certain so-called net foreign base company income.

The application of these provisions is discussed below.

1. Income from U.S. patents, copyrights, exclusive formulas and processes

This is one of the categories of subpart F income which will be taxed to U.S. shareholders in the case of controlled foreign corporations. For the income from these patents, copyrights, etc., to be included, they must be substantially developed, created, or produced in the United States, or, alternatively, be acquired from any U.S. person which, directly or indirectly, owns or controls or is owned or controlled by, or is under common ownership or control with, the controlled foreign corporation. This all-inclusive language is not clear, and there is no definition of "control," "common ownership," or "under common ownership."

This must be left to the vagaries of a decade or more of court decisions. In the meantime, the U.S. taxpayer is hurt for no real good and certainly no real purpose. Eventually the U.S. Treasury taxes such earnings under present law—taxing them now instead of later does not justify throwing a monkey wrench into the tax structure and creating endless litigation.

The income to be taxed here is that derived from the license, sublicense, sale, exchange, use, or other means of exploitation of the patent, copyright, exclusive formula, or process. Thus, the income taxed is not only royalties, but income derived from the manufacture of a product pursuant to a patent covered by this section.

Even more important in the consideration of this section is an inquiry as to what is meant by a U.S. patent, etc., "substantially developed, created, or produced in the United States." One interpretation, and perhaps the logical one, is that the proposed act is intended to tax the income of controlled foreign corporations derived from licensing such patents in the United States. Under some reciprocal treaties this income may otherwise be tax free. This provision (sec. 952(c)) would thus override such treaties. For example, under article 7 of the treaty with France effective January 1, 1945, income received by French citizens or French corporations on account of royalties from licenses in the United States is exempt from U.S. income tax (T.D. 5499, sec. 7, 418).

On the other hand, it might well be argued that this provision (sec. 952(c)) is intended to tax as subpart F income all income derived from licenses or the exploitation of the patent abroad in the case of inventions or patents developed in the United States, regardless of the country issuing the patent. Thus, assume again the case of a French corporation which is the licensee of a U.S. person with respect to certain French patents which are counterparts of U.S. patents developed in the United States. In that case the license agreement does not cover U.S. patents, but French patents. Under this interpretation of section 952(c), the country in which the patents are issued and are licensed is unimportant. The important thing is, were they developed in the United States? If they were, then they come within the tax consequences of this section.

These important questions are not resolved by the language of the bill. They invite immediate and prolonged, costly litigation.

A great body of law has been developed in this country to the effect that an exclusive license which grants to the licensee the right to make, use, and sell the invention, or an undivided part or share of that exclusive right, constitutes the sale of a capital asset and is entitled to capital gain treatment:

Edward C. Myers v. *Commissioner*, 6 T.C. 258.
Massey v. *United States* (C.A. 7, (1955), 226 F. 2d 724.
Storm et al. v. *United States* (C.A. 5, 1957), 243 F. 2d 708.
Rollman et al. v. *Commissioner* (C.A. 4, 1957), 244 F. 2d 634.
Leubsdorf et al. v. *United States* (Ct. Cl., 1958), 164 F. Supp. 234.
Lockhart et al. v. *Commissioner* (C.A. 3, 1958), 258 F. 2d 343.
Merck & Co., Inc. v. *Smith* (C.A. 3, 1958), 261 F. 2d 162.
Bannister et al. v. *United States* (C.A. 5, 1958), 262 F. 2d 175.
Estate of M. P. Laurent, Sr., v. *Commissioner* (1960), 34 T.C. 385.
Wing et al. v. *Commissioner* (C.A. 8, 1960), 278 F. 2d 656.
George J. Aitken v. *Commissioner* (1960), 35 T.C. 227.

Section 1235 of the 1954 code codified this principle so far as it applied to individuals.

Thus, it has been possible for U.S. persons to grant exclusive licenses to foreign corporations on account of foreign patents issued in connection with inventions which are counterparts of U.S. patents. A serious question arises as to whether or not this proposed act nullifies the capital gain treatment accorded such previously existing exclusive license agreements. The language of section 952(c) of the proposed bill has the effect of treating such income as ordinary income, although the amendments made by section 7 of the proposed bill, which do not amend the definition of "foreign personal holding company income," do not purport to incorporate section 952(c) as an additional definition of "foreign personal holding company income." Thus, the Internal Revenue Service has ruled [1] that exclusive licenses entered into between U.S. persons and foreign corporations with respect to foreign patents result in capital gain treatment, and such income is not to be treated as foreign personal holding company income.[2] Such rulings are now voided by the implications of section 952(c).

2. Foreign base company income

"Foreign base company income" (applicable only in the case of a foreign corporation the voting stock of which is owned by five or fewer U.S. persons) means—

(*a*) Personal holding company income as defined in section 553. This includes passive forms of income, such as dividends, interest, rents, etc., but does not include income from U.S. patents, formulas, etc.

(*b*) Certain sales income (equal to at least 20 percent of the gross income of such foreign corporation, without regard for other foreign base company income) derived from the sale of personal property from a related person, where the property is not purchased in the controlled foreign corporation's domicile and is sold outside such domicile.

Here again, "related" is not adequately defined.

This "foreign base company income" is reduced by the increase in investments in qualified property in less developed countries made during the taxable year or within 2½ months thereafter.

Also, if the foreign base company income (before deductions) for the taxable year is less than 20 percent of gross income, no part of the income is to be treated as foreign base company income, but if foreign base company income (before deductions) for the taxable year exceeds 80 percent of gross income, the entire gross income is to be taken into account in determining foreign base company income (sec. 952(e)(6)).

At page 63 of the official summary of H.R. 10650 prepared by the staff of the Committee on Ways and Means, it is stated:

"Where this income is from 20 percent to 80 percent of the company's gross income, only the foreign base company income is taken into account. These rules are similar to those set forth in an earlier provision (sec. 7) of this bill with respect to foreign personal holding company income. Thus, where this foreign base company income is relatively minor, the shareholders will not be taxed on any of it; where it is a major factor, they are to be taxed on the entire income of the corporation. Otherwise only the foreign base company income is taken into account."

The code provisions do not support this statement. Furthermore, the explanatory language quoted above defies interpertation. Does it mean that in the 20 to 80 percent bracket only foreign base company income is taxed, and income from (i) insurance risks on U.S. property or persons, and (ii) patents, etc., developed in the United States are excluded, or just what does it mean?

As mentinoed above, foreign base company income is reduced on account of investments in qualified property in less developed countries. The deduction is measured by the increase in the amount by which the aggregate amount of certain property held at the close of the taxable year exceeds the aggregate amount of such property held at the close of the preceding taxable year. The property taken into account for this purpose is—

(*a*) Qualified property described in section 953(b)(2) (C) and (D) [stock in a controlled foreign corporation carrying on business in a less

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[1] Rev. Rul. 58–353, C.B. 1958–2, 408; Rev. Rul. 60–226, C.B. 1960–1, 8.

[2] For example, exempt interest is not part of "gross income" for purposes of determining applicability of personal holding company income. Rev. Rul. 57–435, C.B. 57–2,462. Private rulings are as stated in text.

developed country, and investments required because of restrictions imposed by a less developed country or made to avoid losses in such underdeveloped country]; and

(*b*) Property (including money) which is located outside the United States and is ordinary and necessary for the active conduct for a qualified trade or business [a business carried on by a controlled foreign corporation outside the United States on or before December 31, 1962, or during the 5-year period ending with the close of the preceding taxable year of such corporation].

III. EARNINGS INVESTED IN NONQUALIFIED PROPERTY

The categories of income referred to in part II above are components of the "subpart F income." In addition to the taxation of such income to the shareholders of controlled foreign corporations, the increase in earnings invested in nonqualified property may also be taxed to the shareholders. "Nonqualified property" is defined to mean any property which is not "qualified property." The intricate and involved definitions of "qualified property" are difficult to resolve.

This income is to be taxed to the shareholders only to the extent that it exceeds any balance of subpart F income remaining (not only for the current year but for prior years) which has not previously been offset by earnings invested in nonqualified property.

IV. DIFFICULTIES ENCOUNTERED IN ADMINISTERING THESE TAX PROVISIONS

Apart from the serious questions of interpretation mentioned in parts II and III, a controlled foreign corporation is thrust into impossible accounting problems because a U.S. person owns 10 percent or more of its voting stock and an aggregate of more than 50 percent of its voting stock is owned by U.S. persons.

It must:

(1) Know what net income is to be allocated to products produced under U.S. patents—or possibly patents registered or issued in its own or other countries but substantially developed in the United States. The law is not clear as to just what is meant by a U.S. patent or secret process, or do different rules apply to patents than to secret formulae or processes?

Then again, suppose some of the research in connection with the patent is performed in a foreign country and some in the United States. Who is to determine which research was more important in the development of the patent?

These are accounting problems which defy solution. Suppose the foreign corporation tells the 10-percent shareholder it will not furnish this information because it is too costly and unimportant to it?

Then, too, even if furnished, it may not be furnished in time to complete the U.S. person's tax return. Are there penalties to be applied, such as the ad valorem penalties for underestimating tax or declaring less than 25 percent of the tax due?

(2) Know what rule is to be applied where a product is manufactured in a foreign country from components derived from various sources pursuant to a variety of patents issued in part to U.S. persons and in part to a foreign corporation. Who is to determine the importance of the patent contribution in the manufacture of such products? This complication will vary from product to product within the same foreign company.

(3) Determine the meaning of intricate provisions relating to foreign base company income. For example, foreign base company income consists of two basic parts: (i) Passive investment income (excluding income from U.S. patents, etc.); and (ii) foreign base company sales income. Under established rulings of the Internal Revenue Service certain exclusive license agreements relating to patents (whether or not U.S. patents) constitute the sale of such patents, and accordingly amounts received thereunder are given capital gain treatment. Amounts received in connection with such exclusive licenses are receipts in connection with the sale of property. Are these rulings now outlawed by the new provisions of this bill? How can a foreign corporation possibly interpret this bill in advance, especially when the likelihood is that Treasury regulations will not be issued for months and possibly years after the passage of this bill?

(4) Establish separate accounting records with respect to the sale of personal property purchased from a related person but not purchased in the controlled

foreign corporation's domicile and sold outside such domicile. In addition, the corporation must establish some kind of allocation of costs with respect to such transactions.

(5) Make investments in "qualified" property in order to avoid the additional tax on earnings. One of the qualified investments is investment in a trade or business carried on by the controlled foreign corporation outside the United States.

What constitutes an investment in the foreign corporation's own business is not at all clear by any of the statutory language. How can a corporation invest in itself?

Here again, another practical problem is injected. There will of necessity be a timelag between the date of calculating a foreign corporation's earnings and then deciding what property to invest in. The corporation may not have any money at the time to make any investment. There are too many practical problems associated with investment in property, qualified or otherwise, so that taxation here is entirely capricious and unrelated to the economic problems confronting corporations conducting business in foreign countries.

V. U.S. CITIZENSHIP

American citizens have invested millions of dollars and their lifetime work in creating substantial foreign corporations and the business associated with such enterprises. This tax bill destroys this investment overnight.

In order to avoid the utter confusion and chaos which will be created by enactment of this bill, it behooves an American citizen to consider whether or not this country is really concerned with the preservation of his rights. Everything that an American citizen does in the form of conducting business in foreign countries through foreign corporations is so heavily taxed as to destroy the incentive to carry on. On the other hand, foreigners can do the very thing that American citizens are deprived of doing, with the end result that an American citizen will find it necessary to sell his foreign investments to foreigners at knockdown prices. This just does not make sense. In order to avoid this disastrous result, all an American citizen has to do is to renounce his American citizenship and to move to a country like Mexico or one of the Bahaman Islands, where he can carry on his foreign corporate activities with practically no tax and at the same time avoid Federal estate taxes. In many cases this will mean millions of dollars of tax savings, with the end result that the U.S. Treasury will lose in the long run.

If the Government wants to destroy a citizen's lifetime savings, why should that citizen hold his citizenship so dearly when he can so very easily avoid such disastrous results.

What this bill does, then, is simply compel a man to leave this country and live abroad. This is so farcical and so fantastic that it seems strange the Congress would even consider this legislation when all of its ramifications are considered.

Most foreign countries do not begin to tax their citizens or their corporate enterprises as heavily as we are taxed in the United States, yet we are supplying funds to these countries out of tax money. Now, we hand over to foreign citizens the investments accumulated by our citizens over many years of hard work.

If this bill makes sense, I have not been able to discover it.

PETER B. ATWOOD.

STATEMENT OF D. E. REICHELDERFER, VICE PRESIDENT, FINANCE, ARMCO STEEL CORP., MIDDLETOWN, OHIO

On September 11, 1961, Secretary of the Treasury Douglas Dillon stated that the U.S. Government and private investors would contribute about $1.25 billion a year for the next 10 years to Latin American development (the Alliance for Progress). Of this amount, $300 million a year would be expected from private investors.

In our opinion, section 11, the gross-up section of H.R. 10650, if enacted into law, will have an adverse effect upon this announced program of the administration.

Attached is a comparison study of the tax treatment accorded the income of foreign subsidiaries of U.S. companies in England, France, and Latin America under present tax laws and as it would be under the gross-up proposal. The

36.41 percent foreign income tax rate used for Latin American countries is a composite rate of taxes levied by those Latin American countries in which Armco Steel Corp. now has active foreign subsidiaries.

This study shows clearly and simply that the gross-up provision will increase the total tax to be paid on the pretax income of foreign subsidiaries in Latin America by over 5½ percentage points. It is also clear that the gross-up provision will have little or no effect in developed countries such as England and France.

The political and economic instability of Latin American countries present formidable risks for a foreign investor. How, sirs, can the administration expect increased American investment in Latin America when at the same time it places further obstacles in the path of such investment? Is this provision not another factor that will retard the building of a strong Western Hemisphere? Certainly section 11 of H.R. 10650 is another reason why the foreign provisions of this bill should not be adopted.

Increase in income taxes under gross-up proposal based on assumed profit before income taxes in various countries

[All amounts stated in U.S. dollars]

	Latin America		England		France	
	Percent (1)	Amount (2)	Percent (3)	Amount (4)	Percent (5)	Amount (6)
Under present Internal Revenue Code:						
Subsidiaries' income before tax	100.00	$2,000,000	100.00	$2,000,000	100	$2,000,000
Foreign income tax on subsidiaries	36.41	728,200	53.75	1,075,000	50	1,000,000
Net income available for dividends	63.59	1,271,800	46.25	925,000	50	1,000,000
Dividend payout at 100 percent		1,271,800		925,000		1,000,000
U.S. income tax	52.00	661,336	52.00	481,000	52	520,000
Less foreign tax deemed paid	36.41	463,062	53.75	497,188	50	500,000
Tax withheld from dividend		0		0	15	150,000
Total foreign tax credits		463,062		497,188		650,000
Remainder U.S. income tax		198,274		0		0
Total tax (U.S. and foreign)		926,474		1,075,000		1,150,000
Under gross-up proposal						
Dividend income before tax		2,000,000		2,000,000		2,000,000
U.S. income tax	52.00	1,040,000	52.00	1,040,000	52	1,040,000
Less foreign tax deemed paid	36.41	728,200	53.75	1,075,000	50	1,000,000
Tax withheld from dividend		0		0	[1]	150,000
Total foreign tax credits		728,200		1,075,000		1,150,000
Remainder U.S. income tax		311,800		0		0
Total tax (U.S. and foreign		1,040,000		1,075,000		1,150,000
Increase in tax under gross-up		113,526		0		0
Percentage point increase in U.S. tax on subsidiaries' income before income taxes (18÷1)		5.68		0		0

[1] 15 percent times $1,000,000.

Source. Armco Steel Corp., comparison study; sec. 11, H.R. 10650, May 3, 1962.

Hon. HARRY F. BYRD,
Chairman, Committee on Tax and Finance,
Senate Office Building, Washington, D.C.

DEAR SENATOR BYRD: I have had the opportunity to review bill H.R. 10650 as passed by the House of Representatives last month. I am deeply distressed at the effect of this legislation insofar as it applies to U.S. citizens who are bona fide foreign residents. I believe that very few such foreign residents will learn of the contents of this piece of legislation in time to present their views to your committee during your present deliberations. I, therefore, gravely fear that, unless I speak out as a representative of a small but, I believe, important section of U.S. citizenry, this proposed legislation may be passed in its House-approved

form. I believe that such passage in that present form is unfair and unwise, and would be detrimental to the interest of the United States.

To consider the circumstances of the case which I seek to plead, allow me to state that I am neither competent to, nor willing to, defend short-term foreign residents who establish such residence primarily for tax advantage. My plea, and such it is, relates specifically to those of us who have for a lifetime lived outside of our country. I shall outline my own history as an example of our truly "bona fide foreign resident" whose welfare has, I fear, been overlooked by the designers of H.R. 10650.

I was born on May 29, 1922, in Ancon, C.Z. My father was from Trenton, N.J., and my mother from New Orleans, La., both being U.S. citizens. They resided in Panama since 1912, having gone there during the era of the construction of the Panama Canal. My family residence shifted from the Canal Zone to the Republic of Panama in 1931, and has remained in Panama since then. Therefore, my family have been foreign residents for 50 years. My 3 brothers and my 10 nephews and nieces live in Panama, all having been born there.

During my childhood I was sent to schools in South America, Canada, Europe, and the United States, graduating from the School of Foreign Service at Georgetown University. I was in the U.S. Navy for almost 4 years during the era 1942 to 1946, serving as commanding officer of a landing boat group in the Pacific. I was cited in combat three times, and was decorated twice.

In 1946 I returned to my legal residence in Panama and shortly thereafter founded the Panama Insurance Co. I am now president of that company, which I have actively managed for almost 14 years, and which company is now the largest insurance company in Central America, except for Mexico.

I believe you will agree that the foregoing set of circumstances confirm that I am a patriotic U.S. citizen whose life has been spent as a bona fide foreign resident.

Now, I have been raised to believe that the United States should have outstanding citizens abroad. These exemplary expatriates—

(*a*) Serve as a bridge of friendship between the people of the United States and the people of the country where the expatriate dwells.

(*b*) Serve as a bridge for the investment abroad of private U.S. capital, thereby aiding in building the economy of friendly countries without placing a burden on U.S. Federal funds.

(*c*) Serve as a sphere of influence for U.S. commerce and politics abroad.

(*d*) Serve as the eyes, the ears, and even the voice of the United States.

(*e*) Serve as advisors to our diplomatic personnel, and thereby aid in guiding and counseling our foreign policies.

I believe my convictions to be sound. Indeed, during these 39 years of my life, two-thirds of which have been spent oversea, I have witnessed our Ambassadors and other U.S. Government officials leaning heavily on our longtime foreign residents for advice and counsel. Certainly, from the files of the State Department, and from the Office of Central Intelligence Agency, your committee can determine that the advice of a lifelong resident in, say, Panama, or the advice of a lifelong resident in Venezuela, is advice that is invaluable to a new Ambassador or to a new head of mission in either of those countries.

These valuable expatriates can only continue to live abroad if their economic circumstances are maintained on a basis consistent with the existing circumstances. The bill, H.R. 10650, as approved by the House and as now under study by your committee, would materially alter these circumstances, and would give rise to at least two intolerable circumstances.

First, the bill actually discriminates against U.S. residents who are living abroad. If that legislation were to take the effect of a law, those U.S. citizens who have plowed into their foreign company a lifetime of income and labor, could not sell their stock in their own company on the basis of the normal capital gains advantage, but rather such expatriates would have to take their profit (on the sale of stock) as earned income with the obviously onerous tax thereon. I assure you that in several instances this will wreck the lifetime planning and even the net worth of some U.S. families now abroad.

The second feature to which I must plead an objection is the new imposed limitation on tax-free income. Some time ago all earned income of expatriates was exonerated from U.S. tax. Then a few years ago a $20,000 exemption was permitted for short-term foreign residents, and bona fide foreign residents continued wholly exempt. Most long-term or lifetime foreign residents understood the intent of Congress in limiting exemptions of short-term residents, it then being widely felt that such temporary expatriates lived abroad simply to escape taxation.

However, we now note that under the new bill this $20,000 is still applicable for short-term foreign residents, but long-term or lifelong residents are to be taxed by the United States on all earned income over $35,000 per annum. While some slight recognition is given to 3-year (or more) expatriates by the increase of $10,000 in such exemption, I submit that the gesture is woefully short of justice.

Many extremely influential U.S. citizens now living abroad are salaried officers, or self-employed men of genius and talent who, with a decade or more of experience in foreign affairs, contribute heavily to U.S. influence in the countries of their present domicile. I do not know how many such foreign-domiciled U.S. citizens would have earned incomes in excess of $35,000 per annum last year, but doubtless the number is small. However, I believe it is safe to assume that an expatriate of 10 years, or of 20 years' duration, now salaried in excess of $35,000 per annum, is a knowledgeable and mature expert in the area of his domicile. One must also assume that the reason for such a person living abroad is in large part related to his ability to earn and to save money. This security would compensate such a foreign resident for the hardships and relative discomfort he and his family experience, particularly in a less developed country.

The imposition of a new tax, when added to the present insecurities of living and working abroad would, without doubt, cause a great number of our top-salaried, mature, and valuable foreign representatives to return to the United States of America. Those limited few who do stay abroad would have their usefulness to the United States impaired.

Even assuming that all such present bona fide, lifelong expatriates remained abroad (which is certainly an invalid assumption), we must realize that this tax would generate a very small amount of moneys for the U.S. Treasury. This taxing of income over $35,000 is in no way proportionate to the loss to the United States that would be suffered by the repatriation of this handful of influential Americans now serving as our beachhead on all foreign shores.

I know that I can speak authoritatively when I say that, without the full exemption on earned income for lifelong, or very long-term U.S. expatriates, there would be no advantage in such continued foreign residence, and most such people would therefore return to America.

It would appear that some consideration should be given to two amendments to the subject bill. One such amendment would assure bona fide foreign residents of nondiscrimination on capital gain-type sales. The second amendment would grant increasing U.S. tax exemptions to bona fide foreign residents, based on the extent of time of such residence.

In view of my comments, and in order to enlarge on these comments, I respectfully request that I be allotted time before your committee. In my opinion the time required would be of very few minutes duration.

Yours very truly,

EUGENE G. MCGRATH.

PROPOSED REVISIONS TO H.R. 10650

SECTION 12

The following revision is proposed to H.R. 10650, section 12—Earned income from sources without the United States. Insert the following phrase to preceed the last sentence of section 911(a)(1) at page 98 of H.R. 10650:

"In the case of an individual who has been a bona fide resident of a foreign country or countries for an uninterrupted period of less than ten consecutive years,"

Section 911(a)(1) as revised would read as follows [additions in italic]:

"SEC. 911. EARNED INCOME FROM SOURCES WITHOUT THE UNITED STATES.

"(a) GENERAL RULE.—The following items shall not be included in gross income and shall be exempt from taxation under this subtitle:

"(1) BONA FIDE RESIDENT OF FOREIGN COUNTRY.—In the case of an individual citizen of the United States who establishes to the satisfaction of the Secretary or his delegate that he has been a bona fide resident of a foreign country or countries for an uninterrupted period which includes an entire taxable year, amounts received from sources without the United States (except amounts paid by the United States or any agency thereof) which constitute earned income attributable to services performed during such uninterrupted period. *In the case of an individual who has been a bona fide resident of a foreign country or*

countries for an uninterrupted period of less than ten consecutive years, the amount excluded under this paragraph for any taxable year shall be computed by applying the special rules contained in subsection (c)."

To conform the remainder of section 911 to the above-proposed revision, section 911(c) should be revised by inserting in the first sentence thereof, after "(a)" and before ", the following", the following phrase (at page 100 of H.R. 10650):

"in the case of an individual who has not been a bona fide resident of a foreign country or countries for an uninterrupted period of at least ten consecutive years"

Section 911(c) as revised would read as follows [additions italicized]:

"(c) SPECIAL RULES.—For purposes of computing the amount excludable under subsection (a) *in the case of an individual who has not been a bona fide resident of a foreign country or countries for an uninterrupted period of at least ten consecutive years,* the following rules shall apply:

SECTION 16

The following revision is proposed to H.R. 10650, section 16—Gain from Certain Sales or Exchanges of Stock in Certain Foreign Corporations. Add the following paragraph under section 1248(c) (at p. 162 of H.R. 10650):

"(3) CERTAIN BONA FIDE RESIDENTS OF FOREIGN COUNTRIES.—Subsections (a) and (b) shall not apply to an individual citizen of the United States who has been a bona fide resident of a foreign country or countries for an uninterrupted period of more than ten consecutive years."

To conform the remainder of section 1248 to the above proposed revision, sections 1248 (c)(3) through (c)(6) (at pp. 162 and 163 of H.R. 10650) should be renumbered (c)(4) through (c)(7).

STATEMENT OF DR. C. F. OWEN, ASSOCIATE PROFESSOR OF ECONOMICS, COLLEGE OF WILLIAM AND MARY, WILLIAMSBURG, VA.

(NOTE.—The following is extracted from a forthcoming publication entitled, "Taxation and the Export of Capital to the Developing Countries: A Comparative Study of American and European Tax Provisions," written by Dr Owen under a NATO advanced research fellowship after extensive researhc in Western Europe and the United States. The final summary was added by the author for the purpose of this hearing record.)

EXTRACTS FROM "TAXATION AND THE EXPORT OF CAPITAL TO THE DEVELOPING COUNTRIES: A COMPARATIVE STUDY OF AMERICAN AND EUROPEAN TAX PROVISIONS"

The tax changes advanced in H.R. 10650 are based on three main arguments: (1) Helping domestic economic growth; (2) strengthening the U.S. balance-of-payments position; and (3) substantially increasing tax receipts.

Economic growth.—The President's tax message to Congress explicitly assumes that if less capital were invested in other countries that this capital would instead be invested in the United States and thus enhance domestic economic growth rather than the economic growth of other countries.

"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 * * * profits are retained and reinvested abroad which would otherwise be invested in the United States."

This statement requires immediate examination.

It is a qualified statement; i.e. "To the extent * * * etc.," yet, on the basis of the actions of a particular group of companies whose investment decisions might be unwisely affected primarily by tax considerations, general tax legislation is being urged which would apply to all U.S. companies. In effect, the proposals relating to the taxation of foreign income infer, but do not explicitly allege, that all U.S. companies operating through subsidiaries in the developed countries do so primarily for tax advantages. This contention is highly questionable. Taxation is an important factor, but only one of the numerous elements which a responsible company must consider in making its investment decisions. Only the most irresponsible type of company would invest in Europe, or the developing countries, primarily to achieve tax advantages.

Stimuli to investment occur as a result of a complex array of economic and other factors. In general terms, in recent years these stimuli have been in greater abundance in Europe (the advance of the European standard of living

into the types of consumer products in which U.S. companies excel, the formation of the European Common Market, etc.) than in the United States. If there are no great stimuli to increased investment in the United States increases in domestic investment will not take place even though the tax provisions affecting the operations of foreign corporations are changed. Furthermore, and of special significance, this assumption infers that in recent years there has been a competition between the United States and Europe for the available capital resources of U.S. companies and their associated subsidiaries, that if more funds had been available for domestic investment this investment would have taken place and stimulated economic growth. All available evidence indicates that in the sluggish business conditions which have existed in the United States in the last 3 years (1958–61) there have been ample funds available for possible capital expenditures but inadequate stimuli to use the funds for investment.

Balance of payments.—There are already indications that the balance-of-payments positions which precipitated a minor "dollar crisis" in the autumn of 1959 has improved considerably. Regardless of this immediate improvement, and even accepting the continuation of balance-of-payments difficulties, it is far from self-evident that foreign direct investments have aggravated these difficulties and that tax measures designed to discourage outflows of investment and to increase the repatriation of earnings will particularly alleviate the possible difficulties.[1] Outflows of capital may help the balance of payments in two major ways, firstly, as a stimulus to exports; secondly, as a source of earning foreign currencies. Frequently, executives prefer to buy machinery and equipment with which they are familiar and from companies with which they have had previous business experience. In this way, foreign subsidiaries form a direct outlet for an economy's export products. This consideration, for example, was advanced as a main reason for the formation of the Overseas Trade Corporation in the United Kingdom. The U.S. Department of Commerce has estimated that in 1960 approximately one-fifth of the adjusted total of U.S. exports was associated with the foreign subsidiaries of U.S. manufacturing companies. A breakdown of the aggregate data is shown in the following table. These data underestimate the amounts of exports, because the survey relates to only 155 U.S. companies. While the foreign investments of these companies, in the aggregate, account for at least 80 percent of all U.S. manufacturing investments abroad, their orders do not comprise the total amount of U.S. exports induced by foreign subsidiaries.

U.S. exports to, or developed by, foreign subsidiary companies

[Millions of dollars]

	Exports from the United States to foreign subsidiaries		Exports developed by foreign subsidiaries on a commission basis		Actual amounts		Total exports to, or developed by, foreign subsidiaries as percent of adjusted total of U.S. exports		Adjusted total of U.S. exports [1]	
	1959	1960	1959	1960	1959	1960	1959	1960	1959	1960
Canada	793	790	15	15	808	805	28.5	29.2	2,838	2,761
Latin American Republics	513	594	176	171	689	765	24.9	27.9	2,771	2,740
Western Europe	275	509	113	203	388	712	19.2	22.8	2,023	3,126
Other countries and unallocated	244	339	55	57	299	396	12.3	13.3	2,429	2,980
Total	1,824	2,232	359	446	2,183	2,679	21.7	23.1	10,061	11,607

[1] Total exports excluding (a) certain military products known as special-category shipments and (b) products such as foodstuffs and raw materials which are not likely to have any counterpart in the exports to this group of subsidiaries.

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

[1] In the discussions of international investment and its effects on the balance-of-payments position there has been a fundamental failure to distinguish between speculative flows of "hot money" and bona fide (and beneficial) direct investment in productive resources.

In the aggregate, goods purchased in the United States amounted to roughly 20 percent of the total materials used by the foreign subsidiaries in their manufacturing operations abroad. The manufacturing subsidiaries abroad reported to the U.S. Department of Commerce that in 1960 imports of capital equipment from the United States totaled $129 million, compared with about half that total in 1959. Canada and Europe each accounted for about one-third of the 1960 total. The U.S. Department of Commerce indicated that, "* * * these results indicate that the foreign subsidiaries do provide an important channel for U.S. exports, both for their own use in producing goods abroad for resale and as an aid in developing sales from the United States to other consumers abroad."

Of special interest to this study are the data on the financing provided by subsidiaries in developed countries to subsidiaries in the developing countries. The U.S. Department of Commerce reports that the flow of capital from European subsidiaries to subsidiaries in Latin America and other developing areas was about $25 million in 1960, mainly originating in Swiss subsidiaries. In addition, Canadian subsidiaries of U.S. companies provided about $10 million to subsidiaries in developing countries. Flows of funds between associated companies in the same region were substantial. In 1960 there was a flow of $32 million between U.S. subsidiaries in different European countries. In the same year about $21 million of funds passed through U.S. subsidiaries in Panama to operating subsidiaries in other Latin American countries. All these figures relate only to subsidiaries of manufacturing companies. The total estimated direct-investment capital outflow from the United States to manufacturing affiliates in the developing countries in 1959 amounted to some $77 million. It will be seen, therefore, that transfers of funds among the foreign subsidiaries are a sizable part of total financing, and that transfers of funds from subsidiaries in the developed countries accounted for a substantial part of overall investment by U.S. companies in manufacturing in the developing countries. As well as the subsidiaries in Europe being a source of capital, European executives of the U.S. subsidiaries can also provide a special technical "know-how" and knowledge of the economic needs and circumstances of the developing countries.

Foreign subsidiaries are an additional source of earnings in the U.S. balance of payments in the form of royalties, license fees, technical and engineering fees, management fees, and other service fees paid back to the United States from the foreign subsidiaries. Of the total $165 million payments in 1960, over $70 million were from Europe, and $40 million from Canada. A further $25 million were paid to the United States as fees and payments for service on business developed abroad by the foreign subsidiaries.

With regard to foreign earnings repatriated to the United States, Mr. Douglas Dillon in his submission to the Committee on Ways and Means presented a chart which sought to show the relative effects of the present tax provisions, and the proposed changes, on the cumulative remittances to the United States from net earnings of a hypothetical foreign subsidiary. For the first 17 of the 20 years covered by the model the cumulative remittances to the United States would be greater with the elimination of the tax deferral than with the maintenance of the present system of tax deferral. Two immediate observations may be made (1) even in the conditions assumed by the model cumulative remittances after the 17th year become greater with the system of tax deferral than without the tax deferral. Furthermore, if the projection is extended for another 10 years this difference becomes increasingly pronounced. At the end of the 30-year period total remittances would be 39.3 percent more with the tax deferral than without the tax deferral. This result occurs because of the important fact that the deferral of tax permits more earnings to be reinvested which increases earnings and hence remittances. (2) The model is an abstraction which has no historical context. The model is presented as if we were at the beginning of the 20-year period covered, that is there is the beguiling prospect that over the next 17 years the elimination of tax deferral would produce greater revenue, despite the change which would then take place. But how do we know that we are in the first phase of events typified by the model? What if we are actually in year 16 or 17, that is, in the conditions where, as a result of past reinvestments undiminished by full taxation of current profits, cumulative remittances will begin to increase rapidly? Such an evolution is characterized by U.S. investment in the United Kingdom. The theoretical model advanced by Mr. Dillon is of definite interest but its relevance to historical facts is not proved and is very probably not provable. Hence its value in relation to formation of tax policy is dubious.

The more pragmatic data advanced by the Secretary of the Treasury may be used as much in defense of the maintenance of the present tax provisions as a basis for making the proposed changes. Mr. Dillon reported that, "Earnings

from these subsidiaries (Western European) in the same period (4 years, 1957–60) were $2.4 billion, of which $1.1 billion were reinvested abroad and $1.3 billion were remitted to the United States in dividends." [2] Even when we include the data for Canada (earnings $2.4 billion, with $1.3 billion reinvested and $1.1 billion remitted in dividends) of the total earnings of U.S. subsidiaries in Western Europe and Canada during the years 1956–60 of $4.8 billion some $2.4 billion were remitted to the United States as dividends. This compares exactly with the general policies of domestic U.S. corporations of reinvesting 50 percent of earnings and distributing 50 percent. Certainly here is no basis for claiming that the deferral of tax is causing unnecessary retention of earnings in tax havens in other countries.

Several details need to be immediately noted about these data. The situation indicated is not completely typical of the years 1946–60 because in the year 1957 U.S. direct investment abroad was at an all-time maximum. Indeed, only in 1957 did the net capital outflow ($2,482 million) exceed the net remittance of investment income from abroad ($2,249 million). However, in every other year of the 1946–60 period remittances of income exceeded the net U.S. capital outflow. For the period as a whole, total remittance of direct investment income amounted to $24 billion, while the net capital outflow totaled $15.1 billion.

Regrettably, comparable data for the United Kingdom are not available, but it is very questionable whether the foreign subsidiaries of British companies remitted to the United Kingdom 50 percent of their earnings during any period since 1946.

The easing of the balance-of-payments position is a major reason advanced for imposing a full tax annually on foreign earnings, yet in terms of the balance of payments a sharp distinction must be drawn between the repatriation of tax dollars and the repatriation of earnings. If the annual tax is imposed increased revenue may accrue to the U.S. Treasury. (This aspect is discussed in detail below.) However, even allowing for the most generous concept of the annual amount of tax revenue which would be obtained this will only be a fraction of the total earnings of foreign subsidiaries after payment of foreign taxes. It is quite possible, as suggested by the British experience, that if the general tax environment in the United States is not congenial American businessmen will be stimulated to keep as much as possible of their foreign earnings abroad. Accordingly, if businessmen are discouraged from remitting income to the United States the flow of earnings in the balance of payments would decline even though there were an increase in tax revenue. The key issue is the remitting of income, not the remitting of tax dollars, so that the vital need is to preserve a congenial tax environment which encourages the maximum repatriation of earnings, not just the maximum repatriation of taxes on the earnings. Given the right tax environment businessmen are inclined to transfer funds not particularly for dividend payments to shareholders but for investment purposes. Thus, the possible repatriation of earnings is to a large extent an economic question of profit expectations in the United States (or other countries to which the funds could be subsequently redirected) versus profit expectations in the country in which the subsidiary is operating.

This economic consideration is clearly shown by (*a*) the declines of reinvested earnings of U.S. businesses in the United Kingdom and the increases in direct investment in Continental Europe; (*b*) the large proportion of U.S. earnings retained for reinvestment in Canada (a policy which inevitably may be expected to change). Alternatively, a parent company will draw earnings from subsidiaries for its expenditures on product improvement or innovation, research, etc., which are expected to result in benefits for all the companies in the business organization.

In conclusion, the real improvement to a balance-of-payments position by means of increasing inflows of funds is the creation of the right domestic economic environment plus a tax policy which facilities the repatriation of funds.

Tax receipts.—The references of Mr. Douglas Dillon to the expected effects on revenue of the proposed tax changes are of special interest to the content of this study. A special object of criticism was the action of American companies in establishing holding corporations in Switzerland. As is generally known, a Swiss holding corporation can be used to coordinate the business operations of a number of manufacturing subsidiaries in other European countries. A common practice is that subsidiaries will be located in different countries according

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[2] Statement by Hon. Douglas Dillon, Secretary of the Treasury, before the Committee on Ways and Means, May 3, 1961, p. 27.

to transportation, production, or other advantages. Title to the goods produced is then transferred to the United States-owned Swiss parent company which arranges the actual sales and derives perhaps half the total profits for this participation. This procedure, and especially the transferring of a large part of the total realized profits to the Swiss holding corporation, appreciably reduces the tax liability of the business group because the Swiss Federal tax rate is only 8 percent and substantial tax concessions may be granted by the cantons. The proposal to tax fully the annual profits of subsidiaries is specifically aimed against this alleged tax avoidance through the use of tax havens.

The interesting question which must now be asked is, What country (or countries) is losing tax revenue as a result of this type of international corporate structure which utilizes the different tax features of the separate countries concerned? Alternatively, against what country (or countries) is the alleged tax avoidance taking place? The inevitable answer to either or both questions is that it is the European countries in which the manufacturing is taking place. Their tax revenues on the operations of the U.S. subsidiaries are being reduced as a result of the sales arrangement through the holding corporation. If there is any basis for complaint against the use of Swiss holding corporations it is by the other European countries. If the holding company arrangement were terminated, or the prices at which products are sold to the holding company were increased, the principal tax beneficiaries would be the European countries in which the manufacturing is taking place. This fact that income is being taken out of the tax sovereignty of the country in which manufacturing is taking place and transferred to Switzerland where it is taxed at low rates explicitly emerges from the type of illustration which Mr. Dillon advanced to the Committee on Ways and Means. "If $100 of income of a German subsidiary can be segmented so that $50 is attributed to the entity in Germany and $50 attributed to a selling entity in Switzerland, half the profit would be subject to the 51-percent German tax rate, but the other half would be subject to a Swiss national tax of only 8 percent." [8]

The references to rates of tax justify further consideration. In the examples designed to show how much tax revenue would result from the proposed tax changes foreign tax rates of 20 or 30 percent are assumed. Yet, in the economically advanced countries which would be made ineligible for the tax deferral the tax rates are generally much higher and are usually comparable to the United States. The rate of tax to which U.S. subsidiaries are subject in Europe is only 30 percent because of the effect of the low Swiss rate of tax. If action is taken by European governments against the holding corporation arrangement, and such action is not impossible (note the actions of the Belgium tax authorities and the discussions on this matter in the Netherlands Parliament), the effective tax rate to which U.S. subsidiaries would be subject would be substantially increased. The net result of such a development and the operation of the foreign tax credit is that even if the two main tax proposals under discussion (elimination of tax deferral and the recomputation of the foreign tax credit) are put into operation there would be very little increase in the amounts of tax revenue accruing to the United States. This is shown in the following example, the first two columns of which are simply reproduced from the presentation made before the Committee on Ways and Means. Columns 3 and 4 are based on the example of a U.S.-owned subsidiary whose earnings are subject to a European rate of tax at the source of the income, equal to the normal U.S. tax rate (52 percent).

Computation of foreign tax credit for dividends from foreign subsidiary

	Present law (1)	Proposal (2)	Present law (3)	Proposal (4)
Profits of subsidiary	$100.00	$100	$100 00	$100
Foreign tax	30 00	30	52.00	52
Dividend to U.S. parent	70.00	70	48.00	48
Plus "grossup" of foreign taxes		30		52
Tentative U.S. tax at 52 percent	36.40	52	24.96	52
Credit for foreign taxes paid by subsidiary	21.00	30	24.96	52
Net U.S. tax	15.40	22	0	0
Combined foreign and U.S. tax	45.40	52	52.00	52

[8] Ibid., p. 25.

The current tax proposals before Congress will only result in any significant increase in tax revenues if the United States is able to extend its tax sovereignty over profits which are not being fully taxed by the European countries in which the profits are being created. The real issue is the relative tax claims of the United States and the European countries and whether these rival tax claims are complementary or not. If the tax proposals are enacted and the European countries continue to accept the siphoning off of profits through Swiss holding companies, then there is a basis for Mr. Dillon's claim that increased tax revenues will result. On the other hand, if the European countries exercise their prior legal claim to tax fully all business operations within their jurisdiction, and hence the profits which can be attributed to the Swiss holding companies are appreciably reduced, no great increases in tax revenue will emerge from any changes made in the U.S. tax laws. On the contrary, it is possible that U.S. tax revenues would actually decline in relative terms because the U.S. owned Swiss holding corporations would have less earnings to repatriate to the United States, as a result of more taxes being enacted by the European countries.

Despite the high moral tones in which the use of Swiss holding companies is criticized, the officials responsible for the current tax proposals are not really concerned with eliminating the tax havens as such. Rather, their concern is to obtain a share of the profits realized by the use of the holding company arrangement. Whether any increases in tax revenue would actually occur is not at all certain.

The tax discrimination between the economically advanced and the less developed countries is completely contrary to tax equity, a concept much evoked by the writers of the submissions to Congress.

GENERAL COMMENTS

As general comments on the tax proposals before Congress, they show an over-concern with immediate conditions, with superficial events and situations. There is an accompanying lack of effective regard for basic elements and longrun trends and considerations.

It is difficult to reconcile the United States' sponsoring of and membership in the Organization for Economic Cooperation and Development with the unilateral action against U.S.-owned Swiss holding companies. This is clearly a matter for discussion between the United States and all the European countries concerned under the auspices of the new international organization. References to the transmitting of profits to the holding corporations quite ignore the extent of both the direct and indirect benefits which are accruing to the developing countries as a result of the international operations of the Swiss financial institutions.

The fundamental ideas and issues involved in the present provisions of the Internal Revenue Code, and the proposed changes in the provisions, are really the same as those with which we are concerned in this study. Specifically, these are—

1. (*a*) The determination of the respective tax sovereignties of different countries.

(*b*) The relationships between these different tax sovereignties.

2. The effects of the actions of one government which, whether it is realized or not, intrude into the tax jurisdiction of another country.

3. The right of a government to tax or not to tax freely and effectively as it wishes without the intent being frustrated by the unilateral action of another government.

NORTH AMERICA AND EUROPE

In the opinion of this writer the suggestion that U.S.-owned foreign subsidiaries be subject to U.S. income tax in the year that profits are made is based on false premises and incorrect logic. It assumes that the U.S. foreign subsidiaries are avoiding U.S. taxes, whereas if any tax avoidance is taking place it is in the European (or other) countries in which the companies carry on their normal business operations. If enacted into law (altogether uncertain because of the highly controversial nature of the subject) the annual taxing of foreign subsidiaries will only produce more revenue for the United States if the European countries do not impose higher effective taxes on the U.S.-owned subsidiaries. If the European countries impose regulations on the U.S.-owned subsidiaries requiring them to compute their profits in the same manner as domestic com-

panies the proposed new method of taxing the subsidiaries will produce little or no revenue for the U.S. Treasury. This is because on the whole the rates of income taxes charged by the European countries are comparable to the U.S. rate of tax, and the effect of the tax credit system would be then to neutralize the U.S. tax liability.

As can be concluded for similar reasons, the use of "tax havens" does not in itself mean that the "tax havens" are a source of tax avoidance. The availability of so-called tax havens may simply accommodate and make possible the coordination of tax avoidance which is actually taking place in other countries. The Swiss tax havens are only meaningful for the U.S. companies which utilize them because the governments of other European countries (to date and with some exceptions, e.g., Belgium) have condoned the "siphoning off" of profits from business operations in their countries to the Swiss holding companies. If real business profits were subject to high taxes in the different European countries the Swiss holding companies would have no tax value to the U.S. business organizations. It is the exercising of the tax sovereignties of the European countries involved which is really the key issue. These countries may not wish to exercise their tax sovereignties fully for political or economic reasons. Under these circumstances, the annual taxing of U.S.-owned foreign subsidiaries in Europe would produce tax revenue for the U.S. Treasury, but this would occur not because tax "leakages" in the present U.S. tax laws would be sealed off but because the European countries continued to refrain from exacting their full tax claims. Alternatively, and of considerable importance, to the extent that European countries provide special forms of tax reliefs in order to create a congenial environment for U.S. investment, the annual taxing of U.S.-owned foreign subsidiaries would "frustrate" this intent on the part of the European countries.

SUMMARY

1. The proposals on the taxation of foreign income assume that if less capital is invested in other countries that this capital would instead be invested in the United States. A further assumption is that there has been competition between the United States and Europe for the available capital resources of U.S. companies and their associated subsidiaries, that if more funds had been available for domestic investment this investment would have taken place. Both assumptions are highly questionable.

2. The tax message to Congress refers to companies which may retain earnings abroad to avoid tax, but urges tax changes which would apply to all companies, including companies which have every economic justification for retaining earnings abroad.

In effect, the proposals infer, but do not explicitly allege, that all U.S. companies operating through subsidiaries in the developed countries do so primarily for tax advantages.

3. A sharp distinction must be made between the remitting of tax dollars and the remitting of income. The assumption seems to be made that any remittance of tax dollars would be in addition to the amounts of income which have been typically remitted. It must be immediately noted, that, all other factors remaining the same, the payment of higher taxes would in itself automatically reduce the amount of income which could be remitted to the United States. There are other aspects; taxpayments to the United States may simply replace repatriated income so that there is no net increase of foreign earnings to the U.S. economy. There could be an actual decrease of foreign earnings if (*a*) the repatriation of income is significantly discouraged; or (*b*) there are no economic incentives for U.S. companies to repatriate income, but instead economic factors stimulate the retention of earnings abroad.

4. After-tax earnings of U.S. companies abroad (of which, on the average, 50 percent have been repatriated to the United States) are increased by the use of "tax havens."

5. Basically, whether the tax proposals would create any additional tax revenues would depend not on the unilateral action of the United States, but on the actions of the European countries in which the U.S. companies conduct their manufacturing operations. If the European countries decided to exercise their prior legal claim to tax fully all business operations within their jurisdiction, and hence the profits which can be attributed to the Swiss holding companies are appreciably reduced, no great increases in tax revenues will emerge from any changes made in the U.S. tax laws. On the contrary, it is possible that U.S. tax revenues would actually decline in relative terms because the U.S.-owned

Swiss holding corporations would have less earnings to repatriate to the United States, as a result of more taxes being enacted by the European countries.

CONCLUSION

The real improvement to a balance-of-payments position by means of increasing flows of funds is the creation of the right domestic economic environment plus a tax policy which facilitates the repatriation of earnings.

THE AMERICAN BANKERS ASSOCIATION,
Washington, D.C., May 3, 1962.

Hon. HARRY F. BYRD,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: You will recall that in connection with the testimony of a banker who stated that he supported the proposed withholding of Federal income taxes on interest and dividends you raised the question as to how many banks shared this view.

In light of this exchange and to test our belief that the testimony of the American Bankers Association on withholding represents the views of the overwhelming majority of bankers, I thought it would be helpful to ascertain the position of the various State bankers associations.

In response to my inquiry as to any resolutions adopted by each State association, I have obtained responses from 39 States, all indicating that the banks in their States were firmly opposed to the use of withholding as the method for tax collection on interest and dividend payments.

I am enclosing a report of the responses received from these States for inclusion in the record of your hearings if you consider it appropriate to do so.

Sincerely yours,

CHARLES R. MCNEILL.

1. Arkansas

"Undoubtedly a resolution will be adopted at our 1962 convention in May, positively and definitely expressing objection to this provision of H.R. 10650. This subject has been discussed by Arkansas bankers in many meetings during the past several months, and without exception they express their displeasure and opposition. It is my opinion that every banker in Arkansas is opposed to such withholding."—Jeff Burnett, Secretary, Arkansas Bankers Association.

2. California

The officers and a delegation of the California Bankers Association on a visit to Washington in April 1962 expressed unanimous opposition to withholding.

3. Colorado

The executive council of the Colorado Bankers Association has expressed its opposition to withholding on interest and dividends and its support of the stand taken by the Federal legislative committee of the American Bankers Association against such legislation.

4. Connecticut

The following resolution was adopted at the Connecticut Bankers Association annual meeting on June 10, 1961:

"The Connecticut Bankers Association endorses the statement and conclusions of the American Bankers Association in regard to the proposed mandatory withholding of taxes on interest and dividends as presented to the House Ways and Means Committee on May 26, 1961, by Mr. G. Edward Cooper."

5. Florida

The following resolution was passed at the annual convention of the Florida Bankers Association on March 24, 1962:

"We recognize the responsibility of all citizens to pay the income taxes due by them to the Federal Government, and to report taxable dividends and interest on their Federal income tax returns. The association has cooperated and will continue to cooperate fully in programs designed to inform all depositors and stockholders of their obligation and responsibilities as taxpayers with respect to dividend and interest receipts.

"A practicable and workable withholding system has not yet been devised. The proposals so far advanced would contribute to confusion and irritation on the part of taxpayers; would impose unreasonable hardship and inequity upon charitable, educational, and other tax-exempt organizations; would be unduly burdensome and costly to banks and other payers of dividends and interest; would confront the Treasury with a costly system of refunds to literally millions of taxpayers—all of which would greatly reduce the net yield to the Treasury.

"Present legislation before the Congress is not the answer. All banks are urged to protect this wholly improper proposal through their duly elected representatives in the Congress."

6. Georgia

The opposition of the Georgia Bankers Association to withdrawing on interest and dividends was spelled out in detail in the statement submitted on behalf of the association to the Senate Finance Committee on R.H. 10650 by Frank P. Lindsey, Jr.

7. Hawaii

The Executive Committee of the Hawaii Bankers Association passed the following resolution at a meeting held on April 13, 1962:

"*Resolved*, That the Hawaii Bankers Association opposes the enactment of House Resolution 10650, the tax revision bill of 1962, with respect to adoption of provisions concerning withholding of tax in interest and dividends; and

"*Resolved further*, That the Hawaii Bankers Association endorse the statements and recommendations in this regard as made before appropriate committees of the Senate and House of Representatives by the representatives of the American Bankers Association."

8. Illinois

"The Illinois Bankers Association, by vote of the executive committee, fully endorses the testimony given by Joseph C. Welman, April 11. It is our opinion this testimony expresses the conclusions of the banking industry in the best possible manner"—Jacob W. Myers, president, Roland W. Blaha, executive vice president, Illinois Bankers Associationfl

9. Indiana

"Many Indiana bankers are opposed to withholding, but Indiana Bankers Association has not adopted any [formal] resolutions. Blaine H. Wiseman, Corydon, spoke for Indiana bankers when he appeared before the House Ways and Means Committee on May 26, 1961, opposing withholding."—Don E. Warrick, executive manager, Indiana Bankers Association.

10. Iowa

"Our committee on Federal legislation and our association officers and Iowa bankers in general are very much opposed to the withholding of dividends and interest provision as contained in H.R. 10650, the Revenue Act of 1962."—Frank Warner, secretary, Iowa Bankers Association.

11. Kansas

"Kansas Bankers Association opposes provision in tax revision bill for mandatory withholding on interest and dividends."—Henry G. Blanchard, chairman, Committee on Federal Legislation, Kansas Bankers Association.

12. Louisiana

"The Louisiana Bankers Association and its membership has expressed itself as being opposed to section 19 of H.R. 10650 regarding withholding tax on dividend and interest income."—R. Irby Didier, executive vice president, Louisiana Bankers Association.

13. Maine

By vote of their executive committee, the Maine Bankers Association has gone on record in opposition to withholding on interest and dividends.

14. Maryland

The Maryland Bankers Association has not adopted a formal resolution on the withholding question up to the present time. However, a folder outlining some of the reasons why such legislation should be opposed was prepared for member banks to distribute to their depositors, and says, in part:

"Because of the adverse impact we foresee upon our economy and our citizens, we believe every effort should be made to protest and defeat this withholding tax proposal."

15. Massachusetts

In March of this year the officers and a delegation from the Massachusetts Bankers Association stated that their banks were almost without exception opposed to the withholding proposal.

16. Michigan

The following resolution was adopted by the Michigan Bankers Association at its annual convention in June 1961:

"This association further resolves that it is opposed to any change in our Internal Revenue Act which would authorize the withholding of Income tax on dividends and the withholding of income tax on interest paid by financial institutions. This association opposes this proposed change, not only on the total volume of paperwork that would be burdensome to our corporations and our financial institutions, and the confusion and needless work that would be involved by our taxpayers in obtaining refunds, etc.; but also, more importantly, we oppose this proposed change on the ground that it is substracting from the individual liberties of our citizens and moving more rapidly toward the goal of socialism if not dictatorship. We urge our members to communcate with their Congressman, with their Senators and with the House Ways and Means Committee, setting forth their views as opposed to the withholding of taxes on dividends and interest paid."

17. Minnesota

On June 7, 1961, the Minnesota Bankers Association adopted the following resolution:

"Whereas it has been suggested that Congress should enact legislation providing that, among other things, banks shall withhold a percent of interest paid to depositors to insure payment of the tax on this interest income; and

"Whereas bankers agree that taxpayers should pay this tax; and

"Whereas withholding of dividends and interest would create a great burden of work on financial institutions and would be an extremely expensive operation for our Government because of the refunds and all of the cumbersome bookkeeping: Therefore, be it

"*Resolved*, That the matter of payment of tax on dividends and interest be taken care of through voluntary payments by the individual taxpayer and that all banks be urged to redouble their efforts to inform the public that income from interest and dividends is taxable and must be included in tax returns, both State and Federal."

18. Mississippi

The resolution relating to withholding of tax on interest and dividends adopted by the Mississippi Bankers Association on May 24, 1961, stated, in part:

"*Now, therefore, be it resolved*, That this association, formally convened in its annual convention, record with each Member of the U.S. Senate and the House of Representatives from the State of Mississippi, the association's opposition to legislation proposed which would impose upon its members the burdensome duty of withholding of taxes on interest and dividends."

19. Missouri

A formal resolution expressing opposition to withholding is expected to be adopted at the convention of the Missouri Bankers Association on May 15.

20. Montana

At its 1961 convention, the Montana Bankers Association adopted the following resolution, expressing its opposition to withholding.

"Whereas it has been brought to our attention that there is being considered national legislation to require banks to withhold taxes on savings and other interest; and

Whereas it is believed that this would place an undue burden on the public and the banks for the overall net results to the Federal Government: Now, therefore, be it

"*Resolved*, That this association go on record as opposing this legislation and a copy of this resolution be sent to the Montana representatives in Washington, D.C., and to the American Bankers Association."

"The sense of a called meeting of the legislative committee, officers, and other interested members of the Montana Bankers Association held at Great Falls, Mont., March 30, 1962, was in opposition to the withholding provisions of H.R. 10650, Internal Revenue Act amendments, principally on the basis that the system is impractical, unworkable, irritating and also costly to dividend and interest payers without assurance of desired resulting increases in tax collections which could come from further educational programs and increased enforcement efforts * * *."—R. C. Wallace, secretary-treasurer, Montana Bankers Association.

21. Nebraska

A representative of the Executive Council of the Nebraska Bankers Association presented a statement to the Senate Finance Committee on April 11, 1962, outlining in detail the association's opposition to withholding.

22. New Hampshire

"I am confident that individual member banks are virtually unanimously opposed to withholding."—Glenn W. Merrill, president, New Hampshire Bankers Association.

23. New Jersey

The Executive Committee of the New Jersey Bankers Association, on June 8, 1961, "voted to oppose the withholding of taxes on interest and dividends as proposed by President Kennedy and the Treasury Department;" and since that time members of the association have been urged to continue to express their opposition in letters to their Congressmen.

24. New York

The Committee on Interest-Dividend Withholding of the New York State Bankers Association issued a policy statement on July 28, 1961, expressing the association's opposition to withholding and outlining the reasons for this stand.

25. North Dakota

A resolution stating the association's opposition to withholding on interest and dividends was adopted by the North Dakota Bankers Association at its 1961 convention.

26. Oklahoma

The Executive Council of the Oklahoma Bankers Association adopted the following resolution on April 12, 1962:

"We believe that all businesses should bear their fair share of the present heavy tax burden. We support the tax uniformity provisions of H.R. 10650, the tax revision bill of 1962, which recently passed the House of Representatives and is now being considered in the Senate, as being a step toward correcting presently existing tax inequality. We are opposed to the provisions of this bill pertaining to the withholding on dividends and interest as being impractical and unworkable in its present form. We urge that the withholding provisions be deleted or substantially modified by the Senate to a more workable formula."

27. Oregon

The association has not had an opportunity to pass upon this subject [withholding] but it is known that the member banks are opposed to it.

28. Pennsylvania

The following resolution opposing Federal withholding on interest was adopted by the Pennsylvania Bankers Association at its convention on May 22, 1961:

"Whereas Secretary of the Treasury Douglas Dillon has recommended that legislation should be introduced in Congress to provide for withholding of taxes on interest and dividends, which would be applied to interest paid on deposits in banks, dividends paid by domestic corporations, dividends paid on savings in savings and loan associations, and interest paid on U.S. Government and corporate securities, other than short-term discount obligations; and

"Whereas Secretary Dillon has recommended that this withholding be done on a flat-rate basis of 20 percent without any exemptions for individuals and tax-exempt organizations not subject to Federal income tax; and

"Whereas nontaxable individuals would be obliged to make a claim against the Government to receive the 20 percent of interest and dividends arbitrarily withheld from their income; and

"Whereas this withholding provision would impose a burdensome duty upon elderly persons, minors, and others who now are not required to pay any income tax to the Government, would be highly discriminatory to these groups, in that their lack of understanding of the refund provisions would mean that millions of dollars of refunds to which they are legally entitled might never be received; and, even if received, would lose the important benefit of the compounding of interest upon these withheld funds: and

"Whereas the withholding and refunding procedures of the Federal Government in handling thousands of accounts which are not in fact taxable would cost the Government substantial amounts in operating procedures, in addition to imposing an additional tax-collecting duty on banks, corporations, and others who are already providing multiple services to the Government without adequate reimbursement for these services: Now, therefore, be it

"*Resolved*, That the Pennsylvania Bankers Association, in convention assembled, opposes the proposed plans for the withholding of taxes on interest and dividends, and directs that a copy of this resolution be sent to the Secretary of the Treasury and to each Member of the United States Senate and the House of Representatives from the Commonwealth of Pennsylvania."

29. Rhode Island

"The members of our association are in full accord with the endeavor of the Treasury to obtain full payment of all taxes due.

"We are, however, very much concerned with the proposal that banks be required to withhold taxes on interest and dividends.

"We submit that such a law would impose a serious, time consuming, and costly workload upon the banks * * *.

"While we fully appreciate that the proposed law is an honest attempt on the part of our Government to obtain additional taxes rightfully due, we do feel that other methods should be considered to accomplish this objective particularly in view of the undue hardship imposed upon literally millions of small savers and investors."—Gilman Angier, president, Rhode Island Bankers Association.

30. South Carolina

The 1961 convention of the South Carolina Bankers Association adopted the following resolution:

"Whereas there is now legislation in the U.S. Congress for withholding taxes on payments of interest and dividends at the source; to abolish the $50 dividend exclusion as well as the 4 percent dividend credit; and

"Whereas the President of the United States and the Secretary of the Treasury are urging the enactment of such legislation; and

"Whereas the passing of such a law will create a tremendous burden on business and industry in addition to creating much misunderstanding by the public; and

"Whereas business and industry are already reporting payments of interest of $600 or more and payments of dividends of $10 or more to the Internal Revenue Service; and

"Whereas it is felt that the Internal Revenue Service should use the information to collect the taxes due the Treasury Department: Now, therefore, be it

Resolved, That the members of the South Carolina Bankers Association express opposition to this proposal; and be it further

"*Resolved*, That copies of this resolution be sent to the congressional committees now considering the proposal, to our two Senators and Members of Congress from South Carolina."

31. South Dakota

The South Dakota Bankers Association, at its State convention on May 12, 1961, adopted the following resolution stating its opposition to withholding.

"Whereas the South Dakota Bankers Association believes that the proposed legislation in Washington as to a withholding tax on interest and dividends is ill advised.

"*Be it resolved*, That the executive secretary of the South Dakota Bankers Association is hereby instructed to notify our Senators and Congressmen in Washington that the South Dakota Bankers Association is opposed to any congressional action which would make it necessary for banks to withhold tax on interest or dividends."

32. Tennessee

The following resolution was passed by the 1961 convention of the Tennessee Bankers Association.

"Whereas, the Congress of the United States is now considering the imposition of a flat 20-percent withholding tax on interest and dividends; and

"Whereas this tax will apply to hundreds of thousands of customers' savings accounts in commercial banks in Tennessee as well as dividends paid to stockholders of said banks in Tennessee; and

"Whereas the imposition of this tax, at the source, will result in a very significant increase in the cost of the payment of interest and dividends; and

"Whereas the withholding of this tax on a great number of individuals will result in undue hardships, because of the necessities of requesting refunds, and

"Whereas the delay in these payments will tend to discourage thrift which is so vital to these individuals and to the economy, and

"Whereas the commercial banks of Tennessee cooperated with request of the U.S. Treasury Department in reminding the recipients of interest and dividends to report these payments in filing their income tax returns by mailing hundreds of thousands of notices to this effect: Now, therefore, be it

"*Resolved*, That the Tennessee Bankers Association formally oppose any legislation to this effect and send a copy of this resolution to each member of the U.S. Senate and the House of Representatives from the State of Tennessee."

Enacted this 10th day of May, 1961.

33. Utah

Although no formal resolution has yet been adopted by the Utah Bankers Association with respect to withholding, a recent informal survey of the membership of the association officers indicates opposition to such legislation.

34. Vermont

At the midwinter meeting of the Vermont Bankers Association, on February 8, 1962, the following resolution was adopted unanimously.

"*Be it resolved*, That this association go on record as opposed to legislation now pending before the Federal Congress providing for the withholding of taxes on dividends and interest."

35. Virginia

The executive committee of the Virginia Bankers Association has expressed the association's opposition to withholding in the following statement:

"We recognize the importance of all taxpayers paying their just taxes including tax on dividends and interest. However, we would hope the Director of Internal Revenue, through the use of modern data processing equipment, could effectively reduce the loss in tax revenue from unreported dividends and interest without the necessity of resorting to a withholding tax. Such a tax would impose a tremendous burden on financial institutions and would result in hardships to taxpayers in many cases."

36. Washington

The executive committee of the Corporate Trustees Association of Washington at its April 13, 1962, meeting approved the following resolution:

"Whereas it has come to the attention of the committee that the bill presently before the Congress dealing with proposed tax revisions for 1962 contemplates the withholding of interest and dividends by the payors thereof to the extent of 20 percent of such amount as would ordinarily be paid, and

"Whereas it is recognized that individuals may file with payors a form of exemption certificate and thus not subject themselves to such withholding procedures,

"It is nevertheless the unanimous view of this committee that any such suggested form of tax collection would result in a more costly administration to our Government and would work undue and unnecessary hardship upon payors and payees alike, as well as causing costly and burdensome procedures to be followed, the full extend of which cannot presently be analyzed.

"*It is, therefore, resolved*, That this association record with the Congress its objection to the suggested form of tax collection and recommend that same be deleted from the tax revision bill now pending and under consideration."

37. West Virginia

On July 22, 1961, the West Virginia Bankers Association adopted the following resolution:

"Whereas, there is pending in the House of Representatives a bill providing for the withholding of 20 percent of all dividends paid by banks and other institutions, and also a like portion of all interest payments made by them, and the payment thereof into the Treasury of the United States, and

"Whereas this action would subject banking institutions, and especially their trust departments, to a great amount of detail work and expense without any reimbursement therefor, and

"Whereas very many persons of small incomes would be handicapped in reciving that income and would be subjected to the necessity of asking the Treasury Department to repay it to them, with attendant delay and inconvenience: Now, therefore, be it

"*Resolved*, That this association record herein their unalterable opposition to any such arrangement, and that their views be expressed to each Senator and Representative from the State of West Virginia by the certification of this resolution by our executive director."

38. Wisconsin

"The Wisconsin Bankers Association has gone on record concurring in and supporting the position of the American Bankers Association in connection with bill No. H.R. 10650 on withholding."—GEORGE FORSTER, *Executive Director and Secretary, Wisconsin Bankers Association.*

39. Wyoming

"At a meeting of the executive council of the Wyoming Bankers Association on February 26, 1962, the proposed withholding on dividend and interest income, as included in the tax bill being prepared by the Ways and Means Committee, was reviewed and discussed. It was the consensus of the council that tax withholding would be impractical for banks and taxpayers, both on a basis for reporting and for banks in particular, costwise. It was the opinion of the committee that all taxable income should be reported and paid; however, that the existing efforts to educate the public in this connection had not been in effect long enough to determine its value.

"The council was unanimous in opposing the withholding portion of the proposed tax bill as outlined."—D. D. GIDDINGS, *Secretary, Wyoming Bankers Association.*

CULBERTSON, PENDLETON & PENDLETON,
Washington, D.C., May 4, 1962.

Re resolution of the Board of Supervisors of Contra Costa County, Calif.

Senator HARRY F. BYRD,
Chairman, Senate Finance Committee,
Washington, D.C.

DEAR SENATOR: As representatives of the County Supervisors Association of California, we have been requested to have incorporated in the records of your present hearings on the Revenue Act of 1962, the enclosed resolution. The resolution was adopted by the Board of Supervisors of Contra Costa County, Calif. In substance the resolution favors a change in the proposed withholding legislation so that public employee retirement systems are exempted from the withholding processes and are permitted to obtain full payment of dividends and interest on corporation securities on regular due dates.

Whereas it is the understanding of this board that there is now pending before the Congress of the United States action relating to the withholding of dividends and interest on corporation securities at the source of payment, and,

Whereas such withholding will result in a loss of income to public employee retirement systems in the period during which the withholding is effective and refunds are obtained, and

Whereas such employee retirement systems would be put to the administrative expense involved in claiming refunds: Now, therefore, be it

Resolved, That this board of supervisors go on record as favoring a change in the proposed withholding legislation such that public employee retirement sys-

tems are exempted from the withholding processes and are permitted to obtain full payment of dividends and interest on corporation securities on regular due dates * * *.

We appreciate very much your cooperation in putting this resolution on record and also hope that you will be able to change the proposed withholding legislation to achieve the desired exemptions.

Very truly yours,

JOHN R. MINOR.

MEMORANDUM SUBMITTED BY AUGUSTUS W. KELLEY, IN BEHALF OF THE PROPRIETARY ASSOCIATION, WASHINGTON, D.C., SUPPLEMENTING HIS ORAL TESTIMONY PRESENTED ON APRIL 4, 1962, WHICH APPEARS ON PAGES 747-751 IN PART 2 OF PRINTED HEARINGS ON THIS BILL

On April 4, 1962, the Proprietary Association through the chairman of its tax committee appeared before the Committee on Finance of the U.S. Senate to present its views on section 2 (the 7 percent investment credit) and section 13 (dealing with taxation of controlled foreign corporations). At that time permission was requested to submit a more detailed technical written statement on those sections of the bill with the association is primarily concerned.

Set forth hereinafter is a summary explanation by section of our views followed thereafter by a more detailed explanation.

Section 2. The investment credit

We are opposed to the adoption of this provision for the reasons set forth in our oral statement of April 4, 1962.

Section 3. Lobbying expenses

We are in agreement with the stated purposes of this section but believe it should go further and permit a deduction for informing the public on legislative issues.

Section 4. Disallowance of certain entertainment expenses

We are opposed to the enactment of this section as we feel it is undesirable, to a large extent unnecessary and in part, unworkable.

Section 5. Distributions of property in kind by foreign corporations

We recommend the rejection of this provision because it will lead to extensive tax litigation and have a restricting influence on improvements in domestic manufacturing techniques.

Section 6. Amendment to section 482

We are not in agreement with this proposed amendment. We feel that section 482 as now drawn is adequate. Furthermore, the contemplated change would add a multitude of complexities to an already complex section of the code.

Section 11. "Gross-up"

This section should be rejected because:

(1) It creates inequities rather than having an equalizing effect.

(2) It will reduce rather than increase Federal revenues.

(3) It will increase domestic unemployment.

(4) It will tend to encourage concentration of foreign investments in developed rather than less developed countries.

Section 13. Controlled foreign corporations

We are opposed to the adoption of this section, primarily because we cannot agree with its underlying philosophy, and secondarily, because it will create more problems than it solves.

Section 14. Gain from disposition of depreciable personal property

We can agree to the provisions of this section only when coupled with realistic depreciation policy reforms. No detailed statement is therefore submitted on this section.

Section 16. Gains from certain sales or exchanges of stock in certain foreign corporations

This section in essence imposes a penalty tax on stockholders of legitimate foreign businesses. Furthermore, it is retroactive to 1913 in its effect. Therefore, we object strongly to the enactment of such a provision.

Section 19. Withholding on interest and dividends

Although there can be little doubt that this proposal will account for the payment of taxes that might not otherwise be collected, we submit that there is a more efficient and less burdensome means of insuring such collection.

Section 20. Information returns as to controlled foreign corporations

Our comments on this provision relate primarily to section 6046 of the Internal Revenue Code. We submit that information returns should not be required each time there is a change in the officers or directors of a controlled foreign corporation. We recommend that the section be limited to require no information returns of a U.S. citizen, resident or person with respect to a foreign controlled corporation except on formation of a newly created controlled foreign corporation.

Set forth hereinafter is a comprehensive discussion of the various sections in support of our views stated above.

Section 3. Lobbying expenses

We are in agreement with the underlying purpose behind the inclusion of this section within H.R. 10650.

There can be no doubt that the IRS regulation disallowing a deduction for amounts spent for the promotion or defeat of legislation either directly, or through another organization, represents a positive restriction on our rights to speak out and tell Congress and the people what we think.

Section 3, as written, does reinstate this basic right, but only insofar as our right to appear before and communicate with both legislators and legislative bodies. Our right to inform the public on legislative issues, no matter how crucial to our business security, still remains curtailed.

For this reason, we feel that section 3 does not go far enough. It cannot be disputed that legislators are influenced by public opinion, and that public support or disapproval of pending legislation plays an important role in congressional consideration thereof. Often, there are times when this may be the only way that a legislator will be aware that a particular legislative proposal warrants more of his attention than he might ordinarily give it. In addition, many legislative matters arise which the general public, as a whole, does not fully understand or appreciate. When this has occurred, the business community has felt an obligation to educate the public usually through their trade organizations, and in some cases, by general advertising to customers, as well as communications to stockholders and employees.

We would propose instead, S. 467, as sponsored by Senators Kerr and Hartke. This bill has the distinct advantage of simplicity and positive directness that is needed to countermand the present IRS regulations, without further complicating the job of the taxpayer or the agent. In addition, it will return to the taxpayer, all his rights of free speech both by petition to the Government and by communication to the public .

Section 4. Disallowance of certain entertainment expenses

Section 4 of the bill would impose restrictions on the deduction of travel and entertainment expenses for Federal income tax purposes. These may be summarized briefly as follows:

(1) Entertainment expenses, with certain exceptions, would be deductible only if the expenses were directly related to the active conduct of the trade or business.

(2) Where a facility was used in connection with such expenses of entertainment, etc., (including the use of social or sporting clubs) no deduction would be allowable unless the taxpayer established that the facility was used primarily for the furtherance of the taxpayer's trade or business.

(3) Business gifts would be limited to $25.

(4) Entertainment and traveling expenses would have to be substantiated in detail.

(5) Only a "reasonable allowance" would be deductible for meals and lodging.

In his testimony before the Finance Committee Secretary Dillon requested the further extension of these provisions to disallow in full the cost of business entertainment with even more strictly limited exceptions.

We believe these provisions are in part unworkable and are entirely or largely unnecessary as well as undesirable. Business management is the best judge of what promotional expenses will produce profits and any attempt to lay down

details and specific statutory rules to control such expenditures would react to the detriment of both business and Government. For example, to restrict entertainment expenses to those which can be shown to be "directly related to the active conduct of the taxpayer's trade or business" either adds nothing to the present statutory limitations on deductions, or if it does, may unnecessarily throttle legitimate business expenses. In any event, the addition of this language to the present statutory language will serve more to raise unnecessary controversies than to solve the Government's present problem.

For example, if a businessman entertains a prospective customer with the expectation of being able to do business with him but does not immediately succeed in developing an active business relationship, controversy may arise as to whether such entertainment is "directly related" to his business. Nevertheless it seems apparent that if such missionary work is discouraged, much business will be lost.

The existing statute provides in section 162 of the Internal Revenue Code that business expenses to be deductible shall be "ordinary and necessary." It is further provided in section 262 that "no deduction shall be allowed for personal, living or family expenses." These provisions have been in the Internal Revenue Code for many years. However, it is only in the last 2 or 3 years that the Internal Revenue Service has made a strong effort to prevent tax avoidance by the deduction of personal expenses under the guise of business expenses. This has been attempted by more stringent audit procedures and extensive publicity to the general taxpaying public of the proper rules for the deductions of business expenses. The regulations under section 162 have been considerably amplified and now provide clear rules for the allowance of travel, entertainment, and other business expenses. (See sec. 1.162–1 regarding business expenses in general; section 1.162–2 relating to traveling expenses; and sec. 1.162–17 which give in considerable detail the rules relating to reporting and substantiation of travel, entertainment, and other business expenses of employees).

These detailed rules have only been brought to the attention of many taxpayers within the last year or so, during which time, also, examining agents have devoted more attention to this matter. It is clear that this tightening-up program has resulted in more accurate returns being filed by taxpayers who were previously unacquainted with the requirements but it is also obvious that the benefit of this program is only now beginning to be felt in the returns now being reviewed by the Internal Revenue Service. Until the results of this new approach have been fully and properly assessed, it would be premature to call for any additional legislation in this field.

Of course, if in some instances business funds are being diverted to personal use or benefit, obviously a tax deduction should not be allowed for such expenditures. To the extent there may be actual cheating by some taxpayers in the area of travel and entertainment expense deductions, the Commissioner undoubtedly has a problem of thorough auditing and enforcement. It seems clear to us that it will never be possible to completely eliminate cheating as it is impossible to completely eliminate crime. However, we believe that existing laws and regulations provide the Internal Revenue Service with sufficient authority to prevent such diversion at Government expense. New laws are not the answer—proper auditing procedures are. It would appear to us that the existing law also contains sufficient authority for the Commissioner to require proper records to be kept of such business expenses in order to substantiate their deduction. If, however, the administration feels that some legislation is required to modify the effects of the Cohan rule and require reasonable recordkeeping, we have no objection thereto. Such a proviison would, it seems, require not more than one or two sentences to be added to the statute (if indeed any change is needed) and certainly no amendment as complicated and fraught with uncertainties and potential controversies as section 4 of H.R. 10650.

Section 5. Distribution of property in kind by foreign corporations

Section 5 provides that dividends in property (other than money) received by a domestic corporation from a foreign corporation will be taxed to the domestic corporation at the fair market value of the property. This method would apply even though under present law, which is not changed, similar property received as a dividend from a domestic corporation is taxed at the distributing corporation's basis when such basis is lower than the fair market value. This departure from present law in the case of property received from foreign corporations must be rejected because it will create extensive tax litigation and it will restrict improvements in domestic manufacturing techniques.

Tendency to create tax litigation.—In many instances, property distributed by a foreign subsidiary to its U.S. parent corporation is of a nature for which a fair market value is not readily determinable although the value is clearly in excess of cost. Where such distributions are in the nature of intangible assets, such as secret processes, it is often impossible to obtain independent appraisals of such assets without disclosing valuable information to unrelated parties. Under such circumstances, enactment of the proposed legislation would place on the payee of such a dividend the burden of placing an equitable value on the property received.

Lacking the benefit of valuations derived from the marketplace or from outside appraisers a taxpayer is subject to the whim of an examining agent who might use the benefit of hindsight in assessing tax on property dividends. Such assessments tend to increase the possibility of tax litigation which is costly to the Government and the taxpayer. It is submitted that legislation which creates such a tendency for litigation must be rejected.

Restrictions of improvements in domestic manufacturing techniques.—One form of dividends of property which has been flowing to domestic corporations from foreign subsidiaries has been intangible dividends in the form of technical aid, secret processes and similar improvements. This flow has helped domestic corporations to improve their manufacturing techniques thereby reduce operating costs and creating profits for the good of the American economy. Taxation of such property, which generally has little or no cost basis, at its fair market value would result in an undue burden on domestic taxpayer. In addition, the tendency to create tax litigation, described above, would overshadow such transactions.

Lacking the funds to make outright purchases of such properties from the foreign subsidiary, coupled with a desire to prevent future litigation, it is probable that such improvements will no longer be available to domestic parent corporations. The effect will be a serious impairment of the capability of domestic corporations to improve their domestic manufacturing techniques.

Section 6. Amendment to section 482

The proposed amendments to section 482 are purported to reduce the difficulties which the Treasury Department allegedly has encountered in dealing with controlled foreign subsidiaries. We object to these amendments because—

(1) They fail to take into account the additional information which the Treasury has available under a recent amendment to the Internal Revenue Code; and

(2) They will not simplify, but will add complications to the problems arising under section 482.

At the request of the Treasury Department, section 6038 was recently added to the Internal Revenue Code to facilitate the examination of transactions with controlled foreign corporations. It is believed that the additional information which taxpayers must file under this section will greatly reduce the problems of the Internal Revenue Service in obtaining information with respect to, and in examining transactions with controlled foreign corporations. This section became operative only in 1961 and although it may be too early to test its efficacy, it is true that the Internal Revenue Service is getting a very substantial volume of new information. It is therefore suggested that it is premature to add additional complexities to the Internal Revenue Code when the recent legislation adopted for the same purpose has not had a chance to prove its value.

The proposed amendments to section 482 provide for an allocation of income among the members of an affiliated group when one of such group is a controlled foreign corporation. The allocation will be based on a three-factor formula plus other considerations if the taxpayer cannot establish that the prices charged among the affiliates were at arm's length and if the taxpayer and the Internal Revenue Service cannot agree upon an alternate method.

The three-factor formula is based upon assets, compensation, and advertising and selling expenses, and are divided into those factors attributable to the United States and those not attributable to the United States. The formula is further complicated by the provision that foreign assets shall be valued at "approximately their adjusted basis" if such basis is not available from the foreign books and records. It is also provided that no income will be allocated to any foreign organization if its assets, personnel and other facilities "* * * are grossly inadequate for its activities outside the United States."

It would appear that the Service will always resort to the three-factor formula. The formula itself its subject to a number of uncertainties not the least of which

is the problem of allocating portions of each factor when all are used in more than one product but less than all of the products are sold to any foreign member of the affiliated group.

Under both the proposed legislation and the existing law the sole problem is the establishment of an arm's length transaction. Existing law grants authority to achieve the result without specifying a methods. However, the proposed legislation by suggesting a formula which is qualified by "other factors" and which is to be used only as an alternative, gives an illusion of certainty where none exists. The taxpayer will be forced to disprove in many instances the correctness of the three-factor formula and the Internal Revenue Service will be hindered in making settlements because it will be required to justify any departure from the formula. Under the guise of a pseudo-scientific approach, the proposed legislation creates new complexities.

It is submitted that there is no need for the proposed legislation.

Section 11. "Gross-up"

Section 11 would require a domestic corporation, when reporting dividend income received from a foreign subsidiary corporation, to gross up such dividend to include therein that portion of a foreign subsidiary's income which could not be declared as a dividend due to its application to the payment of such subsidiary's foreign tax liability. This provision should be rejected because it creates inequities, it will reduce the Federal revenues, it will create domestic unemployment, and is directly opposed to certain policies of the present administration.

Inequities.—Advocates of gross-up insist that this provision is necessary to remove inequities in taxation between foreign branches of domestic corporations and foreign subsidiaries of domestic corporations. These advocates also refer to a mathmatical formula which indicates that inequities exist in the taxation of income earned by separate foreign subsidiaries of domestic corporations.

It is submitted that equity of taxation between foreign branches and foreign subsidiaries cannot be acheived through adoption of "gross-up" because nothing is granted to foreign subsidiaries to equalize the special tax preferences now enjoyed by branch operations. These tax preferences include the following:

(*a*) Depletion allowances.

(*b*) Western Hemisphere trade corporation tax rate reduction.

(*c*) Deductibility by the domestic corporation of branch losses.

It is further submitted that the formula which indicates an inequity of taxation between various foreign subsidiaries is invalid in that it is based on a complete disregard of the tax structures of foreign governments and the fact that many such governments derive their revenues from turnover, sales, capital stock and other taxes which are not allowable for credit purposes. Rather than creating equity, "gross-up" will cause some corporations to bear heavier tax burdens and thereby destroy the rought equity achieved by the present foreign tax credit.

Reduction of Federal revenues.—It has been estimated that adoption of grossup will increase Federal revenues by $30 million annually. Rather than increase revenues, it is probable that gross-up will decrease the revenues. It is submitted that the estimates prepared by the Treasury Department do not take into consideration the effect which adoption of this proposal will have in increasing foreign taxes and thereby decreasing Federal revenues. Factors causing an increase in foreign taxes and a reduction in Federal revenues are as follows:

(*a*) In those instances where it is possible for companies to negotiate tax forgiveness and tax holidays the foreign governments will refuse to grant tax relief to foreign subsidiaries of U.S. corporations. To the extent that such conditions previously created additional U.S. tax revenues the result will be a reduction in revenues.

(*b*) To the extent that gross-up encourages foreign governments to increase their tax rates nearer to 52 percent, the result will be a loss of the anticipated increase in revenues together with a loss of present tax revenues.

(*c*) In those instances where the present foreign tax rate exceeds 52 percent, some corporations will actually realize benefit from the adoption of gross-up. To this extent, Federal revenues will also be decreased.

Domestic unemployment.—It has been demonstrated during the hearings before the House Ways and Means Committee that direct foreign investment yields a favorable return through dividends, creates exports, and aids domestic employment.

It is submitted that enactment of gross-up, without consideration of the inequities created thereby, will result in a reduction in investments abroad with

a corresponding reduction in exports thereby creating domestic unemployment.

Opposed to policies of the administration.—Grossup will be particularly burdensome to those foreign subsidiaries which conduct their operations in countries with an income tax rate between 10 and 40 percent. The countries with tax rates in this category are generally those countries which are capable of being classified as "less developed." Many of these countries have been noted for the instability of their governments which creates the potential for greater risk of losses.

Enactment of grossup would tend to force investment funds to flow to the politically stable, and higher tax rate, countries. The effect would be in direct conflict with the policies of the present administration.

Section 13. Controlled foreign corporations

The basic tenents of the administration's proposals on taxation of foreign subsidiaries are described in exhibit 3 to the statement of Secretary Dillon before the Senate Finance Committee as follows:

"One of the most fundamental of the guiding principles in American income taxation is that there should be equality in the tax treatment of similar groups of taxpayers. 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. Justification of this basic principle, as a principle, is made on two grounds: (1) it is 'fair' or 'equitable'; (2) it promotes the most efficient possible allocation of our own and world resources. Ideally, given the existence of corporate income taxes, the situation which in general would least interfere with efficient resource allocation, and would be most equitable, would be one in which corporate tax rates would be everywhere the same, assuming that Government services are comparable. We cannot control tax rates established by foreign governments any more than they can control ours. We thus cannot alter the fact that a relatively low corporate income tax in certain countries of the world artifically induces capital to stay in that country and artifically induces some other capital to come in from the outside, even though such investment may not be justified on true economic grounds, i.e., on the basis of relative rates of return on investment before taxes, a measure which embodies relative costs of production, future market possibilities, risks, etc. But by taxing the income of our oversea subsidiaries at the same corporate rate as domestic activities in the same way that oversea branches of U.S. firms are now generally taxed in the same manner as domestic branches, we can at least prevent the American tax structure from contributing to the artificial diversion of funds into low-tax areas."

It is believed, however, that the immediate purpose of the administration's proposals were more succinctly described by Commissioner Caplin in his memorandum of June 22, 1961, in which he stated:

"Upon completion of these time-consuming and laborious examinations, there still remains an amount of income the Service must recognize as income of the foreign corporation. These frequently large amounts are not subject to U.S. tax."

Contrary to the Secretary's definition of tax neutrality, it is impossible to equate the taxation of a U.S. corporation with a foreign corporation. The Secretary admitted that it is impossible to control the tax rates established by foreign governments and it must therefore necessarily follow that it is impossible to control or to equate U.S. taxes with the taxes paid by foreign corporations since foreign corporations are judicial entities of sovereign foreign countries. This problem receives implicit recognition in the proposal to tax U.S. shareholders of foreign corporations but not the foreign corporation itself. To tax the undistributed profits of a foreign corporation to its shareholders is an attempt to ignore the judicial separateness of the corporation and its shareholders and it would be, in our opinion, unconstitutional. This issue has been definitely discussed in the memorandum of May 4, 1961, from the chief of staff of the Joint Committee on Internal Revenue Taxation to the chairman of the Ways and Means Committee.

The proponents of currently taxing the income of controlled foreign subsidiaries resort to the foreign personal holding company legislation for precedent. Note, however, that the report of the Joint Committee on Tax Evasion and Avoidance stated: "* * * * in most cases the foreign personal holding company is effectively beyond the jurisdiction of the United States * * *." Since a foreign corporation is beyond the jurisdiction of the United States, it is absurd to speak

of privileges granted to foreign corporations. It necessarily follows that the continued use of such terms as "tax deferral," "privilege of deferral," and "postponement of tax" is an attempt to create a sympathetic climate for making basic changes in long-established legal principles by implying that tax concessions have been specifically granted to foreign corporations by the United States.

Furthermore, the proposals contained in H.R. 10650, instead of equating the taxes imposed upon domestic and foreign subsidiaries, place a penalty tax on such subsidiaries. For example:

(*a*) No provision is made for permitting U.S. shareholders to deduct a pro rata portion of the losses of a foreign subsidiary, nor is any provision made for net operating loss carryovers or carrybacks.

(*b*) Any new business in a developed country regardless of its nature would be subject to tax on its undistributed earnings for a period of 5 years even though such earnings must be retained for valid business reasons.

(*c*) Blocked income would be currently taxable.

(*d*) The corporate reorganization provisions do not apply to a foreign subsidiary.

(*e*) None of the elections contained in the IRC would be available to a foreign subsidiary.

(*f*) The concept of a "qualified trade or business" is designed to prevent the healthy diversification of the business of a foreign subsidiary. It is further circumscribed by the phrase "substantially the same trade or business" to such an extent that mere technological developments could preclude a foreign subsidiary from being a "qualified trade or business."

It is submitted that H.R. 10650 does not jibe even with the Treasury Department's definition of tax neutrality.

The administration's insistence upon also equating the taxation of a foreign branch of a domestic corporation and a foreign subsidiary is unrealistic. A foreign subsidiary is a separate judicial entity created under the laws of a foreign nation. A foreign branch is a part of a domestic corporation. The differences in tax treatment stem from these fundamental characteristics. For example, while it is true that the income of a foreign branch is currently taxable, it is also true that all losses of foreign branches, including exchange losses, reduce the U.S. taxable income of a domestic corporation. The extractive industries frequently use branches in foreign operations to obtain the benefits of percentage depletion and the intangibles option. This is in distinct contrast to a foreign subsdiary whose profits are not taxed in the United States until remitted to the U.S. parent as dividends. However, the losses of a foreign subsidiary can never be used to reduce the U.S. earnings of the parent corporation. If it is desired to equate the U.S. taxation of foreign branches and subsidiaries, it will be necessary to enact legislation which would grant benefits to foreign subsidiaries. Among such benefits would be permission for the domestic parent to reduce taxble U.S. income by deducting the proper portion of any losses of the foreign corporation and the right to recompute the income of the foreign subsidiary in accordance with all of the options granted to domestic taxpayers under the Internal Revenue Code.

Although one immediate result of the administration's tax proposals is the current taxation of the undistributed income of legitimate foreign subsidiaries, the Secretary has admitted before the Ways and Means Committee that the proposed legislation, "* * * is not primarily designed to raise revenue * * *." There also, the Secretary admitted:

"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."

One cannot help wondering what the ultimate goal really is. Is it to use the income tax law to make revolutionary changes in the control which the Government can exert over private business corporations? Could it be that the barbs aimed at U.S. controlled foreign corporations, the complaints of the harmful effect of private foreign investments on the balance of payments, the pleas for domestic investment incentives and the promotion of U.S. exports are nothing more than attempts to rationalize a goal which proponents of the legislation could not directly achieve?

The Secretary of the Treasury has emphasized time and again that section 13 is designed to prevent "* * * the artificial diversion of funds into low tax areas * * *" and to avoid "* * * distortion in resource allocation * * *." The Secretary has pointed out that the taxation of the undistributed earnings of foreign corporations plus the investment credit will promote the U.S. economy

by stimulating capital investment in the United States rather than abroad. If the expansion of U.S. industry is being retarded by a lack of capital, labor would be among the first to recognize the problem. However, Mr. Walter P. Reuther, the chairman of the AFL–CIO Economic Policy Committee, testified on February 7, 1962, before the Joint Economic Committee that there was a surplus of funds available for capital investment and the only problem was the creation of demand. Mr. Stanley H. Ruttenberg, director of research, AFL–CIO, gave substantially the same testimony on April 4, 1962, before the Senate Finance Committee. It logically follows if there is a surplus of capital in the United States, the existing method of taxing foreign corporations does not cause either "* * * an artificial diversion of funds into low-tax areas * * *" or a "* * * distortion in resource allocation * * *." The testimony of labor clearly demonstrates that the U.S. market for capital investment is saturated. U.S. industry has invested abroad, in areas of greater risk, because there was no need, no demand for more investment in the United States. Secretary Dillon, in comparing the effect of foreign investment versus domestic investment on U.S. employment, admitted that his projections assumed, "* * * in both cases that demand is sufficient to absorb the increased output." Mr. Reuther not only pointed out the need in the United States for increased demand "* * * to match the economy's vast and growing capacity to produce * * *" but also stated that modernization of productive equipment "* * * can be accomplished much more effectively by increasing public and private demand than by such artificial stimuli as the proposed investment credit." Demand can be increased only by placing more purchasing power in the hands of taxpayers and the simplest method of accomplishing this is to reduce the Federal income tax rates.

The income from private foreign investments has contributed favorably over a long period of time to the U.S. balance of payments. Contrary to the contentions of the administration, foreign investments by U.S. industry have been made for sound business reasons. Among these reasons was the desire to participate in foreign markets which could not be reached by U.S. exports. It has been amply demonstrated that private foreign investment has at most a short-term detrimental effect on the balance of payments and then only when a new and substantial capital investment in made. The statement of the Chancellor of the Exchequer which the Secretary quoted flatly acknowledges that foreign investment in the long run produces a favorable balance of payment. Furthermore, the spokesman for labor pointed out before the Senate Finance Committee that the short-term imbalance was greatly affected by such transactions as the recent loan of approximately three-quarters of a billion dollars to Japan though the money will never leave the United States. This is an extraordinarily good example of the blind adherence to a system resulting in erroneous conclusions. This system, i.e., the method of computing the balance of payments, is heavily weighted by defense expenditures and foreign aid. Therefore, it is not correct to attribute any imbalance to private foreign investment.

President Kennedy recognized this fact in his press conference on March 7, 1962 (New York Times, Mar. 8, p. 14) when he stated:

"* * * the balance-of-payments problem of the United States could be settled overnight if we withdrew our security efforts around the world. It is the combination of the $3 billion that we spend keeping our defense forces overseas, combined with the assistance we give in other ways, which provides for our dollar drain."

As a matter of cold logic, it is submitted that if there is a need to impose restrictions in the United States on investments abroad, the attempt by the administration to accomplish this by indirection via the tax law will do more harm than a direct imposition of exchange controls.

The failure of the Treasury Department to properly evaluate the understandable but selfish desire of foreign nations to economically advance themselves, even at the expense of their friends, is clearly demonstrated by the testimony of the Secretary before the Committee on Ways and Means that the finance ministers of the six Common Market countries" * * * 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." Of course they would—it would be contrary to their self-interest to do otherwise. The Common Market countries as well as all other group trading agreements have but one objective, the promotion of commerce within such groups to the detriment of nonmember commerce.

When it is recalled that the U.S. Government pioneered the development of free-trade areas, the proposed legislation becomes even more paradoxical. Under it, a foreign trading subsidiary of a U.S. corporation would incur a U.S. tax (unless reinvested under limited conditions) if more than 20 percent of its gross income is from sales outside of the country of incorporation. This provision is diametrically opposed to the concept of a free-trade area. It will encourage the formation of a separate corporation in each foreign country and thereby reestablish the importance of national boundaries for foreign subsidiaries of U.S. corporations at a time when our allies are attempting to eliminate such barriers to international trade.

In addition to our objections on philosophical or conceptual grounds, section 13 is also opposed because it is a legal and accounting nightmare. It is not only replete with new definitions which have no counterpart in legal or accounting terminology and which will therefore be subject to interpretation and litigation for years to come, but it also casts grave doubts as to the treatment to be accorded issues which have heretofore been settled with the Internal Revenue Service. It is not our intent to make a complete listing of such problems but rather to draw attention to some of the more conspicuous.

In the past, rulings have been obtained from the Internal Revenue Service under section 367 of the Internal Revenue Code that the transfer of patents, secret formulas, processes and know-how, developed in the United States, to a foreign corporation in exchange for stock of such corporation was not a transaction entered into for the avoidance of U.S. tax. In other cases, foreign corporations have purchased such assets. The proposed legislation would impute a royalty to the U.S. licensor equal to the royalty that would be paid by an unrelated person in an "arm-length" transaction. Are completed transactions and/or agreements which have been in existence for many years to be ignored, or will the law be applied prospectively? If a royalty will be imputed to the U.S. grantor under existing agreements, will the royalty be valued in accordance with the facts as they existed at the time of the agreement or the facts as they now exist?

Among the new problems which will be the subject of controversy and litigation for years to come if the proposed legislation is adopted are the answers to such questions as the following:

1. What constitutes an exclusive formula and process?
2. When is a process "substantially developed, created, or produced in the United States"?
3. When do goods undergo a "substantial transformation"?
4. What is "substantially the same trade or business"?
5. What is the meaning of the term "almost wholly within"?
6. To what extent is a vendor to be charged with knowing that the vendee is purchasing property "for use, consumption, or disposition" outside the country of sale?
7. When is property "ordinary and necessary for the active conduct of a qualified trade or business"?

Perhaps the foregoing questions can be resolved, but when? Students of taxation inevitably will write learned dissertations on such questions. In a few years, if the issuance of regulations under the 1954 Code is a good criterion, the Internal Revenue Service will issue regulations defining such terms and then it will become the province of the courts to determine what Congress really intended. But consider the plight of the businessman. He must answer all of these questions long before there will be any reliable guidelines. He will be required to adapt his recordkeeping to these uncertainties and to new and equally questionable definitions of income for which there are no benchmarks in accounting theory. He will, for example, be required to classify income by source into that—

(*a*) Derived from a qualified trade or business,

(*b*) Derived from a nonqualified trade or business,

(*c*) Derived from the use of patents, copyrights, and exclusive formulas which were substantially developed in the United States,

(*d*) Foreign base company income must further be subdivided so as to clearly show the amount of income arising from the sale of goods for use outside the country of incorporation which have not undergone a "substantial transformation" in that country; and addition,

(*e*) A detailed annual record of earnings invested in (1) qualified property and (2) nonqualified property will be required.

In determining income for each of the foregoing categories, the businessman will have to make immediate decisions as to what costs or expenses will be properly allocable to each type of income, knowing at all times that, after a number of years have passed, his judgment probably will be questioned by the Internal Revenue Service. Such conditions inevitably lead to unduly expanded recordkeeping and the cost of compliance will soar.

Another example of the impractical nature of the proposed legislation is the exemption from U.S. tax of foreign base company income if it is reinvested in one of the specified ways within 75 days after the close of the taxable year. This is a meaningless rule because not only would it normally be impossible to make the required investment within the 75-day period, but also because frequently earnings, particularly after foreign taxes, may not be known finally for years.

The crux of the administration's proposal appears to us to be contained in Secretary Dillon's statement that since " we cannot control tax rates established by foreign governments * * *, we can at least prevent the American tax structure from contributing to the artificial diversion of funds into low-tax areas." It is our considered judgment that, instead of correcting some scattered abuses in the so-called tax haven areas, section 13 of the proposed Revenue Act of 1962 will be a gigantic step toward the destruction of the foreign commerce of the United States. Certainly it will deter U.S. investment in developed countries. It is unfortunate that the proponents of this legislation fail to recognize that the United States does not have a monopoly on investment capital, manufacturing ability, and management skills. Foreign business competitors, possibly from both sides of the Iron Curtain, will rapidly absorb what would have been U.S.-controlled business in foreign countries and will thereby earn additional funds to expand into any part of the world including the United States. Our exports to developed countries will decrease because it is naive to assume that foreign competitors would favor as a source to supply U.S. manufacturers over either their own nationals or manufacturers in the country in which they are doing business. Even in those cases where the proposed legislation would not drive U.S. business from developed countries, the precedent for a discriminatory tax by foreign countries on U.S.-controlled business will have been laid by the adoption of H.R. 10650.

The Russian accomplishments in space dramatize the fact that the United States is not the only scientifically advanced nation in the world. In recent years scientific developments have resulted in the main from an exchange of ideas from country to country. The proposal to impute a royalty on the use of patents, processes and know-how substantially developed in the United States will not merely encourage, but, in economic self-defense, force U.S. business that can operate abroad to concentrate research efforts abroad to the detriment of the United States.

Certainly it is laudable and humanitarian to attempt to raise the living standards of the underdeveloped countries of the world, but it is a fact that, with the exception of some raw materials, foregin commerce and trade is carried on primarily among economically mature countries. We agree that our foreign business should serve our national interests, but to convert it into an instrument of foreign policy by specifically directing it into underdeveloped countries is contrary to the principles of a free society.

Section 16. Gains from certain sales or exchanges of stock in certain foreign corporations

Once you consider the erroneous philosophy expressed by the administration in stating its reasons for sections 11 and 13, it becomes apparent that section 16 had to follow as a logical extension of this philosophy. Our objections to such falacious reasoning can be found in our remarks on those sections.

However, unlike sections 11 and 13 which are not retroactive in their application, section 16, by taking effect immediately after enactment of H.R. 10650, has the dubious distinction of such retroactivity. It seems unnecessarily harsh and unreasonable to penalize taxpayers who relied in good faith upon provisions of the law in existence prior to this bill.

If the controlled foreign corporation provisions of this bill are enacted, the provisions of section 16 should, in all fairness apply only to accumulated earnings and profits earned subsequent to December 31, 1962, or at the very least, should not take effect retroactively for a reasonable length of time after enactment, as provided for in section 11.

Section 19. Withholding on interest and dividends

Section 19 provides that a payor of dividends, interest, and patronage refunds will be required to withhold tax at the rate of 20 percent. Individuals over 17 years of age will be able to file exemption certificates only if they expect to have no tax liability for the year. The bill does not change present rules requiring payors to file information returns reporting certain payments of dividends, interest and patronage dividends.

Although there can be little doubt that this proposal would account for the payment of some taxes that might not otherwise be collected, the real question is whether this collection is accomplished by a fair and equitable means, and whether there are not other, more practical, alternatives. It cannot be denied that adoption of this proposal will involve personal hardship and additional expenditures to the parties concerned. Certainly the exemption or refund procedures will not assure anyone that they will not be temporarily deprived of 20 percent of their interest and dividend income even though no tax might be due on such income. This will be particularly burdensome on retired individuals. Most of these people are not in a tax bracket equal to 20 percent of gross income.

Withholding on this income would constitute an expensive nuisance to the withholding agent. In many cases it would require the employment of additional personnel as well as the expenses of added equipment and supplies. This bill will create many expensive administrative and operational problems for organizations such trusts and banks that handle disbursements for millions of individuals.

The proprietary association agrees that if the Government fails to obtain all taxes legally due and owing to it, corrective action should be taken. We suggest, however, that better means to accomplish the collection of tax on dividend and interest income are available than the method proposed by this bill. The Internal Revenue Service is making enormous strides in the direction of automatic data processing of tax returns. In the past year Congress enacted legislation requiring the assignment of taxpayer identification numbers. These developments will in the near future make feasible the mechanical matching of tax returns with information returns. There are also reporting requirements in the present law whereby companies report certain payments of interest and dividends.

We submit that the only legislation, if any, which is needed is stiffer penalties for failure to report dividends and interest. This would be a far more efficient and far less burdensome means of obtaining the desired objectives. We should not erode our self-assessment system which has been held out as a model to the rest of the world.

Section 20. Information returns as to controlled foreign corporations

Section 20 of the bill amends the reporting and information requirements of sections 6038 and 6046, Internal Revenue Code of 1954. The information requirements for foreign corporations would be increased and extended with provision for civil penalties for failure to comply. Our concern is primarily with the amendments to section 6046 which requires information returns whenever a U.S. citizen becomes an officer or director of a controlled foreign corporation on and after January 1, 1963.

U.S.-based officers and directors of controlled foreign corporations generally are selected by management because of their functions and duties with the parent company overseeing international operations. A change in function or duty of an executive of the U.S. parent company frequently requires a change in the officers and directors of the controlled foreign corporation. Such changes are routine in nature and lack intent to evade U.S. taxes or hide information which may be of importance to the U.S. Treasury. Changes in functions and duties of such executives of controlled foreign corporations should not give rise to the imposition of civil penalties if such changes are not reported to the Treasury Department.

This added requirement under section 6046 will provide the Treasury Department with large quantities or repetitious information of doubtful value and will result in the further extension of the time-consuming reporting burden now imposed upon taxpayers. As an alternative, it is proposed that no information returns be required under section 6046 of any U.S. citizen, resident, or person with respect to a controlled foreign corporation for which returns are filed under section 6038 except on formation of a newly created controlled foreign corporation. This alternative proposal would not eliminate any essential informa-

tion sought by the Treasury Department, but would relieve taxpayers of burdensome unnecessary paperwork and reporting.

In conclusion it is our sincere opinion that the Revenue Act of 1962 is poorly conceived legislation which should not be enacted. We recommend that the whole matter be taken up as part of the tax reform bill.

MEMORANDUM SUBMITTED BY THE COUNCIL OF PRESIDENTS OF MUTUAL SAVINGS INSTITUTIONS, MORTON BODFISH, CHAIRMAN, SUPPLEMENTING STATEMENT INSERTED IN RECORD OF APRIL 11, 1962, APPEARING ON PAGES 1357–1359 OF PART 4 OF THESE HEARINGS

In my letter of transmittal of suggested amendments to section 8 of H.R. 10650 in the Senate, relating to the reserve for bad debts of mutual savings institutions, dated April 24, 1962, reference was made to a study then in process as to the impact of the changes made by section 8 of the bill, as passed by the House, upon reserves and dividends payable to savers. Permission was requested, if the study should be completed in time, to submit a memorandum summarizing the relevant facts and conclusions, and including further supporting material regarding the basic differences between stock and mutual savings and loan associations. Under the permission granted, this memorandum is respectfully presented.

A. Section 8 of H.R. 10650 would be a severe blow to a substantial number of smaller savings and loan associations.

Our survey of mutual savings and loan associations reveals that approximately 11 percent will find it neecssary to reduce their rate of dividend payable to savers, if compliance with regulatory requirements for reserves is to be maintained. For the sake of uniformity, in order to test the adequacy of the 60–40 formula now provided by section 593(b)(2), as proposed to be amended by section 8 of H.R. 10650, each savings and loan association was requested to assume that there was no increase in the total of loans outstanding during the year.

A typical example is a Minnesota savings and loan association with net income for the year 1961, as reported to the Federal Home Loan Bank Board, of $1,037,259.29. The rate of dividend credited on savings was 4 percent per annum, resulting in total dividends of $952,637.55. The net income before allocation to reserves of 60 percent of taxable income, as provided by section 593(b)(2), was $84,621.74. Deduction of 60 percent of taxable income as addition to reserves before taxes, leaves net taxable income of $33,848.70. The balance after taxes available for loss reserves would be $72,520.42, or $31,205.51 short of the $103,729.93 required addition to the loss reserves. The reduction in dividend rate necessary to provide the addition to the reserve, after payment of taxes imposed under the 60–40 formula, would be approximately 0.16 percent. Instead of a dividend rate of 4 percent, this Minnesota savings and loan association would be impelled to reduce the rate paid to its savers to 3.84 percent.

Although our data might not, standing alone, be accepted as conclusive, they are supported by the analysis made by the Federal Home Loan Bank Board that the impact on dividend rates of full taxability of savings and loans, as proposed by the Treasury Department, would require reduction of a dividend rate of 4 percent to 3.36 percent. See hearings, Committee on Ways and Means, Taxation of Mutual Savings Banks and Savings and Loan Associations (Aug. 9–10, 1961) pp. 23, 29–30.

As further stated by the Federal Home Loan Bank Board (ibid, p. 30), "Since this Board should insist upon a maintenance of the present reserve rates, the impact of the Treasury staff tax proposal upon the net increase in savings capital in savings and loan associations must be *immediate* and *massive*. Previous experience demonstrates that this diversion of funds must at least amount to $3 billion per annum and can well exceed $4 billion." [Emphasis supplied.]

If reduction in dividend rates from 4 percent to 3.36 percent would divert savings capital by this extent, surely it is not unduly pessimistic to assume that reduction to 3.84 percent (under the Minnesota example) will result in diversion of at least $1 billion in net savings inflow into savings and loan associations. And, as asserted by the Federal Home Loan Bank Board, "Every billion dollars of real estate credit dissipated as a result of the diversion of funds from savings and loan associations to commercial banks means an annual reduction of 80,000 housing units." (Ibid, p. 32.)

Accordingly, we urge that due consideration should be given to the concern of the Federal Home Loan Bank Board, the Housing and Home Finance Agency, and the Veterans' Administration. Changing the 60–40 formula under section 593(b)(2) to a 75–25 formula would alleviate the risk that section 8 of H.R. 10650 poses to the savings and loan industry, and through it, to the sector of the economy that is dependent upon homebuilding.

Even the Federal Deposit Insurance Corporation, with primary responsibility for safety of commercial banks, agrees that the Treasury recommendation may be so severe in its impact on mutual financial institutions as to justify a cautious approach of either a 2-year or 4-year transition period. (Ibid, p. 40.)

It is submitted that even the impact of a 75–25-percent formula under section 593(b)(2) might be disruptive to the economic health of the housing and savings and loan industries in this critical period of economic recovery. Accordingly, it is recommended that the 75–25-percent formula should not be imposed abruptly, and that the formula should be 85–15 percent for 1962–63 taxable years, 80–20 percent for 1964–65 taxable years, with the 75–25-percent formula to become effective in 1966 and subsequent taxable years.

B. The present tax status of savings and loan associations rests heavily upon the understanding of Congress and the courts that such organizations are mutual and local in character.

The attached memorandum of fact and law (with exhibits removed) was filed with the Treasury Department in support of an amendment to Treasury regulations to deny the benefit of section 593 to any savings and loan association controlled by a holding company. The arguments set forth in the memorandum are equally as valid to the enactment of a statutory definition of a mutual savings and loan association. The purpose of such a definition is to limit the provisions of section 593, as revised by section 8 of H.R. 10650, to such mutual savings and loan associations, and to tax on the same basis as commercial banks any savings and loan association with nonwithdrawable shares issued after December 31, 1951, the effective date of the bad debt reserves provided by Congress for mutual thrift institutions. Even though permanent shares of a savings and loan association were issued on or before December 31, 1951, it would be disqualified, under the amendments submitted by me on April 24, 1962, if such stock is owned by a holding company, within the meaning of section 408(a) of the National Housing Act.

As asserted by a former Treasury official, Prof. George E. Lent, to the House Committee on Ways and Means, 3 Tax Revision Compendium 1767, 1778 (1959):

"In summary, such stock associations are in no sense mutual organizations of the character contemplated in the special tax provisions accorded mutual savings institutions. They are essentially stock savings banks, in which the controlling interest is vested in a board of directors elected by the guarantee stockholders, leaving depositors (certificate holders) no voice in management. Their operations are not conducted for the benefit of depositors, except incidentally, but for the benefits of the stockholders. The certificate holders receive only a modest interest return sufficient to attract their savings, and they do not share further in the earnings of the business.

"To the extent that the stockholders represent a separate and controlling interest in the business and divert the earnings to their own account, within the discretionary limits of State law, the stock association loses its mutual character and becomes an investment company conducting business for a profit to its stockholders. Control by financial holding companies clearly negates any pretensions of mutuality."

C. Managing officers of mutual savings and loan associations are overwhelmingly against withholding on dividends and interest.

As chairman of the Council of Presidents of Mutual Savings Institutions, on April 19, 1962, I sent the following form letter to the managing officers of nearly 4,000 mutual savings associations:

APRIL 19, 1962.

To the Managing Officers of Mutual Savings Associations:

The Finance Committee of the Senate has received viewpoints both for and against the 20-percent withholding on dividends and interest.

We would greatly appreciate knowing your position in connection with this subject, and accordingly enclose a postal card for your convenience in replying. A line is provided for your identification should you so desire.

Sincerely,

MORTON BODFISH, *Chairman.*

Since then I have received approximately 2,100 replies in opposition to withholding, and only 6 replies in favor of withholding.

The opportunity for presentation of these supplemental views to my letter of transmittal of April 24, 1962, in support of amendments to section 8 of H.R. 10650 in the Senate is very much appreciated.

MEMORANDUM OF FACT AND LAW

A domestic building and loan association is defined as follows in section 7701(a)(19) of the 1954 Internal Revenue Code:

"The term 'domestic building and loan association' means a domestic building and loan association, a domestic savings and loan association, and a Federal savings and loan association, substantially all the business of which is confined to mking loans to members."

From 1894 to 1952 Congress expressly exempted such associations from corporate taxation. This exemption from Federal income taxation was eliminated in the Revenue Act of 1951 and since 1952 building and loan associations have been subject to taxation on the same basis as any "corporation," except that they have retained their exemption from the excess profits tax. However, qualification as a "domestic building and loan association" under section 7701(a)(19) of the 1954 code entitles an association to important tax deductions under sections 591, 592, and 593 of the code, the most significant of which is the deduction for additions to a reserve for bad debts permitted by section 593. As yet no regulations interpreting section 7701(a)(19) have been promulgated by the Secretary of the Treasury.

Existing types of building and loan associations

There were approximately 6,200 building and loan associations in operation in the United States at the end of 1958:

(1) State-chartered mutual associations	3,956
(2) Federal-chartered mutual associations	1,807
(3) State-chartered stock associations	437

(Approximate figures only. See S. Rept. 810, Aug. 25, 1959, accompanying H.R. 7244, U.S. Code, Congressional and Administrative News, 86th Cong., 1st sess. (No. 17, Oct. 20, 1959), pp. 4387–4388.)

The ownership of the first two categories of building and loan associations is vested in their savings account members. All Federal savings and loan associations are mutual organizations, owned by savers through purchase of withdrawable shares in the association. Most State-chartered building and loan associations are also mutuals, in some cases because mutual associations are the only ones permitted by the law of the State, in other cases by preference.

The third category, the State-chartered stock associations, are a relatively small class of private owned associations with permanent stock, the depositors of which are more in the nature of creditors of the stock association than shareholder-owners. It has been assumed by some that all such associations are automatically to be regarded as domestic building and loan associations under the 1954 code because of the 1928 decision of the U.S. Supreme Court in *United States* v. *Cambridge Loan and Building Co.*, 278 U.S. 55. However, it is suggested here that this assumption is entirely unwarranted in cases where the subsequent operations of a State-chartered association clearly establish that substantially all of its business is not confined to making loans to members.

U.S. v. *Cambridge Loan and Building Co.*

The Supreme Court in the *Cambridge* case was concerned with the right of an Ohio association to claim tax-exempt status as "a domestic building and loan association substantially all the business of which is confined to making loans to members" under the Revenue Act of 1921. Under Ohio law the respondent was authorized to issue full-paid stock and to have as members nonborrowing depositors and nonlending borrowers. The Supreme Court observed that "When Congress exempted such associations from the income tax of course it was speaking of existing societies that commonly were known as such * * *" (at p. 58). On this premise the Court concluded:

"But these associations are well known and a State is not likely to be party to a scheme to enable a private company to avoid Federal taxation by giving it a false name The statutes speak of 'domestic' associations, that is, associations sanctioned by the several States. They must be taken to accept, with the qualifications expressly stated, what the States are content to recognize,

unless here is a gross misuse to the name. The State of Ohio has recognized and still recognizes the respondent as belonging within the class which its name indicates. Very possibly the company has strained its privileges to near the limit, but we are not prepared to condemn the nomenclature adopted by the State. When the act of 1921 was passed and added the words "substantially all the business of which is confined to making loans to members," the respondent conformed to the statute, by requiring membership as a condition to a loan" (at pp. 59–60).

It is important to note that the Bureau of Internal Revenue did not take a position in *Cambridge* that guarantee or permanent stock associations could not qualify as a domestic building and loan association. To the contrary, this had been conceded by the Bureau 4 years earlier. (See S.M. 2114 (1924), C.B., III–2, 213.) The position of the Bureau of Internal Revenue in *Cambridge* was that the total combination of nonmutual activities of the particular stock association there involved was such that the respondent in reality was no different than a bank. This contention was there rejected. The Supreme Court did not hold that any building and loan association known as such under State law automatically qualified for Federal tax exemption, but decided only that the particular respondent under consideration had not strained its privileges under State law past the "limit," inferentially recognizing that privileges conferred by State law could be abused in operation and that an association would thereby lose its exempt status.

Recent activities of State-chartered stock associations

It appears now that the restraining "limit" recognized in Cambridge has since been overreached by a number of stock associations presently in operation. This was brought out at recent hearings before a subcommittee of the House Committee on Banking and Currency when a member of the Federal Home Loan Bank Board testified that over 50 percent of the 154 California stock associations were either "owned by holding companies or proposed to be owned by holding companies." (Testimony of William J. Hallahan, House hearings on H.R. 7244, 86th Cong., 1st Sess., June 16 and 17, 1959, p. 5; said hearings attached and hereafter referred to as exhibit A.) Frank J. Mackin, the savings and loan commissioner of California, indicated before the same committee that the interest in the permanent stock of these associations is widespread:

"In addition to the holding company activity in California there has been an intense, enthusiastic, and widespread interest by various individuals and groups in the acquisition of the controlled stock of savings and loan associations. Overtures are being made daily to associations throughout the State and their stockholders for acquisition of the guarantee stock of the associations. * * * A few days ago a representative of a Middle West manufacturing corporation, with offices in Los Angeles, informed me that his corporation was considering the acquisition of the stock of a California savings and loan association. A month or so ago a doorjamb distributing firm in Los Angeles wrote to a Federal savings and loan association in San Francisco as follows: 'We represent a group of businessmen interested in buying two savings and loan companies. One is with a maximum value of $1 million and the other is without any limitation. If you are interested in selling your business, please write us at the above address' * * *" (exhibit A, p. 51).

The merchantable interest stirring up this activity is the equity of the permanent stockholder in the tax-free reserve for bad debts which a "domestic building and loan association" is entitled to set aside for the protection of account holders under section 593 of the code. (See Los Angeles Mirror-News, June 12, 1959, quoted in House hearings, exhibit A, pp. 54–55; New York Times, June 19, 1959, quoted in Senate hearings on H.R. 7244, 86th Cong., 1st sess., Aug. 18 and 19, 1959, pp. 13–14, said hearings attached and hereafter referred to as exhibit B.) The reserve for bad debts allowed under section 593, so essential to the typical nonstock savings and loan association, is emphasized in promotions of holding company stock. (See exhibit C (Wesco Financial Corp.) and exhibit D (Lytton Financial Corp.) for recent examples.)

The holding company promoters assure the public in these offerings that only stock dividends will be declared on its stock to take maximum advantage of the speculative value of the equity in the accumulated reserve for bad debts of the association to which the association permanent stock is entitled under State law:

"The management intends to pay periodic stock dividends, and the investor in Lytton Financial will thereby be able to increase his holding of the stock.

When sold, such dividends will only be liable to the capital gains tax, if held for the 6 months" (Exhibit D, p. 13. A similar statement can be found in exhibit C, p. 5.)

The qualification under section 7701(a)(19) as "domestic building and loan associations" of those stock associations which are under the dominance and control of holding companies (or other interests having no relationship to the building and loan industry) should be questioned.

Obvious purpose behind formation of holding companies to acquire permanent stock of a building and loan association

The primary function which such holding companies perform is to create a public market for the association permanent stock by splitting the nonwithdrawable shares through transfers for multiple shares of holding company stock (Finance magazine, July 15, 1959, quoted at Senate hearings, exhibit B, at pp. 9–12). The advantage derived by the permanent shareholders is the tax advantage of capital gain treatment of their profits. That this is the basic reason for holding company activity in the building and loan industry is recognized by both the promoters and the opponents of such activity (Senate hearings, exhibit B, pp. 78, 81, and 83; paper of Prof. George K. Lent, tax revision compendium submitted to Committee on Ways and Means, Nov. 16, 1959, vol. III, pp. 1776–1779; photocopy of relevant pages attached hereto as exhibit E).

In most cases the capital gains realized by the permanent shareholders through the holding company device are substantial. For examples:

(1) In 1955 the stock of the Slechta family in Great Western Savings & Loan Association in Los Angeles (the largest stock association held by Great Western Financial Corp.) was sold for approximately $9 million; its cost to the Slechtas is estimated at $100,000 (Lent paper, exhibit E, p. 1778).

(2) In December 1958, the principal stockholder of Surety Savings & Loan Association in San Jose exchanged his capital stock for 93 percent of the stock of California Financial Corp., another holding company. The book value of the association's guarantee capital and reserves was slightly under $2½ million. The association was the holding company's sole asset. Yet one-third of this stockholder's shares in the holding company were sold for almost $1½ million and he still retained two-thirds of the stock of the holding company (House hearings, exhibit A, p. 36).

(3) In May 1959, Wesco Financial Corp. was formed to acquire all of the 600 shares outstanding of Mutual Savings & Loan Association in Pasadena for 1,200,000 shares of Wesco. The book value of Mutual's general reserves, undivided profits, and guarantee stock on March 31, 1959, was about $10 million: the book (par) value of the stock was $60,000. On June 24, 1959, one-third of the Wesco stock of former stockholders of Mutual was offered for sale for $8 million. Mutual is Wesco's sole asset (Wesco prospectus, exhibit C).

When the Bureau of Internal Revenue first recognized that under the law prior to the Revenue Act of 1951 a building and loan association did not lose its tax-exempt status merely because it issued permanent stock, it did so on the assumption that "* * * the issuance is incidental to the main business of the association and is for the purpose of providing a fund from which loans can be made to installment shareholders" (S.M. 2114 (1924), C.B. III–2, 213, 216). This assumption is not warranted in any case where all or a controlling portion of such stock is held by a holding company.

Permanent stock of a savings and loan association owned by a holding company is not held "incidental to the main business of the association," but for the sole purpose of sale to and speculation by the general public. When a holding company is the alter ego of a stock association, the association does not qualify as a "domestic building and loan association * * * substantially all the buisness of which is confined to making loans to members."

Holding companies do not confine their activities to "making loans to members"

According to Frank J. Mackin, the savings and loan commissioner of California:

"The articles of incorporation of these holding companies generally provide, among other things, that they may buy, sell, and hold stock of one or more savings and loan associations, carry on general insurance agency and insurance business, carry on real estate and escrow business, borrow and lend money, buy and sell personal property, buy businesses and organize subsidiary companies, participate in joint ventures, partnerships, and other types of organizations" (House hearings, exhibit A, p. 51).

This feature is emphasized in promotions of holding company stock:

"Now while savings and loan associations are not permitted to carry on outside activities directly, holding companies are allowed to engage in the operation of insurance agencies, the title insurance business and in the escrow business through affiliated companies—thus also enhancing the earning power of such holding companies" (exhibit C, p. 3; also see Senate hearings, exhibit B, p. 5).

Such diversification by the holding companies in fact exists:

"The affiliated companies are engaged in an escrow business, an insurance agency business and a trustee business. They do business primarily with customers of the association and in 1958 accounted for approximately 7.6 percent of the combined earnings of the company's subsidiaries, before Federal income taxes and appropriations to general reserves" (exhibit F, Gilbraltar Financial Corp., p. 3; also see exhibit G, First Charter Financial Corp.).

Holding company stock is not locally owned

Moreover, a stock association which is owned by an out-of-State holding company has no relationship to the traditionally local savings and loan institution. This was recognized by Congress recently in the enactment of "An act to promote and preserve local management of savings and loan associations by protecting them against encroachment of holding companies" (Public Law 86–374, 73 Stat. 691, Sept. 23, 1959).

This legislation, which added section 408 to title IV of the National Housing Act (12 U.S.C. 1724–1730), was intended only as a stopgap measure to prevent further holding company acquisition of more than one stock association within the next 2 years. (See subsecs. (c) and (g) thereof.) It does not require divestiture by existing holding companies and will not prevent the formation of a holding company by the shareholders of a single, closely held stock association for the purpose of avoiding the full effect of Federal taxation. (For examples, see exhibits C, D, and F.)

The emergence of holding companies in the savings and loan industry is a recent development. The first holding company in this field appears to have been the Great Western Financial Corp., a Delaware corporation organized in 1955. (Testimony of Albert J. Robertson, Chairman of Federal Home Loan Bank Board, House hearings on H.R. 4135, 85th Cong., 1st sess., Feb. 20 and 21, 1957, p. 3; attached hereto as exhibit H.) Holding company dominance of a stock association obviously was not considered in 1928 by the Supreme Court in the *Cambridge* case when it construed the congressional reference to "domestic building and loan associations" as including "* * * existing societies that commonly were known as such * * *" or by Congress when it enacted the Revenue Act of 1951. Moreover, instead of being a creature of State law, a stock association owned by a holding company is able to flaunt with impunity State regulations pertaining to stock splitting and the permissible range and scope of its operations. (Finance magazine, July 15, 1959, quoted in Senate hearings, exhibit B, pp. 9–12.) This was emphasized recently by the California savings and loan commissioner before a House committee:

"Recent activities of holding companies in California have assumed enormous proportions. The size and scope of these operations have reached such a point as to constitute *a major change in the character of the savings and loan business.* The alleged benefits of such holding companies are meager and are far outweighed by the underlying fact that holding companies destroy the basic concept of the savings and loan business as a *local* thrift and home financing operation. At present many of these holding companies are being organized in the State of Delaware. It is impossible for the State of California, either through the office for which I have statutory responsibility or the office of the corporation commissioner of the State, to stop or even impede the rapid spread of holding companies over State associations. * * *" (House hearings, exhibit A, p. 51). [Italic supplied.]

Holding company ownership of a building and loan association erases the "mutual" aspect of association membership

When the exemption from Federal income taxation of domestic building and loan associations was repealed by the Revenue Act of 1951, Congress recognized that the maintenance of the financial security of millions of individual savings members required that building and loan associations be permitted some latitude as to the size of their reserves for bad debts. Since the depositors of the typical building and loan association are also its owners, a reasonable bad debt reserve to protect small savers whose funds are being used for home loans is desirable.

The undivided interest of a depositor in a typical association's reserve for bad debts is a security interest without negotiable value. On the other hand, the permanent shareholders of a stock association are in a position to siphon off to themselves as dividends these tax-free reserves or to capitalize on the speculative value of their claim to the reserve for bad debts by transferring their stock to a holding company which in turn issues new stock for sale to the public. There is no mutuality of interest between the depositors of a stock association and the shareholders of a holding company which owns the permanent stock of the association.

It was the strict "mutual" nature of the early building and loan association which prompted Congress to exempt these associations from corporate taxation from 1894 to 1952. And the fact that some vestiges of this early mutuality remain in the typical building and loan association today undoubtedly influenced Congress to allow its savings account holders a degree of latitude in maintaining a reserve for bad debts arising from home loans made by the association. As the Senate Finance Company noted in its report on the Revenue Act of 1951:

"One characteristic of the earlier mutuality which remains is the absence of capital stock" (U.S. Senate, Committee on Finance, "Report on the Revenue Act of 1951," p. 27; same, U.S. Code and Admin. Serv., 82d Cong., 1st sess., vol. 2, p 1996)

This observation does not apply to an association the stock of which is owned by a holding company There is no more mutuality of interest between the depositors and owners of such an association than in the case of the depositors and owners of a commercial bank.

Intent of Congress

Under section 593 of the 1954 Internal Revenue Code a "domestic building and loan association" may accumulate a substantial reserve for bad debts which is not subject to corporate taxation. When this provision was added to the Revenue Act of 1951, there was no holding company activity in the building and loan industry. The operations of existing building and loan associations were local in nature and were confined to making loans.

The emergence of holding companies in the building and loan industry since 1955 is due to the speculative attraction of the equity of permanent shareholders of stock associations in the association's reserve for bad debts. It seems obvious that Congress did not intend this tax-free reserve to have a merchantable value. It is also obvious that Congress did not contemplate that attempts to speculate in this tax-free reserve would change the character of the building and loan industry in certain States and that State authorities would be powerless to resist such changes.

Responsibility and powers of the Secretary of the Treasury in implementing section 7701(a) (19)

To qualify as a "domestic building and loan association" under section 7701(a) (19) of the 1954 code, an association must be one "substantially all the business of which is confined to making loans to members." This limitation was first written into the Internal Revenue Code by the enactment of section 231 of the Revenue Act of 1921 at a time when domestic building and loan associations were exempt from Federal taxation. The legislative history of that original provision clearly establishes the intent of Congress that the factual determination as to whether "substantially all of the business" of an association was confined to making loans to members should, in the first instance, be made by the Secretary of the Treasury or his delegate.

This is evident from the following report of the colloquy between Senator McCumber, who was the Senate manager of the amendment, and Senator Willis:

"Mr. McCumber. There has been considerable complaint, Mr. President, on the ground that many of these building and loan associations were really business enterprises, not organized particularly for the benefit of their members mutually, but simply for profit, and that by incorporating as building and loan associations many of them escape the tax. So the House is drawing the bill provided that domestic building and loan associations operated exclusively for the purpose of making loans to members should be excluded.

"There was a class of corporations the most of whose business was in making loans only to its own members, but in some instances they did make loans to some outsiders. So the Senate amended by striking out the words 'exclusively for the purpose of making loans to members' and inserted 'domestic building and loan associations substantially all the business of which is confined to making loans to members.'

"I do not know that that entirely meets the objection that is pointed out by the Senator but I imagine that there may be many methods of doing business between the several associations calling themselves building and loan associations, but if they are engaged strictly in the business of making loans to their own members, or substantially so, without profit to the individual, the law seeks to exempt them from taxation.

* * * * * * *

"Mr. WILLIS. * * * what, in the discussions of the committee, was the meaning that was supposed to be attached to the language 'substantially all the business of which is confined'? I can understand the English language, of course; but I wondered what, in the judgment of the committee, practically speaking, 'substantially all' would mean. What is 'substantially all,' in the judgment of the committee?

"Mr. MCCUMBER. That is rather a difficult question, but the Senator understands it as well as any member of the committee, and as well as anyone could understand it. It was first considered that possibly they should use the words '80 percent of which is purely a business of a mutual character.' Under that there might be a little discrimination, and it was thought best to leave the matter within the discretion of the Department to determine what was substantially a corporation doing business as a building and loan association for the mutual benefit of its stockholders rather than for profit.

"Mr. WILLIS. Then it was the judgment of the committee that probably 75 or 80 percent should be considered as the test?

"Mr. MCCUMBER. The committee considered that, and it was considered better to use the word 'substantially.'

"Mr. WILLIS. I understand; I simply wanted to get the thought of the committee.

"Mr. MCCUMBER. So that it would give the Treasury Department some leeway in determining what was just and fair and proper, and they could take every individual case by itself. One might have 89 percent of its business of a mutual character and 11 percent of another character, and another might have 91 percent of a mutual character, and yet the business might be such altogether that it would be fairer to take the one with the 91 percent and exempt it than the one with the 89 percent; and that was left with the Treasury Department to determine." (Seidman's Legislative History of Federal Income Tax Laws (1938–1861) pp. 861–862.)

While the tax effect to an association of qualifying under the "substantial" compliance test has been changed with the enactment of the Revenue Act of 1951, the qualifying terms have remained unchanged since 1921. Thus, it is clear that the Secretary of the Treasury or his delegate has both the power and the responsibility of determining factually whether substantially all of the business of a building and loan association is confined to making loans to members when its guarantee stock is owned by a holding company.

Facts which disqualify a stock association owned by a holding company

Holding company promotors admit that only the reserves of building and loan associations with permanent stock are subject to exploitation. (Orville Chatt, vice president, San Diego Imperial Corp., House hearings, exhibit A, p. 47; John F. Martin, president, Great Western Financial Corp., ibid., p. 47.) A stock association which is wholly owned or controlled by outside interests can no longer be regarded as a local institution "substantially all the business of which is confined to making loans to members". Holding company ownership and activities are not subject to State regulation. The association's nonwithdrawable stock is thereby opened to manipulation. Reserves which it was permitted to accumulate without taxation to protect depositors are the cause of speculation by the general public and profittaking by promoters. Such an association has "strained its privileges" under State law beyond the "limit" recognized in *U.S.* v. *Cambridge Loan and Building Co.* It should be entitled only to accumulate reserves for bad debts to the same extent as corporate taxpayers generally.

Proposed rule

It is therefore urged that the Secretary of the Treasury or his delegate, by virtue of the authority vested in him by law and after an opportunity for a hearing has been accorded to all interested persons, issue a rule or regulation interpreting section 7701(a)(19) of the Internal Revenue Code to clarify the status of domestic building and loan associations as defined in that section.

The following rule or regulation is suggested on the basis of the facts and law heretofore related:

"As used in section 7701(a) (19) of the Internal Revenue Code of 1954, the term 'domestic building and loan association' means a domestic building and loan association, a domestic savings and loan association, or a Federal savings and loan association, substantially all the business of which is confined to making loans to members, and where not more than 20 percent of the stock of which consists of nonwithdrawable stock, underlying ownership stock other than mutual shares or accounts in a mutual institution, permanent, stock, guarantee stock, or stock of a similar nature by whatever name called, is owned by a corporation (other than the Federal Savings and Loan Insurance Corporation or any corporation the majority of the shares of which is owned by the United States or by any State).

UNIVERSITY OF PUERTO RICO, *April 30, 1962.*

Hon. HARRY FLOOD BYRD,
Chairman, Finance Committee,
Senate of the United States of America.
Washington, D.C.

DEAR MR. CHAIRMAN: The undersigned citizens of the United States and of the Commonwealth of Puerto Rico, professors of the University of Puerto Rico concerned with the political, economic, and cultural relations which now exist between the United States and Puerto Rico, respectfully present for your consideration some of the more serious issues implicitly or explicitly involved in the tax bill of 1962 presently before the Congress. We feel the following points are relevant to a favorable decision in support of the government of Puerto Rico's petition for the exclusion of Puerto Rico from the coverage of the tax bill.

1. The Commonwealth relationship of Puerto Rico to the United States rests, among other things, on the good faith of the Congress in maintaining in Puerto Rico and in doing nothing to harm the economic and political advantages existing at the time of the approval of law 600 of 1952 by the Congress of the United States and the people of Puerto Rico. The substantial removal or weakening of the arrangements which facilitated economic development in this Commonwealth, as contemplated in the tax bill of 1962. without compensatory arrangements in other economic sectors would constitute a serious blow to the expectations upon which the public economic policy of the Commonwealth government has been based during the last decade. (Even prior to 1952, the political and legal relations with the United States were grounded economically on special tax relations). One of the principles underlying our expectations was the confidence that present economic advantages would not be altered, either unilaterally or bilaterally, until Puerto Rico had attained the per capita income of the poorest State of the Union. Such a goal becomes a mirage if the Congress approves unaltered the tax bill of 1962.

2. The people of Puerto Rico have entered into and defended the Commonwealth idea in the secure confidence that the Congress would not unilaterally abolish the economic basis of our relationship before the Puerto Rican economy was strong enough to absorb the shock of any fundamental alteration. We wonder if the Congress is fully aware of the consequences to Puerto Rico which would result from enactment of the tax bill of 1962. We ask: Would the Congress prefer to alleviate the economic consequences of a depressed economy in Puerto Rico through emergency legislation for disaster or depressed areas, for relief purposes, for unemployment compensation, or through any other type of emergency appropriations, as occurred frequently prior to 1940? Has it faced the possibility that Puerto Rico may be forced to adopt a socialist pattern of economic development, with the government as the main producer and distributor of goods, once private enterprise finds it unattractive to invest in our economy? The political consequences of an economic disaster in Puerto Rico are clearly unacceptable, and we trust unwanted, both here and in the United States.

3. As a free and associated Commonwealth within the political and economic system of the United States, Puerto Rico stands out prominently before Caribbean and Latin American countries. They tend to judge American programs and pronouncements concerning economic growth and social justice in terms of our progress. It is here that American preachment and practice about democracy and free enterprise are put to the test. The interest of the United

States in the future of Latin American development requires the continuation of existing or equivalent tax provisions for firms doing business in Puerto Rico. It is indeed unfortunate, both in substance and in timing, that this bill would cut short Puerto Rican economic progress precisely when its demonstration effect in Latin America is at a peak. We ask: Is the Congress of the United States willing to spend the necessary funds to counterbalance the impact of such a reversal in Puerto Rico's economic progress? Teodoro Moscoso, Director of the Alliance for Progress, has repeatedly stated that his main job is one of persuasion. What chance will there be to persuade if the best concrete instance of what is advanced is removed from sight?

4. In absolute economic terms, Puerto Rico is an underdeveloped area lacking in natural resources on which to build its economy. In relative terms it is a poor economy, very far from the level of the poorest American State. It does not qualify for foreign aid; it does not qualify for Alliance for Progress appropriations. Yet its continued social and economic growth is a common responsibility of the Government of the United States and the people of Puerto Rico. That responsibility rests on more than 60 years of association.

5. Puerto Rican migration to the United States, due to the economic opportunities now existing in Puerto Rico as a result of the economic and tax arrangaments now in jeopardy, has reached zero net migration point. However, any reversal of present economic conditions would mean a wave of migrants, with the consequent competition for jobs and the necessity to provide increased relief and other social services. Puerto Ricans prefer to live and earn a living in Puerto Rico, and a growing Puerto Rican economy is the best insurance against the human, economic, and social consequences, both for the United States and for Puerto Rico, of massive migration to the mainland.

6. The tax bill under consideration is directed to control the outflow of dollars from the American economy. We sympathize with such a goal. But Puerto Rico is within the American economic and monetary system, and the reasoning behind the bill does not apply in relation to us. The money invested in Puerto Rico is not money lost to the United States: it is rather an investment of U.S. capital in more productive enterprises within the American economy. In fact, on the mainland there are ways of avoiding the payment of taxes through mergers with less productive enterprises, resulting in less taxes and misallocation of resources. In Puerto Rico, on the contrary, investments attracted by tax exemptions result in benefits to American investors and Puerto Rican citizens in terms of direct personal economic and social growth. Such result benefits Puerto Rico, but it is not detrimental to the United States, since it is a concrete demonstration of the responsibility and good faith of the United States toward Puerto Rico.

To sum up, we believe that because Puerto Rico's political, economic, and ideological role in the Caribbean and in the Americas, the preservation of existing tax arrangements between Puerto Rico and the United States or the adoption of equivalent substitute measures, should receive the endorsement of the Congress. Such endorsement does not add anything new to the content of the Commonwealth relationship, but would rather strengthen the joint effort of the United States and Puerto Rico in their common quest for freedom and justice in the Americas.

Mario Anglada, Jenaro Baquero, Severo E. Colberg, Frederico Cordero, Rafael de Jesús Toro, David Helfeld, Luis Soler Báez, Bartolomé Stipec, José Arsenio Torres, Juan Luis Brusi, Antonio J. Colorado.

KILGORE & KILGORE,
Dallas, Tex., May 2, 1962.

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

DEAR SENATOR BYRD: It was my pleasure to attend the hearings of the Finance Committee last Wednesday, at which time you directed a number of astute and penetrating questions to Mr. Eldridge Haynes, who was testifying on behalf of Business International. One of your questions related to the British tax treatment of the oversea trade corporation and I would like to supply some additional information on that subject which I feel will be of interest to you.

My knowledge of the history and operation of British oversea trade corporations is derived from the fact that, while a member of the faculty of Harvard

Law School, I prepared its World Tax Series volume on "Taxation in the United Kingdom," as well as the volumes on "Taxation in Australia" and "Taxation in India." Since entering private practice I have prepared three supplements to the United Kingdom volume, have written on taxation matters for the British Tax Review, and have generally kept myself informed in this area. I am joint author with Asssistant Secretary Stanley S. Surrey of the Encyclopedia Britannica article on "Corporate Taxation." I am chairman of the Division on Private Investments Abroad of the Southwestern Legal Foundation and my legal practice is concentrated on tax and legal problems of international trade and investment.

The history of the oversea trade corporation device in England should shed much light on the central problem which underlies section 13 of H.R. 10650. At the time the oversea trade corporation device was first proposed by the Royal Commission on Taxation of Profits and Income (the "Radcliffe Commission") the British business community expressed deep concern over their competitive disadvantage vis-a-vis Americans due to the great difficulty encountered by Britishers in establishing foreign corporations which would be free of British tax and the relative ease with which Americans could establish foreign corporations free of U.S. tax. The reason for this difference was that, under British law, a corporation would be nonresident (and therefore free of British tax on its non-British income) only if its "mind and management" were situated outside the United Kingdom. Americans, on the other hand, can obtain nonresident status for their corporations merely by incorporating them abroad.

The British business community, and ultimately Parliament, recognized the value of a convenient foreign trading vehicle as a stimulus to export and an aid to balance of payments. The American experience was frequently cited as an example and it was urged that Britain provide facilities for its foreign investors and traders comparable to those provided by the United States under its tax law. The object, of course, was to remove the serious competitive disadvantage at which the British found themselves and to place them on a parity with Americans by providing a convenient corporate vehicle for the conduct of oversea operations, the income of which would be free of British tax until repatriated.

The Royal Commission expressed this object of its oversea trade corporation proposal thus:

"This country is bound to do what it can to foster the growth of its oversea trade * * * it should be scrupulous to avoid * * * any measures that tend to place its oversea traders at a positive disadvantage in competition with traders in or from other countries * * *. Yet the United Kingdom does succeed in imposing just this disadvantage by its present method of taxing oversea profits."

Enactment of the oversea trade corporation provisions in 1957 accomplished the above objective. In addition, it provided a number of advantages to the British. They can now conduct oversea operations through a domestic corporation and still be free of current taxation on foreign income.

A leading British tax authority, writing in the British Tax Review of December 1957, stated:

"Despite the imperfections of this legislation, the OTC concept provides the United Kingdom enterprise with as good a closed circuit for movement of oversea funds, as does the establishment of a base company to manage and control a network of American branches overseas. In some ways it is a better solution. For one thing, temporarily surplus funds can be repatriated to an OTC head office or to an OTC principal company without payment of United Kingdom tax, whereas a base company's surplus funds cannot be safely transferred to and held by the U.S. parent without being taxed as an actual or a constructive dividend.

Now that the British have brought the competitive situation with respect to foreign operating structures approximately into balance, it is proposed by our Treasury that we tip the scale in the opposite direction and give the advantage to our foreign competitors. It seems only proper that the British should have enacted legislation to eliminate the competitive advantage which our foreign traders had over theirs. I think that there is serious question as to whether it is in our national interest for us now to enact legislation which would give them (and our other foreign competitors) a comparable advantage over us.

Directly relevant to this matter is a letter which I recently received from Sir Frank Bower, formerly tax manager for Unilever, Ltd., and for a number of years chairman of the British Federation of Industries. I am enclosing an excerpt from the letter (which was unsolicited) which forcibly demonstrates the point I am trying to make.

Respectfully yours,

WALTER W. BRUDNO.

EXCERPT FROM LETTER OF SIR FRANK BOWER TO WALTER W. BRUDNO, APRIL 9, 1962

"The administration proposals to make foreign subsidiaries of U.S. shareholders pay U.S. tax on their earnings is one of those occasional acts of lunacy by the administration which distress your friends and amuse your enemies and trade rivals. On the one hand you are taxing yourselves excessively in order to pay for defense and to provide foreign aid. One of the most beneficial instruments of foreign aid, and therefore of defense, is direct investment by business concerns. It is better than Government loans or grants because it carries with it a know-how to develop the countries."

DAVIS POLK WARDWELL SUNDERLAND & KIENDL,
New York, N.Y., April 30, 1962.

Re section 2(b), H.R. 10650

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

DEAR SENATOR BYRD: This letter is directed to that part of H.R. 10650 which deals with the proposed investment credit on leased property. It is submitted that this portion of the bill is directly contrary to the policy lying behind the investment credit as stated in the report of the Committee on Ways and Means. The bill now provides that:

"A person * * * engaged in the business of leasing property may * * * elect with respect to any new section 38 property to treat the lessee as having acquired such property * * *." Proposed Code section 48(d); bill section 2(b).

The report of the Committee on Ways and Means states that this provision has been included in the bill so that

"* * * it is possible for the lessor to pass the benefit of the investment credit on to the party actually generating the demand for the investment." (H. Rept. 1447, 87th Cong., 2d sess., p. 14, (1962).)

For the reason stated by the committee, it seems that the identity of the person who owns property which is put under lease is a completely irrelevant factor. The person who generates a demand for the creation of productive property by leasing it does so without regard to who may be the owner of the property subject to the lease. The bill as it stands will prevent the credit being claimed by a person who leases property from a tax-exempt organization (H. Rept. 1447, supra, p. A–24). However, the bill goes further and would deny the credit to a person who leases property from a taxable organization (such as a life insurance company) which holds its properties as investments and is therefore not engaged in the business of leasing.

Pension trusts, insurance companies, university endowment funds, and other institutional investors are the source of substantial funds which flow into factories, warehouses, office buildings and research facilities leased to industry. The lease terms set by these instiutional investors are a reflection of basic economic factors—the money market, the financial strength of the industrial company which is the lessee and other risk elements inherent in the property as an investment. These terms are not affected by the fact that such institutions are investors rather than persons engaged in the business of leasing.

Where investments in leased property are concerned, there is no difference between taxable and nontaxable institutional investors. A tax-exempt institutional investor cannot trade on its exemption when leasing industrial property and its investment decisions are not affected by its tax-exempt status. Consider, for example, a tax-exempt pension trust. The trustee can obtain a tax-free yield from investing in corporate bonds, from investing in corporate stocks, or from investing in property leased to an industrial corporation. To meet its fiduciary obligations, the trustee must obtain from an investment in leased property a yield which is comparable to that from an investment in securities (after adjustment for whatever risk factors are appropriate). Just as a tax-exempt pension trust buys listed securites at prices quoted on the stock exchange, so it invests in leased property on terms appropriate to the money market and the risks peculiar to the investment.

It is submitted that the words "engaged in the business of leasing property" which appear in the first sentence of proposed code section 48(d) should be stricken.

Very truly yours,

DAVIS, POLK, WARDWELL, SUNDERLAND, KIENDL.

THE STATE NATIONAL BANK,
Maysville, Ky., Apr. 18, 1962.

Senator JOHN SHERMAN COOPER,
Senate Office Building,
Washington, D.C.

DEAR SENATOR COOPER: I am treasurer of the Kentucky Conference Board of Pensions of the Methodist Church.

In our endowment fund, we hold stocks and bonds of some 40 to 50 corporations and various other entities, all of the income from which is fully tax exempt.

Quarterly payments are made to some 150-odd retired ministers and widows, most of whom are almost entirely dependent upon these payments, and few of them would have any income tax liability.

If the proposed legislatoin to withhold 20 percent of interest and dividend payments is passed, it will work a serious hardship on these elderly people and will be regretted by the entire membership of the Kentucky conference as soon as its results are felt because of the slowdown in payments to them until refunds may be had from the Government.

It is sincerely hoped that you will take a firm stand against the passage of this measure.

Sincerely,

F. W. GALLOWAY,
Treasurer, Kentucky Conference, Board of Pensions.

THE WORLD TRADE CENTER IN NEW ENGLAND, INC.,
Boston, Mass., May 1, 1962.

Re Revenue Act of 1962 (H.R. 10650).

Hon. HARRY FLOOD BYRD,
Chairman, Finance Committee,
U.S. Senate, Washington, D.C.

DEAR SENATOR BYRD: The World Trade Center in New England wishes to record with your committee its opposition to certain provisions of the Revenue Act of 1962 (H.R. 10650).

The World Trade Center is a nonprofit corporation organized to promote foreign trade and investment. Its membership represents a large and true cross section of the industrial, commercial, and international business interests of our region. The activities of the World Trade Center are similar to those of International House in New Orleans and the World Trade Center in San Francisco.

While we fully support the administration's objective of eliminating tax evasion accomplished through the use of sham devices in the conduct of foreign operations, we are opposed to any measures which will unnecessarily curtail the freedom of U.S. business to compete with foreign enterprises for world markets. We feel that foreign investment will, in the long run, improve our balance of payments and strengthen our national economy as a whole, with resulting benefits to both business and labor. It seems to us that the proposed changes in the taxation of income from foreign operation go much further than is necessary or advisable and will do far more harm than good. We submit for your consideration the following comments on the provisions of H.R. 10650 which we regard as particularly objectionable.

I. SECTION 13. INCOME OF CONTROLLED FOREIGN CORPORATIONS

A. In general

While recognizing the need for control over the improper use of tax-haven devices designed to avoid U.S. income taxes, the World Trade Center disapproves of both the nature and the scope of the remedy proposed by section 13 of the bill. Since high U.S. production costs, transportation expenses, and foreign custom duties often result in prices noncompetitive in foreign markets, it is essential for U.S. enterprises to manufacture certain products abroad in order not to be obliged to concede the foreign market to competitors. In discouraging foreign investment as a whole, we feel that the bill will in the long run be detrimental to the U.S. economy.

B. Specific criticisms

(1) By applying too broadly the unusual concept of taxing U.S. shareholders on portions of the undistributed income of foreign corporations, the section fails to distinguish adequately between the objectionable abuses and legitimate foreign operations. The inclusion in the U.S. shareholder's gross income of its pro rata share of the foreign corporation's increase in earnings invested in nonqualified property would put an American-owned foreign subsidiary at a serious competitive disadvantage. Its foreign-owned competitors could invest all their net-after-local-tax earnings in horizontal and vertical diversification essential to their growth, while the U.S. shareholders of the American-owned company would be exposed to U.S. tax on all such reinvested earnings which the Treasury might regard as not being ordinary and necessary for the active conduct of its existing line of business. Foreign-owned corporations could invest their earnings in any country where economic opportunity might seem attractive, but the American-owned corporation would be exposed to tax liability if it invested in any country other than those designated from time to time by the President to be less developed. While trying to establish equality of taxation of domestic and foreign earnings of a U.S. taxpayer, section 13 would clearly create serious inequality of taxation as between an American-owned foreign corporation and foreign-owned corporations competing in the same market. Such tax burdens and the uncertainty caused by the excessive area of administrative discretion would discourage sound U.S. foreign investment either in existing businesses or in new businesses in less developed countries.

(2) Although the report of the Committee on Ways and Means (p. 57) declares that the bill does not eliminate tax deferral in the case of operating businesses owned by Americans, the broad definition of foreign base company income would do just that in regard to many forms of active foreign operations. For example, the U.S. shareholders of a foreign corporation actively engaged within the country of its incorporation in the business of leasing and servicing machines which it either purchased at arm's-length prices from an affiliated company or manufactured in its own factories would be subject to U.S. tax on the rental income of that foreign corporation even though no U.S. tax would be due if the same machines were sold rather than leased.

(3) The liability of the U.S. shareholder to pay U.S. tax on income not received could be a serious burden in some cases. There are many factors other than the avoidance of U.S. tax which limit the remittance of earnings from foreign subsidiaries. The shortage of cash, unexpected liabilities, exchange restrictions and unfavorable exchange rates, and the decisions of other shareholders, might prevent the remittance of earnings while the U.S. shareholder would still have to pay out of his own funds the U.S. tax on subpart F income and the increase in investment in nonqualified property.

(4) This new form of Government control would interfere with normal business considerations in regard to dividend policy, reinvestment decisions and many other aspects of foreign operations. Faced with the uncertainty of controls based on Treasury and Presidential discretion, business would be severely handicapped in its long-run planning for foreign operations. Such interference might well lead to conflicts between the U.S. shareholders, foreign minority shareholders and foreign governments. The added tax burden imposed by section 13 might induce U.S. investors to seek to reduce their holdings in foreign corporations to minority interests with the result that there would be greater difficulty in retaining those foreign subsidiaries as customers for the exports of the affiliated U.S. corporations.

(5) Such a flagrant extension of U.S. tax authority to the foreign field would probably lead to retaliatory measures abroad which would be prejudicial to both the U.S. Treasury and the U.S. investor. The specific statement in section 21 to the effect that the provisions of the bill when enacted into law would have precedence over any conflicting prior treaty obligations would seem to us to be an inexcusable foreign policy error. The vociferous objections already raised against the bill by the President of Panama and the Governor of Puerto Rico give some indication of the adverse effect the tax provisions could have on our foreign relations.

(6) Some of the provisions of section 13 are aimed at arrangements entered into not for the reduction of U.S. taxes but rather for the reduction of taxes of foreign countries. For example, proposed section 952(e)(2) calls for differing U.S. tax consequences depending upon whether the controlled foreign corporation purchases goods from or sells goods to corporations domiciled in countries

other than where the goods are produced or consumed. Arrangements such as this provision is aimed at are entered into for the purpose of reducing foreign taxes, not for the purpose of avoiding U.S. taxes. Such arrangements are entered into by foreign competitors for the purpose of obtaining similar foreign tax advantages. There would seem to be no reason why it should make a difference from the point of view of U.S. taxation whether a foreign corporation is domiciled in Switzerland or in France, since in either case the foreign corporation's contacts with the United States would presumably be the same.

(7) Because of the complexity of section 13, it would be extremely difficult for both the taxpayer and the Treasury to determine the tax liability of a shareholder of a foreign corporation. Many of the provisions would call for computations of a purely hypothetical nature. For example, the determination of the amount a foreign subsidiary would have paid an unrelated person for the use of the patents, processes, and formulas it obtained from its affiliated company is really in the realm of guesswork. In many cases it would be impossible to determine the extent to which such information and property has been used by the subsidiary and, where related companies cooperate in their research efforts, it would be difficult to determine what was actually developed in the United States. The section would also add greatly to the complexity of computing the foreign tax credit, particularly in the case of "grandsubs." The provisions of section 13 would not only lead to frequent disputes and litigation but would also impose on the taxpayers the burdensome uncertainty as to what tax liability would eventually be assessed after the Treasury has exercised its discretionary powers. This would be particularly undesirable in the case of corporate taxpayers who must record in their financial statements reserves for contingent tax liabilities and consider such liabilities in their long-run corporate planning.

(8) The accumulation of the information required to comply with the provisions of clause 13 would be a herculean task. Accounting methods and tax concepts vary from country to country. Rapidly changing exchange rates would complicate the conversion of foreign data for use in the tax computations. The details required would probably not be readily obtainable from many foreign companies, particularly where the foreign management is not dominated by the U.S. shareholders. One of the World Trade Centers's corporate members having more than 50 foreign subsidiaries including some with active minority shareholders has expressed the opinion that full compliance with the section would in practice be an impossibility.

C. *Suggested alternative proposals*

The World Trade Center believes that there has been a great deal of over-emphasis placed on the extent of tax abuses in connection with foreign operations. However, it does recognize that some changes in present law may be desirable to cover the relatively few instances where there have been tax avoidance schemes. It suggests that your committee consider, as an alternative to the highly complicated, unworkable and unfair proposals contained in section 13 of H.R. 10650, the possibility of an approach analogous to that contained in the accumulated earnings surtax provisions under present law. Thus, the earnings of a controlled foreign corporation under such a proposal might be taxed to the controlling U.S. shareholders to the extent that the earnings of the controlled foreign corporation are accumulated beyond the reasonable needs of its business. The concept of accumulations beyond the reasonable needs of a business has been present in the Internal Revenue Code for many years. A substantial body of case law has been built up in clarification of that concept, and it is accordingly a familiar concept to corporate taxpayers. It is suggested that the adaptation of this concept to controlled foreign corporation arrangements (1) would eliminate schemes truly aimed at the avoidance of U.S. taxation, (2) would not place American-owned foreign business corporations at a competitive disadvantage with foreign-owned corporations competing in the same markets, and (3) would avoid introducing into the tax law such complicated and litigation-breeding provisions as are contained in section 13.

Alternatively, your committee might consider a proposal under which the U.S. shareholders of foreign controlled corporations might be taxed on earnings of the latter where one of the principal purposes for which control of the foreign corporation was acquired was evasion or avoidance of U.S. Federal income taxes. This would be similar to the concept contained in section 269 of the present Internal Revenue Code.

Either of such proposals would afford far greater flexibility and greater adaptability to the wide variety of situations and arrangements involved in foreign business operations than the arbitrary rules contained in proposed section 13.

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II. SECTION 6. AMENDMENT OF SECTION 482

In our opinion, the Treasury already has ample statutory authority under section 482 to prevent tax avoidance achieved through improper handling of transactions between related companies. In order to escape the application of the arbitrary profit allocation formula set forth in the proposed amendment to section 482, the taxpayer would be obliged to prove that the intercompany price was the same as the "arm's length price" charged third parties under similar circumstances. Since such proof is often difficult or impossible, many taxpayers would be submitted to inequitable tax liability through the application of this inflexible formula which fails to give due consideration to the true economic factors influencing a sound pricing policy. The proportion of profit properly assignable to the production, distribution and sales functions varies considerably from industry to industry and is often unrelated to the asset, compensation, and sales expense mix upon which the Treasury formula is based.

The proposed formula would present serious definitional problems which might well render it unworkable. No guidance is given as to how to separate "income arising from such sales" from other taxable income. The ambiguous terms "to the extent used" and "to the extent attributable" as applied to limit the scope of the asset, employee compensation and sale expense factors appearing in the formula would certainly give rise to burdensome uncertainty, controversy and litigation.

Another serious obection to this proposed section is the burden in both time and expense that it would impose on the taxpayer in making available the voluminous amount of information required for each transaction covered by the formula. If the assembled data failed to satisfy the Treasury, the entire income realized on the transaction could be allocated to one of the taxpayers. The practical problem of accumulating the information which might be required for the formula would be tremendous. For example, assets might be used in varying degrees to produce and distribute a number of different types of products. Some of these products might be sold abroad, others might be sold domestically and some might still be in year-end inventory abroad or in the United States. The usual records would not supply the formula's requirements as to tax basis of assets and as to employees and selling expenses related to the production and sale of each product. The cost of establishing such records for many companies would be prohibitive.

The proposed formula of section 6 has an illusory simplicity about it. According to the report of the House Committee on Ways and Means (p. 29), one of the principal aims of the proposal is to—

"enable the Secretary 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 sales price of the goods in question and build up from this to the taxable income, a process much more difficult and requiring more detailed computations than the allocation rule permitted by this bill."

But the allocation formula, involving as it does a preliminary allocation of the factors of compensation, assets and advertising and sales expenses, is no less complicated. Under present law, the steps run from A to Z; under the proposal, similar steps are involved but they run backward from Z to A.

The proposed formula is at the same time too flexible and too inflexible. It is too inflexible because it selects certain guidelines (assets, compensation, and advertising and sales expenses) and gives them an importance beyond that which they deserve. It is too flexible because it apparently permits the Secretary to give whatever relative weight he desires to these three factors.

The three factors contained in this formula may have no relation to the proper determination of what is the right price for the goods sold. For example, suppose an American corporation sells an article at the same price through two foreign sales companies, the first a large one and the second a small one. Under the proposed formula, apparently the share of the foreign income to be allocated to the United States on account of the sales through the small sales company would be far greater than in the case of the sales through the large sales company, regardless of the similarities in market conditions in the two areas, simply because of the smaller size of the smaller sales company in relation to the size of the American corporation.

In tax cases generally, the taxpayer has the burden of proof. Provisions such as present section 482 make the taxpayer's burden of proof even greater. A provision such as the proposed section 6 places an almost impossible burden of

proof on the taxpayer. It is respectfully suggested that the normal presumption of the correctness of the determination of the Internal Revenue Service, coupled with the added presumption of present section 482, gives the Service all the weapons which it needs or is reasonably entitled to.

Since the formula does not take into account such factors as the lower costs of foreign competitors, the passage of this amendment as a whole might well cause a marked reduction in U.S. exports. American corporations would be encouraged either to abandon their foreign sales efforts or to manufacture abroad for the foreign market. Corporations operating through foreign subsidiaries in danger of falling within the "grossly inadequate assets" test might choose to build up the overseas installation operations rather than make further investment in their U.S. facilities.

The proposed amendment to section 482 does include a much-needed provision that foreign taxes paid by a foreign corporation would be considered as having been paid by the domestic affiliate to which the income of the foreign corporation has in effect been transferred. The House committee report indicates that the domestic affiliate could take a foreign tax credit or a deduction for such taxes, but that the income transferred would not be considered foreign source income for the purpose of computing the limitation upon the foreign tax credit. In many cases the benefits of the transfer of the foreign tax to the domestic organization would thus be illusory and the practical effect of the proposed amendment would be a double income tax upon the transferred income.

We recommend that no amendment be made to section 482 except the addition of a provision to allow a foreign tax credit in regard to taxes paid abroad by affiliated companies on income allocated to the U.S. corporation by the Treasury. Such reallocated income should be treated as foreign income in computing the limitation on the foreign tax credit.

III. SECTION 11. COMPUTATION OF FOREIGN TAX CREDIT FOR TAX ON DIVIDENDS FROM FOREIGN CORPORATIONS

The World Trade Center is opposed to section 11 of the bill, which provides for the so-called gross-up in the computation of the foreign tax credit. This has as its theory and aim the equalization of tax treatment as between foreign subsidiaries and foreign branches of U.S. corporations. While this aim is not objectionable, the proposal does not achieve it; and, moreover, in unsuccessfully attempting to achieve this aim, it inadvertently creates a large number of tax problems for the domestic parent corporation.

The center is opposed to the approach taken by section 11 of the bill in effecting the change by increasing the parent U.S. corporation's gross income by a constructive dividend equal to the taxes paid by the foreign corporation on the income out of which the dividends came. This would have tax consequences totally unrelated to the tax credit aspect for which the amendment is intended. For example, the inclusion of this income which the U.S. corporation never actually receives would have an effect on the corporation's tax bracket, on the utilization of loss carryovers and on the charitable contribution limitation. Furthermore, grossing-up could cause a U.S. corporation to lose its qualification under subchapter S or under the Western Hemisphere Trade Corporation provisions, could cause it to be taxed as a personal holding company, and could prevent its shareholders from taking a deduction for losses under section 1244.

While the amendment is described as a means for putting foreign operations conducted through foreign subsidiaries on the same U.S. tax basis as those conducted through foreign branches of U.S. corporations, this objective would not be accomplished by the proposed amendment. For example, such benefits as depletion deductions and the use of foreign losses to offset domestic gains, which are now enjoyed by foreign operations in branch form would not be available in regard to operations conducted through foreign subsidiaries. In other words, the proposed amendment would eliminate the advantages of doing business through a foreign subsidiary but grants none of the advantages of doing business through a foreign branch.

The proposal in section 11 fails to take into account that the foreign tax credit provisions give no relief with respect to the payment of foreign taxes other than those qualifying as income taxes. In many countries, turnover taxes, property taxes, and other types of taxes not qualified for the foreign tax credit constitute a far greater source of revenue to the foreign governments than do income taxes, and consequently constitute a major part of the tax burden of companies doing business in those countries. The U.S. foreign tax credit provisions do not allow

these taxes to be credited against U.S. taxes, even though they are in effect substitutes for income taxes. It is believed that whatever slight advantage the present method of computing the foreign tax credit provides is small compensation for the fact that so many foreign taxes are not eligible for crediting under the present provisions in any event.

The proposal of section 11, if enacted, would have relatively little effect on the amount of foreign tax credit to which a taxpayer is entitled where it is doing business in a country with an income tax rate approaching that of the United States. This is illustrated by the table appearing on page 51 of the report of the House Committee on Ways and Means. Typically, those countries with tax rates approaching that of the U.S. rate are the more developed countries. Countries having income tax rates in the range affording the major benefit to American taxpayers under the present method of computing the foreign tax credit are typically the less developed countries. Thus, this proposal in practical effect has its most drastic consequences on taxpayers with investments in the less developed countries. This is inconsistent with the aims of H.R. 10650 to favor foreign investment in less developed countries.

In our opinion the foreign tax credit provisions should be left unchanged. The proposed arrangement is defective in that it eliminates this relatively minor advantage of doing business through a foreign subsidiary while it grants none of the advantages of doing business through a foreign branch. Thus it leaves taxpayers with the disadvantages and takes away compensating advantages.

If it is really considered essential to make a change, however, it is suggested that if foreign subsidiaries are to be put on a par with foreign branches with respect to the foreign tax credit, the domestic parent should have the option of including its foreign subsidiaries in the filing of consolidated U.S. tax returns, thereby putting them on a par with foreign branches in other respects as well.

Moreover, if it is deemed necessary to make a change and provide for a gross-up in the foreign tax credit computation, at the very least the technical defects of the bill should be corrected to eliminate the changes that the present bill's language makes—apparently inadvertently—in the other respects outlined above.

IV. SECTION 16. GAINS FROM CERTAIN SALES OR EXCHANGES OF STOCK IN CERTAIN FOREIGN CORPORATIONS

The World Trade Center objects to this proposal. The first objection is its retroactivity. It makes no pretense at limiting the ordinary income treatment on the sale or exchange of stock of a foreign corporation to the sharehodlers' proportionate part of that corporation's earnings and profits accumulated after the date of enactment of H.R. 10650. On the contrary, in calculating the amount of gain to be taxed at ordinary rates, the provision takes into account all earnings and profits accumulated in the foreign corporation since 1913. This is changing the rules of the game over 40 years after the game was started. Retroactivity of this type should be avoided wherever possible in legislation.

The proposal singles out stock in foreign corporations for especially adverse treatment. It proposes a change in the concept of a capital asset in a very restricted area. There has been no showing that such special treatment is warranted in the case of stock in foreign corporations.

Moreover, the section will place an impossible burden on many shareholders. Unless the taxpayer establishes the appropriate amount of earnings and profits of the foreign corporation his entire gain will be taxed at ordinary income rates. In many instances it will be impossible for a minority shareholder in a foreign corporation to acquire the data necessary to establish what the earnings and profits of the foreign corporation in fact are. This will place minority shareholders in the foreign corporation in a more disadvantageous position than controlling shareholders in the foreign corporation, since controlling shareholders are presumably in a much better position to acquire the necessary data and information.

If section 13 of the bill is enacted in some form or other, such as in the form suggested earlier by the World Trade Center, the proposal contained in section 16 will be totally unnecessary. Current earnings of a foreign corporation will be taxed to U.S. shareholders to the extent that they are accumulated beyond the reasonable needs of the business. This is as far as the law should go in taxing U.S. shareholders at ordinary rates on the earnings and profits of foreign corporations.

CONCLUSIONS

The World Trade Center believes that the expansion of U.S. foreign investment is essential to our national economy and our standing in world affairs. We consider the foreign aspects of H.R. 10650 discussed above to be highly undesirable and an unjustifiable boon to foreign competition. For these various reasons we emphatically oppose the adoption of the sections of H.R. 10650 discussed in this statement and urge your commitee to reject them.

Respectfully submitted.

ERNEST HENDERSON, *Chairman.*

HEUSER, RYAN & CO.,
Oklahoma City, Okla., May 2, 1962.

In re expense recovery for banks and savings institutions that collect 20 percent withholding tax on interest and dividends.

Hon. HARRY BYRD,
U.S. Senate, Washington, D.C.

DEAR SIR: I read in today's Wall Street Journal of the grassroots opposition to the 20 percent withholding tax experienced by Senators and Congressmen on their 10-day Easter holiday.

It is my personal opinion that the opposition of the little people to the tax bill is kept alive by the banks and savings and loan institutions, who are not really so much interested in their investors' tax problems as they are interested in the expense and difficulty of the institution collecting the tax.

The Treasury Department and the administration should be interested in an expense recovery for the collecting institutions.

I mailed only 20 copies of the attached letter to officials and to Members of the House and Senate on April 17.

Large investors should encourage the bill rather than oppose it because they know their own tax on that kind of income has always been paid. We know from our own experience of many years preparing income tax returns that the 20 percent withholding act will produce a great amount of revenue which has not previously been assessed.

Yours truly,

GEO. J. HEUSER.

In re expense recovery measure for institutions collecting the 20-percent withholding tax on dividend and interest payments.

HEUSER, RYAN & CO.,
Oklahoma City, Okla., April 17, 1962.

There has been much objection to the 20-percent income tax withholding measure on dividends and interest paid, because of the considerable amount of expense, time, and work that would be incurred by cooperative associations, banks, credit unions, savings and loan associations, and other thrift institutions.

Perhaps the objection to the measure could be overcome by an expense deduction allowed to be recovered by the institutions required to collect the tax and remit to the U.S. Treasury Department.

A quarterly, or semiannual expense allowance is proposed at 10 cents for each share account, bond account, deposit account, or other interest bearing account, without limitation as to the number of accounts for each person, family, or business firm receiving such dividend or interest payments; plus 50 cents each for each first time processing of exemption certificates. Such expense allowance to be deductible from the withholding tax required to be collected and remitted to the Treasury Department. An overall limitation could be imposed at 1½ percent of the tax actually collected.

It is proposed that the 10 cents expense recovery for each account would be allowed for each quarterly, semiannual or annual reporting period required by the Treasury Department in which period tax withholding was effected.

The effect of such an expense recovery allowance is illustrated in the following three examples taken from actual institution records:

(1) One of the largest corporations in the United States has approximately 2 million shareholders and pays dividends, on a quarterly basis, of over $800 million dollars. Quarterly dividend payments to 2 million shareholders would provide an expense recovery of about $80,000, at 40 cents each, for the institution handling such dividend payments. If 15,000 exemption certificates were processed in the first year, there would be an additional expense recovery of $7,500.

The total expense recovered would therefore be less than six one-hundredths of 1 percent of the taxes collected. The corporation cited here also pays a large amount of interest to a smaller number of investors.

(2) A savings institution with 50,000 shareholders, paying $4 million in dividends on a semiannual basis, would collect approximately $800,000 in withholding tax. The expense recovery at 20 cents per shareholder account on a semiannual basis would be about $10,000. If 5,000 exemption certificates were processed for the first time in that year, an additional expense recovery of $2,500 would be indicated to make a total expense recovery of $12,500. However, an overall limitation of 1½ percent of the actual tax withheld would reduce the expense recovery below $12,000 depending on the reduction in tax withheld caused by the amount exempt under the exemption certificates.

(3) A small corporation paying $60,000 per year in quarterly dividends to 45 shareholders would recover only $18 in expense from the $12,000 in taxes collected, plus a possible few dollars for servicing a few exemption certificates.

All large institutions will incur a great amount of expense in the necessary changeover of mechanical equipment designed to compute dividend or interest payments and provide a withholding tax computation.

The greatest amount of difficulty and time spent by officers and employees of a tax withholding institution would be incurred in the processing of first time exemption certificates for persons with small incomes, such as retired persons and guardians of the estates of minors.

It would also be necessary for institutions to program some sort of information reporting system to supply investors with annual reports of the amount of dividends or interest paid, and the amount of tax withheld. Even with a good reporting system there will still be hundreds or possibly thousands of inquiries and protests to be answered.

The dividend and interest withholding tax measure is not comparable with the withholding tax on salaries and wages. The savings institution cited herein has less than 75 employees, but has more than 50,000 shareholders.

If an expense recovery measure is adopted that does not provide a reasonable recovery commensurate with the expense incurred, you may still have considerable objection to the Tax Withholding Act.

Yours truly,

GEO. J. HEUSER, *Certified Public Accountant.*

ELI LILLY INTERNATIONAL CORP.,
Indianapolis, Ind., May 2, 1962.

Hon. HARRY F. BYRD,
U.S. Senate, Washington, D.C.

DEAR SENATOR BYRD: Eli Lilly International Corp., of which I am president, is a wholly owned subsidiary of Eli Lilly & Co., of Indianapolis. This subsidiary is responsible for the management of Lilly's worldwide operations outside the United States.

The Senate Finance Committee now has before it H.R. 10650, the Revenue Act of 1962. Two sections of this act, Nos. 6 and 13, would seriously affect our business, and we would like to present in this letter information for your consideration. A similar letter is being sent to other members of the committee, and copies will also be mailed to Members of Congress from Indiana for their information.

As background, I should tell you that Eli Lilly & Co. employs more than 10,500 men and women and does business in the United States and 133 foreign countries. World distribution by Lilly began before the turn of the century.

For many years the company carried on most of its business abroad through export channels. Now, however, Lilly is doing more and more business within foreign countries from manufacturing plants based there. The major percentage of Lilly products which are sold outside the United States today are processed entirely or in part in foreign countries.

This has come about, in part, from the action of foreign nations in closing their borders to importation of finished merchandise while continuing to permit importation of raw materials for manufacture within the country. This development has made it necessary for us—unless we are willing to relinquish the market—to invest considerable capital in foreign plants and equipment.

We cannot justify continued investment in foreign countries without incentives commensurate with the risks involved. Such risks include the possibility of

currency devaluation, expropriation, price control, discrimination against foreigners, and other hazards which are frequently unknown at the time the investment must be made. Taxation by the United States of our foreign income before remittance to this country would seriously lessen the incentive to continue and expand our operations abroad. It is significant, we believe, that other governments, including some in the Common Market, are now taking an opposite approach and are encouraging exports and investments abroad through their own tax incentive programs.

If countries in the free world wish to attract industry by providing favorable tax rates, American investors should not be deprived of this opportunity. Furthermore, these coluntries should not be deprived of the opportunity to attract American investment by U.S. tax laws which nullify foreign tax incentives. The underdeveloped nations need American technology and the contributions which American industry can make in helping build a strong economy. The so-called developed countries need the mutual benefits and understanding which come from interchange of technology.

We understand that there is a belief that there is little, if any, repatriation of earnings on foreign investments of U.S. companies. This is certainly not true in our business, and we do not believe it is true of business generally. We do not invest in foreign countries unless we have a reasonable expectation of returning a profit to our shareholders in the United States. During the period 1936–56 our company built manufacturing plants in five foreign countries. In the last 25 years remittances from Eli Lilly & Co's., operations in those countries have amounted to 492 percent of the total original investment from the United States. We find that the rate of return tends to accelerate as our investments age. This is evidenced in the fact that remittances during the last 5 years have contributed 333 percent of the 25-year total.

Our discussion so far has referred to the provisions of section 13 which we find objectionable. As mentioned earlier, we also have serious objections to section 6 of the act. We believe that the language of the formula in section 6 could provide a basis for unreasonable and arbitrary allocation of profits which would not adequately reflect the creativity and enterprise of the foreign subsidiary.

Our management agrees with the expressed views and objectives of the present and past administrations—that it is in the best interests of the United States, the American consumer, and American industry that trade be expanded with the free world nations and that continued support be given to their economic development.

However, we believe that sections 13 and 6 would have the effect of curtailing foreign investment and would work against the objectives of the administration. To the extent that ingredients and intermediaries of finished products are produced in this country for further processing by our plants abroad, injury to those foreign subsidiaries would result in reduced employment and a lower payroll in our Indiana plants. We believe that the taxation of foreign-source income before remittance to the United States would result in—

A slowdown in the economic progress of certain underdeveloped countries;

A reduction in exports from the United States;

A decrease in employment in the United States;

A further aggravation of our balance-of-payments problem;

And surrender of a significant portion of foreign trade to competition from other nations.

We do not believe your committee and the Congress would want to take actions which would cause a decrease in exports and a decrease in remittances from abroad. We do not believe that American business should be placed at a competitive disadvantage by its own Government. We do not believe that the interests of the American people should be jeopardized.

Therefore, it is our earnest hope that the serious consequences which would be caused by sections 13 and 6 can be eliminated from any tax legislation which your committee and the Congress may enact.

Sincerely,

BURTON E. BECK.

AMERICAN CHAMBER OF COMMERCE IN FRANCE, INC.,
Paris, April 27, 1962.

Ref: H.R. 10650.

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

DEAR MR. CHAIRMAN: With reference to H.R. 10650 which is now under consideration before your committee, the American Chamber of Commerce in France herewith submits for the consideration of your committee the following comment pertaining to this new and radical legislation. Your courtesy in receiving this comment is most appreciated. While it is a fact that this organization has stated its protest to the basic content of the present bill by is letter of December 20, 1961, to the Honorable Wilbur D. Mills, and has made further protest by its telegram of February 21, 1962, to the Honorable Wilbur D. Mills following the publication of certain intermediate modifications, in view of the drastic change in both corporate and personal tax concepts of H.R. 10650, we feel obliged to restate our case before this Senate committee.

The proposal to tax at prevailing American rates the income of foreign subsidiaries after credit for local tax paid at source, violates basic American tax concepts without proper justification and at a most inopportune time. The U.S. Treasury proposals would take away from U.S. subsidiaries operating abroad what has not been locally taxed at U.S. rates. In other words, the U.S. Treasury will be discriminating against U.S. corporations in a foreign country while the foreign local competitors will not face this extra burden.

If the foreign country, because of reasons of its own history and experience, has determined that its tax rates should be less than those of the United States, then the U.S. Treasury will tax away the difference. This would mean that the local subsidiary will face an annual drain on its treasury, which its local competitors do not face. With the rise of competition in the Common Market and the European free trade area, our American subsidiaries will have less internal funds for refinancing their expansion and improvement with the result that, inevitably, we feel our corporations will lose their position in these important trading areas.

We believe a careful review of the figures proves that the growth of American subsidiaries abroad contributes greatly to the favorable flow of foreign exchange to the United States with the return of dividends, technical assistance fees and the purchase of American material, so that the dollar drain cannot be justified by this proposed tax legislation. On the contrary, the draining off in this manner of such funds will reduce the capacity of these subsidiaries to purchase American material and to reinvest on a competitive basis so as to meet foreign competition.

The current proposal also is a clear violation of the separate status of a corporation from its stockholders and further by reaching out and taxing a foreign corporation, the United States would be violating the spirit of just about all of its international double tax agreements as well as its network of treaties of establishment of friendship, and navigation, and commerce.

At this time, in our national history, when we are striving for world leadership, we are considering the invasion of the territory of our allies, and perhaps also, suggesting to them measures which they might take in a like matter against their own corporations which have establishments in the United States.

The proposal that tax deferral can be achieved if the foreign subsidiary invests in developing countries, appears to us to be a dictate to management as to where it should reinvest its own funds. The need for funds will be greater in the developed countries where existing competition is getting stronger and where an increasing amount of reinvestments will be increasingly necessary.

In most countries of Western Europe, the combination of local corporation income taxation plus local dividend withholding taxes, now exceeds the U.S. tax rates so that in effect, after having caused the local subsidiary the trouble of preparing special tax return for the United States and putting our Government to the expense of auditing this tax return, the U.S. Treasury will in all likelihood have gained nothing.

We also believe that the responsible American corporations which have established European headquarters in such special tax areas, now utilize any untaxed funds for reinvestment which, eventually, produces a larger flow of dividends back to the United States so that in the long run our Government gains from this procedure.

As a compromise proposal, we respectfully recommend to your committee that, if the status quo must be changed, at least the U.S. subsidiaries operating abroad should be given a grace period of 3 years in which to justify that they have reinvested any untaxed income for the expansion of their business. This should be more than adequate protection for our Government and a sufficient guaranty that the concerns are expanding their activities and contributing to the development of American interest abroad, which eventually produces a greater flow of revenue from abroad. We might also add that if this tax bill is passed, a number of countries may be inclined to increase their own rates through various devices so as to reach the 52 percent U.S. level, with the knowledge that, in such cases, the U.S. subsidiaries will have no reason to protest. In the past, our American concerns have been vigorous in the defense of their position and the net result has been that the local tax saving effected has produced additional local income for reinvestment and eventually a higher return of income to the United States.

With respect to the proposal to change the tax exemption of foreign residents by limiting same to $35,000 per year after 3 years of foreign residence, we believe that this discriminates against American citizens who, as individuals, must compete with Europeans who are not so taxed by their country of origin when they live abroad. One of the greatest contributions that America has made, and will continue to make to world trade, particularly at the time when we face serious competition from cheaper labor abroad, is the presence abroad of a highly experienced and skilled group of dedicated American business and professional personnel. Their counsel and guidance is frequently the difference between success or failure in a foreign country. The uncertainties of life abroad, the special costs of maintaining families abroad, transportation costs for periodic visits of family members to the United States, special charges incurred in educating children in the United States, are such that a limitation upon the present U.S. tax exemption is a discouraging feature which would make recruitment of top personnel exceedingly difficult. The combination of local European income taxation plus the fact that in most European countries excise taxes can run as high as 30 percent, rendering the cost of living extremely high, would indicate that an important incentive in obtaining and keeping such personnel abroad, would be lost.

With respect to the limitation of a $20,000 exemption for the first 3 years of nonresidence, this seems entirely arbitrary and without any economic justification of which we know

We respectfully request that your committee carefully consider the proposed legislation and determine what will be its long-range impact upon the U.S. business in world markets. We feel that for the little good that may be produced in some isolated cases of abuses, which could be cured by better enforcement of present legislation, much positive harm will result.

Respectfully yours,

HORTON P. KENNEDY, *President.*

THOMPSON RAMO WOOLDRIDGE, INC.,
Cleveland, Ohio, April 13, 1962.

Hon. FRANK J. LAUSCHE,
U.S. Senate, Washington, D.C.

DEAR SENATOR LAUSCHE: The tax bill H.R. 10650 now before the Senate Finance Committee embodies several provisions affecting the tax on foreign income. Our corporation is concerned with one of these proposed provisions which exempts certain foreign income from U.S. taxes under specifically defined conditions, but does not exempt certain other income. As one of your constituents, we would like to comment on this point and to voice our reasons why we consider this particular feature of the proposed tax bill to be undesirable and not only detrimental to our company, but as we believe, also detrimental to business in general and to the overall interests of the United States.

It would appear to be our national policy to promote the growth of underdeveloped countries such as South America, Africa, the Middle East and Far East. This should, in time, greatly reduce the need for reliance on U.S Government assistance to those countries. The much greater risks to which venture capital is exposed there justifies a national policy to stimulate such investments.

To this end the proposed section 13 exempts from U.S. taxes certain foreign income if it is reinvested in underdeveloped countries. However, the bill does

not so exempt foreign income derived from royalties on foreign patents. If stimulation of investment in underdeveloped countries is intended, as the bill indicates, then why should the bill not exempt foreign royalty income when so reinvested?

We believe that this particular provision will have a detrimental effect on many corporations such as ours. Let us present our case. Thompson Ramo Wooldridge Inc. (formerly Thompson Products, Inc.) for many years prior to World War II did a considerable export business in automotive parts to most countries in the world. Since then many underdeveloped countries have imposed or are about to impose import restrictions and prohibitive tariffs on these articles in order to stimulate their domestic production and the influx of foreign capital. A company such as Thompson Ramo Wooldridge either has to reconcile itself to the present loss of these markets and abandon them to other foreign competition, or it can preserve them by starting manufacturing enterprises in those countries, either jointly with foreign investors there or as sole owner. Thus we have established within the last few years parts plants in the underdeveloped countries of Brazil, Mexico, and Argentina, as well as new ventures in such countries as Germany, France, and Japan. We are being pressed to start up production in other underdeveloped countries such as India, and also to increase our investments in the underdeveloped countries where we now have plants to meet their growing markets.

To make these operations feasible, we formed last year a Swiss subsidiary named TRW International S.A. in which to centralize our foreign investment activity. This company was conceived not as a tax haven, but as a management and investment center into which all foreign income derived from dividends, interest and royalties would flow to be partly reinvested in underdeveloped countries, partly returned to the United States as a taxable profit of Thompson Ramo Wooldridge Inc. A very substantial portion of the foreign income of our Swiss company is derived from royalty payments being collected from our foreign licensees. Our investment plans were based on the assumption that this foreign royalty revenue could be used to fund these projects, being subject only to applicable taxes of the country where such income is derived.

The exclusion from the exemption of this type of income imposes on our company and others similarly situated a serious hardship in planning investments for the retention or recapturing of these foreign markets, which would otherwise certainly be lost to Britain, Germany, Italy, and other industrial countries. At this very time we are considering the desirability of an operation in India and this adverse change in the law could have a seriously adverse effect on our investment plans.

We do not want to make it appear that our investments in underdeveloped countries are being made solely as a patriotic duty. Each plan is measured by the usual yardstick being applied to any business investment; namely, whether our company is going to derive an adequate return for its investment in the light of the risks to be encountered. However, we are influenced by the national policy with respect to the economic development and progress of underdeveloped countries through investment of capital and technical know-how. We anticipate eventual good profits from those markets if they are not lost to other countries and look forward to the eventual repatriation of those profits. If we and other companies in this country are successful in this, it will enhance our future domestic income from which the U.S. Government will derive taxes. On the basis of the House committee report, we do not think that the revenue consequences of this exemption that we seek would be very significant. In fact, they might well be negligible, when considered over future years.

In light of the foregoing, we seek an extension of the exemption from U.S. tax to undistributed earnings of controlled foreign corporations derived from patent royalty income. We sincerely seek your assistance in securing an amendment to the present bill to cover this point.

Sincerely yours,

J. H. Kerr,
Vice President and General Counsel.

(Supplemental letter with respect to the above letter follows:)

APRIL 24, 1962.

Hon. STANLEY SURREY,
Assistant Secretary of the Treasury,
Washington, D.C.

DEAR MR. SURREY: This is with further reference to a discussion which I had last Tuesday, April 17, with Mr. L. M. Stone of your office and Mr. Emil Gibian of this company. As a former Acting General Counsel of ICA (presently AID) I and others in my company have been particularly interested in a special aspect of one section of H.R. 10650 which I think warrants your attention. The section of which I speak is section 13 which, as you know, exempts from U.S. taxes undistributed earnings of controlled foreign corporations when derived from dividends, interest, etc., if such earnings are reinvested in underdeveloped countries. However, this section does not so exempt undistributed earnings derived from royalties on foreign patents.

We favor the principle inherent in such an exemption for reinvested earnings in underdeveloped countries. We accordingly seek to extend rather than restrict its application. We believe that logic demands its extension to royalty income as well as to dividend and interest income. And, from the standpoint of tax administration, we believe that the exemption will be far easier to administer if applied across the board rather than to specific types of income.

During the present and previous administrations it has, as you know, been our national policy to promote as far as possible the economic growth of underdeveloped countries such as those of South America, Africa, the Middle East, and the Far East. It has been our goal that in time private enterprise would participate in this growth in many areas to such an extent that the need for reliance on U.S. Government assistance to underdeveloped countries would, in fact, be greatly reduced, which would, of course, mean a corresponding reduction in U.S. governmental expenditures. However, because of the degree of risk involved in investment in underdeveloped countries, capital so invested is essentially venture capital. To secure the commitment of such capital greater incentives are required to offset such risk. One offset against such risk can be the tax advantage which is the subject of this letter, which can help to compensate for the degree of risk involved. Moreover, mere reinvestment of foreign source income in underdeveloped countries has the additional advantage of not requiring corporate commitments of U.S. source income to such investments. If our suggestion were adopted, undistributed earnings derived from patent royalties could merely be reinvested without being returned to the United States and without adverse tax consequences.

As a company in a highly competitive line of business we are at all times mindful of our competitive position vis-a-vis competitors from other countries. I would presume that it is also the administration's objective that U.S. firms not be at a competitive disadvantage with those of European countries in entering underdeveloped countries; and, I think you would agree that the existence of the exemption, assuming, of course, that the bill is passed, could substantially help us in relation to our competitors in other countries who may now be favored with such tax treatment regardless of whether the reinvestment is in developed or underdeveloped countries.

My own information, supported by the Ways and Means Committee report, is that the revenue consequences of the provision we seek would not be very great. Actually, upon reflection you may agree with me that they may well be negligible when considered over the long pull.

In light of the foregoing and particularly the desirability of facilitating the economic growth of underdeveloped countries and in fostering the growth of U.S.-owned private enterprise therein, my view and that of my company is that an exemption from U.S. tax on undistributed earnings of controlled foreign corporations derived from patent royalty income is in order. We sincerely request your assistance in securing such an amendment to the present bill on this point.

Sincerely,

HENRY T. KING, Jr.

WILMER, CUTLER & PICKERING,
Washington, D.C., May 7, 1962.

Re section 12 of H.R. 10650.

Hon. HARRY BYRD,
Chairman, Senate Finance Committee,
Washington, D.C.

DEAR MR. CHAIRMAN: I wish to call the attention of your committee to what is, in my opinion, a most necessary amendment to the Internal Revenue Code if the proposed section 12 of H.R. 10650 should be enacted by the Congress. This amendment will be necessary in order to prevent a grave injustice to certain Americans residing abroad.

As your committee is well aware, section 6013 of the Internal Revenue Code provides that a husband and wife may file a joint return, except, among other things, if either the husband or the wife at any time during the taxable year is a nonresident alien. This provision may have been entirely appropriate at a time when the foreign earned income of U.S. citizens residing abroad was not subject to tax; but it should be carefully examined once again if section 12 is enacted, since, in many cases, a major part of the income of U.S. citizens residing abroad will become subject to U.S. tax.

If section 12 is enacted without change in the applicable provisions of section 6013, U.S. citizens residing abroad who are married to alien spouses will be required to file their returns on an individual basis and will not be permitted to file joint returns. Thus, taxpayers residing abroad will be discriminated against when compared with taxpayers residing in the United States and, moreover, those residing abroad who are married to alien spouses will be discriminated against when compared with those residing abroad who are married to U.S. citizens. Thus, American citizens who are otherwise in substantially the same economic position will pay greatly different taxes depending on the nationality of their spouses. As a matter of fact, this treatment will result in the complete absurdity that an American who is married to an alien spouse living in this country will be able to file a joint return while they reside in the United States; but, when he is sent abroad, he will not be permitted to file a joint return unless he leaves his wife in the United States.

I suggest, therefore, that, if section 12 should be enacted by your committee, a conforming amendment to section 6013 should also be enacted to permit a U.S. citizen residing abroad with an alien spouse to file a joint return if he and his spouse declare both their incomes for U.S. tax purposes. I cannot see how such a procedure would present the Treasury Department with any more difficult administrative or collection problems than those which it currently must face with respect to the taxation of U.S. citizens residing abroad. If necessary, the Treasury could be empowered by regulations to prescribe the conditions under which such an election must be made. Furthermore, since the filing of a joint return is elective in any case, it would seem that the result of filing such a return would only be to reduce the amount of tax otherwise owing and due. Indeed, such filing might well present the Treasury Department with additional assets to secure the payment of the tax.

I hope very much that your committee will consider this problem and, in the event it should adopt section 12, permit U.S. citizens with alien spouses to elect to file joint returns for U.S. tax purposes.

Respectfully yours,

REUBEN CLARK.

WILMER, CUTLER & PICKERING,
Washington, D.C., May 7, 1962.

Re H.R. 10650.

Hon. HARRY F. BYRD,
Chairman, Senate Finance Committee, Washington, D.C.

DEAR MR. CHAIRMAN: On behalf of several clients of this firm, I wish to call the attention of your committee to certain technical deficiencies in section 13 of H.R. 10650, which, if left uncorrected in the event this section were to be approved by your committee, would result in undesirable tax rules and in most inequitable consequences as between taxpayers who would otherwise be similarly situated. For convenience's sake, I will set forth my comments in the form of three suggested amendments to the proposed sections 951 and 953 now contained in section 13.

Suggested new section 951(a)(4)

The proposed section 951 of subpart F of the Internal Revenue Code would include in the gross income of U.S. persons who own the requisite stock in a controlled foreign corporation a pro rata share of the corporation's subpart F income and of the corporation's increase in earnings invested in nonqualified property. Such inclusion in the income of U.S. taxpayers would be effectuated nothwithstanding the fact that such earnings are not repatriated to the United States but are retained by the controlled foreign corporation. The purpose of this provision is, it seems clear, to subject the earnings of such foreign corporations to U.S. tax as if the earnings were in fact wholly distributed as dividends to U.S. shareholders. However, section 951 as now written would in many cases subject U.S. shareholders to much harsher tax on such imputed income than would be the case if they in fact desired to distribute such income to the United States as dividends or, for that matter, than would be the case if such earnings had been directly earned by them.

As your committee is well aware, the earnings of foreign branches of a domestic U.S. taxpayer have always been included in U.S. income, regardless of whether or not such earnings were repatriated to the United States. However, problems arose where such income was earned in countries having monetary or exchange restrictions which made it difficult for taxpayers to ascertain the value, in terms of U.S. dollars, of the blocked income arising in countries having such restrictions. After considerable uncertainty, the Treasury in 1950 provided a highly satisfactory method, both from the point of view of the Government and of the taxpayer, whereby foreign earnings arising in countries having such monetary or exchange restrictions could be treated as deferable income, with respect to which the taxpayer could elect to defer the U.S. tax. (See Mim. 6475, 1950–51 C.B. 50, as amended by Mim. 6494, 1950–51 C.B. 54, and Mim. 6584, 1951–51 C.B. 19.) Under this election, the payment of tax on such income is deferred until the year in which it no longer qualifies as "deferable income."

This same problem will, of course, arise under section 951, which for the first time seeks to tax the earnings of controlled foreign corporations directly to U.S. shareholders even though they are not distributed as dividends. Indeed, a further problem will arise: If, by law, the controlled foreign corporation is prevented from paying dividends to U.S. shareholders, it would seem to follow that such shareholders also should not be in receipt of current taxable income from the corporation. It would seem entirely appropriate, therefore, to give U.S. shareholders of controlled foreign corporations who are to be taxed under section 951, the same election to treat imputed earnings in blocked currency as deferable income that other U.S. taxpayers now enjoy and, furthermore, to extend this election to the earnings of controlled foreign corporations which are subject to restrictions with respect to the payment of dividends. Accordingly, it is respectfully suggested that your committee consider adding the following additional section 951(a)(4) to the proposed section 951:

"(4) ELECTION TO TREAT INCOME OF CONTROLLED FOREIGN CORPORATIONS AS DEFERABLE INCOME.—

"(A) GENERAL RULE.—Any United States person may, in accordance with regulations prescribed by the Secretary or his delegate, elect to use a method of accounting in which the reporting as taxable income of amounts included in gross income under section 951(a)(1) which constitutes 'deferable income' is deferred until such income ceases to be 'deferable income', at which time it is includible in gross income.

"(B) DEFINITION.—The term 'deferable income' shall mean income included in gross income under section 951(a)(1) which is—

"(i) owing to monetary exchange or other restrictions imposed by a foreign country, not readily convertible into United States dollars, or into other money or property which is readily convertible into United States dollars, subject, however, to the provision that such income shall cease to be 'deferable income' when—

"(a) money or property in such foreign country is readily convertible into United States dollars or into other money or property which is readily convertible into United States dollars; or

"(b) notwithstanding the existence of any laws or regulations forbidding the exchange of money or property into United States dollars, conversion is actually made into United States dollars or other money or property which is readily convertible into United States dollars; or

"(ii) is earned by a controlled foreign corporation which, owing to restrictions imposed by the law of the country under the laws of which it is created or organized, may not distribute dividends to United States shareholders, subject, however, to the provision that such income shall cease to be 'deferable income' when such restrictions are no longer in force.

"(C) NOT TO EXCEED EARNINGS AND PROFITS.—The amount of 'deferable income' included in the gross income of a United States person with respect to any controlled foreign corporation shall not, in any taxable year in which it ceases to be 'deferable income', exceed the accumulated earnings and profits of such corporation."

Suggested amendment to proposed section 953(b) (2) (B) (i)

The proposed section 953 provides that "qualified property" of a controlled foreign corporation cannot be located within the United States, unless it represents certain specified types of investments which are described by the report of the Ways and Means Committee (p. 65) as being "ordinary and necessary to the active conduct of the foreign corporation's business" and, furthermore, are "normal commercial transactions." These investments are described in section 953(b)(2)(B) and, as the aforesaid committee report indicates, are subject to the clear restriction contained in subparagraph (A) that they must be "ordinary and necessary for the active conduct of a qualified trade or business." In other words, no investments specifically described in subparagraph (B) can constitute qualified property unless they meet the "ordinary and necessary" test.

Section 953(b)(2)(B)(i) permits a controlled foreign corporation to hold qualified property in the United States in the form of "deposits with persons carrying on the banking business." The word "deposits" would seem clearly to encompass normal deposits of money in commercial banks but would not seem to include the equally normal situation where such a deposit may consist of the negotiable notes of other parties. For example, a controlled foreign corporation may, as a normal part of the active conduct of its business, carry balances with U.S. banks which may, in whole or in part, be represented by negotiable receivables from U.S. creditors. If such a transaction is in fact "ordinary and necessary" for the active conduct of a controlled foreign subsidiary's business, there would seem no good reason to limit the word "deposits" merely to include monetary deposits. It would seem desirable to clarify the definition of this term so as to include the types of deposits above described.

Accordingly, it is respectfully suggested that section 953(b)(2)(B)(i) be amended to read as follows:

"(i) obligations of the United States, money, or deposits *of money or negotiable obligations of United States persons* with persons carrying on the banking business;" (New matter in italic).

Suggested amendment to section 953(b) (2) (B) (iii)

The proposed section 953(b)(2)(B)(iii) describes a further type of U.S. investment which may constitute "qualified property" if, as noted above, it is "ordinary and necessary for the active conduct of a qualified trade or business." This provision refers to loans "arising in connection with the sale of property * * *." Once again, it would seem that the intention of this language is to permit a controlled foreign corporation to loan money to U.S. persons in connection with normal commercial transactions. It should be apparent that normal commercial transactions may not only include loans arising in connection with the sale of property, but also services rendered in connection with the processing of property. It should be immaterial whether the factual transaction giving rise to the loan involves the sale or the processing of property, as long as it constitutes a normal commercial transaction and is ordinary and necessary.

Accordingly, it is suggested that the proposed section 953(b)(2)(B)(iii) be amended to read as follows:

"(iii) any loan arising in connection with the sale *or processing* of property if the amount of such loan outstanding at no time during the taxable year exceeds the amount which would be ordinary and necessary to carry on the trade or business of both the lending corporation and the

borrowing U.S. person had the sale been made between unrelated persons."
[New matter in italic.]

I hope very much that your committee will look with favor upon these suggested amendments.

Respectfully yours,

LLOYD N. CUTLER.

CALIFORNIA STATE CHAMBER OF COMMERCE,
San Francisco, Calif., May 3, 1962.

Re H.R. 10650 Revenue Act of 1962.

Hon. HARRY F. BYRD,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D.C.

DEAR SENATOR BYRD: It is my privilege as chairman of the statewide tax committee of the California State Chamber of Commerce to file with the Senate Finance Committee this summary of the chamber's views on certain provisions included in the above act.

Taxation of income of controlled foreign corporations

The proposed measure contains a proposal to require American corporations to pay tax on income of foreign subsidiaries as it is earned abroad whether or not it can be remitted to the United States in dollars. The bill would impose full U.S. income tax on the net income of all foreign subsidiaries anywhere in the world arising from patents, copyrights, trademarks, formulas, and secret processes and similar rights which were developed by or acquired through a related U.S. corporation. Another provision would impose U.S. income tax on income from the sale of goods by a foreign subsidiary outside of the country in which it is incorporated where the goods are not manufactured by the foreign corporation. An exception would be provided if the income is invested in certain assets and the foreign corporation is in a "less developed country" as designated by the President.

Witnesses on behalf of the American business community have testified that these proposals are not necessary in order to bring about a more favorable balance of payments and make more jobs for American labor.

It would appear that a major effect of the proposal, if enacted, would be to enrich the treasuries of foreign governments who would be quick to revise their laws so as to raise income taxes without fear of losing the U.S.-owned corporation which could claim such credits against the U.S. taxes that this bill would impose. Moreover, if passed, these provisions would force American business, operating abroad, to limit its activities and in many cases to reorganize them merely to maintain their position. We believe these provisions would seriously hamper further expansion by U.S. enterprises in the foreign field and would result in significant revenue losses and injury to our national economy.

The European Common Market is a good example of where the provisions in the bill would make it difficult for U.S. corporations to compete with those organized in any one of the Common Market countries. The California State Chamber of Commerce wishes to register its opposition to these provisions of the bill.

Investment credit

The investment credit was allegedly proposed as a stimulant to the economy by encouraging expansion of plant and equipment. It has been opposed by most business groups and many companies have indicated that its adoption will not result in any expansion of investment in new equipment and that the failure to adopt it will not result in any diminishment of such investment.

It seems clear that encouragement of such investment can best be provided by major depreciation reform. Therefore, the California State Chamber of Commerce opposes the proposed investment credit and supports enactment into law of adequate depreciation reform.

The California State Chamber of Commerce also opposes certain other important provisions in the act such as the disallowance of entertainment and other business expenses but wishes to confine this presentation to opposition to the two major matters discussed above.

Respectfully submitted.

J. ROBERT WHITE,
Chairman, Statewide Tax Committee.

AMERICAN CHAMBER OF COMMERCE
IN THE NETHERLANDS,
The Hague, May 2, 1962.

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

DEAR SENATOR BYRD: This has reference to President Kennedy's message of taxation of April 20, 1961, as well as to the "discussion" draft bill released by the Ways and Means Committee of the House of Representatives on August 24, 1961. The American Chamber of Commerce in the Netherlands wishes to add its comments on the proposed legislation to those raised elsewhere by its sister organizations.

We believe the proposed changes in tax treatment of foreign subsidiaries controlled by American corporations or individuals and of Americans working abroad will have a detrimental effect on the conduct of their businesses. We would like to emphasize that the proposal to tax as income profits of foreign subsidiaries prior to distribution of dividends to the shareholders represents definite interference in the management of an enterprise. It would mean in effect that dividends will have to be paid in some situations where prudent business factors would dictate otherwise. This would result in unnecessary financial problems and in some cases result in unnecessary cost penalties. This would certainly affect various American organizations in the Netherlands obtaining financing from local banks which make loans on the basis of undistributed profits without requiring further collateral security.

With respect to the proposal to terminate or limit the tax exemption now applicable to the earned income of Americans living abroad, we wish to offer the following specific observations for your consideration:

(1) Most European countries do not tax their nonresident citizens on earnings made abroad. Thus, only Americans would be subject to a domestic tax on their earnings which would, by creating a fiscal inequality with foreign competitors, help to place American business at a competitive disadvantage.

(2) It is not possible to take credit against U.S. income tax assessments for certain foreign taxes paid, such as duties, excises, etc. which form a significant part of total revenue of many European countries. Thus, imposing U.S. taxation on income earned abroad would subject Americans residing in such countries to two systems of taxation which would be compatible only by chance. As a result, many Americans would find themselves in effect to be partially subject to double taxation. For the future, this could create difficulty on the part of American businesses to attract sufficient qualified personnel to accept job assignments outside of the United States without having to assume a further increase to the already high employment costs.

Included in the proposed changes in taxation of American personnel is the amendment of section 72(f) of the Internal Revenue Code of 1954 relating to pensions and annuities earned in foreign service. This amendment would tax amounts received under employee pension and annuity plans even though such amounts would have been exempt if paid directly by the employer to the foreign service employee instead of being contributed by the employer to the plan. There is no sound basis for taxing deferred income received by a foreign service employee as pension and annuity benefits. If the law is amended, amounts equivalent to and in lieu of plan contributions could be paid directly to the employee and invested by him in a personal annuity. The amount so invested would constitute the cost of the annuity which would be returned to the employee tax free. Accordingly, the proposed amendment would have the effect of undermining the established policy of encouraging employers to set up pension and annuity plans in order to assure social and economic security for retired employees.

Respectfully yours,

J. M. HANSEN, *President.*

THE COCA-COLA EXPORT CORP.,
New York, N.Y., April 30, 1962.

Hon. HARRY F. BYRD,
Chairman of the Senate Finance Committee,
U.S. Senate Building, Washington, D.C.

DEAR MR. CHAIRMAN: The beverage Coca-Cola is sold to consumers in 112 countries outside the United States by the Coca-Cola Export Corp., its affiliates, and over 600 franchise bottlers. Our business has for many years been conducted largely through foreign branches of domestic corporations. At the present time, we operate 27 such foreign branches, the income of which is currently subject to Federal income tax whether or not it is remitted to the United States. Because of foreign business conditions and foreign laws we also carry on operations abroad through approximately 25 foreign subsidiaries, the income of which, to the extent not needed for reinvestment in the business, is remitted to the United States as dividends as soon as permissible under the laws of the foreign country.

We are in sympathy with the purpose of efforts being made by the administration to prevent tax abuses in connection with foreign income, but we wish to bring to your attention certain important aspects of these proposals which in our opinion would be harmful to the great majority of companies operating abroad through foreign subsidiaries. We also wish to submit a number of suggestions for amendments which would alleviate certain harsh features and make the bill more equitable.

The most important aspects of the bill which we propose to discuss in this letter are—

I. (*a*) Whether it is advisable to change the method of taxing dividends received by U.S. companies from certain foreign corporations, a method which has been accepted as fair for over 40 years, and adopt a novel method (grossing-up) which is in conflict with the method of taxing dividends received from domestic companies, and

(*b*) Whether, if such a new method should be adopted, it should apply to all foreign countries or limited to the less developed countries, and whether the effective date in H.R. 10650 or that proposed by Secretary Dillon should be adopted.

II. Whether the almost unprecedented and perhaps unconstitutional method should be adopted of taxing a large number of U.S. shareholders on certain types of undistributed income of controlled foreign corporations.

I. ADOPTION OF THE GROSS-UP METHOD OF TAXING DIVIDENDS RECEIVED BY U.S. COMPANIES FROM FOREIGN CORPORATIONS (SECTION 11)

Section 11 of H.R. 10650, as passed by the House of Representatives, includes a proposal for a change in the method of taxation of dividends received from foreign corporations which has been in effect since 1921. The effect of this proposal, which is known as grossing-up, is to increase the Federal tax liability of U.S. parent companies by approximately 9 percent of dividends received from foreign corporations subject to foreign income tax rates of from 25 to 35 percent, and by lesser percenetages of Federal tax in respect of dividends received from foreign corporations subject to foreign rates higher than 35 percent or lower than 25 percent. This sharp increase in rates would taper off to zero as the foreign tax rates approach either zero or the U.S. rate of 52 percent.

Since many of the less developed countries of the world impose income taxes at rates in the intermediate rate of 20 to 40 percent, the effect of the gross-up proposal would be to increase sharply the U.S. tax on dividends received from subsidiaries in the less developed countries. This would be a discouragement to investment in such countries, which is contrary to the expressed economic objectives of the administration. If the gross-up method should be enacted and if it is desired to favor investments in the less developed countries, it would seem clearly advisable to limit the new method to the developed countries and not apply it to the less developed countries.

Basically, however, there are a number of reasons why the grossing-up of foreign dividends should not be applied to dividends from companies in either the less developed or the more developed countries.

(*a*) *The proposed method does not conform to U.S. concepts of what may be included in taxable income*

It is generally recognized that taxation should be based on concepts which are recognized by taxpayers as fair and reasonable.

Under present law, the combined U.S. and foreign tax liability on dividends received from foreign corporations by U.S. companies with income of more than $25,000 amounts to 52 percent of the actual dividends. Under the proposal in H.R. 10650, the U.S. tax on such dividends would be based on actual dividends received plus the amount of foreign income tax attributable thereto.

While a foreign tax credit would be allowed for the amount added back, the U.S. shareholder would be taxed on an amount in excess of the actual dividend received. A hypothetical amount which is neither actually received as a dividend nor an amount offset by a tax actually deducted at the source (such as a withholding tax) would not generally be considered in the United States as income which can properly be taxed.

(*b*) *The proposal aims but fails to achieve the same results as if the foreign subsidiary did not exist*

By grossing-up it is apparently hoped to impose the same U.S. tax liability on dividends received from a foreign corporation as the tax which would be imposed if the same operations had been carried on through a foreign branch of a U.S. corporation. However, the proposal goes only a small part of the way to achieving this result. It does not, for example:

1. Allow a deducation for net operating losses sustained by the foreign corporation, but which would be allowable if sustained by a foreign branch.
2. No deduction is allowable to a subsidiary for foreign exchange losses measured by the difference between net current assets valued at current exchange rates at the beginning and end of the taxable year, which would be allowable in the case of the foreign branch.
3. Capital gains realized by a foreign subsidiary, but distributed as dividends, are taxed at full rates rather than at the capital gains rate, as they would to a branch of a U.S. company.

There are many other differences between branches and subsidiaries, and the only effect of making an adjustment for the rate differential without taking into account all of the differences between branches and subsidiaries would be to achieve a distorted result, which would be weighted against the U.S. corporate stockholder.

(*c*) *The proposal would require amendment of existing treaties to the disadvantage of the United States*

The proposal is in direct conflict with the literal wording of a number of treaties between the United States and foreign countries for the avoidance of double taxation which require that the foreign tax credit be computed on the same basis as that in effect at the date the treaties went into effect. These treaties would have to be renegotiated. Since the effect of grossing-up is in most cases to increase the net U.S. tax liability (after foreign tax credit) on dividends received from the foreign corporation, the obvious position for any foreign country to take in such renegotiation would be to demand an increase in the ceiling on the dividend tax rate which it could impose on dividends paid to U.S. stockholders by companies formed under the laws of that country. Since this additional taxation would be an increase in the allowable foreign tax credit against the U.S. tax, it is probable that a good portion, if not all of the additional revenue for the foreign country, and a reduction in the net profits of the U.S. shareholder.

Effective date.—The bill passed by the House of Representatives (H.R. 10650) provides that the gross-up method will be applicable to all distributions received by a domestic corporation after December 31, 1964 and to distributions received prior to that date in a taxable year of the domestic corporation beginning after December 31, 1962, out of earnings of a foreign corporation for a taxable year beginning after December 31, 1962.

In his statement to your committee on April 2, 1962, Secretary of the Treasury Dillion recommended that the gross-up method be applied to all distributions made after December 31, 1961, asserting that this proposal had been before Congress since 1959 and taxpayers should be considered therefore to have been properly forewarned.

If the gross-up proposal should be adopted in principle, it would be extremely unfair to make it applicable at the time suggested by Secretary Dillion. Since the method was not adopted in 1959, the mere fact that it was considered by

Congress at that time certainly does not constitute a reason for retroactively applying the proposed method to distributions already made out of prior years' earnings. Other proposals affecting the taxation of foreign income are generally applicable only to taxable years beginning after December 31, 1962, and we therefore urge strongly that if the gross-up method is adopted, the effective date contained in the House bill be accepted by the Senate.

II. ADOPTION OF THE METHOD OF TAXING U.S. SHAREHOLDERS ON CERTAIN TYPES OF UNDISTRIBUTED INCOME OF CONTROLLED FOREIGN CORPORATIONS (13)

We urge unequivocally that section 13 of the bill, "Controlled Foreign Corporations," be deleted by your committee.

Apart from any merits or demerits of the substantive provisions, this section is extremely complex to the point that there is grave doubt whether it is administratively workable. The normal conduct of business would be impeded by the necessity of having many of the transactions of foreign subsidiaries, often handled entirely up to now by aliens with no knowledge of the U.S. tax law, reviewed from the standpoint of U.S. income tax effectis before business decisions could be taken.

Administration of this section of the bill would require the services of numerous tax specialists in the employ of taxpayers, public accounting firms, and legal firms as well as the U.S. Government. Even with such assistance the meaning of some of the most important subsections is so uncertain that taxpayers would in many cases not be able to prepare returns on any reasonable self-assessment basis. The Internal Revenue Service would no doubt feel it obligatory to make an assessment on some arbitrary basis, and many of these matters would eventually have to be settled by the courts. The tax returns of many taxpayers would thus be in a state of uncertainty for many years.

It is foreseeable that this section would create all the administrative difficulties that were encountered in section 722 of the World War II excess profits tax law, some of which are still in litigation. There is this important distinction that taxpayers had the right at that time to choose whether or not to become involved in the intricacies and uncertainties of section 722, whereas section 13 of the present bill would be imposed on a large number of U.S. shareholders at great expense and inconvenience in order to eliminate abuses of a few persons which can be detected and eliminated without a change in the present law by an improvement in auditing methods of the Internal Revenue Service. As is well known, the International Operations Division of the IRS is now engaged in making an intensive scrutiny of the returns of taxpayers having operations abroad. It would seem reasonable to await the results of this investigation before enacting such a complex provision to the detriment of many taxpayers, including those doing their best to comply with the law. Any new legislation should be confined to that necessary to correct abuses such as sham corporations and improper allocation of income among members of a group of related domestic and foreign persons.

In addition to the elimination of alleged avoidance of U.S. tax due to shifting of income from U.S. companies, the proponents of this section have indicated their desire to eliminate U.S. tax deferral of U.S.-owned tax haven companies which act as distributors of goods for affiliated parties, although neither U.S.-manufactured goods nor the shifting of U.S. income to foreign corporations may be involved. It is difficult to understand this viewpoint, as the formation of foreign tax haven companies in such cases serves primarily to reduce the burden of heavy foreign taxes. The reduction of foreign taxes would of course ultimately lead to an increase in U.S. tax on repatriation of the earnings.

The international balance-of-payments aspects of this proposal will undoubtedly be emphasized in other statements to your committee. Published statistics have shown conclusively that U.S. private investments abroad as a whole over a period of years have materially aided the U.S. balance-of-payments position. It would seem to be completely contrary to the best interests of the United States to take any short-term action which would tend to reduce this long-term inflow of dollars.

A number of suggested technical improvements in section 13 of the bill, if it should be adopted, are discussed in an attached memorandum, together with suggestions on other important aspects of this bill summarized below:

(1) That under section 6 the Commissioner should be required to assume the burden of proof that there has been a substantial distortion of income before imposing the formula method of reallocating income between domestic and

foreign organizations, in any case where (a) there has already been a price determination by foreign authorities or (b) a pricing method has been consistently is use for, say, 10 years.

(2) That section 12 be amended to exclude from gross income various types of differential payments to U.S. citizens working and living abroad designed to equalize their status with persons working in the United States and by deleting proposed code section 911(c)(4) which would have an unduly harsh effect on deferred compensation attributable to services rendered abroad.

(3) That section 9 be amended to allow an exemption from filing returns in respect of each transfer of property by a U.S. person to a foreign pension or profit-sharing trust.

It is respectfully submitted that the tax effects under the proposals as submitted by the administration would be harmful to the best interests of most U.S. companies operating abroad through foreign subsidiaries. It is, therefore, requested that your committee give full consideration to the suggestions set forth in this letter and the accompanying memorandum and to the amendment of the proposed legislation to the extent necessary to eliminate the harmful effects of these proposals. In view of the complexity of this legislation, as well as its far reaching effects on American business, you may wish to consider the appointment of an advisory group (similar to those appointed to review subchapters C. J. and K.) of qualified specialists from the legal and accounting professions, business, and the Government to gather all the relevant facts, weigh them carefully and submit recommendations to your committee for legislative action.

Yours very truly,

ROY S. JONES, *Executive Vice President.*

MEMORANDUM ATTACHED TO LETTER OF MR. ROY S. JONES, EXECUTIVE VICE PRESIDENT, THE COCA-COLA EXPORT CORP., DATED APRIL 30, 1962

A. *Reallocation of income between domestic and foreign corporations* (*sec. 6*)

Section 6 of H.R. 10650, as passed by the House of Representatives, authorizes the Secretary of the Treasury, or his delegate, 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, sales, and sales promotion expenses attributable to the United States and to the foreign country or countries involved.

This provision is designed to enable the Internal Revenue Service to reallocate taxable income among the members of an affiliated group more readily than under existing law. The bill provides that the allocation formula mentioned above will not be used where a fair market value for the product can be determined, that other factors besides those named may be taken into account, such as special risks of the market in which the property is sold, and that entirely different allocation rules may be used where these can be established to the satisfaction of the Secretary or his delegate.

While it is appreciated that the Internal Revenue Service must have sufficient powers to deal with any case of tax evasion, the proposal provides no protection against arbitrary application of the formula to taxpayers who have in good faith and for many years made sales between domestic and foreign corporations as to which no arm's length price can be established but which nevertheless may be entirely fair to both the United States and the foreign country. In many instances, the prices or valuations at which goods are imported into a foreign country have been subject to intensive scrutiny and valuation by foreign tax or customs officials for foreign income and customs duty purposes and a fair and reasonable determination has been made even though no arm's length price can be established. It would seem inadvisable to permit the U.S. authorities to impose an arbitrary formula in cases of this nature, especially since the possibility of double taxation of foreign income is not effectively removed by the relief provisions in the bill.

Even in those instances in which foreign authorities have not made a determination in respect to a particular intercompany price, it would be unreasonable for the U.S. authorities to disturb a price, a rate of commission or a method of establishing a price (such as a fixed percentage mark-up on cost) or commission which had been consistently used for many years and as to which the Internal Revenue Service has had ample opportunity to make adjustments under existing section 482.

We suggest, therefore, that proposed section 6 of the bill be amended to provide that, unless there is a clearly evident and substantial distortion of income, the proposed allocation formula shall not be applied in any case in which (a) the inter-company price (or commission) in question has been accepted by a foreign government for income or customs duty purposes for at least 1 year, or (b) in which, even though there has been no determination by a foreign authority, the price, rate of commission or a method of determining the price or commission has been consistently used by the taxpayer for the last 10 years.

A limitation of this kind would not prevent the Internal Revenue Service from adjusting prices of most sales to foreign subsidiaries where the goods are "drop-shipped" to the customers of the foreign subsidiary, which is probably the principal type of transaction at which this section is aimed.

Unless the Internal Revenue Service is required to bear the burden of proving that there has been a substantial distortion of income in such cases, section 6 will become an area of ceaseless litigation between taxpayers and the Government in matters as to which there is no precise answer.

B. Amendments affecting U.S. citizens working abroad as employees (*sec. 12*)

The amendments limiting the exclusion of earned income outside the United States of American citizens living abroad to $20,000 for the first 3 years and $35,000 thereafter appear to be reasonable in principle. However, these simple amendments do not deal adequately with all of the factors involved when a U.S. citizen is working and living outside his native country.

In order to make foreign service attractive to a U.S. citizen, it is necessary to transport him and his family to and from the foreign post at reasonable intervals, as well as to provide certain differentials in addition to his base pay in order to equalize his living conditions (which in a foreign country are tantamount to working conditions) with those in the United States to some extent. Such differentials may under existing law be treated as compensation to the employee, but they would be wholly exempt under present code section 911(a)(1) to the extent attributable to services performed outside the United States. Properly speaking, they should be considered as additional expense to the employer of providing suitable working conditions for his employees and not as taxable compensation to the employee. Under the proposed amendment 12, however, such differentials may be taxed to the extent that they (together with salaries) exceed the $20,000 or $35,000 limitations.

Among these differential payments are the following:

(*a*) *Home leave expenses.*—Such expenses include transportation to and from the United States and traveling expenses en route for both the employee and his family. Similar allowances, if granted to a domestic employee returning to his home on vacation, would presumably be treated as taxable compensation. In the case of an oversea employee, it is usually understood or expressly agreed that such home leave expenses will be paid by the company every 2 or 3 years. If such expenses were subject to U.S. taxation, home leaves would become virtually impossible for many employees in distant countries or with large families.

(*b*) *Home leave salary.*—The employee's salary is usually paid during his home leave, which is usually spent in the United States. This leave may cover, for example, a period of 3 months plus travel time every 3 years. It thus is in the nature of deferred compensation. Proposed code section 911(c)(4) provides that no amount received after the close of the taxable year following the taxable year in which the services to which the amounts are attributable are performed may be excluded from gross income. An employee taking his home leave in January to March 1966, based on services during 1963, 1964, and 1965, could thus apparently exclude from U.S. taxable income only that portion of his home leave pay attributable to services performed in 1965 and would be taxed on the portion of it attributable to 1963 and 1964 even though it would usually be subject to foreign tax and is clearly foreign source income. This is an inequity which could best be remedied by deleting proposed code section 911(c)(4).

(*a*) *Moving expenses of a new employee and his family to a post in a foreign country.*—The Treasury Department holds that moving expenses reimbursed to a new employee are taxable to him. In the case of a transfer to a distant foreign country, the tax on such expenses would often be almost prohibitive.

(*d*) *Expenses of an employee and family before establishment of residence in the United States or a foreign country after a transfer from another post.*—It has been held that the reimbursements of the living expenses of an employee and his family, after he has taken up his duties at a new post, but before he

is able to move into a new residence, are taxable to him. This becomes a serious problem in the case of employees transferred from one foreign country to another or to the United States, as it often takes several months for household furniture and other belongings sent by ocean freight to reach the new location.

(*e*) *Education expenses.*—It is often found necessary to reimburse employees for the expense of private schooling for their children in countries in which the educational system is not adequate or suitable as preparation for later education in the United States, or to provide other allowances for education. Taxation of such allowances would constitute a heavy burden on taxpayers with large families in the less developed countries.

(*f*) *Reimbursement for excess of foreign over U.S. taxes.*—In certain countries, the rates of income tax are graduated so steeply and the rates are so high that U.S. citizens are subject to a severe burden of foreign tax. Any increase in salary designed to give an employee a reasonable net take-home pay would itself be subject to the high rates of foreign tax and be impractical. It may, therefore, be fair to make an additional payment to the employee following his retirement in recognition of the additional burden of foreign tax. Such a reimbursement would not be excludable from gross income under the bill except perhaps to the extent attributable to services performed during the year preceding the year of retirement. This is another instance of deferred compensation which indicates the desirability of elimination of the harsh rule in proposed code section 911(c)(4).

(*g*) *Cost-of-living allowances.*—In some cases (e.g., Venezuela) the cost of living is so very much higher than in the United States that it is necessary either to increase salary while the employee is residing there or to pay a special cost-of-living allowance. The designation of a flat exclusion of either $20,000 or $35,000 per annum provides a different measure of protection to employees residing in different foreign countries, and reasonable exclusion, perhaps based on cost-of-living indices, should be allowed in addition to these flat amounts.

(*h*) *Special local vacation allowance for persons in hardship posts.*—An employee and his family assigned to a tropical country may, if he chooses, be granted a local vacation in a cooler climate, during which his employer will pay the expenses of transportation for the employee and his family and their living expenses or a flat per diem allowance during such vacation.

(*i*) *Housing allowances.*—In some countries extreme shortages of housing of a suitable type have the effect of increasing rentals and the value of real estate to such an extent that the employer must either furnish satisfactory housing at a reasonable rental or grant a special rental allowance to the employee.

It is suggested that—

(1) All of the above allowances or payments to employees residing abroad be entirely excluded from taxable compensation. Failure to exempt such special allowances and payments would produce an unfair difference in treatment between (*a*) employees stationed in distant countries versus those in countries near the United States, (*b*) employees taking leave annually versus those taking home leave every 3 years, (*c*) those with children versus those without children, (*d*) those in hardship posts versus those in highly civilized countries, and (*e*) those in countries having a high cost of living versus those in low-cost countries.

(2) Deletion of section 911(c)(4), which largely nullifies many payments of deferred compensation relating to prior years.

(3) The requirement of residence abroad for an uninterrupted period of 3 consecutive years in order to qualify for the $35,000 exclusion, should be amended to provide some relief in the case of an interruption due to illness of the employee or a member of his family, a return to the United States for training or for reassignment, or other similar legitimate reasons. This would avoid unfair burdens on career employees who temporarily return to the United States for reasons not entirely within their control.

C. Information return re foreign trusts

Section 9(f) provides for the filing of information returns by U.S. persons who transfer money or property to a foreign trust within 90 days after each such transfer. Severe penalties are provided for failure to file timely returns.

This provision does not appear to take into account that U.S. corporations have established foreign trusts in connection with foreign employee pension and profit-sharing plans, whose beneficiaries are solely nonresident aliens and include no U.S. citizens. The U.S. employer's contributions to the foreign trust in these

cases may be required to be made monthly or quarterly, and the requirement to file returns after each payment seems unnecessary in such cases.

In other cases involving pension plans which are handled by a foreign insurance company or similar organizations, it is sometimes necessary to establish an intervening trust, which serves as a conduit for payments by the employer to the insurance company.

In either case a multiplicity of returns or little or no importance to the Internal Revenue Service would be required.

It is suggested that a specific exemption be provided or that the Commissioner be empowered to grant such an exemption or the right to file a single annual return upon application of the taxpayer.

D. Technical suggestions in connection with controlled foreign corporations (section 13)

As stated in the attached letter, we urge that section 13 be entirely removed from the bill. However, if this section should be retained, the following amendments are suggested:

(1) Clarify that any oversea territory, department, province, or possession of a foreign country may be designated as a less developed country even though such country may not under proposed code section 953(b)(5) be designated as less developed. Example: It should be permissible to designate Calabria or Sicily as less developed, even though Italy as a country may not be so designated.

(2) Any country designated as "less developed" under section 953(b)(5) should be permitted to retain this designation for at least 10 years after the controlled foreign corporation has increased its investment in such country in reliance upon the designation. Unless there is a reasonable permanency in the designation, the deferral privilege will not constitute an investment incentive.

(3) Proposed code sections 952(a)(1)(B) and 952(c) provide for the taxation to a U.S. owner of 10 percent or more of the capital stock of a controlled foreign corporation of income from the license, sale, use, or other exploitation of patents, copyrights, and exclusive formulas and processes substantially developed, created, or produced in the United States, or acquired from a related U.S. person.

Proposed section 952(c)(3) provides that the income from use or other means of exploitation by the controlled foreign corporation of such property shall be the amount which would be obtained as a gross rent or royalty in an arm's length transaction with an unrelated person for similar use or exploitation of such property.

The above-mentioned provisions would apply to operating companies as well as to foreign base companies. The amounts of any imputed royalties would be extremely difficult to determine in the absence of any arm's length transactions with unrelated parties. It is inevitable that these provisions would therefore lead to extensive dispute and much litigation between taxpayers and the Government.

It is known that the Internal Revenue Service has issued rulings under section 367 of the code to taxpayers permitting the transfer of similar intangible property to foreign corporations. These rulings would not have been granted if the Service had any indication that avoidance of Federal income tax was a motivating factor in the transfer. In many such cases the Service was well aware that foreign corporations would after the transfer be using intangible property developed in the United States or obtained from related U.S. interests. Nevertheless, the income of the controlled foreign corporations attributable to such intangible property would in many cases be taxed to the U.S. shareholder under H.R. 10650.

In other cases, U.S. taxpayers have for many years permitted related foreign corporations the royalty-free use of patents and processes developed in the United States without obtaining a formal ruling from the U.S. tax authorities as it was not deemed necessary to obtain such a ruling. It is only recently that the Internal Revenue Service has indicated an interest in the transfer of know-how and similar intangible property to foreign corporations. Application of proposed code section 952(a)(1)(B) would thus constitute a radical and sudden change in the long-established treatment of U.S. persons having interests in foreign corporations.

This section would apply to corporations in the less developed countries, even though all of the profits were reinvested in such countries. It would thus represent a deterrent to investments in such countries and be in conflict with the administration's policy of fostering such investment.

The enactment of this provision would have the effect of granting a tax preference to businesses using patents and processes developed abroad over those using patents and processes developed in the United States. Where such patents or processes were developed partly abroad and partly in the United States, the difficulty of arriving at the amounts allocable to the foreign and U.S. elements could be almost insuperable.

It is urged that section 952(a)(1)(B) and the related sections be removed from the bill because of (a) the administrative difficulties mentioned above, (b) the effect on taxpayers who have in good faith relied on rulings granted by the Internal Revenue Service permitting the transfer of intangible property of this type to foreign corporations, or on the sanction given to the royalty-free use of such property for many years, and (c) the preference given to patents and processes developed abroad over those developed in the United States.

Alternatively, it is suggested that section 952(a)(1)(B) should not apply in any case in which income from the intangibles in question is less than 20 percent of the total gross income of the controlled foreign corporation.

Such an amendment would serve to eliminate numerous minor controversies in regard to imputed royalties and much of the administrative difficulty inherent in this section.

(4) Under proposed code sections 951(a)(1)(B) and 953, a U.S. owner of 10 percent or more of the voting stock of a controlled foreign corporation would be taxed on the increase in earnings of a controlled foreign corporation which is invested in so-called "nonqualified property," including therein any assets in excess of those needed in an established business in a developed country or any business, old or new, in a less developed country.

As in the case of the intangible property provisions, these sections would apply to operating companies as well as to mere holding companies. They would also create preferences. Foreign corporations already established in business in the developed countries would have a preferential tax position for 5 years over companies starting new businesses in such countries after December 31, 1962.

Adoption of this proposal would sanction intervention by the U.S. tax authorities in the actual operations of foreign corporations. It would not be necessary for the Internal Revenue Service to establish that a purpose existed of avoiding U.S. income tax in order to assert tax on the U.S. stockholder. It would on the other hand be incumbent on the U.S. shareholder to justify the holding of all assets of controlled foreign corporations as ordinary and necessary in the conduct of their trade or business, despite the fact that up to 50 percent of the stock of the foreign corporation (and more in certain cases) may be owned by foreign interests and 40 percent of the stock by unrelated U.S. interests. The additional pressure exerted by U.S. shareholders to pay dividends in order to avoid U.S. taxes on "improper accumulations" would in many cases result in conflicts with foreign stockholders who may not have a similar interest in such dividends paid. This would seriously interfere with joint ownership of foreign ventures by U.S. and foreign interests.

These provisions, together with the tax haven provisions, will in many cases conflict also with the interests and sovereignty of foreign governments. President Chiari of Panama has protested to President Kennedy that the controlled foreign income proposals would amount "almost to economic aggression" against his country insofar as the income of Panamanian corporations would be taxed by the United States prior to distribution of dividends. It is to be expected that many other countries will have the same reaction of resentment against the current taxation by the United States of income derived by corporations formed under the laws of such countries prior to the payment of dividends.

It can also be anticipated that the accumulated earnings proposal will cause difficulty because of the difference between U.S. and foreign concepts in regard to the distributions of earnings. In the United States distributions are usually made quarterly or at other stated intervals without designation of the particular earnings which are being distributed. In many foreign countries, on the other hand, the earnings for a particular year are not distributed until the following year. Annual dividends are often declared in connection with the annual stockholders meeting at which time the disposition of the earnings for the preceding year is effected. Under this arrangement larger cash reserves may be maintained by a corporation at the end of the business year than would be customary under U.S. practice. There is no indication in the bill or in the committee reports that any difference between U.S. and foreign business practices

would be taken into account in determining the amount of property which is required in connection with a particular trade or business of a controlled foreign corporation.

An example of a factor which is often of importance in foreign businesses and which may not be recognized readily by the Internal Revenue Service, is the need for maintaining substantial inventories of imported raw materials as a protection against future exchange controls or import restrictions.

In many foreign countries, local corporations are required to set up legal reserves which may not be distributed to their shareholders. No provision is made in the bill to permit accumulations of funds equivalent to such legal reserves.

In the application of the accumulated earnings tax under section 531 to domestic corporations, it is recognized that some margin must be allowed. An accumulated earnings credit of the amount by which $100,000 exceeds the accumulated earnings and profits of the corporation at the close of the preceding taxable year is allowed. Under H.R. 10650 no such margin is allowed. Every dollar of increase in nonqualified property during the taxable year would be taxed to the U.S. shareholder.

Because of special factors incident to business outside the United States referred to above, it is even more important in the case of "controlled" foreign corporations than in the case of domestic corporations that a reasonable amount of latitude be permitted. It is suggested, alternatively:

(*a*) That a fixed amount of, say, $100,000 be treated as qualified property at the end of each taxable year of the controlled foreign corporation in addition to property qualifying under section 953(b) (2), or

(*b*) That if the increase in nonqualified property under proposed code section 953(a) for any taxable year is less than 20 percent of the earnings and profits for such taxable year, no part of such increase will be included in gross income of the U.S. shareholder.

As in the case of the suggested amendment of the provisions relating to income from intangible property, such an amendment would serve to eliminate many of the administrative difficulties.

A Statement on H.R. 10650 by the Virginia Manufacturers Association, Richmond, Va.

The purpose of this statement is to reaffirm the views of the Virginia Manufacturers Association which were presented to the House Ways and Means Committee on May 16, 1961.

As noted in the aforementioned statement, we agree with the present administration that we have most compelling reasons for being concerned over the condition of the private sector of our economy. Viewing our present and future employment needs and our national defense requirements against the declining financial position of American industry, there is, indeed, cause for alarm.

We have been very much concerned as we have pondered: (1) The increasing age of American productive facilities, which is exactly the opposite of the direction of movement of technology; (2) the declining profit margins experienced by a growing number of American producers; (3) outdated depreciation schedules which result in a gross overstatement of annual earnings; (4) a threatening decline of equity capital for reasons of lack of return to investors; and (5) the growing gap between job opportunities in the private sector and number of jobseekers. These are the accummulated results of taxing industry at a rate beyond which it can support over a long period of years.

The need for bold, clean tax reductions and up-to-date depreciation allowances to reverse the unfavorable trend in U.S. enterprise is clearly indicated. Tax reduction and elimination of unnecessary complexities are not the object of this measure. Offered as tax relief, the proposal advanced by the administration introduces new principles of taxation plainly designed to further centralize political and economic power.

The investment credit proposal not only fails to deal boldly or forthrightly with the lagging growth of the private sector of our economy, but it actually generates undesirable complications, gross inequities, and invites bureaucratic intervention on a grand scale. This is a new principle of taxation which would ultimately give the Federal Government effective control over all business decisions. Under such conditions, we would move swiftly and surely toward a totally regulated economy. We are opposed to anything which would aid or encourage such an objective.

The problem of tax evasion has been much overstated by representatives of the administration. With high-speed automatic data-processing equipment installed and improved enforcement promised by Internal Revenue. we see little need for any law change to collect any taxes due.

The proposed tax treatment of cooperatives is far short of what is fair and just.

This tax measure has so much bad and so little good to commend it. The most we can say for the administration package is that it has provided the time and the forum for a full discussion of our tax problems.

STATEMENT BY TYRE TAYLOR, GENERAL COUNSEL, SOUTHERN STATES INDUSTRIAL COUNCIL ON CERTAIN PROVISIONS OF H.R. 10650 (THE REVENUE ACT OF 1962)

My comment will be brief and it will be confined to four sections of H.R. 10650 on which the council has taken a definite position and on which it feels strongly. The first is the proposal for an investment tax credit.

At a meeting held at Sea Island, Ga., May 29–31, 1961, the council's board of directors approved the following statement:

"Tax credit for expenditures on new plant and equipment: The council opposes this proposal in its present form. Admittedly a type of subsidy, it is designed solely to encourage investment in new plant and equipment and does not take into account the urgent need for funds for replacement, rehabilitation, and modernization."

In addition, there is the immense loss of revenue involved, estimated by the staff of the Joint Committee on Internal Revenue Taxation to start at $1.4 billion in 1962 and climb to $20 billion by 1972.

We feel that a far more meaningful approach to the problem of encouraging industrial growth and modernization would be for Congress to establish adequate, realistic allowances for depreciation. Not only would this encourage new investment in plant, machinery, and equipment, but it would not be open to the usual objections against subsidies, nor would it be discriminatory between taxpayers.

Moreover, unlike the investment tax credit the cost of which would never be recouped by the Treasury, the tax money permitted to be retained by taxpayers under depreciation will be returned to the Treasury as the asset becomes fully depreciated.

II. APPEARANCES, ETC., WITH RESPECT TO LEGISLATION

Section 3 of the bill provides for the deduction as an ordinary and necessary business expenses certain expenditures the purpose of which is the passage or defeat of legislation. As the bill now stands, two categories of expenses would be recognized as deductible under section 3:

1. Expenses in direct connection with appearances, submission of statements or sending of communications, presented to committees or individual Members of Congress, or to committees or individual members of State or local governmental legislatures.
2. Expenses in direct connection with the communication between the taxpayer and an organization of which he is a member, either from the organization to the taxpayer or vice versa.

We feel that both of these provisions are excellent. Certainly, there should not be one rule for appearances, etc., before the executive branch of the Government and the courts (the expense of which is now deductible) ,and another totally different one for legislative appearances, as is now the case.

There is, however, a serious defect or limitation in the bill in its present form. This is the denial of any deduction where the money is spent to influence the public, or any segment thereof, with respect to legislative matters, elections, or referendums. This means, in effect, that the expense of direct dealings with Federal, State, and local legislation would be deductible, but that the expense of indirect communications, such as advertising in newspapers, would not be. We think that any such distinction is highly improper.

III. TAX TREATMENT OF COOPERATIVES AND PATRONS

The council believes in tax equality and urges the Congress to plug the loopholes in the present laws which give cooperatives, credit unions, Federal savings and loan associations and all similar businesses an unfair tax advantage over

private enterprise. We feel that the bill, as it passed the House, goes some little distance in this direction, but not nearly far enough. For example, it contains a series of complicated provisions intended to excuse cooperative corporations of all but the 20-percent withholding tax, while continuing the present 52 percent—as well as the 20-percent withholding tax—upon their competitors.

Incidentally, it seems to us most unfortunate that the Ways and Means Committee departed from its original version of this part of the bill. Under this simple three-way option, the farmer could agree to pay the tax and let the co-op keep the money; or the farmer could tell the co-op if it wanted to retain the money, it would have to pay the tax; or the farmer could get the money and pay the tax.

IV. WITHHOLDING INCOME AT SOURCE ON INTEREST AND DIVIDENDS

Two major considerations prompt the council to oppose this provision of the bill.

The first is the tremendous additional burden and expense it would impose upon the corporations, banks, insurance companies, etc., who would do the withholding. To this would be added the annual and quarterly processing of millions of exemption certificates, applications for refunds, etc. It is conservatively estimated that there would be more than 500 million dividend and interest accounts affected by this provision.

Our second concern is the taxpayer himself and the immensely complicated, bureaucratic procedure he would have to follow to obtain a refund. There is a vast difference between what is here proposed and withholding on wages and salaries. In the case of the latter, there is only one withholder, one reporter. H.R. 10650 would enforce a withholding relationship whose ramifications are quite beyond anyone's imagination. It is also quite conceivable, indeed it is probable, that the individual who owns a few shares of stock or a few dollars on which the bank pays him interest will forgo applying for a refund (thereby unjustly enriching the Treasury) rather than sweat through the interminable redtape which such procedure would involve.

In conclusion, the council suggests that where there are so many and such grave doubts about this bill, the course of wisdom would be to take no action, at least not at this session. This conclusion is further supported by the fact that the budget is already seriously unbalanced and there is no firm assurance that H.R. 10650 would not increase the substantial deficit which is now in prospect. Certainly we do not feel that the Congress can, in good conscience, grant a special subsidy to business at a time when we are facing a tremendous deficit in the Federal budget.

STATEMENT OF THOMAS N. TARLEAU ON BEHALF OF WILLYS MOTORS, INC., ON H.R. 10650

I

Proposed code section 952(d)(2) makes no provision for the deduction from foreign base company income of earnings required to be retained by the controlled corporation for the purpose of carrying on the active trade or business of such corporation. I therefore recommend that at the end of paragraph (2) of section 952(d) the word "and" be inserted and there be added a paragraph (3) thereto reading as follows:

> "(3) the increase in investment in qualified property as defined in section 953(b)(2)(A) and (B) which is ordinary and necessary to the production of foreign base company sales income as defined in subsection (e)(2)."

The purpose of the above amendment is to permit the reinvestment of income for use in financing export transactions. Such purpose is consistent with the policy of the Government of encouraging exports to all parts of the world, in furtherance of which policy, Government guarantees and other aids in the financing of export transactions have been authorized by law. Sales subsidiaries of corporations engaged in export require substantial funds for the carrying of export inventory in transit both within and without the United States. They also require funds for the financing of sales made on credit to foreign purchasers in order to compete with foreign manufacturers ready and table to provide long-term export credits. In addition, the proposed

amendment would permit the reinvestment of funds for use in sales promotion and other activities abroad which stimulate exports. A provision which would encourage the reinvestment of such funds would, therefore, be in the interest of the development of our export trade.

II

Paragraph (2) of proposed code section 952(f) limits deductions for investments in qualified property to those made within 75 days of the close of each taxable year. I should like to recommend that in the last line of paragraph (2) of the proposed code section 952(f) the words "the 75th day" be deleted and in lieu thereof the words "12th month" be inserted.

In many instances it will not be possible to know what the profits of the controlled corporation are within 75 days of the close of the taxable year. Furthermore commitments for investments require considerable time for negotiation and in many instances involve long-term planning.

III

Section 951(a) when read in conjunction with section 952(a) provides for the attribution of income to the shareholder in the controlled corporation irrespective of whether such income is available for distribution by the controlled corporation. I should like to recommend the amendment of paragraph (3) of the proposed code section 952(a) to read as follows:

"(3). Not to Exceed Earnings and Profits Available for Distribution—The Subpart F income of any controlled corporation for any taxable year shall not exceed the earnings and profits of such corporation for such year available for distribution to its stockholders under the laws of the domicile of said corporation."

Under the laws of many foreign countries it may not be permissible to declare all of the earnings and profits of a corporation domiciled there as dividends. This arises not only from differences in the accounting practices applied in the determination of earnings and profits but also because of the legal requirements for the establishment of statutory reserves. To require payment of tax by an American shareholder on funds not available for distribution as dividends would clearly be inequitable and might possibly be unconstitutional.

IV

Section 953(b)(2)(C) limits investment in less developed countries to investment in the stock of a corporation where at least 50 percent of the voting stock is owned by four or fewer U.S. persons unless under the laws of the less developed countries such percentage of ownership is not permitted. I suggest amending subparagraph (C) of paragraph (2) of proposed code section 953(b) to read as follows:

"(C) Stock in, or long-term indebtedness of, a foreign corporation organized or created under the laws of a less developed country, all or substantially all of the property of which is ordinary and necessary for the active conduct of a trade or business engaged by it wholly or almost wholly in a less developed country or countries."

Under the bill as drafted investments in corporations in underdeveloped countries are discouraged unless such companies are dominated by American interests. This would appear to be contrary to a policy of encouraging less developed countries to use their own resources to the greatest extent possible.

Furthermore there appears to be no reason why the investment should not take the form of a purchase of bonds, debentures, or other long-term indebtedness.

V

I should like to recommend the amendment of paragraph (2) of proposed section 955(a) to insert the word "controlled" before the words "foreign corporation."

As drafted the bill attributes stock ownership through foreign corporations even though these foreign corporations are publicly held. The stock of a foreign publicly held corporation is, of course, constantly changing hands and it is very difficult to determine as of any particular time where the ownership of certain blocks of shares is held. Also if stock ownership is attributed through such a corporation a difficult situation will arise in connection with jointly held foreign

corporations. For instance, assuming that a joint venture is undertaken through a foreign corporation organized for such purpose which is jointly held by a foreign publicly held corporation and a U.S. corporation the purchase of a few shares of stock in the publicly held corporation by one U.S. person might have the effect of making the corporation carrying on the joint venture a controlled corporation although the stock ownership in a publicly held foreign corporation would in no wise change the actual voting control of the corporation carrying on the joint venture.

VI

Proposed code section 1248 will tax as a dividend gain on sale of stock in or liquidation of a foreign corporation to the extent of earnings and profits accumulated after February 28, 1913. I recommend that the date "February 28, 1913" appearing in section 1248(a) be amended to read "December 31, 1962".

The provision as drafted appears to be discriminatory in that it calls for a different basis of taxation on gain realized from the sale of stock in or liquidation of a foreign corporation from that realized on the sale of stock in or liquidation of a domestic corporation. Such discrimination may be justifiable if limited to the amount of earnings accumulated after the effective date of the act. It would appear clearly inequitable, however, when it is based on earnings accumulated prior to enactment of the bill.

GULF STATES UTILITIES CO.,
Beaumont, Tex., May 1, 1692.

Re tax revision bill H.R. 10650.

Hon. HARRY F. BYRD,
Chairman, Senate Finance Committee,
New Senate Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: Time did not permit making an appearance before your committee concerning section 3 of H.R. 10650 relating to the deductibility of certain expenses incurred in connection with legislative matters. Therefore, it is respectfully requested that this letter be entered in the record of the hearings now being held on H.R. 10650.

Section 3 of H.R. 10650 provides a Federal income tax deduction for ordinary and necessary expenses incurred in a business in direct connection with (1) appearances before, submission of statements to, or sending communications to, the committees, or individual members, of Federal, State, or local legislative bodies with respect to legislation or proposed legislation of direct interest to the taxpayer, and (2) communication of information between the taxpayer and an organization of which he is a member with respect to legislation or proposed legislation of direct interest to the taxpayer and to such organization. Further, dues paid to a trade organization incurring expenses attributable to legislative matters referred to in (1) and (2) above also are deductible provided the taxpayer is a member of such trade organization. Section 3 of the bill, however, specifically states that its provisions are not to be construed as allowing a deduction for any amount paid in connection with any attempt to influence the general public, or segments thereof, with respect to legislative matters, elections, or referendums.

Our company, Gulf States Utilities Co., is in agreement with the objective of the proposal to allow as a tax deduction ordinary and necessary business expenses incurred in regard to legislative matters but we feel that the proposal in its present form does not fulfill the entire need for legislative change in code section 162. We strongly urge that the proposal should be modified by your committee to make it clear that the cost of advertising incurred by a taxpayer in the ordinary course of his business is deductible for Federal income tax purposes even though the advertisement may have some general reference to pending or prospective legislative matters.

Regarding the scope of the reform needed in the tax treatment accorded so-called "legislative" or "lobbying" expenses, we note that although the Treasury Department is on record as opposing section 3 of the House bill, apparently for revenue reasons, it made certain relevant statements and observations in a letter, dated February 26, 1960, to the Chairman of the House Ways and Means Committee which we feel merit consideration here. The Treasury Department stated that with the growing impact of government at all levels upon individuals and upon all segments of our society, businessmen and organizations representing

their interests, have often found it necessary or desirable to make large expenditures for the purpose of influencing legislation. The Department called attention to the effect that the proper treatment of such expenditures was important to the equity and fairness of the income tax and that such tax treatment, in turn, was pertinent to our sound governmental policy. The Treasury recognized existing law as developed has frozen concepts relating to expenditures in the area of legislative process which are quite distinct from generally accepted attitudes in regard to expenditures related to fields of administrative and judicial processes.

In another portion of the Treasury's discussion, it was suggested that any proposed legislative revision in this area should necessarily take account both of the practical administrative problems which now exist under present law as well as those which might develop under any proposed modification. In this regard it observed, particularly as it related to dues paid to trade associations, institutional advertising, and the grassroots type of lobbying expenditure, that the present law is difficult for the Internal Revenue Service to administer. In this connection the Treasury stated that it is difficult, if not impossible, for the Internal Revenue Service to "censor" or "monitor" lobbying of the advertising or grassroots variety. Further, it stated that it had been the general position of the Internal Revenue Service that it is not only impractical but undesirable to attempt to subsitute the judgment of the tax collector for that of the businessman in determining the character of the advertising appropriate for the business as long as it may reasonably be expected to increase the patronage of the business.

It is our belief that a thoughtful consideration of the foregoing statements and observations made by the Treasury Department suggests that not only is immediate tax reform needed in the area of legislative expenses by permitting their deductibility but that practical and equitable reasons require that such deductibility be based upon the "ordinary and necesasry" test provided for in code section 162 rather than on the type of channel into which they are directed or the form in which they are manifested. The only exception which we would suggest to the application of this general rule in determining the deductibility of so-called "lobbying" expenses would be expenses relating to the participation in, or intervention in, any political campaign on behalf of any candidate for public office, which should not be deductible in any case. We feel sure this proposal would not only be realistic and sound for business and tax administration reasons but would be fair and insure uniformity of application.

It is appropriate to point out here in regard to the deductibility of advertising expenses with which we are very much concerned, that the industry of which Gulf States Utilities Co. is a part is engaged in competition with the U.S. Government and tax exempt rural electrification cooperatives in supplying electrical energy. This competition is real. Accordingly, a portion of our advertising cost is directed to meet Government competition. Likewise, it should be noted that our tax-exempt cooperative competitors in an attempt to gain more of the market demand for electric energy continue to promote their interests by full-scale adverising in national magazines, local newspapers and on television and radio. Although Gulf States Utilities Co., as well as a large segment of the privately owned electric companies, has taken the position that advertising cost incurred in competition with the Government and the coops is nonpolitical and fully deductible since the Government is acting in its proprietary capacity, the Internal Revenue Service has not accepted this position. The Service takes the position that the cost of any advertisement which reflects unfavorably upon public power is "lobbying" and, therefore, not deductible. This position by the Service necessarily requires yearly apportionment of ordinary and necessary business expenses incurred in advertising between those deductible and those not deductible because a portion thereof are administratively classified as "lobbying" expenses. This tax treatment employed by the Service, when contrasted with the full deductibility of advertising expenses incurred in connection with a nongovernmental competitor, is unjustified and discriminatory. Accordingly, modification of section 3 of the House bill to elminate this injustice and discrimination is in order.

The House report accompanying the bill also suggests that it is desirous that taxpayers who have information bearing on the impact of present laws or proposed legislation on their businesses should not be discouraged in making this information available to the legislative or other governmental bodies. It would seem equally desirable, if not more so, that such views affecting the taxpayer's business should be made known to the public. If this latter view were incorporated within section 3 of the bill, it would result in a better informed public and

put "lobbying" activities more in the open, to the good of the Nation as a whole. Moreover, the objective of the suggested modification would be in keeping with the purpose of the present proposal since it would allow as a deduction expenses incurred informing the general public with respect to a referendum submitted to the vote of the public which concerns taxpayer's business. Seemingly, it appears that there is no justifiable reason for distinguishing between expenses incurred in connection with communicating one's views to a legislator as compared with communicating one's views to the public where, in effect, the public is acting as a legislator in a referendum or initiative matter.

We urgently request that section 3 of H.R. 10650 be modified by your committee in order to include the deductibility of ordinary and necessary business expenses incurred in advertising and dues paid to a trade organization, even though a portion of such expenditures may be interpreted as being attributed to a legislative matter. The Treasury Department's objective of section 3 of the above-mentioned bill—to permit a true reflection of real income for tax purposes, we believe, requires the extension of the deductibility feature of section 3 to include such expenditures as outlined above. Fairness to all demands such a revision to eliminate the discrimination now contained in section 3 of the House bill.

Yours very truly.

JOHN J. MORRISON, *President.*

GRAVES, DOUGHERTY, GEE & HEARON,
Austin, Tex., April 30, 1962.

Re suggested amendment to H.R. 10650, revenue bill of 1962.

COMMITTEE ON FINANCE, U.S. SENATE,
New Senate Office Building, Washington, D.C.
(Attention Mrs. Elizabeth B. Springer, chief clerk).

GENTLEMEN: It is respectfully recommended that H.R. 10650 be amended by your committee by adding a new section 22 designed to make it clear that a real estate investment trust organized under the laws of the State of Texas may qualify under subchapter M of chapter 1 of the Internal Revenue Code of 1954.

The State of Texas has enacted laws to protect investors in real estate investment trusts. These laws have been widely applauded for the high standards they impose in order to protect the public. It is very important that these provisions designed to protect investors should not give rise to a controversy as to the applicability of the Federal tax law.

TREASURY INTERPRETATION OF LAW

Section 856(a) of the Internal Revenue Code of 1954 defines a real estate investment trust as "an incorporated trust or an unincorporated association—(1) which is managed by one or more trustees; * * *"

This language has now been interpreted by the Department of the Treasury as follows:

"Thus, the trustee must have continuing exclusive authority over the management of the trust, the conduct of its affairs, and (except as limited by sec. 856(d)(3) and sec. 1.856–4) the management and disposition of the trust property. For example, such authority will be considered to exist even though the trust instrument grants to the shareholders any or all of the following rights and powers: to elect or remove trustees; to terminate the trust; and to ratify amendments to the trust instrument proposed by the trustee."

PROTECTION OF INVESTORS UNDER TEXAS LAW

In order for an organization to qualify under the Federal tax laws as a real estate investment trust, it must have 100 or more persons as beneficial owners (I.R.C. sec. 856(a)(5)). It is obvious that in such a business entity, designed as a vehicle for investment by small investors (see Ways and Means Committee report, 1960–2 C.B. 819 at p. 820), there is considerable need for management to be responsive to the interests of the investors. It would appear highly desirable that these many small investors should be able to protect their interests by appropriate provisions in the declaration of trust and in the bylaws which regulate the powers of the trustees. Having once made such provisions these same small shareholders ought to be allowed to change them if the need

therefor arises. They should likewise be allowed to terminate the trust if they so desire.

The 1961 Texas Legislature seeing this problem provided in its Real Estate Investment Trust Act of 1961:

"The initial bylaws of the trust shall be adopted by shareholders in person or by proxy. *The power to alter, amend, or repeal the bylaws or to adopt new bylaws shall be vested in the shareholders.* The bylaws may contain any provisions for the regulation and management of the affairs of the trust not inconsistent with law for the declaration of trust." Acts 1961, 57th leg. ch. 384, sec. 9, art, 6138A, Vernon's Tex. Stat. [Emphasis supplied.]

Under the foregoing provisions of the Texas statute, real estate investment trusts in Texas must afford the shareholders rights analogous to those exercisable by the shareholders of a corporation including the right to alter, amend, or repeal the bylaws of the trust, or to adopt new bylaws. The Texas statute also gives shareholders the right to terminate the trust and the right to elect trustees. The Treasury regulations fall short of making clear to examining revenue agents that the powers required by the Texas law are proper for a trust seeking to qualify under the Federal law.

This matter was called to the attention of the Treasury Department after its publication of regulations in proposed form. While the Treasury Department has made some changes in the final regulations, it has failed to clarify the matter sufficiently.

LEGISLATION REQUESTED

The provision of the Texas statute is entirely appropriate for the protection of investors and is consistent with the purposes of the Federal tax law. The Treasury Department has failed to clarify its position on this matter. It is requested that any possible doubt and controversy directed against trusts organized under the laws of the State of Texas should be avoided through an appropriate amendment of the Federal tax law.

In view of the foregoing, we urge your committee to adopt the following amendment to section 856(a)(1) of the Internal Revenue Code of 1954:

"(1) which is managed by one or more trustees, *subject to the same types of control exercisable on the part of the shareholders of a corporation, including amendment to the declaration of trust and the bylaws of the trust, and including the power to terminate the trust.* [Italicized material represents an addition to the existing provision of the code.]

Respectfully submitted.

J. CHRYS DOUGHERTY.
EDWIN L. KAHN.

PHILADELPHIA, PA., *April 28, 1962.*

Re proposed Revenue Act of 1962, H.R. 10650.

Hon. HARRY F. BYRD,
U.S. Senator from Virginia,
Senate Office Building,
Washington, D.C.

DEAR SENATOR BYRD: A corporate client of mine is trustee of approximately 900 small trusts, the purpose of which is to provide for the perpetual care of family cemetery lots.

Almost all of these trusts are under $500, and the average is about $300. Less than a dozen are $1,000 or over. Many of them are three-quarters of a century old or more: created at a time when prices were about 10 percent of what they are today, and yields on investment were much higher.

In order to enable these trusts to satisfactorily accomplish their purpose, they are merged into a common fund (not to be confused with a "common trust fund" as that expression is used in bill section 19(b)(2) which amends section 584(c) of the act). No dividends are paid to any "participant." The sole purpose of the fund is to provide for the perpetual care of the cemetery lots in which the dead of the donor have been buried.

In addition to filing a return and paying a corporate income tax, the company makes a fiduciary return for each individual trust where the share of that individual trust in the current return of the merged fund, described above, equals at least $100 gross. The modus operandi is as follows: The principal of the individual trust is divided by the total principal of the merged fund,

and a decimal fraction is obtained. This decimal fraction is then applied to the gross return of the merged fund, and the product obtained is the gross return applicable to that individual trust. If this equals at least $100, then a fiduciary return is filed for that individual trust and a tax paid thereon.

The treatment of these individual cemetery lot trusts as taxable entities for the purpose of the fiduciary tax was made necessary 3 years ago as a result of a ruling by the Department Up until that time these funds were treated as charitable organizations, and as such were exempt from the income tax imposed by chapter 1. However, at that time the Commissioner ruled that funds for the care of the cemetery as a whole did qualify as "charitable," but that funds for the perpetual care of individual lots were not "charitable," and did not qualify for the exemption.

The funds treated in this letter are for the perpetual care of individual lots, and under the ruling are, therefore, not "exempt organizations." They would not, therefore, be entitled to file exemption certificates under section 3483(a)(3)(A). Even if they did so qualify, exemption would not be of such benefit, since exemption does not cover interest from corporate or government obligations. More than 40 percent of the assets of this merged fund are in such securities, while the rest is invested in the preferred and common equities of American industry or exists in cash reserves. Although the exemption feature of the proposed act does not apply to the situation being discussed, will you permit a digression to say that it is so drawn as to be patently discriminatory and worthless even to those who can take advantage of it.

This brings us to the refund provisions of section 3485(a)(2) of the proposed act. This limits refunds to "an organization which is exempt from the tax imposed by chapter 1." So these individual trusts are excluded from claiming a refund under this section, even if the filing of approximately 900 claims for refund quarterly were a practical matter.

If you will once again pardon a digression from the main thesis of this letter, may I say that the refund provisions of this act as proposed in section 3484 to 3489 inclusive are so complicated with the computations of credits and allowances, and single and married individuals anticiapted annual income computed quarterly, that one would have to close his books every quarter instead of once a year; he would have to practically prepare an income tax return every quarter forecast on an annual basis; and in order to be reasonable sure of compliance with the law, he would have to employ tax counsel as well as a certified public accountant. The provisions of section 3484(e), limiting the right to refund for individuals to those single ones with income less than $5,000 a year, and to those married ones with less than $10,000 per year, is plainly discriminatory. Although I am aware that since the adoption of the 16th amendment there is no longer any safeguard in the U.S. Constitution (as there is in most of our State constitutions) against class legislation, nevertheless, I think that this feature of the proposed act should be recognized by all for just what it is, and is intended to be.

Out of approximately 900 such individual trusts, only 8 earn at least $100 a year gross: for these 8 a fiduciary return is made and a tax paid.

Now, if this bill is passed in its present form, it will mean that this fiduciary will have to file, not just 8, but 900 such individual fiduciary returns each year, in order to get back the taxes withheld from the 99 percent of these trusts that owe no tax at all. The gross return of most of these individual trusts is less than $25 a year.

If this bill is enacted, not only will there be a continuous deprivation of 20 percent of the income of these individual trusts, for a period of more than a year (the return is not due until April 15 of the following year, and refunds could not be expected much before July of that year, whereas moneys would be withheld starting with January 1 of the preceeding year), but in order to get a refund of the money's withheld from the 99 percent who owe no tax at all, additional bookkeeing and stenographic help will have to be hired, which will just about cripple the fund. Its operating margin now is so narrow, that this additional burden will either put it in the red, or else necessitate a drastic curtailment in the services in the care of these lots for which this fund was established. This difficulty is aggravated by the fact heretofore mentioned that many of these trusts were established at a time when yields were much higher and costs much lower than at present.

It does not seem to me that two wrongs make a right. It does not seem fair to subject the 98 percent of the taxpaying public who observe their obligations

to the inconvenience, hardship and unnecessary expense involved in catching the 2 percent who evade their obligations. I listened twice during this past month to Mr. Caplin, and once to Mr. Surrey defend this procedure. Mr. Caplin at the same time smilingly stated that beginning this year the computer at Morgantown, W. Va., would be capable of catching every evader. If this be true, then there would appear to be no necessity for withholding at all. It would be condemned out of its own mouth. The only reason for it then would be to enable the executive branch of the Government to get its hands on money before it is entitled to it, or to which it is not entitled at all.

Please do not let us repeat the hysteria of the thirties. The enactment of this bill in its present form will be simply one more step in the direction of big government and big spending. It will make it possible to spend more by merely making more immediately available. The immediate availability of money will act as an incentive to bigger and freer spending. It will have no influence on combating inflation, but rather the opposite. It will also be one more step in the destruction of our individual freedom: in this case, the destruction of our right to possess and control our own money until that time of the year when we must render our account unto Caesar.

Your earnest and careful consideration of this feature of the bill is respectfully requested.

Very sincerely yours,

JOSEPH D. MURPHY.

(Whereupon, at 12:05 p.m., the committee adjourned subject to call of the Chair.)