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INTEREST EQUALIZATION TAX EXTENSION ACT OF 1967

JULY 21, 1967.—Ordered to be printed

Mr. LONG of Louisiana, from the Committee on Finance, submitted the following

REPORT

[To accompany H.R. 6098]

The Committee on Finance, to which was referred the bill (H.R. 6098) to provide an extension of the interest equalization tax, and for other purposes, having considered the same, reports favorably thereon with amendments and recommends that the bill as amended do pass.

I. SUMMARY

H.R. 6098 extends the interest equalization tax for 2 additional years, for the first time provides discretionary authority for the President to vary the rate of tax within limits, and, as amended by your committee, provides for a maximum rate equal to an annual interest cost of 3 percent. A new procedure for administering the exemption for the sale of foreign stocks held by Americans is also provided by your committee's amendments.

The present interest equalization tax rate provides, in effect, the equivalent of a 1 percentage point per annum increase in interest costs for foreigners who obtain capital from U.S. sources either through the sale of stock or through the sale of debt obligations with a maturity of 1 year or more. The tax—which was first made effective in the middle of 1963—in conjunction with the program of voluntary limitations on the extension of credit and on the placement of direct investments abroad has diminished considerably our balance-of-payments deficits. Purchases of foreign securities and debt obligations in interest equalization tax countries have fallen substantially since the tax was imposed.

The present interest equalization tax expires July 31, 1967. The bill continues the tax for 2 more years, until July 31, 1969.

The present tax on foreign stock purchases by Americans is 15 percent of the actual value of the stock, and the rates of tax on debt obligations with maturities of 1 year or more vary from 1.05 percent

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on the obligations with the shortest maturity to 15 percent on those with a maturity of 28½ years or more. These rates provide as nearly as possible the equivalent of a 1 percentage point increase in interest costs. Interest rates in the United States in many cases are more than a percentage point below comparable interest rates abroad, and while tight credit conditions in the United States have prevented an increase in the outflow of U.S. capital, such an outflow may occur should credit here become more plentiful. Moreover, the announced administration policy of exerting downward pressure on interest rates may further widen the differential between domestic and foreign interest rates. To insure that the tax remains an effective instrument of balance-of-payments policy, your committee's bill authorizes increases in the rate of tax which would double the present level; that is, your committee's bill authorizes an increase in the rate of tax on issues of stock and debt obligations with maturities of 28½ years or more from 15 to 30 percent with corresponding increases in the rates on debt obligations with shorter maturities. The House bill authorized rates of tax from 15 to 22.5 percent for stock and debt obligations with the longest maturities.

To further insure that the tax remains a flexible instrument of balance-of-payments policy, your committee's bill gives the President the authority to vary the rate of tax between zero and the maximum rate authorized under your committee's bill. The House bill would have permitted the President to vary the rate of tax between the equivalent of a 1-percent increase in interest costs and a 1½-percent increase in these costs.

During an interim period from January 26, 1967 (the day after H.R. 3813, the administration proposal and the earlier version of this bill, was introduced in the House), until 30 days after the date of enactment of this bill, your committee's bill and the House bill provide that rates equivalent to a 1½ percent per annum interest cost are to be applicable. At the end of that period the rates will automatically revert to the interest equivalent of 1 percentage point unless the President exercises his authority to raise or lower the rates from that level. Interim rates above those under present law are provided in order to forestall buying of foreign stocks and debt obligations in anticipation of an increase in the rates of tax.

Your committee has also amended the House bill to provide a new system for administering the exemption applicable to sales of foreign stocks to Americans by prior American owners. This new system is intended to prevent evasion of the tax through the use of fraudulent certificates of prior American ownership. Evasion of this nature has reached serious proportions under existing law.

Under the new system, an American holding foreign securities who desires to sell them to a U.S. buyer without a tax being imposed must either both purchase and sell the securities through a group of brokers and banks which have agreed to keep specified records and accept responsibility for seeing that there has been compliance on the part of the American seller or the American must at the time of sale furnish a validation certificate, to be obtained from the Internal Revenue Service upon demonstrating that any interest equalization tax liability with respect to the stock has been paid. Under the new procedure, only in one of these two ways can an exemption from interest equalization tax be obtained by Americans selling foreign stock or debt issues to other

Americans. It is believed that this procedure will foreclose the type of evasion which has occurred in the past and which has resulted primarily from the fact that brokers relied on American ownership certificates without determining whether any tax liability due had been paid.

In addition to the major amendments referred to above, your committee approved certain amendments to the interest equalization tax made by the House, modified other House provisions, and added certain new amendments. All of the amendments made by your committee deal exclusively with the interest equalization tax.

The remaining amendments in the House bill approved by your committee without modification are as follows:

(1) An exception to the tax is provided for stock or debt obligations acquired by a foreigner during the first 90 days of residency in the United States. However, securities purchased under this exemption will be subject to tax if sold subsequently to Americans.

(2) Present law provides an exception from the interest equalization tax for debt obligations acquired in connection with the sale of ores or minerals obtained by a U.S. person under a contract entered into before the initiation of the interest equalization tax. The bill extends this exemption also to cover substitutes for these earlier contracts which are entered into on or before January 25, 1967. The exemption in this case is limited in a manner which gives assurance that the debt obligations acquired free of tax may not exceed those which could have been acquired under the earlier contract.

(3) U.S. dealers in foreign debt obligations presently may acquire these obligations without payment of tax (through a credit or refund) if they resell to foreigners within 90 days after purchase or if they resell within 90 days to another U.S. dealer who resells within the same or the next business day to foreigners. In the case of debt obligations which are acquired and sold to a second U.S. dealer, the bill provides that the acquisitions are to be free of tax if the second dealer resells to foreigners within 30 days from the date of his purchase.

(4) Present law provides an exemption from the tax for foreign branches of U.S. banks which make loans to foreign persons with funds obtained abroad. The bill provides a similar exemption for small finance companies. Thus, under the bill, a U.S. corporation engaged in the small loan and finance business outside the United States, which makes loans to the general public with funds acquired abroad, may elect to be exempt from the interest equalization tax.

Three other provisions passed by the House your committee also approved but with modifications:

(1) The House provided an exclusion from the tax for debt obligations acquired by Americans in connection with the sale of real property located outside of the United States if the sellers held such property before July 18, 1963, the date the tax was announced. Your committee amended this provision to extend the exclusion to debt obligations acquired by an estate, or the heirs of a decedent in connection with the sale of foreign real property acquired by a deceased American on or before July 18, 1963.

(2) In connection with the exclusion of acquisitions of newly issued Canadian stock or debt obligations, there is a penalty imposed for failure to file information concerning such purchases within the prescribed time. The penalty is 5 percent of what the tax would be if

there were no exclusion for each month the notice is late up to a maximum of 25 percent. This penalty applies, however, only to acquisitions made after October 9, 1965; for periods before that time, late filing resulted in the complete loss of the exclusion. The House bill extended the limited penalty applicable since October 9, 1965, to the entire period since July 18, 1963. Your committee amended this provision of the House bill to reduce the penalty for late filing to 1 percent of what the tax would be in the absence of the exclusion for each month the notice is late up to a maximum of 5 percent. This penalty is to apply to the entire period beginning with July 19, 1963.

Your committee has approved the provision of the House bill which provides State governments with a period up to 60 days after the enactment of this bill in which to file the required notice concerning past acquisitions of Canadian stock or debt obligations without incurring a penalty.

(3) The House bill provided that a U.S. corporation primarily engaged in the business of borrowing funds abroad and using those funds to finance sales by affiliated domestic companies of property or services to foreign persons, may elect to be exempt from the tax on the debt obligations it acquires as a result of these financing activities. The financing company may only make loans, however, in connection with those sales where 15 percent of the property or services sold consists of U.S. property or services of U.S. persons.

Your committee has made a series of modifications in this provision, primarily in order to provide greater flexibility for these financing arrangements. Generally, a financing company will also be allowed to lend money in connection with sales of products manufactured by related (50 percent owned) domestic or foreign corporations even though the sales are made by unrelated dealers, and even though the products do not have a U.S. content. In addition, the modifications permit tax free direct investments in a foreign subsidiary which satisfies the requirements set forth for domestic financing subsidiaries.

In addition, your committee has approved the following new amendments to the House bill:

(1) An exemption is provided for debt obligations acquired in connection with export transactions in which the Export-Import Bank or a similar instrumentality guarantees or insures the obligation. Under present law the exclusion is only available in this case if the debt obligation issued by the importer.

(2) The exclusion provided for less developed country corporations is limited in the case of shipping corporations to those corporations which are 80 percent owned by Americans or residents of less developed countries.

(3) An exclusion is granted to transactions which involve the transfer of a portion of the commission income of a U.S. securities dealer to a foreign branch which has elected to be treated under this tax as a foreign corporation, but only to the extent that the commission income is generated through, and attributable to, the foreign branch.

(4) The definition of a class of stock is amended in the case of the exclusion of stock in a foreign corporation 65 percent or more owned by U.S. persons prior to July 19, 1963, to permit stock once restricted as to dividends to be treated as a single class of stock with the unrestricted stock provided the restriction existed prior to July 19, 1963, and lapsed under a provision in effect prior to July 19, 1967.

(5) An amendment was agreed to which permits certain acquisitions made in the period from July 18, 1963, through September 1, 1964, to be tax free. For the exclusion to be available the investor must generally have made the acquisition with funds held in Canada on July 18, 1963, the transactions must have been completed on or before September 1, 1964, and the acquisitions must have involved Canadian securities.

(6) An exemption is provided for debt obligations reacquired from foreign lenders if the obligations initially were tax free and arose from certain export-related transactions.

II. REASONS FOR THE BILL

Background

The balance of payments of the United States continues to represent a serious problem requiring the further extension of the interest equalization tax. The balance of payments has been in a deficit position in every year save one since 1949. These persistent deficits have resulted in a significant drain on U.S. gold supplies. Table 1 indicates that the stock of gold held by the United States fell by $11,325 million in the years 1950 through 1966.

TABLE 1.—*U.S. balance of payments: Balance on a liquidity basis and on an official reserve transactions basis, and changes in U.S. gold stock for the period 1949–66*

[Millions of dollars]

Year	Balance: Liquidity basis (deficit —)	Balance: Official reserve transactions basis	Change in gold stock [1] (decrease —)
1949	136	(2)	169
1950	−3,489	(2)	−1,743
1951	−8	(2)	53
1952	−1,206	(2)	379
1953	−2,184	(2)	−1,161
1954	−1,541	(2)	−298
1955	−1,242	(2)	−40
1956	−973	(2)	305
1957	578	(2)	799
1958	−3,365	(2)	−2,275
1959	−3,870	(2)	−1,075
1960	−3,881	−3,402	−1,703
1961	−2,370	−1,347	−857
1962	−2,203	−2,706	−890
1963	−2,670	−2,044	−461
1964	−2,798	−1,546	−125
1965	−1,337	−1,305	−1,665
1966	−1,367	244	−568

[1] Including convertible currencies and IMF gold tranche position.
[2] No officially published figures on this basis are available for years prior to 1960.

Source: U.S. Treasury Department and the Federal Reserve Bulletin.

While the problem has persisted, in recent years the balance-of-payments deficit has been reduced. Measured on a liquidity basis,[1] the deficit fell from an average of $3,705 million in the years 1958 through 1960 to $1,337 million in 1965, and to $1,367 million in 1966.

[1] Equals change in liquid liabilities to foreign official holders, other foreign holders, and changes in official reserve assets consisting of gold, convertible currencies, and the U.S. gold tranche position in the International Monetary Fund.

On an official transactions basis,[3] a small surplus was recorded in 1966 as compared to a deficit of $1,305 million in 1965.

The progress that has been made is, in important part, attributable to the effectiveness of the specific programs undertaken by the Government to correct this situation. Among the more important of these are the interest equalization tax and the program to enlist the voluntary cooperation of business firms and banks in a procedure to restrain the outflow of capital, including both direct investment and bank loans.

[3] Equals changes in liquid and nonliquid liabilities to foreign official holders and changes in official reserve assets consisting of gold, convertible currencies, and the U.S. gold tranche position in the International Monetary Fund. The 1966 surplus was due in important part to an influx of private foreign held short-term dollars that were attraced to the United States as a result of conditions of tight money.

TABLE 2.—*U.S. balance of payments, 1960–67, 1st quarter*

[In millions of dollars]

	1960	1961	1962	1963	1964	1965	1966	1st quarter 1967 seasonally adjusted
Trade	4,757	5,444	4,417	5,079	6,676	4,772	3,658	1,001
Exports	19,489	19,954	20,604	22,071	25,297	26,244	29,168	7,690
Imports	−14,732	−14,510	−16,187	−16,992	−18,621	−21,472	−25,510	−6,689
Travel (including fares)	−1,238	−1,235	−1,444	−1,596	−1,499	−1,613	−1,644	−416
Receipts	1,025	1,057	1,070	1,133	1,357	1,545	1,768	459
Payments	−2,263	−2,292	−2,514	−2,729	−2,856	−3,158	−3,412	−875
Other services and transfers (excluding direct investment income)	164	389	677	629	829	875	880	200
Military (excluding commerical transactions)	−2,741	−2,564	−1,941	−1,972	−1,880	−1,823	−2,747	−692
(Receipts, DOD basis)	(320)	(540)	(1,350)	(1,230)	(1,210)	(1,330)	(1,290)	(1,310)
(Payments, DOD basis)	(−3,090)	(−3,000)	(−3,110)	(−2,960)	(−2,870)	(−2,910)	(−3,700)	(−4,190)
(Net, DOD basis)	(−2,770)	(−2,460)	(−1,760)	(−1,730)	(−1,660)	(−1,580)	(−2,410)	(−2,880)
Government grants and capital	−2,736	−2,710	−2,635	−3,502	−3,331	−3,432	−3,472	−1,128
Outflows	−3,405	−4,054	−4,293	−4,551	−4,263	−4,277	−4,680	−1,419
(Dollar outflow)	(−1,126)	(−1,146)	(−1,044)	(−814)	(−685)	(−708)	(−720)	(−191)
Debt repayments	610	1,249	1,253	962	694	832	1,188	198
U.S. Government nonliquid liabilities	59	95	405	87	238	13	13	93
Direct investment	681	1,169	1,390	1,153	1,239	545	583	301
Capital outflows	−1,674	−1,599	−1,654	−1,976	−2,435	−3,418	−3,462	−695
Investment income	2,355	2,768	3,044	3,129	3,674	3,963	4,045	996
Bank claims (short and long)	−1,148	−1,261	−451	−1,535	−2,464	93	253	71
Nonbank claims (short and long)	−394	−558	−351	159	−966	340	−441	−142
Foreign securities:								
New issues	−555	−523	−1,076	−1,250	−1,063	−1,206	−1,210	−333
Outstanding issues and redemptions	−108	−239	107	146	386	448	728	93
Foreign capital	339	622	157	303	222	81	2,445	707
Purchases of U.S. securities (other than Treasury securities)	282	324	134	282	−84	−357	909	112
Long-term deposits and CD's	6	−5	5	62	237	203	976	368
Other	51	303	18	−41	69	235	560	227
Errors and omissions	−922	−904	−1,053	−285	−949	−415	−383	−206
Liquidity balance	−3,901	−2,370	−2,203	−2,671	−2,800	−1,335	−1,357	−544
Official settlements balance	−3,403	−1,347	−2,705	−2,044	−1,549	−1,304	225	−1,822

Sources: Department of Commerce, Survey of Current Business, June 1967; Department of Defense.

The interest equalization tax is an important segment in the broad balance-of-payments program. By raising the cost to foreigners of obtaining capital in U.S. markets, the tax serves to moderate the outflow of private capital abroad. While such outflows, in time, result in a return flow of earnings to this country, initially they are deficit items in the balance of payments and, if permitted to flow unchecked at a critical time, such as the present, could cause such a serious weakness in the balance of payments that drastic action would have to be taken—action which would have longrun, harmful effects.

The tax was introduced after a sharp increase occurred in the outflow of private long-term capital. Private long-term capital outflow, shown in table 3, increased from $2.6 billion in 1961 to $3.7 billion in 1963, an increase of 40 percent. In the first 6 months of 1963, such outflows accelerated to a level which, if sustained throughout the year, would have resulted in an outflow of $4.5 billion, or nearly 75 percent more than the 1961 figure.

TABLE 3.—*U.S. private capital outflows, 1961–66*

[In millions of dollars; outflow (—), 1961–66]

	1961	1962	1963	1964	1965	1966	Seasonally adjusted annual rates							
							1963		1964		1965		1966	
							January to June	July to December	January to June	July to December	January to June	July to December	January to June	July to December
Total private outflow	—4,180	—3,425	—4,456	—6,542	—3,743	—4,132	—5,360	—3,552	—5,712	—7,372	—4,172	—3,313	—4,304	—3,960
Long term	—2,624	—2,881	—3,671	—4,396	—4,496	—3,719	—4,506	—2,836	—3,242	—5,550	—5,428	—3,564	—4,070	—3,368
New foreign security issues	—523	—1,076	—1,250	—1,063	—1,206	—1,210	—1,840	—660	—822	—1,304	—1,262	—1,150	—1,542	—878
Redemptions	148	203	195	193	222	405	186	204	184	202	214	230	482	328
Transactions in foreign outstanding securities	—387	—96	—49	193	226	323	—302	204	268	118	358	94	226	420
Long-term bank claims	—136	—127	—754	—941	—232	337	—368	—1,140	—640	—1,242	—520	56	256	418
Other long term	—127	—131	[1] 163	[2] —343	—88	—112	6	320	—168	—518	0	—176	—136	—88
Direct investment [3]	—1,599	—1,654	—1,976	—2,435	—3,418	—3,462	—2,188	—1,764	—2,064	—2,806	—4,218	—2,618	—3,356	—3,568
Short term	—1,556	—544	—785	—2,146	753	—413	—854	—716	—2,470	—1,822	1,256	251	—234	—592
Bank claims	—1,125	—324	—781	—1,523	325	—84	—726	—836	—1,872	—1,174	398	252	172	—340
Other short term	—431	—220	—4	—623	428	—329	—128	120	—598	—648	858	—1	—406	—252

[1] Reflects transfer of $150,000,000 to long-term banking credits.
[2] Includes $254,000,000 loaned to Canada in connection with Columbia River power project.
[3] Includes use of funds raised abroad by U.S.-based subsidiaries.

NOTE.—Subtotals may not add due to rounding.

Source: U.S. Treasury Department

Issues of new foreign securities accounted for much of the increased outflow. U.S. citizens increased their purchases of foreign securities from $523 million in 1961 to $1,076 million in 1962 and accelerated their rate of purchases in the first half of 1963 to a seasonally adjusted, annual rate of $1,840 million.

The interest equalization tax became effective on July 19, 1963 (Aug. 17, 1963, for listed securities). The tax originally was imposed on U.S. purchasers of foreign stocks and on U.S. purchasers of foreign debt obligations having a maturity of 3 years or more. The rate of tax was intended, as nearly as possible, to aline the rate of interest foreigners would have to pay to obtain capital from U.S. markets with the rates of interest prevailing in other industrial countries. To achieve this objective, the scale of tax rates imposed, 15 percent in the case of stocks and lesser percentages in the case of debt obligations with maturities of less than 28½ years, was designed to raise the cost that foreigners would have to pay to obtain capital here by the equivalent of approximately 1 percent per annum. A tax rate of 15 percent on an obligation with a maturity of 28½ years is approximately equal to the present value of a 1-percent per year interest charge on the obligation. The lower tax rates for the obligations with shorter lives achieve substantially the same effect. The tax, which is imposed on the buyer or lender but is passed on to the seller or borrower, therefore is about the equivalent of an increase in the interest rate paid by the borrower of 1 percent.

This tax was applied to outstanding issues, as well as new issues, to forestall tax avoidance through the substitution, directly or indirectly, of new issues for outstanding issues held by foreigners and the subsequent sale of the outstanding issues to Americans. This provision also served to strengthen the balance of payments by moderating purchases of outstanding securities. In the act, discretion was given the President to apply the tax to bank loans, including those with a maturity of 1 to 3 years. Subsequently on February 10, 1965, the President exercised this authority and applied the tax to bank loans with a maturity of 1 year or more. In 1965, the tax was extended until July 31, 1967, and was also extended to cover other debt obligations with a period remaining to maturity of 1 to 3 years.

The effectiveness of the tax

The introduction of the interest equalization tax was followed by a substantial decline in the volume of sales of securities and debt obligations subject to tax. Sales of new foreign securities to U.S. residents, shown in table 4, fell from a total of $999 million in the first half of 1963 to $251 million in the second half of that year.

TABLE 4.—*New issues of foreign securities purchased by U.S. residents, by area, 1962–1967 first quarter*

[In millions of dollars]

	1962	1963		1964	1965	1966	1967 1st quarter[1]
		1st half[1]	2d half[1]				
Total new issues	1,076	999	251	1,063	1,206	1,210	332
IET countries:							
West Europe	195	219	53	20	80	15	....
Japan	101	107	57	....	52	4	....
Other[2]	60	17	....	....	....	....	....
Subtotal	356	343	110	20	132	19	....
Subject to IET	....	....	....	....	80	9	....
Exempt from IET	....	....	110	20	52	10	....
Commitments made prior to July 18, 1963	....	....	(110)	....	....	....	....
U.S. export-related	....	....	....	(9)	....	....	....
Japanese exemption	....	....	....	....	52	....	....
Other	....	....	....	[3] (11)	....	[4] (10)	....
Other countries:							
Canada	457	608	85	700	709	[5] 922	256
Latin America[6]	102	13	23	208	37	69	38
Other countries	77	35	33	131	149	120	24
International institutions	84	....	....	4	179	80	14
Subtotal	720	656	141	1,043	1,074	1,191	332

[1] Not seasonally adjusted.
[2] Australia, New Zealand, South Africa.
[3] Issue had maturity less than 3 years, which was lowest maturity to which tax had applied prior to Feb. 11, 1965.
[4] Issue by United Kingdom subsidiary of Canadian firm.
[5] Before deducting $162,000,000 of Canadian Government purchases from U.S. residents of outstanding Canadian and other foreign securities in accordance with Canada's agreement not to let its foreign exchange reserves rise as a result of borrowing in the United States.
[6] Includes Latin American Development Bank issue of $145,000,000 in 1964.

Source: U.S. Treasury Department.

Moreover, all the new issues sold in the second half of 1963 were exempt from the tax, either because purchase commitments had been made prior to the date the tax went into effect or because the issues originated in countries designated as exempt from the tax. No taxable issues were sold in 1964, with the result that sales of new issues of foreign securities fell to the 1962 level. In 1965, $80 million of taxable issues were sold, but all of these sales were by United Kingdom firms and reflected a special situation in which the firms were borrowing to finance direct investment expenditures here. In 1966 only $9 million of taxable issues were sold and no taxable issues were sold in the first quarter of 1967.

The tax also moderated purchases by U.S. citizens of outstanding issues held by foreigners. In the 3½ years which preceded the announcement of the tax, U.S. residents were, on balance, net purchasers of outstanding foreign stocks and bonds. Their net purchases averaged $275 million per year. Since mid-1963, U.S. residents have, on balance, sold $200 million more of these securities annually than they have purchased. This shift in the position of U.S. residents, which is indicated in table 5, has been of material benefit to the Nation's balance of payments.

TABLE 5.—*Net transactions in outstanding foreign securities by U.S. residents, 1960–1967 first quarter*

[U.S. transactions with residents of all countries (in millions)[1]]

1960	−$309
1961	−387
1962	−96
1963 1st half annual rate	−302
Average annual rate, 1960 to June 1963	−274
1963 2d half annual rate	204
1964	193
1965	226
1966	323
Average annual rate, July 1963–66	238
1967 1st quarter annual rate	−24

[1] Minus sign indicates net purchases by U.S. residents and no sign before a figure indicates net sales by U.S. residents.

Source: "Survey of Current Business," Department of Commerce.

While commercial bank loans were not initially subjected to the interest equalization tax, it became increasingly apparent that such loans were being substituted, directly or indirectly, for the sale of securities in the U.S. capital market. As indicated in table 3, long-term bank claims against foreigners increased from $127 million in 1962 to $941 million in 1964. Short-term bank claims increased from $324 million in 1962 to $1,523 million in 1964. Following a sharp increase in bank loans to foreigners in the final months of 1964, the President, on February 10, 1965, exercised authority granted him under the Interest Equalization Tax Act and applied the tax to commercial bank loans made to foreigners provided the loans had a maturity of 1 year or more. As a result of the tax, the voluntary program, and conditions of monetary stringency, the increase in long-term commercial bank claims against foreigners was reduced to $232 million in 1965. The amount of long-term bank claims fell and was therefore a plus factor in the balance of payments in 1966.

While the tax has succeeded in moderating the outflow of private capital from the United States, it has not eliminated it. Such investment has continued at a relatively steady level. Furthermore, direct investment by U.S. firms, which is not covered by the tax, has also continued. The income from the overseas investments of U.S. individuals and corporations rose to $4,045 million in 1966,[3] or nearly twice the 1960 level. The tax, in conjunction with the program of voluntary cooperation, however, has succeeded in moderating the rate of overseas investment to more sustainable levels, a result which is beneficial to both the short- and long-term balance-of-payments position of the United States.

The exemptions provided by the President, under the authority in the act to provide international monetary stability, have not impaired the effectiveness of the tax. The exemption for new issues originating in Canada and the limited exemption provided for Japan were necessary to maintain the stability of the international monetary system. However, the two countries have not enjoyed unlimited recourse to the U.S. capital market. In the case of Japan, the exemption is limited to $100 million of new debt issues each year. With respect to

[3] See table 2.

Canada, Canadian officials, as they indicated they would, have seen to it that Canada's official foreign exchange reserves have not increased out of the proceeds of borrowings from the United States. Canadian officials also have indicated that they are fully aware of the necessity of avoiding the use of the Canadian exemption as a method of channeling American funds to other countries.

Extension of the tax is required

While progress has been made toward the elimination of the persistent deficit in the balance of payments of the United States, further progress is necessary. Furthermore, much of the gain that has been made would be lost if existing programs were discontinued. In the absence of the interest equalization tax, U.S. capital markets would again become highly attractive to foreign borrowers. Such borrowers would prefer the U.S. markets to their own domestic markets because of the lower interest rates that generally prevail here and because the U.S. market is more effectively organized to supply the rapidly expanding needs of foreign borrowers than the capital markets in their own countries. Moreover, underwriters and securities buyers in the United States have become familiar with foreign securities. In the absence of the tax, there would be a substantial increase in sales of foreign portfolio securities, which would undermine recent improvements in our balance-of-payments position.

Failure to extend the tax would also jeopardize other measures in the broad program that has been undertaken to narrow the balance-of-payments deficit. The tax has a particularly important bearing, for example, on the program of voluntary cooperation to reduce capital outflows that was inaugurated in 1965. The voluntary program seeks to curb the grant of credits to foreigners by banks and other financial institutions and to moderate outflows of funds associated with direct investments overseas by U.S. business firms. In the absence of the tax, more foreign borrowers would seek to raise funds in the U.S. capital markets. Such a development would increase the pressure of foreign demand that the voluntary program must stem. Moreover, the tax, by reaching investors who are not under the voluntary program, assures participants in the voluntary program that they are not being asked to assume a disproportionately large share of the burden of eliminating the payments deficit.

In view of these considerations, the House bill and your committee's bill provide for a temporary, 2-year extension of the interest equalization tax, from July 31, 1967, to July 31, 1969. This temporary extension emphasizes the fact that the tax is not considered as a permanent component of the tax structure. Your committee continues to view this tax as a transitional device to permit orderly progress toward a satisfactory longrun solution to the balance-of-payments problem faced by the United States.

Authority to vary the rate of tax

In their appearance before your committee, the representatives of the Treasury Department emphasized the uncertainties surrounding the outlook with regard to the differential between interest rates in the United States and interest rates in other industrialized countries. The interest rate differentials which existed in 1963 called for tax rates equivalent to about a 1-percent increase in the rate of interest paid by foreigners to obtain funds from this country. The difference in yields has widened since the tax was imposed in 1963. While interest rates rose sharply in this country, interest rates also rose abroad. Last December the average yield on outstanding long-term bonds issued by Western European governments was almost 1½ percentage points above the yield on long-term U.S. Government bonds. Since February, the differential has narrowed as interest rates in the United States have risen, approaching the September 1966 levels, while interest rates in Europe have continued to decline gradually, on average.

The recent decline in the interest rate differential provides no assurance, however, that the gap will not widen again in the near future. The Under Secretary of the Treasury, in his appearance before your committee, stated that there is some indication that European interest rates may rise again, a development which would increase the width of the differential. Furthermore, the 1.11 percentage point differential in May 1967 exceeded the 0.86 percentage point differential that existed in June 1963, when the tax was proposed. It was also above the 1 percentage point differential that the existing interest equalization tax rates are based upon. A comparison of yields on Government bonds in the United States and various industrialized countries of Western Europe and elsewhere is shown in table 6.

TABLE 6.—*Comparison of yields on U.S. and various foreign government long-term bonds, June 1963–May 1967* [1]

[Percent per annum; monthly average]

	Yield					Foreign differential over U.S. Treasury bond yield as of—				
	June 1963	September 1966	December 1966	February 1967	May 1967	June 1963	September 1966	December 1966	Februaly 1967	May 1967
Western Europe (average)	4.86	6.15	6.10	5.95	5.87	0.86	1.36	1.45	1.48	1.11
Belgium	4.00	5.84	5.90	5.88	5.86	0	1.05	1.25	1.41	1.10
Denmark	6.54	8.05	8.13	8.24	7.95	2.54	3.26	3.48	3.77	3.19
France	5.09	5.45	5.64	5.58	[2] 5.71	1.09	.66	.99	1.11	.95
Germany	6.03	8.11	7.76	7.40	[2] 6.90	2.03	3.32	3.11	2.93	2.14
Italy	5.06	5.90	[3] 5.96	5.55	[4] 5.62	1.06	1.11	1.31	1.08	.86
Netherlands	4.12	6.45	6.45	5.89	5.81	.12	1.66	1.80	1.42	1.05
Norway	4.66	4.45	4.44	4.41	4.38	.66	−.34	−.21	−.06	−.38
Sweden	4.52	5.85	5.49	5.37	5.26	.52	1.06	.84	.90	.50
Switzerland	3.15	4.25	4.47	4.74	4.67	−.85	−.54	−.18	.27	−.09
United Kingdom	5.44	7.12	6.76	6.40	6.51	1.44	2.33	2.11	1.93	1.75
Other developed:										
Australia	4.50	5.25	5.25	5.25	5.25	.50	.46	.60	.78	.49
New Zealand	5.17	5.38	(5)	5.43	[4] 5.49	1.17	.59	(5)	.96	.73
U.S. Treasury bonds	4.00	4.79	4.65	4.47	4.76					

[1] Outstanding issues with at least 12 years' life.
[2] April data.
[3] November data.
[4] March data.
[5] Not available.

NOTE.—In some cases where the interest ratio are much higher than in the United States—for example, Germany—the high interest rates do not mean that the governments involved were borrowing any appreciable amounts of new funds at these rates.

Sources: International Financial Statistics, Treasury Bulletin, and Federal Reserve Board.

The balance-of-payments impact of the gradually widening differential between yields on bonds in this country and other developed nations was undoubtedly mitigated in 1966 by conditions of credit stringency in this country. Domestic lenders were unable to fill all domestic demands, let alone satisfy the needs of foreign borrowers. If monetary conditions here ease as a result of the stated policy of the administration, renewed pressure may be created for an outflow of U.S. capital. This pressure may be intensified if the differential in interest rates widens as a result of the downward movement of domestic interest rates.

In view of the considerations set forth above, there exists the real possibility that the current interest equalization tax rates may become inadequate to equalize effective rates of interest between the U.S. capital markets and foreign capital markets. The House bill therefore made provision for an increase in the rates of tax of as much as 50 percent above those in present law during the period until July 31, 1969. If the President exercised the discretionary authority granted him and raised the effective rate of tax, he would be permitted under the House bill, when conditions warranted, to reduce that rate, but not below the interest rate equivalent of 1 percent per annum.

In the view of your committee, the increase in existing tax rates permitted by the House bill is not adequate. The differential between interest rates in the United States and interest rates in Western Europe might well exceed the maximum tax rate provided in the House bill. In February 1967, for example, the average differential was 1.48 percent. To carry out the purpose of the provision allowing an increase in the rate of tax above the current level, your committee has, therefore, amended the House bill to permit the existing rates of tax to be doubled, if the President believes such an increase is necessary in order to limit the total acquisitions of foreign securities and debt obligations by U.S. persons to a level consistent with the balance-of-payments objectives of the United States.

Your committee has also concluded that the range of discretionary authority granted the President in the House bill is insufficient to achieve the objective of providing greater flexibility in balance-of-payments policy. Under the House bill, the President would have authority only to vary the tax between the existing level and a level 50 percent greater. While attention has been focused on the possibility of an increase in the differential between U.S. and foreign interest rates, the possibility also exists that the differential will narrow. Furthermore, the balance of payments of the United States may improve to such an extent that in any case it will become desirable to reduce the rate of tax below the current level. Your committee has, therefore, amended the House bill to extend the President the discretionary authority to vary the rates of tax under the interest equalization tax between zero and the maximum rates authorized. This provision differs from the House bill only insofar as it permits the President to reduce interest equalization tax rates below existing levels. In the House bill, the President was given the authority to vary the tax rates between the existing levels and the new maximum levels. Your committee agrees with the House that the existing relationship between the rates of tax on foreign stocks and on foreign debt obligations with various dates to maturity should be maintained in any subsequent change in the rates of tax.

The House bill and your committee's bill provide that the tax rate will be equivalent of a 1½ percent added interest rate during a transitional period that is to extend from January 26, 1967, to 30 days following the date of enactment of this bill. On the 30th day the rate of tax will fall to the previous level—the rates under present law. The President can then, if conditions warrant, exercise his discretionary authority to vary the rate of tax. It is necessary to impose a higher rate of tax during the transitional period in order to prevent a speculative outflow of capital. Such an outflow would occur if potential lenders and borrowers felt that the tax rate would be raised soon after the date of enactment of the bill. This provision is similar to the action taken by Congress when the interest equalization tax was first imposed. At that time, the tax was made effective beginning with the date it was announced rather than the date of enactment in order to forestall speculative outflows of private capital.

It is your committee's clear understanding that the discretionary authority granted the President in this bill to vary the rate of tax is not to serve as a precedent for granting the President similar authority with respect to other taxes.

The interest equalization tax is essentially a regulatory measure and, therefore, differs from the major taxes in the Federal revenue system. The regulatory nature of the tax is clear from the fact that only $54 million of revenues have been raised by the tax since its inception. Moreover, the interest equalization tax is much more the exercise of monetary, rather than fiscal, authority since it in reality is a substitute for raising domestic interest rates for foreigners. In the monetary area the authority to increase or decrease rates has traditionally been exercised by the executive or by an independent agency.

The discretionary authority granted the President also is similar to the discretionary authority previously granted the President to apply the tax to bank loans, and to exempt some or all new issues from certain countries from the tax in part or in entirety in the interest of international monetary stability.

Measures to prevent evasion

Recent articles in the press have called attention to incidents in which unscrupulous persons have evaded the interest equalization tax by obtaining false certificates of prior American ownership. In this way they have been able to sell securities purchased from foreigners in the American market and illegally profit from the prior American ownership exclusion in the law.

Your committee is concerned about this matter and questioned Treasury witnesses carefully about it. They assured your committee that official investigations were underway well in advance of the reports in the press. They also stated that, based on these investigations, they believe the illegal transactions were running at the rate of $100 million to $150 million a year in the first part of 1967, significantly less than some commentators had supposed.

Your committee and the Treasury Department are agreed, however, that the amounts involved are likely to increase unless additional steps are taken to curb evasion. These steps are needed in large measure because it is difficult under present law to deal directly with the persons primarily responsible for the evasion. Typically, such persons have operated through a foreign country, channeling foreign stock with false certificates of American ownership through a foreign brokerag firm to a small American over-the-counter broker-dealer who the sold the securities to a larger broker-dealer specializing in foreig securities. While steps can be taken against Americans who sign fals certificates of ownership, they are not generally the ones primaril responsible for the evasion.

Your committee believes that it would be inappropriate to end suc evasion by applying the interest equalization tax to all transaction in which foreign stocks are either bought or sold by Americans, eve if the other party to the transaction is also an American. This actio would penalize many transactions which have no impact on the balanc of payments merely to prevent a relatively small number of fraudulen transactions.

Your committee also concluded that it would be inappropriate t exempt from tax all purchases of outstanding foreign stocks purchased from foreigners as well as Americans. Such an exemption would en- courage widespread avoidance of the tax. New issues of stock could be transferred to Americans through secondary distributions since, once issued, shares of stock cannot be distinguished from one another. That is, the sale of outstanding issues would be substituted for the sale of new issues; new issues would be exchanged for outstanding issues held by foreigners and then these outstanding issues would be sold to Americans. This would encourage a renewed outflow of capital that would have an adverse effect on the U.S. balance of payments.

Your committee has rejected the extreme solutions outlined above and has provided for the establishment of a new system designed to prevent evasion of the interest equalization tax. The system requires that a person selling foreign stocks to a U.S. buyer must establish that any interest equalization tax obligation has been met. It replaces the present system under which the seller need only assert that the shares were owned by a U.S. citizen.

Under the new system, validation of the foreign securities can be obtained in one of two essential ways. In the case of foreign stocks held by certain broker-dealers or by certain banks as custodians on July 14, 1967, for accounts of Americans validation will be granted automatically if proof of American ownership has been obtained. The eligible broker-dealers will initially include all firms which are members of the New York Stock Exchange and the American Stock Exchange and the larger firms which are members of the National Association of Security Dealers or those presently having frequent transactions in foreign securities. The list of eligible banks will initially include those Federal Reserve member banks which are classified as reserve city banks. Additional brokerage firms and banks may be added to these lists when assurances are received that they will meet the reporting and recordkeeping requirements imposed under the new system.

In the case of foreign securities not held by eligible broker-dealers or eligible banks on July 14, 1967, validation must be obtained from the Internal Revenue Service. Once this validation is obtained subse- quent sales of these foreign securities may be made through these eligible broker-dealers or banks. To obtain validation, the seller will have to establish that he either held the securities continuously since July 18, 1963, paid the tax due on their acquisition, or obtained the securities under the terms of a valid exemption or exclusion. In this connection, validation cannot be obtained unless any interest equal- ization tax liability with respect to the shares has been paid.

To forestall fraudulent transactions based on the desire to rush completion before the application of the new rules, your committee, following the procedures employed when the tax was imposed, recommends that the new validation requirements be placed in effect with respect to transactions on or after July 15, 1967, the day after the procedure was first outlined before your committee. Eligible broker-dealers may validate foreign securities held for the account of American owners as of July 14, 1967. The Internal Revenue Service will establish validation procedures for other foreign securities.

III. GENERAL EXPLANATION OF THE BILL

1. *Extension of interest equalization tax (sec. 2 of the bill and sec. 4911(d) of the code)*

Under present law the interest equalization tax terminates as of July 31, 1967. The House bill and your committee's bill extend the application of this tax for a period of 2 years, or until July 31, 1969. As explained more fully in the prior part of this report, "Reasons for the Bill," the extension of the application of this tax for 2 more years is essential to prevent the renewed outflow of capital funds and a deterioration in our balance of payments. The latter has been gradually improving in recent years, in no small part as a result of this tax and the voluntary program to limit foreign lending and direct investment abroad.

2. *Imposition of tax, rates, and executive authority for modification (sec. 3 of the bill and sec. 4911(b) of the code)*

Present law provides that, in the case of foreign stock, the interest equalization tax is to be imposed at a rate of 15 percent of the actual value. For foreign debt obligations present law contains a sliding schedule of tax rates varying from 15 percent on obligations with a maturity of 28½ years or more down to 1.05 percent for those with a maturity of 1 to 1¼ years.

The bill as passed by the House provides generally that the President is to have the authority, by Executive order, to raise the rates of tax up to a maximum of approximately 150 percent of the present rates. For the reasons explained more fully in a prior part of this report, your committee has amended this provision of the bill to provide maximum tax rates of approximately 200 percent of the present rates. The maximum rate of tax on foreign stock is to be 30 percent and the maximum rate for foreign debt obligations is to vary from 30 percent on obligations with a period to maturity of 28½ years or more down to 2.10 percent for those with a period to maturity of 1 to 1¼ years. A schedule of maximum rates is supplied in the statute for these debt obligations.

Under the House bill, the President was granted discretionary authority to vary the tax rates within a range represented by the present rates and rates 50 percent higher. As is explained more fully in the prior part of this report "reasons for the bill," your committee has modified this provision of the bill to enlarge the range of the President's discretionary authority. Your committee's bill provides the President with discretionary authority to vary the rates between zero and the new maximum rates which are approximately 200 percent of the present rates.

The President may vary the rates of tax upward or downward so long as the rates he provides do not exceed the new maximum rates. Any increases or decreases in the schedule of rates provided by the President are to be proportionate, providing the same percentage increase or decrease in all brackets (except that the rates may be rounded to the nearest one-hundredth of 1 percent.)

The authority to vary the rates is to be exercised only when the President makes a finding that the rates of tax then applicable are lower or higher than the rates necessary to limit the total acquisitions by U.S. persons of foreign stock or debt obligations within a range consistent with the balance-of-payments objectives of the United States.

Any increase or decrease in the rates of tax resulting from the exercise of this Presidential authority is only to affect acquisitions made after the effective date of the increase or decrease. Where the President increases or decreases the rate of tax, he may or may not take into account preexisting commitments in the same manner as they are taken into account where there is a legislative change made in the interest equalization tax (see the discussion below).

As is explained more fully in the prior part of this report, "Reasons for the Bill," this discretion granted to the President to raise or lower the rates of the interest equalization tax within the range of an interest equivalent of 0 to 2 percent per annum is provided because of the difficulties in determining the differential in interest rates likely to exist in the future between the United States and the various developed foreign countries. In no event is this discretionary authority to vary interest equalization tax rates to be viewed as a precedent for varying tax rates generally applicable.

Although your committee's bill provides generally for an interest equalization tax ranging up to 15 percent with discretion in the hands of the President to increase the tax to rates ranging up to 30 percent, during the interim period beginning on January 26, 1967 (the day after the administration's proposal with respect to the interest equalization tax was announced) and ending on the 29th day after the date of enactment of this bill, the rates of tax on foreign stock and debt obligations are to be the maximums provided for in the House bill—that is, 22.5 percent in the case of foreign stock and rates ranging up to that level for foreign debt obligations. As indicated in the prior part of this report, these higher rates of tax are provided during this interim period to forestall purchases of foreign stock or debt obligations in anticipation of a tax rate increase which may be made by the President after the enactment of this bill. On the 30th day after the date of enactment of this bill, the rates of tax under present law are automatically restored. Although increases effective on or after that date (up to the maximum rate specified) can be made, they will occur only if the President makes a finding that such higher rates are necessary in view of our balance-of-payments objectives.

The higher rates of tax provided during this interim period will not apply to preexisting commitments; i.e., in those cases where there was an unconditional obligation on January 25, 1967, or where partial performance had already occurred before that date. In addition, the higher rates of tax are not to apply where the U.S. person acquiring the security had taken all of the actions necessary to signify approval of the acquisition on or before that date and where the U.S. person had sent to the foreign person sufficient written evidence of the agreement to purchase the obligation. Also excluded from the application of the higher tax are public offerings of securities in the case of acquisitions on or before March 27, 1967, if an SEC registration statement was in effect with respect to the security at the time of its acquisition, this registration statement was filed in the 90-day period ending on January 25, 1967, and this registration statement is not amended after that time in a manner which has the effect of increasing the number of shares of stock or face amount of the debt obligations covered by the statement. A final category to which the higher rate of tax is not to apply is stock obtained as the result of the exercise of an option or similar right (including the privilege of converting a debt obligation into stock) where the option or right was held on January 25, 1967, by the person making the acquisition (or by a decedent from whom such person acquired the option); or securities obtained as a result of the foreclosure by a creditor under an instrument he held on January 25, 1967. Although these rules apply only with respect to the tax increase occurring in the interim period ending 29 days after the date of enactment of this bill, they may also be applied with respect to any subsequent increase made by the President under his delegated authority at his discretion.

3. Exemption for prior American ownership and compliance (sec. 4 of the bill and secs. 4918, 6011(d), 6076, 6681, and 7241 of the code)

Under present law, a U.S. person who purchases a foreign stock or debt obligation is exempt from the interest equalization tax if the foreign securities are acquired from another U.S. person. There are two principal ways in which an American who acquires foreign securities may establish that he is entitled to this exemption. First, a certificate of American ownership (which states that the seller was a U.S. person) received in connection with the acquisition establishes that the purchaser is entitled to the exemption. Second, in the case of an acquisition through a broker-dealer (which is a member or member organization of a national securities exchange or a national association of securities dealers registered with the Securities and Exchange Commission) in a trade on certain national securities exchanges or in the over-the-counter market, a "clean confirmation" from the broker-dealer (that is, a confirmation of the purchase which does not state that the securities may be subject to the tax) establishes that the purchaser is entitled to the exemption. In this type of trading, a selling broker-dealer may inform, in effect, the buying broker-dealer that the latter can issue a clean confirmation if the selling broker-dealer has in its possession a certificate of American ownership with respect to the stock being sold. In cases of sales on a securities exchange, the selling broker-dealer so informs the buying broker-dealer by selling on the "regular" market. In the case of sales in the over-the-counter market, the selling broker-dealer so informs the buying broker-dealer by issuing a comparison or confirmation that contains no reference to the interest equalization tax.

As is discussed more fully in the prior part of this report, "Reasons for the Bill," it has become apparent that the provisions of present law regarding this exemption are inadequate to insure that the exemption is obtained only in the proper cases. For the reasons set forth, your committee has added an amendment to the bill which makes a series of modifications in the provisions of this exemption.

First, the focus of the exemption is shifted from one for prior American ownership to an exemption for prior American ownership and compliance. That is, a seller of foreign securities must not only be a U.S. person, but in addition must have satisfied any interest equalization tax liability he may have had in connection with his acquisition of the securities.

Second, an American who acquires foreign securities which are subject to tax must pay the tax before he can dispose of the securities. Generally he pays the tax with a quarterly tax return but if he wishes to dispose of the securities before that time he must pay the tax with a transaction return (as provided under new procedures).

Third, two primary methods are provided by which the exemption can be established by an American who purchases foreign securities. Under the first method a purchaser can establish that he is entitled to the exemption if he receives a validation certificate (generally issued by the Treasury Department) with respect to the securities, he relies in good faith on the validity of the certificate, and files a copy of the certificate in accordance with procedures established by the Treasury Department. Validation certificates will be issued upon presentation of evidence which establishes that the owner of the foreign securities is a United States person who either paid the tax on the securities or acquired them without liability for the tax. The second method of establishing that the foreign securities are subject to the exemption is by receipt at the time of the acquisition of an "IET Clean Confirmation" from the participating firm through, or from, whom the securities were acquired if the purchaser relies in good faith on the validity of the confirmation.

The principal changes which your committee's amendment makes in existing law with respect to broker-dealers, and financial institutions concern: (1) the establishment of rules for determining those broker-dealers, and financial institutions ("participating firms" and "participating custodians") which may use the new procedures provided by the amendment; (2) the circumstances in which a selling broker acting for a U.S. person may sell foreign securities so that a United States buyer would be entitled to the exemption for prior American ownership and compliance; and (3) the establishment of documentation, recordkeeping, reporting, and auditing requirements for participating firms and participating custodians. Those broker-dealers and financial institutions which do not desire to become participating firms or participating custodians can sell foreign securities under the exemption for prior American ownership and compliance only if the securities are accompanied by a properly executed validation certificate.

Any member or member organization of a national securities exchange or a national securities association registered with the Securities and Exchange Commission may become a participating firm by agreeing to comply (and actually complying) with the documentation, recordkeeping, reporting, and auditing requirements as prescribed by the Secretary of the Treasury or his delegate. During a transition period from July 15, 1967, to August 14, 1967, the following firms (whether or not actually agreeing as outlined above) are deemed to be participating firms: All members of the New York and American Stock Exchanges and those members of the National Association of Securities Dealers which either reported a net capital of at least

$750,000 in their latest (prior to July 13, 1967) financial statement filed with the Securities and Exchange Commission or which effected at least 300 transactions in foreign securities during either the week commencing July 2 or July 9, 1967.

Because of the reliance placed upon participating firms under the new procedures, the status of a participating firm may be terminated when the Secretary or his delegate has reason to believe such participating firm is failing to comply with the new statutory provision and procedural requirements.

A participating firm which acquires foreign securities for a customer may issue an IET clean confirmation to the customer primarily in two cases. An IET clean confirmation may be issued to the customer if the firm received a written comparison or broker-dealer confirmation, which indicates that the exemption for prior American ownership and compliance applies to the acquisition, from another participating firm which acted as the selling broker in the transaction. An IET clean confirmation may also be issued to the customer if the acquisition was effected on a national securities exchange and if the Secretary or his delegate has determined that the rules of the exchange require transactions in securities which are subject to the exemption for prior American ownership and compliance to be carried out in such a manner that the new procedures are satisfied. A similar procedure is provided in the situation where the selling participating firm and the buying participating firm are both members of a national securities association and the association has been determined by the Secretary or his delegate to have the necessary rules.

In order for a participating firm which acts as a selling broker of foreign securities to be able to give the participating firm acting as buying broker a written comparison or broker-dealer confirmation which indicates the securities are subject to the exemption, your committee's amendment requires the selling broker to have substantially more evidence than under existing law that the requirements for the exemption have been satisfied. Thus, a selling broker generally must have evidence that his customer, in addition to being a U.S. person, has either paid the interest equalization tax or has acquired the securities in a transaction which was not subject to the tax because of the exemption for prior American ownership and compliance. In addition, if the selling broker held the foreign securities for the account of its customer on July 14, 1967, or purchased the securities for its customer before that date and received the identical securities from the customer after that date, it also may issue a written comparison or broker-dealer confirmation which indicates the exemption for prior American ownership and compliance is applicable.

Your committee's amendment also provides procedures under which foreign securities may be transferred between and among participating firms and participating custodians (other than between a seller broker and a buying broker as discussed previously) and which will enable U.S. persons owning such transferred securities to sell them under the exemption without the necessity of obtaining a validation certificate.

The participating custodian referred to above is a trust company or bank insured by the Federal Deposit Insurance Corporation, which notifies the Treasury Department that it agrees to comply with the new provisions and the documentation, recordkeeping, reporting, and auditing requirements and actually is complying. During a transition period from July 15 through August 14, 1967, all Federal Reserve member banks classified as reserve city banks are treated as participating custodians. Rules for the termination of this status similar to those applicable to participating broker-dealers are provided.

This amendment is effective with respect to acquisitions of stock and debt obligations occurring after July 14, 1967.

4. Transfers to foreign branch offices of domestic securities dealers (sec. 5(a) of the bill and sec. 4912 of the code).

A foreign branch office of a U.S. securities dealer which is engaged in the foreign securities business may presently elect to be treated as a foreign person for the purposes of the interest equalization tax. This election exempts the foreign branch office from the payment of tax with respect to its acquisitions of foreign securities. If, however, money is transferred from the U.S. office to the electing foreign branch office or if money is applied for the benefit of such an office, the transfer is treated as if the U.S. head office had made a taxable acquisition of foreign stock.

It has been pointed out that certain branch offices of U.S. securities dealers have as a principal function the generation of business for the U.S. head office. Under present law, no part of the commissions earned on such business can be returned to the foreign branch office if it has elected the treatment described above without giving rise to an interest equalization tax liability. Your committee believes that this result is inappropriate since a similar commission payment made by the U.S. office to an unrelated securities dealer which generated business for the U.S. office would be tax exempt. Your committee has, therefore, amended the House bill to provide that in the case of a U.S. securities dealer with a foreign branch office which for purposes of this tax has elected to be treated as a foreign corporation or foreign partnership, any commission on a transaction generated by the foreign branch office is to be excluded from the interest equalization tax when paid by the U.S. office to the foreign branch office to the extent the commission is not greater than would be paid in an arms-length transaction for the generation of this business for the U.S. office.

This provision is effective with respect to transfers made on or after the date of enactment of this bill.

5. Exclusion of acquisitions arising out of sales of certain foreign real property (sec. 5(b) of the bill and sec. 4914(b)(14) of the code)

Generally, transactions in which Americans sell foreign real property do not involve the interest equalization tax because the foreign purchaser is usually able to finance the purchase with a foreign credit source. Therefore, it becomes unnecessary for the American to acquire a foreign debt obligation which would be subject to the tax. Moreover, present law provides an exemption for debt obligations acquired by Americans in connection with the sale of tangible property located outside the United States where the property (such as a residence) has been held for personal use. However, under present law, an American who sells foreign real property not held for personal use is subject to the tax if he provides the foreign purchaser with financing for more than 1 year.

The acquisition of debt obligations, such as mortgages, etc., by sellers is sometimes necessary in order to effect a real estate sale.

Also, sales by Americans of foreign real estate generate income for Americans that, in most cases, is repatriated to the United States, which favorably affects the U.S. balance of payments (as long as the property was owned by the American seller before the imposition of this tax). Therefore, your committee agrees with the House that debt obligations acquired as the result of the sale of foreign real estate should be exempt from the interest equalization tax in those cases where the property was acquired before the effective date of the interest equalization tax.

For the reasons given above, your committee has approved the provision of the House bill which amends the present exemption provided for certain foreign property. The House amendment excludes from the application of the tax debt obligations acquired by American sellers which arise out of the sale of real property located outside the United States. However, the foreign real property must have been owned by the American seller on July 18, 1963.

Your committee has amended the House bill to extend the exemption provided in this case to the heirs, beneficiaries, or estates of deceased Americans who owned foreign real property on July 18, 1963. That is, the heirs or the estate of a deceased American may receive a debt obligation from an alien in order to finance the sale of foreign real property owned by the decedent on July 18, 1963, and continuously thereafter until the time of his death. This provision is a logical extension of the treatment provided by the House bill, and may have been overlooked in its consideration.

This provision is effective with respect to debt obligations acquired on or after the date of enactment of the bill.

6. Exclusion of certain acquisitions by residents not citizens (sec. 5(c) of the bill and secs. 4914(b)(15) and 4914(j)(2) of the code)

Present law provides that aliens present in the United States become subject to the interest equalization tax when they acquire the status of a U.S. "resident."

Your committee agrees with the House that aliens who have acquired the status of resident should, at the beginning of that status, be provided with a reasonable period of time before the interest equalization tax is applied in their case. This exception should be available because it is often difficult for a foreigner to determine precisely when he becomes a "resident." In addition, persons in transition from a foreign to a resident status are likely to be unfamiliar for a time with our interest equalization tax.

For the reasons given above, your committee has approved the provision in the House bill which grants an exception from the tax with respect to stock or debt obligations acquired by a foreigner who is a "resident" if the acquisition is made during the 90-day period beginning on the date the foreigner first became a "resident" of the United States. However, a foreigner who is a U.S. "resident" will not be able to sell foreign securities as eligible for the exemption for prior American ownership and compliance, if his acquisition of the securities was exempt from tax under this provision. Therefore, if a foreigner acquires foreign securities during his first 90 days of U.S. residency and does not pay the tax, he will not be able subsequently to sell these securities to other Americans without the imposition of the tax.

This amendment is effective with respect to acquisitions after July 18, 1963. However, the provision denying a foreigner, in the cases described above, the right subsequently to sell the securities as eligibl for the exemption for prior American ownership and compliance : to be applied only in the case of sales after February 27, 1967 (th date of introduction of this bill).

7. Loans guaranteed by the Export-Import Bank (sec. 5(d) of the bi and sec. 4914 (c)(1) of the code)

A debt obligation issued by a foreign importer in connection witl the sale of property or services by an American to the importer i exempt from the interest equalization tax if an agency or wholl owned instrumentality of the United States, such as the Export Import Bank, guarantees or insures payment of the obligation.

This provision of existing law is not available if the debt obligatioı is issued by a company affiliated with the importer, or by anotheı obligor such as his bank or a credit institution, rather than directly by the importer. Your committee believes that this restriction in present law is unnecessary. The fact that a U.S. Government agency or instrumentality, such as the Export-Import Bank, guarantees the obligation is sufficient evidence that the transaction is related to an export and therefore strengthens the U.S. balance of payments. Your committee has therefore amended the House bill to remove the requirement that the foreign importer must be the person who issues the debt obligation in order for the acquisition of a debt obligation in connection with an export, payment of which is guaranteed by the United States or its instrumentalities, to be exempt from tax.

This provision is effective with respect to debt obligations acquired on or after the date of enactment of the bill.

8. Certain sales of ores or minerals by U.S. persons (sec. 5(e) of the bill and sec. 4914(c)(5) of the code)

Under present law, the acquisition of foreign debt obligations by U.S. persons is not subject to the interest equalization tax in certain situations where the debt arises out of the sale of ores or minerals extracted abroad by U.S. persons. Included in this category under present law are situations where the ore or minerals (or derivatives) are: (1) Extracted outside of the United States by U.S. persons or by corporations in an affiliated group of which the U.S. person is a member; (2) Extracted outside of the United States by a corporation at least 10 percent of which is owned directly or indirectly by the U.S. person (or a corporation in the same affiliated group or by a domestic corporation which owns directly or indirectly 50 percent of the stock of the U.S. person); (3) Obtained under contracts entered into on or before July 18, 1963, by the U.S. person (or corporations included in the same affiliated group or a domestic corporation having the 50-percent interest referred to above); or (4) Extracted outside of the United States and obtained by the U.S. person (or by a corporation included in the same affiliated group or by a domestic corporation referred to above) in exchange for similar ores or minerals (or derivatives).

In any of the four types of situations referred to above, a debt obligation acquired by the American person is free of interest equalization tax where part or all of it constituted the purchase price for the ores or minerals referred to and a purchase contract for the ores or minerals for a period of at least 3 years is in effect. Alternatively, where ores or minerals are purchased and one of the four types of situations referred to above is in existence, a loan made by the American person is not subject to the interest equalization tax where the proceeds are to be used by the debtor for the installation, maintenance or improvement of facilities outside the United States for the storage, handling, transportation, processing, or servicing of the ores or minerals (or derivatives), a substantial portion of which is extracted outside of the United States by the U.S. person (or corporation referred to in the four categories described above) as a result of the sale to the debtor of part or all of the ores or minerals in question.

Cases have arisen where contracts entered into on or before July 18, 1963, by a U.S. person (category 3 referred to above) have had to be canceled and substitute contracts for the obtaining of ores or minerals from the same parties entered into since that time. Although the terms of the contracts and quantities of ores or minerals in the substitute contracts may vary from the terms or quantities specified in the earlier contracts, where the contracts are entered into between the same parties (including corporations in the same affiliated group, referred to in category 3 above) and replace the earlier contracts, the latter contracts essentially constitute a substitute for the earlier ones. Your committee agrees with the House that there is no reason why in cases of this type the exemption from interest equalization tax should not continue to be available on the same basis as in the case of contracts entered into on or before July 18, 1963. The date initially was placed in the provision to prevent contracts of this type from being entered into merely with the intent to acquire foreign debt obligations. The substitution of a more recent date, which nevertheless is a past date, presents no opportunities for avoidance in this respect.

Since the new contracts may provide for different quantities of purchases than the preceding contracts, the amount of debt obligations acquired from the foreign purchaser by the U.S. person might, if no restriction were imposed, be increased. Therefore, the House bill and your committee's bill, while making provisions for substitute contracts entered into before January 26, 1967, where the earlier contracts have been canceled or terminated, nevertheless limit the amount of debt obligations which may be acquired under this exclusion to the same amount which could have been acquired under the earlier contracts entered into on or before July 18, 1963. Thus, whether the debt obligation is acquired as partial payment for the ores or minerals sold by the American person or to finance facilities outside the United States to be used in the processing, etc., of these ores or minerals, the amount of debt obligations which may be acquired by the American persons free of tax may not exceed the amount which could have been acquired had the earlier contracts remained in effect.

This amendment is effective with respect to acquisitions of debt obligations made on or after the date of enactment of this bill.

9. Reacquisitions of certain export-related debt obligations (sec. 5(f) of the bill and sec. 4914(c)(7) of the code)

Under present law, the interest equalization tax does not apply to the acquisition by an American of a foreign debt obligation if the obligation is related to the export of American goods or services in one of a number of specified ways. In general, the acquisition of the debt obligation is exempt from tax if the payment of the obligation is guaranteed by the Export-Import Bank or another agency of the United States, or if the obligation is acquired in connection with the sale of goods or services which were largely produced in the United States. If the debt obligation arising in such a sale, after acquisition by the U.S. exporter, is placed with a foreign lender, however, the interest equalization tax applies if it is subsequently reacquired by the American exporter.

When American exporters attempt to sell debt obligations acquired in export sales to foreign lenders, they often find it necessary to sell the obligation at a discount or agree to pay a stated percentage above the prime interest rate applicable to similar obligations. American exporters prefer not to undertake such arrangements, however, unless they can reserve the right to repurchase such an obligation from the foreign lender if the undertaking becomes too costly. Such a repurchase is a taxable acquisition under present law. Your committee believes this provision discourages the placement of export-related debt obligations abroad. These placements improve the U.S. balance of payments. Your committee has, therefore, amended the House bill to provide that the reacquisition of such an export-related debt obligation will not be subject to tax if the obligation arose in an export-related transaction in which the debt obligation would have been exempt from tax if it had been transferred by the exporter to another U.S. person, rather than to a foreigner.

This provision is effective with respect to reacquisitions made on or after the date of enactment of the bill.

10. Exclusion for Canadian acquisitions made with funds held outside the United States on July 18, 1963 (sec. 5(g) of the bill and sec. 4914(k) of the code)

Under present law the interest equalization tax applies, in general, to acquisitions of foreign stock and foreign debt obligations made after July 18, 1963. The tax was announced on that date and was made effective as of July 19, 1963 to prevent speculative purchases of foreign securities which would lead to an outflow of U.S. funds and weaken the balance of payments in the interim period before the tax was enacted into law.

The attention of your committee has been called to a number of cases in which Americans purchased foreign securities between July 18, 1963, the date the tax was announced, and September 2, 1964, the date it was enacted, with funds which were held in Canada on July 18, 1963. These funds were used to purchase Canadian securities during the period the interest equalization tax was being considered by Congress. In some cases Canadian securities acquired before July 18, 1963, were sold to finance the purchase of other Canadian securities. The Americans concerned were uncertain as to the final disposition of the bill. Many assumed that the exemption for Canadian securities would apply to outstanding as well as to new issues, or that an exception would be made for acquisitions made with funds held outside the United States at the time the tax was announced. Those who held the latter view understood the tax as an attempt to discourage the further outflow of capital from the United States and did not realize that it was also designed to encourage the repatriation of funds already invested abroad.

Although your committee agrees that it was appropriate to apply the tax to transactions which occurred between the time the proposal was first announced and the time the tax was enacted, it agrees that the retroactive application was unduly harsh in the case of the Americans described in view of the uncertainties created, because the securities were Canadian and because the transactions did not affect the U.S. balance of payments. Therefore, your committee has amended the House bill to provide that the interest equalization tax will not apply to an acquisition by a U.S. person of a Canadian stock or Canadian debt obligation if the purchase was made prior to September 2, 1964, and if it was made with Canadian currency, Canadian bank deposits, the proceeds of the disposition of Canadian stock or debt obligations, provided these funds or securities were held by the person on July 18, 1963 or with credit obtained in Canada. Furthermore, if the conditions described applied to certain Canadian securities later sold, the tax will not apply to Canadian securities purchased with the proceeds of the sale provided the purchase took place before September 2, 1964. No interest is to be paid with respect to any credit or refund allowed or made by reason of this amendment.

11. Definition of less developed country corporations (sec. 5(h) of the bill and sec. 4916 of the code)

Under existing law, the interest equalization tax does not apply to the acquisition of stock or of a debt obligation issued by a less developed country corporation. A less developed country corporation may be a corporation which derives at least 80 percent of its income from the use in foreign commerce of aircraft or ships registered under the laws of a less developed country, provided at least 80 percent of the assets are used in this transportation business.

The present definition thus includes certain shipping companies owned (directly or indirectly) by residents of developed foreign countries whose ships or aircraft are registered in a less developed country, where 80 percent of its income is from such shipping and 80 percent of its assets are used in the shipping business. It was not intended that such companies—owned by residents of developed countries apart from the United States—should be able to issue stock or debt obligations in the United States without payment of tax. Your committee has, therefore, amended the House bill to add a further requirement for qualification as a less developed country shipping corporation. The further requirement is that the corporation be at least 80 percent owned by residents of less developed countries, by U.S. persons, or by a combination of both.

This provision is effective with respect to acquisitions made after the date of enactment of this bill.

12. Treatment of late filings of acquisitions for international monetary exclusion (sec. 5(i) of the bill and sec. 4917(d) of the code)

(a) *Penalty for late filing of notice of acquisition.*—Present law provides the President with standby authority to exempt original or new issues of stock or debt obligations of a foreign person if failure to grant an exemption would imperil or threaten to imperil international monetary stability. The President has exercised this authority with respect to new issues of Canadian stock or debt obligations and, to the extent of $100 million a year, in the case of debt obligations issued or guaranteed by the Japanese Government.

With respect to acquisitions to which the Canadian exclusion applies, the exclusion was available in the case of acquisitions before October 10, 1965, only if a notice of acquisition was filed within a period prescribed by regulations (the earliest date by which any notice was required to be filed was August 3, 1965). Failure to comply with the notice requirement for such acquisitions resulted in complete loss of the exclusion which, in effect, constituted a 100-percent penalty. With respect to excluded Canadian acquisitions made after October 9, 1965, however, present law provides that if the required notice of acquisition is not timely filed, the person required to file shall, in effect, lose 5 percent of the exclusion for failure to file on time. An additional 5 percent of the exclusion is lost for each 30-day period that the notice continues to be delinquent, up to a maximum loss of 25 percent of the exclusion. Under present law, complete loss of the exclusion is applied in the case of limited exclusions, such as those involving Japanese issues, since under such an exclusion the notice serves the necessary additional function of providing the information regarding the portion of the limited exclusion which has been utilized.

Your committee agrees with the House that the penalty of complete loss of the exclusion for late notice filing, which applies with respect to pre-October 10, 1965, exempted Canadian acquisitions, is unnecessarily severe. Also, your committee agrees that the penalty for late filings of notices of acquisitions for exempted Canadian acquisitions should not differ depending upon whether or not the acquisition was made before or after October 9, 1965. The limitation on the loss of the exclusion undoubtedly would have been applied from the initial effective date of the tax had it been foreseen that numerous cases would arise in which timely notice inadvertently was not filed.

For the reasons indicated above, the House bill provided that the penalty presently provided with respect to acquisitions made after October 9, 1965 (described above), would apply with respect to all exempt Canadian acquisitions made after the effective date of the original act (July 19, 1963).

Your committee believes that the maximum 25-percent penalty provided for late filing is too severe in view of the fact that the exemption is granted to all new Canadian issues and, therefore, tax avoidance is not promoted by failure to file timely notice of acquisitions. As a result your committee has amended this provision of the House bill to reduce the penalty for late filing with respect to acquisitions of new Canadian issues to a penalty of 1 percent of the tax that would apply but for the exemption for each month that the notice is late, provided that the maximum penalty may not exceed 5 percent of the tax that would otherwise be imposed. This penalty is to apply with respect to the entire period in which the interest equalization tax has been in effect. However, no interest is to be paid with respect to any credit or refund allowed or made by reason of the applicaton of this amendment.

As under present law in the case of the limited exclusion for Japan, failure to file a notice of acquisition within the specified period of time will continue to result in a loss of the entire exemption. Here it is important to know precisely the amount already exempted since the exemption is limited to $100 million a year. Thus the notice of acquisition in this case is highly significant since it indicates the amount of aggregate exemption still remaining available for use. In the case of the Canadian exemption, however, which is unlimited with respect to new issues, this reason for denial of exemption does not exist.

(*b*) *Notices of acquisition filed by State agencies.*—The existing rules outlined above regarding the need to file timely notice of acquisitions covered by the international monetary exclusion apply to State governments and their instrumentalities as well as to other purchasers of foreign securities or of foreign debt obligations.

It was brought to the attention of the House that in certain cases pension funds administered by State governments have purchased new Canadian securities but have failed to file notice of their acquisition as required. Under present law, therefore, they are liable for the payment of some or all of the interest equalization tax liability associated with these purchases.

It is the view of the House—and your committee is in accord with this view—that the failure to file timely notice was inadvertent on the part of the States concerned and was attributable to the fact that State agencies are not ordinarily affected by Federal tax laws and are therefore unaccustomed to the need to concern themselves with Federal tax regulations

The House bill and your committee's bill therefore provide the States and their instrumentalities with additional time in which to file notice of acquisitions under the international monetary exclusion and thereby receive the full exclusion of these purchases from the tax. Under this provision, the States and their instrumentalities will have until 60 days after the date of enactment of this bill to file such notice. However, no interest is to be paid with respect to any credit or refund allowed or made by reason of this provision.

13. Resales of debt obligations by U.S. dealers (sec. 5(j) of the bill and secs. 4919(a)(2) and 4919(b)(3) of the code)

Generally, dealers are subject to the interest equalization tax on their acquisitions of foreign stock or debt obligations. However, they may obtain a credit or refund for the tax if they resell to foreign persons within 90 days after purchase. They may also obtain a credit or refund for the tax if they resell the foreign stock or debt obligation to another U.S. dealer who, in turn, resells the stock or debt obligation to a foreign person on the same or next business day. Where the U.S. dealer is selling short, he may make purchases from a foreigner to cover the short sale within 90 days after his short sale to a foreigner. Where the U.S. dealer selling foreign securities short sells to another U.S. dealer, that U.S. dealer must, in turn, resell to a foreigner on the same or the next business day.

The House concluded, and your committee agrees, that the present 1-business-day rule described above which applies to sales of foreign debt obligations from one U.S. dealer to another is not of sufficient duration. It makes it impracticable to sell to other U.S. dealers and therefore, limits the extent to which U.S. dealers can participate in developing a market for these foreign securities. This, in turn, discourages the use of U.S. dealers in handling new issues of foreign securities even though they are placed abroad. Allowing the second U.S. dealer to hold the foreign security not over 30 days will enable U.S. dealers to participate in the sale of the foreign securities abroad without allowing them to increase their inventories of these bonds to the extent of having any appreciable effect on the balance of payments.

The House bill and your committee's bill therefore substitute a 30-day rule for the present 1-day-business rule. In other words, under this amendment, a U.S. dealer will have 30 days to resell foreign debt obligations acquired from another U.S. dealer.

The amendments made by this provision are to apply only wil respect to an acquisition of a debt obligation which is sold aft January 25, 1967, by the first U.S. dealer to the second U.S. deal (whether the acquisition by the first dealer occurs before or aft the resale).

14. Foreign lending and finance businesses (sec. 5(k) of the bill and sec 4920(a)(3) and 4920(a)(4) of the code)

The interest equalization tax as originally enacted did not apply t loans with the period remaining to maturity of less than 3 year Therefore, the tax generally did not apply where foreign branches of U.S. lending and finance corporation lent local funds because suc personal-type loans usually have a period remaining to maturity c less than 3 years. However, the Interest Equalization Tax Extensio Act of 1965, broadened the application of the tax to include, at th option of the President, foreign debt obligations with a remainin maturity of 1 to 3 years. As a result, foreign personal loans of 1 t 3 years in maturity were subjected to the tax.

Your committee agrees with the House that the loans made by U.S corporations operating lending and finance businesses abroad, wher the loans are made to the public generally and are derived from foreig sources, should be exempt from the tax. In this case the loans will b financed out of foreign funds which it is unlikely would in any even be invested in the United States and, therefore, they will not adversel affect our balance of payments. Moreover, a similar exemption i presently provided for foreign branches of U.S. banks which accords a competitive advantage which would continue were an exemption not provided for the small finance companies.

For the reasons set forth above, the House bill and your committee's bill provide an election for a U.S. corporation which, in effect, exempts it from the interest equalization tax, if it (together with any subsidi- aries) is primarily engaged in a lending or finance business (making loans for 48 months or less) through offices located outside the United States and holds itself out in the ordinary course of its foreign lending and finance business as lending money to the public generally. This result is accomplished by permitting the U.S. companies meeting these tests to elect to be treated as foreign corporations for purposes of this tax. Of course the United States does not subject a foreign corporation to tax when it purchases foreign obligations but the Americans acquiring stock or debt obligations of this corporation will be subject to the tax.

It should be noted that this election is available either where the domestic corporation carries on the foreign lending and finance business through branches or through affiliated corporations (if 50 percent directly or indirectly owned subsidiaries). In addition, a corporation may file this election if it is primarily used to raise money abroad and loan it to other corporations in the lending and finance business abroad so long as these latter companies are in the same affiliated group or would be eligible to file a consolidated return with the first corporation if they were all domestic corporations. It is the under- standing of your committee that present law does not tax a mere guarantee by another corporation of a debt obligation.

The amendments made by this provision provide that elections made under this provision are effective as of January 26, 1967, or the date of the organization of the corporation, whichever is later.

15. Foreign financing companies (sec. 5(l) of the bill and secs. 4920(a) and 4915(c) of the code)

Under present law, a branch office of a domestic corporation which is located outside the United States may elect to be exempt from the interest equalization tax if it is primarily engaged in the business of financing sales of tangible personal property manufactured, assembled, or produced by related corporations. The branch office must have been in this financing business, however, for at least a year prior to February 10, 1965, in order to qualify under present law. An exemption from the tax is provided in this type of situation inasmuch as it is expected that funds derived from foreign sources will be used in the financing activities, and, accordingly, these activities will not have an adverse effect on the balance of payments. Moreover, the competitive position abroad of the related manufacturing and producing companies is significantly improved where financing can be provided in connection with the sales of their products.

Your committee agrees with the House that it is appropriate to provide an exemption from the interest equalization tax, similar to that provided in existing law, in situations where a domestic corporation finances sales abroad by related corporations with funds obtained abroad. The activities of this type of financing company generally will not adversely affect our balance of payments. In addition, by allowing financing to be provided in these situations, the competitive position of the related corporations in foreign markets will be improved.

The House bill provides that a U.S. corporation substantially all of the business of which consists of borrowing funds abroad and using those funds to finance sales by affiliated (80 percent directly or indirectly owned) domestic companies of tangible property, certain intangible property, or services to foreign persons, may elect to be exempt from the tax on the debt obligations it acquires as a result of these financing activities. This result is accomplished by allowing the domestic financing company to elect to be treated as a foreign corporation for purposes of the tax. The financing company may only make loans, however, in connection with those sales where 15 percent of the property or services sold consists of U.S. property or services of U.S. persons. The company may not acquire any foreign securities (other than those debt obligations resulting from its financing activities) which would have been subject to the tax if the company had not elected to be treated as a foreign corporation for purposes of the tax. In addition, the company is treated as a foreign corporation in which nontaxable direct investments may be made.

Your committee has retained the House amendment but has modified it in certain respects, primarily in order to provide the financing company with a greater degree of flexibility in financing the sales of products manufactured or produced by related corporations.

Your committee has provided that the financing company may loan money in connection with sales of tangible personal property produced, assembled, manufactured or extracted by related (50 percent owned) domestic or foreign companies, even though the sales are made by dealers or distributors, in addition to sales by related corporations. Financing may also be provided in connection with sales of tangible personal property traded in on the property manufactured by related companies and in connection with sales of tangible personal property traded in on the traded in property. The financing company may also make loans to dealers or distributors primarily engaged in selling the products manufactured or produced by the related companies.

The requirement that 15 percent of the content of property or services, the sale of which is financed, must be U.S. property or services has been retained, but is limited in its application to situations where the financing is provided in connection with the sale of tangible property, certain intangible property, or services by a related domestic corporation.

In order to insure that the financing company is primarily engaged in the business of making the specified types of loans, your committee has provided that 90 percent of the debt obligations acquired by the company must be the specified types of debt obligations.

Your committee has modified the requirement that the funds which the financing corporation lends must be obtained by borrowing from foreign sources by providing that the funds generally cannot be borrowed from a foreign partnership or foreign corporation in which a tax-free direct investment could otherwise be made. In addition, if the financing company borrows short term (less than 1-year maturity) funds, other than pursuant to an overdraft arrangement, the company must lend at least an equal amount on a short-term basis.

Under the House bill, only a domestic corporation is allowed to make the financing company election. It was called to the attention of your committee that it is sometimes more appropriate from a business standpoint to use a foreign subsidiary to finance overseas sales of products manufactured or produced by related companies. At times, foreign law may require that a foreign corporation be used for these financing activities. Moreover, the use of a foreign corporation to finance sales of products manufactured by related companies will not adversely affect our balance of payments.

For the reasons given above, your committee has added a provision to the bill which provides similar treatment for a foreign corporation which is at least 50 percent owned (directly or indirectly) by a domestic corporation (or related corporations) and which would be entitled to make the domestic financing company election except for the fact that it is a foreign corporation. The effect of the new provision will be to allow direct investments (including loans) to be made tax free by the domestic parent in the foreign corporation. In the absence of such a provision, the foreign corporation would be treated as "formed or availed of" to make otherwise taxable acquisitions of foreign securities, and, accordingly, the exclusion for direct investments in the corporation would be denied.

The amendments made by this provision of the bill provide that elections (or in the case of a foreign corporation, a notice) under this provision are effective when made. The elections may be made within 60 days after the enactment of the bill, or within 60 days after the organization of the corporation, whichever is later.

16. Treatment of certain foreign stock issues as domestic issues (sec. 5(m) of the bill and sec. 4920(b) of the code)

Under present law, a class of stock of a foreign corporation is treated as domestic stock if more than 65 percent of the class of stock was owned by U.S. persons prior to July 19, 1963. By reason of this treatment, the stock is not subject to the interest equalization tax when acquired by Americans. Only those shares of stock which were outstanding on the foreign corporation's last record date before July 19, 1963, and which possess identical rights in the control, profits, and assets of the corporation are considered to constitute a single class of stock.

Your committee has been informed of certain situations in which shares of stock in a foreign corporation were identical in all respects prior to July 19, 1963, with the single exception that some of the shares were restricted as to their participation in dividends paid by the corporation. Moreover, in the case noted by your committee, this restriction was imposed under a bylaw of the corporation which was adopted before the tax went into effect. The restriction was lifted automatically in 1965 pursuant to the provisions of the bylaws. If this temporary restriction is held to have created two separate classes of stock, one class will not be treated as domestic stock since less than 65 percent was owned by Americans prior to July 19, 1963. If the corporation's stock is considered to be one class of stock, however, it will be treated as domestic stock since more than 65 percent of the total stock was held by Americans prior to July 19, 1963. Your committee does not believe that the distinction described above should result in the classification of the stock into two classes after the restriction is lifted. The restriction was terminated automatically pursuant to a bylaw which existed before the effective date of the interest equalization tax. All shares of stock in the foreign corporation then became identical and indistinguishable in all respects. Your committee has therefore amended the House bill to provide that a class of stock may include shares of stock subject to a temporary restriction of the type outlined above.

This provision is effective with respect to acquisitions made on or after the date of enactment.

IV. CHANGES IN EXISTING LAW

In the opinion of the committee, it is necessary, in order to expedite the business of the Senate, to dispense with the requirements of subsection 4 of rule XXIX of the Standing Rules of the Senate (relating to the showing of changes in existing law made by the bill, as reported).

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