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INTEREST EQUALIZATION TAX EXTENSION ACT OF 1971

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Mr. Long, from the Committee on Finance, submitted the following

REPORT

[To accompany H.R. 5432]

The Committee on Finance, to which was referred the bill (H.R. 5432) 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. 5432, as passed by the House and as agreed to by the committee, extends the interest equalization tax for 2 years or until March 31, 1973. The tax otherwise would expire on March 31, 1971. The committee added an amendment which gives the President the authority to apply the interest equalization tax if he deems it desirable, in light of our domestic balance-of-payments and other economic objectives, to bank loans and other debt obligations with a maturity of less than 1 year. The House-passed bill also provides for several minor modifications of the tax. The committee has accepted these with slight modifications and has adopted an additional minor modification of the tax. (The House and committee modifications are summarized below.)

The present interest equalization tax, in effect, provides the equivalent of a three quarters perc ntage point per annum rise in interest costs for foreigners obtaining capital from U.S. sources either from the sale of debt obligations with a maturity of 1 year or more or from the sale of stock (which is treated, in effect, as a long-term debt obligation for the purposes of the tax). The discretionary authority presently available to the President enables him to vary this tax between zero and an interest equivalent of up to 1½ percent per annum should he find this necessary in order to carry out national

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balance-of-payments objectives, which include achieving a minimum reliance on the tax.

The interest equalization tax, first made effective in the middle of 1963 and subsequently used in conjunction with the limitations on extensions of credit and direct investments abroad has contributed significantly to our balance-of-payments position by causing a reduction in foreign securities purchased by U.S. persons. In view of the current deficit in our balance of payments and the increased amount of borrowing in the United States by foreigners that would occur if the tax were allowed to expire, the committee concluded that an extension of the interest equalization tax for an additional 2-year period is necessary. In addition, the recent increase in short-term borrowing, particularly bank loans, and the absence of any effective method of controlling these outflows other than higher U.S. interest rates, led the committee to conclude that an extension of the President's discretionary authority so that the tax can be applied to these debt obligations with a maturity of less than 1 year is desirable.

A series of minor modifications in the existing provisions of the tax are contained in the House bill. These modifications were accepted by the committee with a few adjustments which are noted below. The committee also adopted an additional modification of the tax which also is noted below.

MINOR HOUSE MODIFICATIONS

(1) At present, some domestic companies, in order to obtain funds for their foreign affiliates in a manner which complies with the restrictions on foreign investment imposed by the Office of Foreign Direct Investment, have a domestic subsidiary borrow funds abroad and then use those funds for the foreign affiliates. This procedure is acceptable, however, only if there is assurance that the debt obligations of the subsidiary won't be acquired by Americans since this would, in effect, substitute U.S. funds for the borrowed foreign funds. One method used in the past to provide this assurance has been to obtain a ruling from the Revenue Service that the domestic subsidiary was merely a conduit for investing abroad; this has the effect of making the debt obligations it issues subject to the interest equalization tax if they are acquired by Americans. This procedure has proved unsatisfactory in some situations, however, where it might have been argued that an exclusion from the tax applied with respect to the subsidiary's debt obligations (e.g., where the funds obtained were invested in a less developed country). To resolve this problem, the House bill provides that a domestic company may elect to treat a new issue of its debt obligations (and in the case of convertible debt, any class of stock into which the obligations may be converted) as subject to the tax, notwithstanding any exclusion from the tax.

The committee made 4 modifications in this provision, primarily in order to make it a more usable means of obtaining funds from abroad in a manner which complies with the foreign direct investment restrictions. First, the election is made available in the case of obligations issued by domestic partnerships. Second, in the case of convertible debt obligations, the election is not to apply to the stock into

which the obligations may be converted. Third, it is provided that the election also may be made with respect to previously issued debt obligations of foreign or domestic subsidiaries where the U.S. parent company (or a domestic affiliate) assumes the obligation. Finally, it is provided that the 30-percent U.S. withholding tax generally imposed on interest paid by a domestic company to a foreign person is not to apply to interest paid on debt obligations (with maturities of 15 years or less) subject to an election under this provision if they were originally marketed in a public offering.

(2) Present law provides an exception from the tax for foreign debt obligations which a U.S. person acquires as a result of reinvestment requirements imposed by a foreign country under a sale or indemnification contract which arises from that country's nationalization, expropriation, or seizure (actual or threatened) of a substantial portion of the U.S. person's property within that country. This exception only applies, however, if the foreign country is a less developed country. The bill extends the application of the exception to situations where the foreign country is a developed country.

(3) Under present law an exclusion is provided for debt obligations acquired by a U.S. person from a foreign person, if the money loaned to the foreign person is to be used by him to install, maintain, or improve a foreign mineral facility and if a substantial portion (35 percent) of the minerals or ores processed in the facility are extracted outside the United States by the U.S. person or an affiliated company. The exclusion also is applicable under present law where the loan supplied by the U.S. person covers only part of the cost of the facility, if more than 50 percent of the minerals processed in the proportion of the facility represented by the U.S. person's loan are those extracted by the U.S. person or an affiliated company. Because of the difficult tracing problems involved where the foreign person has a number of facilities, the House bill provides that the 35-percent substantial portion test also is to be considered satisfied with respect to a facility if the U.S. person supplies a substantial portion (35 percent) of the minerals processed in *all* of the foreign person's facilities of this type.

The committee made two changes in this provision. First, it provided that the 50-percent substantial portion test is to be considered satisfied where the *additional* amount of minerals supplied by the U.S. person to *all* of the foreign person's facilities of the specified type (as determined by comparing the amount supplied before and after the loan is made) would satisfy the 50-percent test if that additional amount were supplied only to the new facility. Second, it limited the application of the House provision relating to the 35-percent substantial portion test to those cases where the *additional* amount of the minerals supplied by the U.S. person to *all* of the foreign person's facilities would have satisfied the 35-percent test if the additional amount had been supplied only to the new facility.

(4) Present law provides an exception from the tax for debt obligations received in connection with the sale or liquidation of a foreign subsidiary which is 100 percent owned by the acquiring U.S. person or its affiliates. The bill makes this exception applicable to debt obligations received from the sale or liquidation of a foreign subsidiary

which is less than 100 percent (but more than 10 percent) owned by the acquiring U.S. person (and its affiliates).

(5) Under present law a domestic subsidiary engaged in the lending or financing business abroad is, in the absence of the special exceptions, discussed below, subject to the tax on the loans it makes in its financing business. In addition, a U.S. company generally may not make tax-free direct investments in a domestic or foreign subsidiary which is engaged in the lending or financing business abroad. The tax would apply in such a case because the subsidiary would be "formed or availed of" by the parent company to make what would be taxable acquisitions of foreign securities if made directly by a parent. Two exceptions to these general rules are provided under present law. First, a domestic financing subsidiary engaged in financing sales of affiliated company's products or engaged in the small loan business abroad may elect to be exempt from the tax. The former type of company may make this election, however, only if it satisfies a number of conditions designed generally to require the use of foreign funds in its business and to prevent it from being used to make foreign portfolio investments. In addition, a tax-free investment may be made in an electing domestic subsidiary which finances sales of affiliated companies' products, but not in the case of an electing domestic subsidiary engaged in the small loan business abroad. This tax-free investment treatment also applies in the case of a foreign subsidiary which finances sales of affiliated companies' products if it satisfies the specified conditions. (The foreign subsidiary itself, of course, is exempt from the tax on the loans it makes because it is a foreign corporation.)

The House bill focused on the problem of direct investments by U.S. financial institutions in financing subsidiaries and provided for tax-free treatment of the direct investment when adequate assurances were given that the amounts invested will not be used to acquire foreign securities (or otherwise used outside the United States).

The committee amended this provision in a number of respects. First, it made the tax-free treatment available in the case of direct investments by any U.S. company in a domestic or foreign financing subsidiary. Second, it provided that, as an alternative to the invested funds remaining in the United States, they could be used abroad in the subsidiary's lending and financing business but only if the funds are obtained from foreign sources. Third, for an investment to qualify under this provision, the subsidiary in which the investment is made must either be a domestic financing subsidiary engaged in the small loan business abroad (as provided in the House bill) or it must be a "qualified lending and financing" subsidiary. Fourth, a "qualified lending and financing" company under the bill is one which is engaged in the lending or financing business abroad and which satisfies a series of conditions similar to those presently provided in the case of companies which finance sales of affiliated companies' products.

The committee's bill also includes in this provision the amendment (contained in another section of the House bill) to the existing financing company provision which permits the foreign funds which a financing company must use in its business to be obtained (and then

lent to the financing company) by any corporation which is a member of the same affiliated group as the financing company. Investments in subsidiaries which finance affiliated companies' products are to be allowed tax-free treatment only if the general rule provided by this provision is satisfied (i.e., only if the amount invested either will remain in the United States or if the amount invested was obtained from foreign sources). Fifth, it is provided that acquisitions of stock of a financing subsidiary from third parties (rather than directly from the subsidiary) also may be eligible for tax-free direct investment treatment under this provision. Finally, any domestic company which qualifies as a "qualified lending and financing" company is to be allowed to elect to be exempt from the tax on the loans it makes regardless of whether the loans are made in connection with sales of affiliated companies' products.

(6) Under present law, a U.S. dealer may acquire foreign stock in the ordinary course of his business without payment of tax (through a credit or refund) if he resells it to foreign persons on the day of purchase or on either of the two succeeding business days (or if he acquired it to cover short sales made on the day of purchase or on either of the two preceeding business days). The bill provides that the President may extend by Executive order the present two-business-day period to a period not to exceed 13 calendar days in situations where the dealer's acquisition is for a customer and not for investment and adequate procedures (which the Treasury has been notified of in advance) exist for identifying which of the broker's acquisitions are for customers and which are for investment.

(7) Present law provides that additional shares of a class of stock of a foreign corporation which is held principally by U.S. persons are treated as domestic stock and therefore are not subject to the tax if a number of conditions are met. One of these conditions requires that 15 days before the issuance of the additional shares, the issuing corporation must notify the Internal Revenue Service of its intent to issue the stock. To reduce the inflexibility of this notice requirement, the bill provides that it may be waived by the Treasury Department (within the 2-year period following the time the notice was due) where it finds that the failure to file was inadvertent and not done with intent to avoid the requirements of the tax. The committee clarified the availability of this waiver treatment in situations where the 2-year period expires after the date of enactment of the bill and before 60 days after enactment. It provided that in this case the notice requirement may be waived if application is made to the Treasury Department within 60 days after the enactment of the bill.

(8) Under present law, U.S. persons who make taxable acquisitions of foreign securities, and firms which withhold the interest equalization tax in connection with transactions which they make on behalf of their customers, must file a quarterly return and remit the tax. Present law, however, provides no penalty for late filing of the quarterly return by firms acquiring for customers or for failure to remit the tax withheld. To insure compliance with these requirements, the bill provides that a failure of a firm to file the quarterly tax return, or to remit the tax, is to be subject to the penalty generally

applicable in the case of other taxes. Thus, a failure to file the quarterly return is to be subject to a penalty equal to 5 percent of the amount of the tax due for each month the failure continues (but not in excess of 25 percent). Where a return was filed but there was a failure to remit the tax, there is to be a penalty equal to 0.5 percent of the amount of tax due for each month the failure continues (but not in excess of 25 percent).

The House bill also specifically made these penalties applicable to a customer's failure to file an interest equalization tax return or to pay the tax. The committee concluded that the penalties already apply in this case under present law, and, accordingly, this provision was deleted as unnecessary.

(9) Present law provides for a civil penalty (equal to 125 percent of the amount of the tax) for persons who knowingly execute false statements regarding their status as a U.S. person or who knowingly furnish clean confirmations, clean comparisons, or transfer of custody certificates without proper documentation. These documents constitute conclusive proof of prior American ownership and exempt persons possessing the documents from tax liability. To facilitate the administration of the tax, the bill provides that this penalty is to be applicable in any situation where a false document of the type referred to is issued, unless the action is due to reasonable cause and not to willful neglect.

ADDITIONAL COMMITTEE MODIFICATION

The committee also approved one additional modification of the tax.

The application of the special provision under present law which allows a U.S. mutual fund to elect to be exempt from the tax if (on July 18, 1963, and at the end of every quarter thereafter) at least 80 percent of the securities held by the fund were foreign securities is modified in two respects. First, the exemption is made inapplicable to future acquisitions of foreign securities by a fund to the extent those acquisitions are attributable to new capital (either equity or debt) obtained by the fund after March 24, 1971. Second, it is provided that if at the close of any calendar quarter 15 percent or more of the stock of a fund is owned by one person, the special exemption is to be terminated for all acquisitions by the fund which occur in subsequent calendar quarters.

II. REASONS FOR THE BILL

The committee agrees with the House that the continued deficit in the U.S. balance of payments represents a serious problem requiring a further extension of the interest equalization tax. Evidence available to the committee indicates that without the extension of this tax the deficit could increase significantly. The balance of payments has been in deficit in every year since 1949 with the exception of 1957 and 1968 and these continued deficits have resulted in a significant drain on the U.S. gold stock. Table 1 shows that the U.S. gold stock has fallen by $13,491 million in the years 1950 through 1970.

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 1950-70

[In millions of dollars]

Year	Balance		Change in gold stock (decrease −)
	Liquidity basis (deficit −)	Official reserve transactions basis	
1950	−3,489	(1)	−1,743
1951	−8	(1)	53
1952	−1,206	(1)	379
1953	−2,184	(1)	−1,161
1954	−1,541	(1)	−298
1955	−1,242	(1)	−41
1956	−973	(1)	306
1957	578	(1)	798
1958	−3,365	(1)	−2,275
1959	−3,870	(1)	−1,075
1960	−3,901	−3,403	−1,703
1961	−2,371	−1,347	−857
1962	−2,204	−2,702	−890
1963	−2,670	−2,011	−461
1964	−2,800	−1,564	−125
1965	−1,335	−1,289	−1,665
1966	−1,357	266	−571
1967	−3,544	−3,418	−1,170
1968	171	1,641	−1,173
1969	−7,012	2,700	967
1970	[2] −3,848	[2] −9,819	−787

[1] No officially published figures on this basis available for years prior to 1960.
[2] Including $867,000,000 allocation of special drawing rights.

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

TRENDS IN BALANCE OF PAYMENTS

Measured on a liquidity basis,[1] the deficit for an extended period of years was declining. More recently, however, the variations which have occurred make it difficult to identify any trend. The deficit fell from an average of $3,712 million in the period 1958 through 1960 to an average of $2,511 million in the period 1961 through 1964. In 1965 and 1966, the deficit declined still further to an average of $1,346 million. In 1967 it increased to $3,544 million, but this was followed by a surplus of $171 million in 1968. Then, in 1969, the deficit was back up to $7 billion, and for 1970 the deficit was $3.8 billion.

An important factor in our balance of payments in recent years has been the deterioration in our trade surplus since the 1961 to 1965 period (Table 2). Traditionally, a surplus in the trade account, particularly a surplus in the merchandise trade account, has partially offset deficits in the service account and outflows of capital. Rapidly rising prices in the United States (in addition to other factors), however, have made the price of imports more attractive compared to domestic products. At the same time the prices of our exports have increased, making them less attractive to foreigners than goods from other countries. The seriousness of this development for our balance of payments is shown by the decline in the merchandise surplus since the period 1961–65. In that period the surplus averaged $5.4 billion and by 1966 it had decreased to $3.9 billion.

[1] Equals change in liquid liabilities to foreign official holders, other foreign holders, and changes in official reserve assets consisting of gold, convertible currencies, the U.S. gold trance position in the International Monetary Fund, and, beginning in 1970, allocations of special drawing rights.

TABLE 2.—U.S. BALANCE OF PAYMENTS, 1961–70

[In billions of dollars]

	1961–65 average	1966	1967	1968	1969	1970
Merchandise trade balance	5.4	3.9	3.9	.6	.6	2.2
Exports	23.0	29.4	30.7	33.6	36.5	42.0
Imports	−17.6	−25.5	−26.8	−33.0	−35.8	−39.9
Investment income balance	3.5	4.1	4.5	4.8	4.4	[1] 4.3
Receipts from U.S. investments abroad	4.9	6.3	6.9	7.7	8.8	[1] 9.6
Payments on foreign investments in United States	−1.3	−2.1	−2.4	−2.9	−4.5	[1] −5.3
Balance on other services	−2.5	−2.7	−3.2	−2.9	−3.1	[1] −3.1
Balance on goods and services	6.5	5.3	5.2	2.5	1.9	[1] 3.9
Unilateral transfers, excluding Government grants	−.8	−.9	−1.2	−1.1	−1.2	[1] −1.3
Balance on current account, excluding Government grants	5.7	4.4	4.0	1.4	.8	[1] 2.6
U.S. Government economic grants and credits [2]	−3.7	−3.9	−4.2	−4.2	−3.7	[1] −3.4
Balance on private direct investment	−2.2	−3.6	−2.9	−2.9	−2.2	[1] −3.8
Balance on securities transactions	−.8	.4	−.3	3.1	1.6	1.3
Balance on various other long-term capital transactions [3]	−.5	.6	.2	.9	.7	[1] .3
Balance on current and long-term capital accounts [4]	−1.4	−2.0	−3.1	−1.7	−2.8	[1] −3.3
Balance on various other capital transactions: Short-term, other than liquid liabilities; long-term bank liabilities to foreign official agencies; nonmarketable U.S. Government liabilities; unscheduled debt payments on U.S. Government credits; and Government sales of foreign obligations to foreigners		1.2	.6	2.3	−1.3	[1] .1
Errors and omissions	−.9	−.5	−1.1	−.5	−2.8	[1] −2.0
Allocation of special drawing rights						.9
Balance on liquidity basis	−2.3	−1.4	−3.5	.2	−7.0	−3.8
Less certain nonliquid liabilities to foreign official agencies	1	.8	1.3	2.3	−1.0	.3
Plus liquid liabilities to private foreigners and international organizations	.7	2.4	1.5	3.8	8.7	−6.2
Balance on official settlements basis	−1.8	.3	−3.4	1.6	2.7	−9.8

[1] 1st 3 quarters of 1970 at a seasonally adjusted annual rate.
[2] Net of scheduled repayments.
[3] Excluding changes in long-term bank liabilities to foreign official agencies and in nonmarketable U.S. Government liabilities.
[4] One version of the so-called basic balance.

Note: Details will not necessarily add to totals due to rounding.

Source: Treasury Department.

In 1968, the trade balance declined more rapidly to $600 million and remained at that level in 1969. In 1970, a $2.2 billion surplus was recorded because of the stimulus to our exports provided by an unusually high level of demand in foreign markets, a condition that we cannot rely on as a permanent solution to our balance-of-payments problem. Moreover, if our trade balance were measured the way most foreign nations measure their trade position, we would show a sizable deficit instead of a small surplus. If insurance and freight charges are included in our import data—and it would present a more accurate picture if they were—and if non-remunerative foreign aid shipments are excluded from our exports, then the trade balance would show a deficit of something like $4 billion instead of a surplus of $2 billion.

The Committee believes that the so-called c.i.f. (cost including insurance and freight) measurement of imports is a more realistic measure of our competitive position. Over 100 foreign nations calculate their import data to include the cost of insurance and freight. Comparability alone would appear to dictate the need to calculate our import data on a c.i.f. basis. In spite of the fact that both the Commerce Department and the Tariff Commission believe that c.i.f. import statistics

would be extremely valuable in analyzing U.S. balance of trade data, the Treasury Department has not heretofore collected data to show the cost of insurance and freight which would make our import data comparable to the import data used by over 100 other nations. The Committee strongly urges the Treasury Department to collect c.i.f. import statistics and pass them on to the Department of Commerce which has the main responsibility for publishing balance of trade and balance of payments statistics. The Committee also believes that foreign aid exports should be shown separately from commercial and privately-induced exports in our balance of trade figures, to give a more realistic picture of our true competitive position. In any event it is clear that however the trade account is measured, there has been a serious decline in our trade position and that this emphasizes the importance of continuing to moderate capital outflows.

DEVELOPMENT OF INTEREST EQUALIZATION TAX

Contributions to the improvement in the balance-of-payments deficit have been made by programs undertaken by the Government to deal specifically with the problem. The interest equalization tax, the foreign direct investment program, and the voluntary program for limiting foreign credits and investments by U.S. financial institutions are among the more important of these.

The interest equalization tax has moderated the outflow of private capital abroad, by raising the cost to foreigners of obtaining capital in U.S. markets. 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 a serious weakness in the balance of payments.

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 $2,881 million in 1962 to $3,673 million in 1963, an increase of 27 percent. In the first 6 months of 1963, the outflows accelerated to a level which, if sustained throughout the year, would have resulted in an outflow of $4.6 billion, or about 60 percent more than the 1962 figure.

Issues of new foreign securities accounted for much of the increased outflow. U.S. persons increased their purchases of new 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 an annual rate of $2 billion.

The interest equalization tax became effective on July 19, 1963 (August 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 long-term debt obligations and lesser percentages in the case of debt obligations with maturities of less than

28½ years, were 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 ordinarily is passed on to the seller or borrower, therefore was about the equivalent of an increase in the interest rate paid by the borrower of 1 percentage point.

This tax was applied to outstanding issues, as well as new issues. A purpose of this was 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.

In 1967, the tax was extended to July 31, 1969, and the tax rates were increased to a 1½ percent per annum interest equivalent (a 22½-percent tax rate in the case of stock and long-term debt obligations) for the period January 26, 1967, to August 29, 1967.

TABLE 3.—U.S. PRIVATE CAPITAL OUTFLOWS, ALL AREAS

[In millions of dollars; outflow (−)]

	1962	1963 1st half	1963 2d half	1964	1965	1966	1967	1968	1969	3 quarters annual rate 1970
Total private outflow	−3,426	−2,781	−1,678	−6,578	−3,794	−4,310	−5,655	−5,157	−5,233	[1] −5,691
Long term	−2,881	−2,314	−1,359	−4,431	−4,547	−3,895	−4,446	−4,108	−4,658	−5,337
New foreign security issues	−1,076	−1,000	−250	−1,063	−1,206	−1,210	−1,619	−1,659	−1,667	[2] −1,457
Redemptions	203	93	102	192	222	406	469	495	478	[2] 413
Transactions in foreign outstanding securities	−96	−151	102	194	225	323	−116	−102	−305	[2] 186
Long-term bank claims	−126	−151	−604	−941	−232	337	255	358	330	[2] 201
Other long term	−132	3	159	−485	−88	−112	−281	−174	−424	−713
Direct investment[3]	−1,654	−1,018	−858	−2,328	−3,468	−3,639	−3,154	−3,025	−3,070	[3] −3,967
Short term	−546	−468	−317	−2,147	753	−415	−1,209	−1,049	−575	−1,005
Bank claims	−324	−325	−456	−1,524	325	−84	−730	−89	−871	[2] −1,081
Other short term	−222	−143	139	−623	428	−331	−479	−960	296	79

[1] Does not equal sum of detail categories which are preliminary.
[2] Actuals for the year.
[3] Includes use of funds raised abroad by U.S. finance subsidiaries.

Source: Department of Commerce, Survey of Current Business.

In addition, the President was provided discretionary authority to decrease the tax rate to zero or to increase it up to 150 percent of the basic 15-percent rate provided by the law if he determined that an adjustment of the tax rates was necessary to limit acquisitions of foreign securities to an amount consistent with our balance-of-payments objectives.

On August 28, 1967, the President provided that the rate of tax applicable to acquisitions after August 29, 1967, of stock and debt obligations with maturities of 28½ years or more would be 18.75 percent, the equivalent of an annual interest cost of 1¼ percent. On April 4, 1969, the President issued an Executive order reducing the rate on stock and long-term debt obligations to 11.25 percent where it has remained. This was the equivalent of a reduction in the annual interest rate from 1¼ percent to three-quarters of 1 percent.

In 1969, the tax was extended to March 31, 1971, and the President's discretionary authority to vary the tax rates was modified to permit a lower rate of tax on new issues than the rate applicable to outstanding issues. This authority has not yet been exercised.

TABLE 4.—NEW ISSUES OF FOREIGN SECURITIES PURCHASED BY U.S. RESIDENTS, BY AREA, 1962–70 (BALANCE OF PAYMENTS BASIS)

[In millions of dollars]

	1962	1963[1]		1964	1965	1966	1967	1968	1969	1970
		1st half	2d half							
All areas	1,076	1,000	250	1,063	1,206	1,210	1,619	1,703	1,667	[2] 1,457
IET countries, total	356	343	110	35	147	19	14	45	23	[3] 130
Western Europe[4]	195	219	53	35	95	15		42	14	130
Japan	101	107	57		52	4	14	3	9	
Other[5]	60	17								
Of which—										
Exempt from IET[6]			[7] (110)	(20)	(52)	(10)	(14)	(3)	(9)	(130)
Subject to IET				(15)	(95)	(9)		(42)	(14)	
Other countries, total	722	656	141	1,027	1,058	1,191	1,605	1,659	1,645	1,327
Canada	458	608	85	700	709	922	1,007	949	1,270	776
Latin America[8]	119	13	23	208	36	68	140	144	32	120
Other countries	61	35	33	115	134	121	212	176	179	190
International institutions	84			4	179	80	246	390	164	241

[1] Not seasonally adjusted.
[2] Preliminary.
[3] Exchange of stock in U.S. company for stock in foreign company under reorganization provisions of IET legislation.
[4] Including United Kingdom.
[5] Australia, New Zealand, and South Africa.
[6] Related to export, Japanese and reorganization exemptions.
[7] Represents commitments made prior to July 19, 1963, the date of inception of the IET.
[8] Includes Inter-American Development Bank issues.

Source: Department of Commerce, Office of Business Economics.

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 $1,000 million in the first half of 1963 to $250 million in the second half of that year. Moreoever, all the issues sold in the second half of 1963 were exempt from the tax, either because purchase committments 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.

Since 1963, purchases by U.S. residents of new foreign securities from countries subject to the interest equalization tax have generally declined, to $23 million in 1969 and, except for stock which was exempt from the tax because it was exchanged for stock in a U.S. company as part of a reorganization, to zero in 1970.

TABLE 5.—NET TRANSACTIONS IN OUTSTANDING FOREIGN SECURITIES BY U.S. RESIDENTS, BY AREA, 1962-70
[Balance of payments basis, in millions of dollars, net U.S. purchases (—)]

	1962	1963 1st half [1]	1963 2d half [1]	1964	1965	1966	1967	1968	1969	1970
All areas	−96	−151	102	194	225	300	−135	−61	−305	186
IET countries, total	15	−85	85	181	234	222	−111	−3	−285	(2)
United Kingdom	31	17	23	49	9	−7	−71	−54	−173	(2)
Western Europe	−47	−69	31	103	110	156	−25	21	263	(2)
Japan	−23	−25	−4		6	10	−5	6	−294	(2)
Canada [3]	79	7	30	17	147	68	−8	33	−82	(2)
Other [4]	−25	−15	5	12	−38	−5	−2	−9	1	(2)
Other countries, total	−13	−6	10	2	−8	26	−36	−75	−51	(2)
Latin America [5]	−25	−3	1	−13	−13	2	−13	−73	−65	(2)
Other countries	12	−3	9	15	5	24	−23	−2	14	(2)
International institutions	−98	−60	6	11	−3	51	13	15	31	(2)

[1] Not seasonally adjusted.
[2] Not available.
[3] Excludes Canadian repurchases, undertaken in 1966–68 for reserve management purposes.
[4] Australia, New Zealand, South Africa.
[5] Includes Latin American Development Bank issue of $145,000,000 in 1964.
Note These data reflect residence of seller rather than the original country of issue of the security—the basis on which the IET applies. Also, the above date show net purchsaes (or sales) whereas the IET applies to gross purchases.

Source: Department of Commerce, Office of Business Economics.

Although it is impossible to measure precisely the effect of the interest equalization tax on purchases of new securities by U.S. residents, it is clear that purchases from countries subject to the tax would not have declined from $356 million in 1962 to a current level of zero (apart from purchases not subject to tax) in the absence of the tax. If purchases from these countries had increased above the 1962 level in the absence of the tax, by the same percentage since 1962 as did purchases from countries not subject to the tax (84 percent), the 1970 level would have been $655 million, which would represent a 55 percent increase in the total amount of new foreign securities purchased by U.S. residents in 1970.

The tax has also moderated purchases by U.S. persons of outstanding foreign 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 $274 million per year. Purchases and sales, by area, are shown in table 5. Since mid-1963, U.S. residents have, on balance, sold more of these securities than they have purchased, thus contributing to the improvement in our balance of payments. Their net sales have averaged $43 million a year.

In 1967 through 1969, however, U.S. residents were net purchasers at an average rate of $167 million a year. In 1970, the flow was reversed and U.S. residents again were net sellers, on balance selling $186 million worth of foreign securities.

While commercial bank loans were not initially subject 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, the balance of long-term bank claims held by Americans against foreigners has gone up much faster than claims of foreigners against Americans. In 1962, the net balance of claims against foreigners went up $126 million over the prior year. In 1963, this same balance went up $755 million over 1962, and in 1964 the balance went up $941 million over 1963. Short-term bank claims on this same basis in 1962 went up $324 million over the prior year, in 1963 went up $781 million over the prior year, and in 1964 went up $1,524 million over the prior year. 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 they had a maturity of 1 year or more. As a result of the interest equalization tax, the voluntary program, and conditions of monetary stringency, the increase in long-term commercial bank claims against foreigners was only $232 million in 1965. Since 1965, the amount of long-term bank claims has fallen and this, therefore, has become a plus factor in our balance of payments.

While the tax has succeeded in moderating the outflow of U.S. private long-term portfolio capital, it certainly has not eliminated it. Such outflow in 1969 was $1.6 billion compared to $2.6 billion during the first 6 months of 1963 (annual rate) immediately before the tax became effective, and in 1970 was at a level of $1.3 billion. Direct investment by U.S. firms also rose $1 billion between the first half of 1963 and 1969 and evidenced a further increase in the first three quarters of 1970. (Direct investments are not covered by the tax, but are subject to the direct investment regulations.)

Thus the tax, in conjunction with the other programs, has succeeded in moderating the rate of overseas investment and in this manner has been beneficial to the balance-of-payments position of the United States.

EXTENSION OF THE TAX IS REQUIRED

Our current balance of payments position, a deficit of nearly $4 billion on a liquidity basis in 1970, would deteriorate further if, at this time, 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. Therefore, the relatively high interest rates such securities carry would, in the absence of the tax, result in a substantial increase in sales of foreign portfolio securities thereby further jeopardizing our balance-of-payments position.

The inflation in recent years in the United States has contributed to the decline in our trade surplus by making the price of imports more attractive and discouraging foreigners from buying our higher priced exports. In view of this, it is particularly necessary to avoid a large-scale increase in capital outflows at the present time.

Extension of the interest equalization tax also is necessary at this time because interest rates in the United States are significantly lower than in many foreign countries. This is indicated by a comparison of current interest rates on U.S. government bonds with those applicable to foreign government issues, as shown in Table 6.

TABLE 6.—COMPARISON OF YIELDS ON U.S. AND SELECTED FOREIGN GOVERNMENT LONG-TERM BOND [1]

[Percent per annum]

	Yield				Foreign differential (+) over U.S. Treasury bond yield as of—			
	June 1963	August 1968	June 1970	December 1970	June 1963	August 1968	June 1970	December 1970
Western Europe (average)	4.99	6.02	7.69	7.77	0.99	0.98	0.70	1.80
Belgium	4.94	5.54	5.95	5.70	.94	.41	−1.04	−.27
Denmark	6.54	8.33	10.53	11.29	2.54	3.29	3.54	5.32
France	5.09	5.96	7.69	7.64	1.09	.92	.70	1.67
Germany	6.10	6.30	8.50	8.30	2.10	1.26	1.51	2.33
Italy	5.38	5.89	8.58	9.33	1.38	.85	1.59	3.36
Netherlands	4.12	6.38	7.90	7.32	.12	1.34	.91	1.35
Sweden	4.52	5.88	7.14	(2)	.52	.84	.15	(2)
Switzerland	3.15	4.35	6.03	5.70	−.85	−.69	−.96	−.27
United Kingdom	5.44	7.44	9.51	9.69	1.44	2.40	2.52	3.72
Norway	4.66	4.25	5.10	4.93	.66	−.79	−1.89	−1.04
Other developed: [3]								
Canada	4.89	6.47	7.95	6.85	.89	1.43	.96	.88
New Zealand	5.17	5.50	5.50	(2)	1.17	.46	−1.49	(2)
U.S. Treasury bonds	4.00	5.04	6.99	5.97				

[1] Monthly average yields to maturity on issues with at least 12 years' life.
[2] Not available.
[3] Comparable rates for Japan are not available.

Source: International Monetary Fund.

For corporate bonds, the differential between the U.S. and the foreign interest rates is also substantial. While the U.S. rate on industrials was 6.98 percent in January 1971, the rates in foreign countries ranged from 7.37 percent in Germany to 9.42 percent in Italy as shown in table 7. Thus, there is still large potential borrowing which would take place in the absence of the tax. The fact that there has been substantial borrowing by countries and institutions that are exempt from the tax also lends support to the view that there would be substantial borrowing from countries that are not exempt if the tax were allowed to expire.

To the extent our inflation is brought under control, we can expect our interest rates to decline from their present levels without a corresponding decrease in foreign interest rates. This, of course, will widen the differential and increase the pressure to sell securities in the United States.

Moreover, in the absence of the tax, there would be an incentive to buy back from foreigners some of the securities that American companies have issued abroad to finance direct investment. The currently outstanding volume of these issues, some of which are convertible into stock, is $5.6 billion. In many cases, the U.S. company has no comparable domestic issue outstanding. The tax, therefore, guards against the resale to Americans of bonds issued abroad by U.S. companies to finance their direct investments.

TABLE 7.—LONG-TERM INTEREST YIELDS ON OUTSTANDING STRAIGHT DEBT ISSUES FOR U.S. AND SELECTED FOREIGN COUNTRIES

[At or near end-of-month rates]

Corporate issues	Yield on outstanding issues		
	September 1970	December 1970	January 1971
Domestic markets:			
U.S. industrial issues in the United States (Moody's Aa)	7.95	7.33	6.98
Canadian industrials in Canada	9.19	8.83	8.19
French industrials in France	8.65	8.83	8.74
German industrials in Germany	8.28	7.77	7.37
Italian industrials in Italy	10.55	9.74	9.42
Swedish industrials in Sweden	9.25	8.68	8.65
International markets:			
U.S. corporate dollar issues	8.64	8.08	7.60
Foreign corporate dollar issues	8.81	8.45	7.92

Source: "World Financial Markets" (Morgan Guaranty Trust Co.) for yields abroad.

Failure to extend the tax would also jeopardize other measures in the balance-of-payments program that have been undertaken to narrow the balance-of-payments deficit. The tax has a particularly important bearing, for example, on the program of voluntary cooperation by banks to reduce foreign lending that was inaugurated in 1965. In the absence of the tax, more foreign borrowers would seek to raise funds by borrowing from U.S. banks. Such a development would increase the pressure of foreign demand that the voluntary program must face.

Also, by reaching investors who are not under the other programs, the tax assures participants in these programs that they are not being asked to assume a disproportionately large share of the burden of eliminating the payments deficit.

Foreign reaction to our failure to extend the tax could also jeopardize our attempts to improve other aspects of the international trade and monetary system and place increased pressure on the dollar. The cooperation we obtain from other countries depends, in many instances, on what they believe our attitude and intentions are toward our balance of payments. In addition, the role of the dollar as a reserve currency and the willingness of foreigners to hold dollars are also affected by their confidence in our willingness and ability to cope with our balance-of-payments deficit.

In view of these considerations, both the House and the committee bill provide for a temporary 2 year extension of the interest equalization tax from March 31, 1971 to March 31, 1973. The committee views this tax as a transitional device to permit orderly progress to a satisfactory long-run solution to the balance-of-payments problem faced by the United States.

PRESIDENTIAL AUTHORITY TO EXTEND THE TAX TO SHORT-TERM DEBT OBLIGATIONS

The interest equalization tax does not presently apply to bank loans or other debt instruments with a maturity of less than one year. Such bank loans are subject to the voluntary control program of the Federal Reserve. At one time the President also did not have discretionary authority to apply the tax to bank loans with a maturity of more than one year. This authority, however, was provided by the Congress in 1964 and although this provision was not sought by the

administration, it was exercised by it in February 1965. Since then, long-term bank loans have shifted from a capital outflow to a capital inflow, thus becoming a plus factor in our balance of payments.

While short-term bank claims as a drain on our balance of payments declined from a level of $1.5 billion in 1964 to no more than about half that amount in recent years, in the first three quarters of 1970, the total was again up to a level of about $1.1 billion (annual rate) as shown in Table 3.

The committee is concerned about the impact on our balance of payments of the recent increase in these short-term loans. However, the committee is also concerned about the possibility of still larger capital outflows to acquire short-term financial obligations in the future it there is no effective method of discouraging such acquisitions. It would be most unfortunate if, in the absence of authority to apply the interest equalization tax to these short-term capital flows, the monetary authorities would attempt to discourage these capital flows by keeping short-term interest rates higher than is consistent with the domestic requirements of our economy.

For these reasons, the committee decided to give the President discretionary authority to apply the interest equalization tax to bank loans and other debt obligations with a maturity of less than one year.

The type of short-term obligations the committee believes the President might especially want to cover by the tax, should he decide to exercise this authority, are short-term financial assets associated with temporary placement of funds abroad by a U.S. person, which are not associated with his trade or business. In addition to non-business related bank deposits, these might include bankers acceptances, commercial paper, and certificates of deposit. These outflows seem to be motivated primarily for an interest rate gain.

In providing this authority to the President to extend the tax to short-term debt instruments, the committee does not expect him to use this authority in a way which will impede the flow of capital to pay for goods, services, tourism, dividend remittances, direct investments under the Office of Foreign Direct Investments program or similar types of transactions. As a result, the President is given broad authority to exclude from the tax selected types or categories of debt obligations. This authority granted the President also should enable him to exclude from the tax types of debt obligations which present particularly difficult administrative proglems. The authority provided the President to specify the maturity (within the one-year range) of the debt obligations to which the tax is to apply also should be of help in this regard.

CANADIAN EXEMPTION

Under present law (sec. 4917), the President is given authority to exempt by Executive Order new issues of any foreign country if he determines it is in the interest of "international monetary stability" Canada is the only country which enjoys this exemption for new issues, although outstanding Canadian issues are subject to the tax. Japan had a limited exemption ($200 million), but in 1969 the President terminated it by Executive Order on the grounds that it was no longer necessary. New Canadian issues have risen progressively since the tax went into effect in 1963, reaching $1,270 million in 1969, although they dropped off in 1970 to $785 million.

This exemption was provided because of the close relationship of our financial markets. Moreover, there has always been an understanding that Canada would not use its exemption to increase its international monetary reserves and in 1968 she undertook to "ensure that the exemption would not result in Canada's being used as a pass-through' by which the purpose of [the United States'] balance of payments is frustrated." The understandings regarding reserves and pass-through are included in an exchange of letters between then Secretary Fowler and Finance Minister Benson in December 1968 and was included in the 1969 Senate Finance Committee report on the extension of the interest equalization tax.

The Canadian balance of trade and balance of payments position has continued to improve for several years and Canada's international reserves have increased accordingly. Table 8 shows the Canadian current account position since 1964, and the volume of Canadian new issue flotations in the United States over this period.

In the light of Canada's continued balance of trade surplus ($860 million in 1969 and $3.0 billion in 1970 in Canadian dollars) and the aggravated U.S. balance of payments deficit, the committee is concerned over the necessity of the Canadian new issue exemption and its effect on the U.S. balance of payments. In this general regard, Under Secretary Volcker, in his appearance before the committee, testified, "They are in a much stronger position now and, for balance of payments reasons, much less heavily reliant on our market, and we would expect that phenomenon to be reflected in the volume of their borrowings in the future." The committee expects the administration to watch carefully the situation regarding this relationship and the consistency of the present exemption with our overall objectives. If the problems continue the committee may want to reconsider the Canadian new issue exemption.

TABLE 8—CANADIAN CURRENT ACCOUNT POSITION AND NEW ISSUE FLOTATIONS IN THE UNITED STATES 1964-70

	1964	1965	1966	1967	1968	1969	1970
Canadian current account (millions of Canadian dollars) (plus surplus)	−424	−1,130	−1,162	−499	−107	−751	+1,297
New Canadian issues in the United States (millions of U.S. dollars)	700	709	922	1,007	949	1,270	785

Source. Dominion Bureau of Statistics and Department of Commerce, Survey of Current Business, various.

INTERNATIONAL ORGANIZATIONS

Obligations of international development institutions are also exempt from the interest equalization tax. The volume of new issues floated by these institutions and purchased by U.S. residents has increased from $4 million in 1964 to $241 in 1970. These issues are backed by the guaranty or callable capital subscribed by the member countries and as a result the full faith and credit of the United States is involved to a substantial degree.

Most of the borrowings of these institutions abroad are, on the average, shorter than the borrowings in this country. Moreover, according to Secretary Volcker, about one-half of the borrowings of these institutions is in the United States. However, procurement in the

United States under the World Bank loans (which is the major borrower) has fallen steadily in recent years to such an extent that it is significantly below our share of the financial support of the bank.

The committee believes that it would be in the interest of international monetary stability if the various international institutions obtained a larger proportion of their funds from Europe and Japan and also borrowed on a longer term basis from these areas.

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 expires as of March 31, 1971. The bill extends the application of this tax for a period of 2 years, or until March 31, 1973. As explained more fully in the prior part of this report, "Reasons for the bill," this tax continues to be an essential part of the U.S. balance-of-payments program, and its extension for the additional period is believed to be necessary in view of our present balance-of-payments situation.

2. Election to treat certain debt obligations as subject to the tax (sec. 3(a) of the bill and sec. 4912(b) of the code).—At the present time, direct investments by U.S. corporations in their foreign subsidiaries are not subject to the interest equalization tax, but instead are subject to the guidelines and restrictions imposed by the Office of Foreign Direct Investment in the Commerce Department. These restrictions limit the amount of new capital which the U.S. parent company may transfer abroad to its foreign affiliates. To meed the needs of foreign affiliates for additional funds, over and above the investments which the foreign direct investment program permits the parent to make, some U.S. corporations have borrowed money from foreign sources and then contributed or loaned that money to their foreign affiliates. Generally, this is allowed under the foreign direct investment restrictions provided there is assurance that the debt obligations which the U.S. corporation issues when it borrows the foreign funds will not be purchased by U.S. persons, since this would result in the funds which were made available to the foreign affiliate having come indirectly from the United States.

One of the means used by U.S. companies to insure that the debt obligations which are issued to foreign persons in connection with their foreign borrowings will not be purchased by U.S. persons is to have the foreign borrowing made by a domestic subsidiary with respect to which the Revenue Service has issued a ruling that the subsidiary is "formed or availed of" to obtain funds for a foreign person. Under present law, the acquisition by a U.S. person of a debt obligation of a domestic corporation which is "formed or availed of" to obtain funds for a foreign person (i.e., a domestic corporation which may be viewed as a conduit) is deemed to be an acquisition by the U.S. person of the foreign person's debt obligation. As a result, the U.S. person's acquisition is subject to tax if it would have been subject to tax had the U.S. person directly acquired the debt obligation of the foreign person.

The device of obtaining a "formed or availed of" ruling has not presented significant problems where the foreign affiliate to which the funds borrowed abroad are made available is located in a developed country. Where, however, the foreign affiliate is a less developed country corporation, problems have arisen. This is because a U.S.

person who acquired a debt obligation of the "formed or availed of" domestic company might argue that, since under the "formed or availed of" rule he is deemed to have acquired stock or a debt obligation of a less developed country corporation for which an exclusion from the tax is provided, his acquisition is not subject to tax. This, of course, would be contrary to the intent and purpose of the foreign direct investment restrictions. As a result, the Internal Revenue Service, when it issues a ruling to a "formed or availed of" corporation may not permit the corporation to make investments which are exempt from the interest equalization tax (such as an investment in a less developed country). This sometimes significantly limits the usefulness of "formed or availed of" corporations to borrow funds abroad for the use of foreign affiliates.

The committee agrees with the House that, in view of these circumstances, it is appropriate to provide a procedure under which a U.S. company which borrows funds abroad (generally in order to comply with the foreign direct investment restrictions) can be assured that the debt obligations it issues in connection with the foreign borrowing will not be acquired by U.S. persons.

In general, the House bill approached this problem by providing that a domestic company can elect to treat a new issue of its debt obligations as subject to the tax, notwithstanding any exclusion from the tax. If the obligations are convertible into stock, the election also would be applicable with respect to the entire class of stock into which the obligations can be converted.

The committee has retained this basic approach, but has made four modifications in it to insure that the approach represents a viable means of allowing domestic companies to comply with the restrictions imposed by the foreign direct investment program. First, the committee extends to domestic partnerships the election to treat a new issue of debt obligations as subject to tax, since they also are subject to the foreign direct investment restrictions and need this method of assuring that foreign funds they obtain for their foreign investments cannot subsequently be acquired by U.S. persons without payment of tax. Second, the committee has provided that in the case of debt obligations which are convertible into stock, the election to have debt obligations treated as foreign issues is not also to apply to the class of stock into which the debt obligations may be converted. The committee believes that it is not necessary to have the election extend to the stock in such cases since the new stock at the time of the conversion is fully subject to the foreign direct investment restrictions in the same manner as any other newly issued stock in the company. Moreover, to extend the election to the stock into which the debt obligations may be converted could subject all of the parent's stock, currently traded in the United States, to the interest equalization tax.

Third, the committee has modified the House provision to permit the election to have debt obligations treated as foreign issues to cover not only new issues, but also an issuer's outstanding obligations which are presently treated as foreign obligations and presently outstanding debt obligations of foreign or domestic subsidiaries where the U.S. parent company (or a domestic affiliated company) assumes the obligations.

Finally, in order to make the House provision operate in a practical manner, the committee also amends the 30-percent withholding tax

generally applicable to interest paid by a domestic company to a nonresident foreign person. It has been pointed out to the committee that this 30-percent withholding tax, which may be applicable where a U.S. parent corporation borrows funds from abroad to reloan to its foreign affiliates, may well make the House provision with respect to the interest equalization tax of questionable use since foreign persons are not likely to want to buy debt obligations where the interest payable to them may be subject to a 30-percent U.S. withholding tax.

Under present law, the 30-percent withholding tax does not apply where less than 20 percent of the domestic company's gross income is derived from U.S. sources. Thus, if a domestic subsidiary is established only for the purpose of borrowing the funds from abroad and then relending the funds abroad the 30-percent withholding tax is not a problem. However, the domestic parent corporation in other cases would prefer to have the financing subsidiary loan the foreign funds to it, and then, it would reloan the funds to the foreign affiliates, or some of the funds so borrowed may be for use in the United States. In such case, the 30-percent withholding tax would apply since the important sources of income for the subsidiary would be the interest paid to it by the domestic parent company and, therefore, the 20-percent exception referred to previously would not be available. As a result, domestic companies desiring to operate in the manner described above often have found it preferable to utilize foreign subsidiaries to handle their financing since interest paid by the foreign subsidiary is not subject to the 30-percent U.S. withholding tax.

The bill, as a result, allows domestic companies to obtain foreign funds for foreign affiliates (or for their own use domestically) by providing that interest paid by U.S. company (or a partnership) to a foreign holder of a debt obligation, where the election provided in the House bill has been made, is not to be subject to the 30-percent U.S. witholding tax. This is to be true, however, only where the debt obligations issued have a maturity of not more than 15 years and are originally marketed in a public offering.

The procedure provided by the bill, as modified by the committee, allows a domestic corporation or a domestic partnership to elect to treat any new issue of its debt obligations (but not a class of stock into which they may be converted) as subject to the tax without regard to the type of investments the company makes with the borrowed funds and notwithstanding any exclusion provided from the tax. As a result, debt obligations with respect to which this election is made will be subject to the tax if acquired by a U.S. person even though, for example, the domestic company made investments in less developed countries or even though, in the case of the debt obligations, the obligations had maturities of less than one year. The rate of the tax which is to apply if a U.S. person acquires such a debt obligation is to be the rate applicable in the case of acquisitions of stock (which presently is 11.25 percent). In the case of convertible debt obligations, however, an election under this provision is not to apply to the class of stock into which the debt obligations are convertible. Interest which is paid by the issuing company on debt obligations subject to the election referred to here would not be treated as U.S. source income. This has the effect of exempting the interest from the 30-percent U.S. withholding tax when it is paid to a nonresident alien individual or a foreign corporation. This treatment of interest as U.S. source

income is to apply only to interest paid on obligations which had (when issued or assumed) a maturity not exceeding 15 years and which were originally marketed in a public offering. The exemption from withholding tax applies only with respect to interest attributable to periods after the date on which the election to treat the debt obligation as subject to the tax is made.

The bill, as modified by the committee, also provides that if a domestic company assumes debt obligations previously issued by a foreign or domestic affiliate, the assumption is to be treated as a new issue of the debt obligations and, thus, the company may make the election provided by the bill with respect to the debt obligations.

The committee bill also eliminates the House-passed feature of the provision which, in the case of convertible debt obligations, would have applied the election to the entire class of stock into which the obligations could be converted.

As previously indicated, debt obligations with respect to which an election has been made under this provision are to be subject to the tax if acquired by an American, notwithstanding any exclusion provided from the tax. Accordingly, the exclusion for prior American ownership or the exclusion for direct investments is not to be available in the case of acquisitions of these debt obligations. It is intended, however, that the credit or refund of tax presently allowed U.S. underwriters and securities dealers who participate in the initial offering and sale of debt obligations to foreign persons (or who acquire and resell debt obligations to foreign persons) is to be available in the situation where the underwriters or securities dealers purchase and resell debt obligations of a domestic company (or partnership) subject to an election under this provision. In other words, although the initial acquisition of the obligations is subject to the tax, the bill does not prevent underwriters or securities dealers from obtaining a credit or refund of the tax paid by them in connection with their acquisition of these debt obligations, if they otherwise satisfy the conditions provided under present law for obtaining the credit or refund.

In the case of a "formed or availed of" company which has obtained a ruling on its status as such a company from the Revenue Service and which is prohibited by the terms of the ruling from making investments in less developed countries, it is intended that, if the company makes the election provided by this provision with respect to a new issue of its debt obligations, it may make investments which would be exempt from tax (such as in less developed countries) up to the amount of the proceeds from the new class of debt obligations without being considered to affect the provisions of its previous "formed or availed of" ruling on the taxability of its prior issues.

The procedure provided here to permit a domestic corporation to elect to treat an issue of debt obligations as subject to tax in the same way as for a foreign corporation, of course, will not affect the interest equalization tax liability of the domestic company itself if it should acquire foreign stock or debt obligations which are subject to the tax.

If an election under this provision is made with respect to a new issue of debt obligations, the documents evidencing the debt obligations must indicate that they are subject to the interest equalization tax (at the rate applicable to stock acquisitions) if they are acquired by a U.S. person. In the case of an election with respect to previously issued debt obligations, the documents evidencing the debt obligations must be marked or endorsed, in a manner to be prescribed by the

Secretary or his delegate, to indicate that their acquisition by an American is subject to the tax. It also is provided that an election under this provision must be made prior to the issuance of the debt obligations which are subject to the election. In the case of a domestic or foreign subsidiary's previously issued debt obligations which are assumed by the U.S. parent company (or a domestic affiliate), the election must be made prior to the assumption of the obligations. An election is to take effect as of the issuance (or assumption) of the debt obligations which are subject to it and is to be irrevocable.

This provision is to take effect on the date of enactment of the bill.

3. Acquisitions of stock or debt obligations in connection with nationalization, expropriation, etc. (sec. 3(b) of the bill and secs. 4914 and 4916 of the code).—Present law (sec. 4916(a)(4)) provides an exclusion from the tax for foreign stock or debt obligations which a U.S. person acquires as a result of reinvestment requirements imposed by a foreign country in situations involving that country's nationalization, expropriation or seizure (either actual or threatened) of a substantial portion of the U.S. person's (or a controlled foreign corporation's) property within that country. This exclusion applies where the reinvestment requirement arises under the terms of a sale or indemnification contract with the government of the foreign country (or an agency or instrumentality of the government). At present, however, the exclusion is available only if the foreign country in question is a less developed country.

When this exclusion was adopted, it was limited in application to situations arising in less developed countries because it was thought it would be unlikely for a nationalization or expropriation to occur in a developed country. The status of a country, however, as developed or less developed for purposes of the interest equalization tax is determined more with respect to considerations affecting movements of capital than on the basis of the level of the country's political and economic development. As a result, if an expropriation were to occur in a country having substantial capital flows although lacking political or economic stability, the exclusion would not be available. The committee agrees with the House that there is no sound reason for limiting the application of the exclusion to situations involving nationalizations, expropriations or seizures occurring in less developed countries. The acquisition by a U.S. person of a foreign debt obligation or foreign stock which is required by a foreign country in connection with a nationalization or expropriation does not involve the voluntary type of capital outflow to which the tax is directed. Accordingly, the bill extends the applicability of this exclusion to situations involving nationalizations, expropriations, or seizures in developed countries as well as less developed countries. (This involves the transfer of the present exemption from sec. 4916(a)(4) to sec. 4914(k) and making it applicable to nationalizations, expropriations, or seizures in foreign countries generally rather than only in less developed countries.)

This amendment is to apply with respect to acquisitions of foreign stock or debt obligations made after the date of enactment of the bill.

4. Foreign mineral facilities (sec. 3(c) of the bill and sec. 4914(c)(5) of the code).—Under present law, an exclusion from tax is provided for debt obligations acquired by a U.S. person from a foreign person in connection with the construction of a foreign mineral facility. For the exclusion to apply, the money loaned by the U.S. person must be intended to be used by the foreign person to install, maintain,

or improve a mineral facility outside the United States for the storage, handling, transportation, processing, or servicing of ores or minerals (or derivatives thereof).

The exclusion is applicable if during the period the loan is outstanding a substantial portion of the ores or minerals processed in the facility will be extracted outside the United States (or obtained in other specified ways) by the U.S. person or by an affiliated corporation. This substantial portion test has been interpeted to mean that at least 35 percent of the minerals processed in the facility must be supplied by the U.S. person making the loan. The exclusion also is applicable under present law where the loan supplied by the U.S. person covers only part of the cost of the facility, if more than 50 percent of the minerals processed in the proportion of the facility represented by the U.S. person's loan (in relation to the total cost of the facility) are minerals extracted by the U.S. person or an affiliated company.

Significant tracing problems can arise under this "substantial portion" test in situations where the foreign person has a number of foreign mineral facilities and adds a new facility. Often the foreign person will divert to the new foreign mineral facility, in connection with which the loan by the U.S. person is made, its ores and minerals which previously were processed in its other facilities, and the U.S. person will then supply an increased amount of ores or minerals to the other facilities. In such a situation, it is difficult to trace the ores and minerals supplied by the U.S. person and relate them specifically to the new foreign mineral facility. The committee agrees with the House that in such a situation it is appropriate to allow the exclusion without requiring the ores and minerals supplied by the U.S. person to be traced specifically to the new foreign mineral facility if, considering the amount of ores or minerals of the U.S. person which are processed in all the similar foreign mineral facilities of the foreign person, the exclusion would have been allowed.

The House bill provided a rule of this nature, however, only where the 35-percent test applied and not where the 50-percent test applied. The committee sees no reason for not applying any relief provided to those under both tests. In addition, the House bill considered the 35-percent test satisfied if the ores or minerals extracted by the U.S. person (or affiliate) which were processed in all of the similar facilities of the foreign person represented at least 35 percent of the total amount of ores or minerals processed in those facilities. The committee believes that in determining whether the exclusion should apply it is more appropriate to look at the additional amount of ores or minerals supplied by the U.S. person to the foreign facilities after a loan is made for the new facility.

Accordingly, the committee has modified the House bill to provide that either the 35-percent test or the 50-percent test is to be considered satisfied if certain conditions are met. These rules would be considered as satisfied if the "additional" amount of ores or minerals of the same type extracted outside the United States (or obtained in other specified ways) by the U.S. person or an affiliated corporation and processed in all facilities of the foreign person to which the U.S. person makes the loan would satisfy the 35-percent test or the 50-percent test were the additional amount to be processed only in the new facility. The additional amount is to be determined by comparing the amount of ores or minerals of the same type extracted, etc., by the U.S. corpora-

tion (or affiliate) which were processed in all facilities of the foreign person prior to the time the loan was made to the foreign person with the amount processed after the new facility is in operation.

This amendment is to apply with respect to acquisitions of foreign debt obligations made after the date of enactment of the bill.

5. Sales or liquidations of foreign subsidiaries (sec. 3(d) of the bill and sec. 4914(g)(1) of the code).—Under present law, an exclusion from the interest equalization tax is provided for foreign debt obligations acquired by a U.S. person in connection with the sale of all the stock (except for qualifying shares) of a 100-percent-owned foreign subsidiary, or as the result of the liquidation of a 100-percent-owned foreign subsidiary following the sale of substantially all of the subsidiary's assets to a foreign person who gives the debt obligation as part or all of the purchase price of the assets. This exclusion was provided because sales of stock or assets of this type are favorable to our balance of payments even though there is a temporary partial offset by reason of the acquisition of the foreign debt obligations. As indicated, however, at present the exclusion only applies if the foreign subsidiary is 100-percent-owned by the acquiring U.S. person (and its affiliated companies).

The committee agrees with the House that the reason for the exclusion in the case of a sale or liquidation of a "wholly owned" foreign subsidiary is equally applicable where the U.S. person (and its affiliated companies) sell their entire interest in a less than 100-percent-owned subsidiary so long as their interest is of the type which constitutes a direct investment which could be made on a tax-free basis under the interest equalization tax. Accordingly, the bill provides that the exclusion referred to above also is to be available where the debt obligations are acquired by a U.S. person in connection with the sale or the liquidation of a less than 100-percent-owned foreign subsidiary, provided the U.S. person and its affiliated companies own at least 10 percent of the voting power of the foreign subsidiary (i.e., enough so the investment is considered a direct investment rather than a portfolio investment).

This amendment is to apply with respect to acquisitions of foreign debt obligations made after the date of enactment of the bill.

6. Direct investments in certain lending and financing corporations (sec. 3(e) of the bill and secs. 4915 and 4920 of the code).—Under the direct investment exclusion of present law, a U.S. company may acquire tax-free stock of a foreign corporation in which it has at least a 10-percent voting interest. This exclusion is not available, however, if the foreign subsidiary is "formed or availed of" by the U.S. company to make otherwise taxable acquisitions of foreign securities. It can be argued that a foreign subsidiary which is engaged in the lending or finance business abroad is "formed or availed of" with the result that its U.S. parent institution would not be able to make a taxfree direct investment in the subsidiary. This situation also could arise where the subsidiary is a domestic company which is engaged in the lending or finance business abroad and which except for the exceptions noted below would be subject to the interest equalization tax on its lending activity. In this case also under present law, it could be argued that the subsidiary was "formed or availed of" by the parent company, thus rendering the parent's direct investment in the subsidiary subject to

tax. These results could occur regardless of whether the amounts invested in the subsidiary will actually be used outside of the United States or will remain in this country or regardless of whether the amounts invested were obtained from foreign or domestic sources.

Under present law, however, two somewhat different exceptions are provided to the general rules set forth above. The first exception relates to foreign financing companies which finance the products of affiliated corporations. In such cases the foreign financing subsidiary is not considered as "formed or availed of" for purposes of avoiding the interest equalization tax. Therefore, investments by a parent corporation in its foreign subsidiary in such a case are not subject to tax. In addition, of course, the loans made by the financing company itself are not subject to tax since it is a foreign corporation. Second, an exception is provided to the general rules of present law for certain domestic financing companies. In this case an exemption is provided with respect to the loans of the subsidiary (if it so elects) either if it is engaged in making loans with respect to the products or affiliated corporations or if it is in the business of making small loans. In the case of a domestic subsidiary engaged in financing products produced by an affiliated corporation, present law also provides that the subsidiary is not treated as "formed or availed of" with respect to direct investments in it by the parent company. However, in the case of investments in a domestic subsidiary engaged in the small loan business abroad the "formed or availed of" provision applies and, therefore, investments in such a case are subject to interest equalization tax under present law.

The House bill focused on situations involving investments in financing subsidiaries of U.S. financial institutions. It provided that where investments are made in a financing subsidiary, either domestic or foreign, the subsidiary would not be treated as "formed or availed of" with respect to the investment and as a result the investment would not be subject to tax. The condition which the House bill required must be met in order for the investment to be free of tax is that adequate assurance be given that the amount invested by the financial institution in the domestic or foreign financing subsidiary not be used to acquire foreign stock or debt obligations or otherwise utilized in any way outside of the United States.

The committee agrees with the House that this treatment is appropriate. By requiring the invested funds to remain in the United States assurance is provided that the investments of the financial institution in the domestic or foreign financing subsidiary will not adversely affect our balance of payments. However, the committee believes that this treatment should also be made available where the investment in the financing subsidiary is made with funds obtained from foreign sources. As is true in the case where the funds invested do not leave the United States, where the funds for the investment are obtained abroad this also gives assurance that the transaction does not have an adverse effect on our balance of payments.

The committee does not believe it is necessary to restrict the availability of this tax-free treatment to investments by financial institutions in financing subsidiaries if there is assurance generally that the financing subsidiary operates in a manner which is consistent with our balance-of-payments objectives. The type of conditions which presently apply in the case of the financing company election available to companies financing the sales of products manufactured by affiliated

companies provide this type of assurance. These conditions in essence are directed to insuring that the financing subsidiary in fact is principally engaged in the financing business, that it uses foreign source funds in this business, and that it is not merely a conduit for making portfolio investments abroad.

The committee has concluded that regardless of whether or not the parent corporation is a financial corporation and regardless of whether or not the subsidiary is engaged in the business of financing products produced by affiliated corporations, it is appropriate that the investments of the parent corporation be free of interest equalization tax where they are made in a subsidiary which is engaged in the lending or financial business, either where the investments remain in the United States or, of they do not, where they have been obtained from foreign sources. Where a domestic subsidiary is used, the committee also believes that it is appropriate that it be free of interest equalization tax where it elects to be treated as a foreign corporation, is engaged in the lending or financial business abroad and obtains its funds from abroad. The committee believes that freeing investments in financing subsidiaries from tax in the manner outlined above and also freeing the financing subsidiary from tax where a domestic corporation is used is consistent with our balance-of-payments objectives since, in either situation, there is not drain on our balance of payments.

Accordingly, the committee has modified the House bill with respect to the treatment of financing subsidiaries and direct investments in the subsidiaries in a number of respects. First, it has made the tax-free investment treatment provided by the House bill available in the case investments by any U.S. company (rather than just a financial institution) in a domestic or foreign lending financing company if assurance is given to the Treasury Department that the invested funds will be used exclusively within the United States or if the funds invested are obtained from foreign sources. This result is accomplished by treating the financing subsidiary in either situation as a foreign corporation which is not "formed or availed of" to make otherwise taxable acquisitions.

Second, this treatment is to be available in the case of investments in a domestic company which is primarily engaged in the lending or financing business outside the United States (as under the House bill) and also in the case of investments in a "qualified (domestic or foreign) lending or financing corporation," which essentially is a company that meets requirements similar to those presently imposed on companies wishing to make the financing company election under present law. Under the House bill, investments would have been permitted in a foreign lending or financing company but no requirements were imposed as to the type of activity in which the company had to engage and the manner in which it had to conduct its business.

Third, the committee revised the financing company election provided under present law to permit it to be made in any case where the company is a "qualified lending or financing corporation." Accordingly, if the somewhat more flexible requirements imposed by the committee's bill for making this election are met, an electing company will be eligible for the tax-free direct investment treatment provided by the bill. In addition, if the electric company is a domestic corporation it will be exempt from the tax on the loans it makes in its financing

business. To obtain this tax-free direct investment treatment, however, the conditions provided by the bill (which require that the amounts invested either will remain in the United States or will have been obtained from foreign sources) must be met.

Under the bill as modified by the committee, tax-free direct investment treatment is to be available for investments by a U.S. company in either a domestic corporation (described in sec. 4920(a)(3)(C)) which is primarily engaged in the lending or financing business outside the United States and which has elected to be treated as a foreign issuer or obligor, and also in the case of investments in a domestic or foreign company which is a "qualified lending or financing" company. To obtain this treatment, it must be established to the satisfaction of the Secretary or his delegate, pursuant to regulations which the Treasury Department promulgates, that the amounts invested in the financing subsidiary which are obtained from U.S. sources will not be used to acquire foreign stock or debt obligations or utilized in any other way outside the United States. Thus, the amounts from U.S. sources could not be used for physical plant or equipment located outside of the United States or for working capital purposes outside the United States. Alternatively, if the amounts invested are to be used outside the United States it must be shown to the satisfaction of the Treasury Department that the funds were obtained from foreign sources.

In determining whether funds were obtained from foreign sources, it is contemplated that amounts which are considered repatriated to the United States are not to be treated as foreign source funds. In addition, for this treatment to be available, it also must be established to the satisfaction of the Treasury Department that the information and records with respect to the financing subsidiary in which the investment is made that are necessary to insure compliance with the provisions of interest equalization tax will be made available to the Treasury Department.

Fourth, under the bill as passed by the House, this tax-free investment treatment does not apply to acquisitions from third parties who are foreigners since purchases of stock from foreigners necessarily means the funds used for the acquisition could not remain in the United States. However, since the committee has made this treatment available where the funds used for the investment are obtained from foreign sources, it believes that it is appropriate to permit the U.S. financial institution to acquire stock of a financing subsidiary from third parties if the other conditions provided by the bill are satisfied. Accordingly, the committee's bill makes this tax-free investment treatment available for acquisitions of stock in a financing subsidiary from a third party.

Fifth, the bill provides that if tax-free direct investment treatment was obtained under this provision with respect to amounts invested in a financing subsidiary and the amounts are used in a prohibited manner (i.e., to acquire foreign securities or for other purposes outside the United States) or the information required to be filed with respect to the financing subsidiary is not furnished, then the company making the investment is to be subject to the tax at the time the amounts are so used. The amount of the tax is to be the amount which the investing company would have been liable for in the absence of this provision when it made the investment in the financing company.

Sixth, in order for a company to be a qualified lending and financing corporation under the bill in which a tax-free direct investment may be made (or in the case of a domestic company, which may elect to be exempt from the tax on the loans it makes in its financing business) a number of conditions must be satisfied.

The first requirement which must be met is that substantially all of the business of the company must consist of specified activities. These activities are—

(1) making loans (including loans made under a lease which is principally a financial lease);

(2) acquiring accounts receivable, notes, or installment obligations if these arise out of the sale of tangible personal property or the performance of services;

(3) the leasing of tangible personal property where financial leasing is not involved (but only if this activity accounts for less than one-half the business of the company);

(4) servicing debt obligations; and

(5) incidental activities carried on in connection with the foregoing types of businesses.

The second requirement which must be met by the financing company in order to qualify under this provision is that the loans made by the financing company to foreign persons must be made with foreign funds (i.e., all the foreign debt obligations acquired by the company must be acquired solely out of funds from specified foreign sources). In addition, the foreign produced or manufactured tangible personal property acquired by the company for use in its regular leasing business must be acquired solely out of funds from the specified foreign sources. The specified foreign sources generally are those provided in present law under the existing financing company election. Generally, these are loans from any foreign person other than a foreign partnership or corporation in which a tax-free investment could be made and certain additional types of foreign funds. One of these additional types of foreign funds is retained earnings and reserves of the company which are attributable to its foreign lending or financing business. Another type of permissable foreign source funds is certain trade accounts and accrued liabilities which are attributable to the company's foreign lending or financing business. A third additional source of foreign funds are funds the financing company receives as a contribution to its capital or as a payment for its stock where the funds were derived from the sale of debt obligations by a related company to the specified types of foreign persons.

Under present law, the foreign funds utilized by the financing company generally must be borrowed either by it or by a domestic corporation (described in sec. 4912(b)(3)) which owns all of the stock of the financing company. The House, in a different section of its bill, modified this requirement to permit borrowings to be made also by any domestic corporation (described in sec. 4912(b)(3)) which was an includible corporation in the same affiliated group as the financing company. The committee agrees with the House that present law is unduly restrictive in limiting the corporations which may borrow funds from foreign sources to operate the financing business abroad to the financing company itself or to a corporation owning 100 percent of the financing company. There are often sound business reasons, not motivated by the interest equalization tax considerations, for structuring foreign operations in a way that makes it advisable for the foreign

borrowings to be made by an affiliated domestic corporation which either is not the parent of the financing company or which does not own 100 percent of the stock of the financing company. Accordingly, the committee has included the House modification in this provision of the bill.

The third requirement provided by the bill which must be met by a company to be a qualified lending or financing corporation is that the company may not acquire any stock, either foreign or domestic, other than stock of a related company which it acquires as payment for its stock or as a contribution to its capital.

As under present law, the financing company must satisfactorily identify its stock certificates or debt obligations so they clearly indicate they are subject to the tax if acquired by an American. In addition, the financing company must maintain the necessary records and accounts and submit the necessary reports to establish that it has satisfied the prescribed conditions.

The bill provides that a domestic company may elect to be treated as a qualified lending or financing corporation (and a foreign corporation may give notice to the Treasury Department that it is a qualified lending or financing corporation) in such manner as is provided in regulations prescribed by the Secretary or his delegate. If a qualified lending or financing company which has made the election fails to meet any of the prescribed requirements, its election is to be deemed revoked. Generally, if the election is revoked, the financing company, if it is a domestic corporation, is to be subject to tax on all stock or debt obligations which are held by it at the time of the revocation to the extent it would have been liable for tax if it had acquired those stock or debt obligations at that time. If a domestic financing company becomes liable for tax in this manner and this also causes the company, which previously made the tax-free investment in the financing company under this provision of the bill, to be liable for the tax on the direct investment, the tax liability of the financing company (as otherwise determined under this provision) is to be reduced by the amount of tax paid by the company making the direct investment.

The amendments made by this section regarding the tax-free treatment of investments in a financing company are to apply with respect to acquisitions made after the date of enactment of the bill. The remaining amendments made by this section are to take effect on the day after the date of enactment of the bill. In addition, it is provided that an election by a domestic company under the financing company provision of present law (or the giving of a notice by a foreign financing company under the financing company provision of present law) is to be treated as an election (or the giving of notice) under the qualified lending or financing company provision provided by the bill.

7. *Extension of resale period for dealers in foreign securities (sec. 3(f) of the bill and sec. 4919 of the code).*—Generally, dealers in securities are subject to the interest equalization tax on their acquisitions of foreign securities. A dealer, however, may qualify for a credit or refund of the tax imposed where he purchases foreign stock in the ordinary course of his business and resells the stock to foreign persons on the same day on which he purchases it or on either of the next two business days (or in the case of purchases made to cover short sales, on the same day or either of the two immediately preceding business days).

The attention of the House was called to the fact that in some situations the present 3-day period during which a dealer may resell the foreign stock (or cover the short sale) may be too short. Under present law, for example, it may be difficult for a U.S. broker-dealer to assemble a large block of stock for sale to a specific customer within the 3-day period.

Accordingly, the bill provides that the President may, by Executive order, extend the present period of two business days (after the date of purchase or before that date if the purchase is made to cover a short sale) to a period not to exceed 13 calendar days. An extension of this nature, however, may be made under the bill only with respect to transactions which are made for a specific customer and not for the broker-dealer's own investment purposes. To be sure that the extended period for resale does not apply to acquisitions which are essentially investments by the acquiring dealer, only acquisitions which are made pursuant to orders or indications of interest of specific customers, or with specific customers in mind, and which are identified at the time of acquisition on a special record of the dealer as made for or with respect to the specific customer, are to be eligible for resale during the extended period under circumstances which give rise to a credit or refund of the tax. Further, the right to obtain a credit or refund for a sale made during the extended period is to be contingent upon the submission, by the acquiring dealer, of a satisfactory procedure for identifying which of the dealer's acquisitions are for customers and which are for investment purposes. The acquiring dealer must notify the Secretary or his delegate of the identifying procedure in advance of any acquisition of foreign stock which the dealer wishes to resell (or wishes to use to cover a short sale) during the extended period provided for by the Executive order, if a credit refund is to be obtained. In addition, when the dealer files a claim for credit or refund with respect to stock which he acquired and sold during the extended period, he must indicate whether the person to whom the sale was made was the specific customer identified on his special records at the time the stock was acquired. A dealer's acquisitions are not to be considered as made for customers if any significant level of the dealer's sales of stock during the extended period are to persons other than the specific customers identified on his special records at the time the stock was acquired.

An Executive order providing for an extension of the permissible resale or acquisition period may be applicable for any period provided in the order and subject to other conditions which may be provided for in the order. The Executive order may extend the resale period for a period less than 13 calendar days and the President may, by a subsequent Executive order, reduce or extend (but not for more than a total period of 13 calendar days) the period set in a prior order.

If a dealer claims a credit or refund with respect to any sale or acquisition made after the expiration of the two-businesss-day period referred to in present law, he must establish that he complied with the requirements set forth in the Executive order extending the two-day period and that he followed the identification procedures which he previously had submitted to the Treasury Department.

This amendment is to apply with respect to acquisitions made after the date of enactment of the bill.

8. Failure of a foreign corporation to file notice respecting issuance of additional shares (sec. 3(g) of the bill and sec. 4920 of the code).—Under

present law a class of stock of a foreign corporation which was chiefly owned by Americans, or primarily traded on U.S. security markets, prior to the application of the interest equalization tax is treated as stock of a domestic corporation and can therefore be acquired by U.S. persons free of the tax. The exemption also applies to new shares of the same class (issued after November 10, 1964) if specified requirements are met.

Under one of these requirements (sec. 4920(b)(2)(D)(v)) the corporation issuing the additional shares must, at least 15 days before the day the additional shares are issued, file a notice with the Secretary or his delegate indicating its intent to issue the additional shares. The House was advised that in several situations, through inadvertence, the 15-day notice has not been filed as required. The result of this omission under present law is that the additional stock is not treated as stock of a domestic corporation with the result that its acquisition by a U.S. person is subject to the tax.

In situations where the failure to meet the notification requirement is inadvertent, the committee agrees with the House that making the additional shares ineligible for exempt treatment is too harsh. The bill provides, therefore, that the Secretary or his delegate may waive the 15-day requirement, upon application by the issuing corporation within 2 years after the additional shares were issued, if it is shown by the issuing corporation that the failure to file the required notice was due to inadvertence and was not done with an intent to avoid any requirement of the interest equalization tax.

This amendment is to take effect on the date of enactment of the bill. The House bill also provided that, if in the case of a corporation which previously issued additional shares and failed to meet the 15-day notice requirement, more than 2 years had elapsed since the date on which the notice should have been given, the Treasury Department could nevertheless waive the notice requirement if the issuing corporation applied to the Treasury Department within 60 days after the date of enactment of the bill. The committee has clarified the application of this provision to insure that a corporation which previously issued additional shares has at least 60 days after the date of enactment of the bill to apply for a waiver of the 15-day rule, regardless of whether the 2-year period expired before or after the enactment of the bill. It provided that if the 2-year period after the issuance of the shares (during which application for a waiver can be made) elapsed or elapses prior to 60 days after the enactment of the bill, the issuing corporation may apply for a waiver of the rule within the 60-day period following the enactment of the bill.

9. Treatment of mutual funds investing abroad (sec. 3(h) of the bill and sec. 4920 of the code)

Under present law acquisitions of foreign securities by a U.S. person generally are subject to the tax even though the purchases are made with funds previously invested in foreign securities. This provision generally applies to acquisitions of foreign securities by mutual funds for their investors as well as where investors directly acquire the foreign securities. In the case of a mutual fund formed toac quire foreign securities, the tax also applies to the acquisition of the mutual fund shares by its shareholder. However, when the mutual fund uses these funds to acquire foreign securities, the tax which has already been paid by the investor is allowed as a credit against the tax due

when the mutual fund acquires foreign securities. (The credit is available in this case only for the first investment by the mutual fund. Subsequent investments or "roll-overs" are subject to tax with no credit.)

While the treatment described above is the generally applicable treatment, present law provides an exception for certain mutual funds established to acquire foreign securities before July 18, 1963, the initial effective date of the interest equalization tax. Under this provision an exemption is provided for a mutual fund which on July 18, 1963 (and at the end of every quarter thereafter) had at least 80 percent of its stock and debt holdings invested in foreign stock or debt obligations and which elected to be exempt from tax. In such a case, although the tax continues to apply to investments of shareholders in the mutual fund, it does not apply to investments of the fund in foreign securities (or to subsequent roll-overs of these investments).

While the exception for mutual funds holding foreign securities was initially added to the law in order not to disturb existing arrangements at the time the interest equalization tax first went into effect, the committee has had called to its attention the fact that this gives mutual funds which qualify under this provision continuing advantages over prospective new mutual funds. As a result new mutual funds have requested similar treatment. The committee agrees that the pre-July 18, 1963, mutual funds have under present law a significant competitive advantage and that the continuation of this advantage is unwarranted. However, rather than provide additional exceptions to the interest equalization tax for purchases of foreign securities by new mutual funds, the committee concluded that it would be better to withdraw the advantage of the pre-July 18, 1963, mutual funds with respect to new investments.

The committee also is concerned that the existing exemption for pre-July 18, 1963, mutual funds continues in effect under present law even if the fund does not, in fact, remain mutual in character. For example, the exemption would continue even though a significant interest (for example, 15 percent) in the fund was acquired and owned by one person. The committee does not believe that it is appropriate to continue the exemption for one of these funds where there is a loss of mutuality to this extent.

Accordingly, the committee has added an amendment to the House bill to deal with these two problems. The amendment provides that qualifying mutual funds are to be taxable on their acquisitions of foreign securities which are attributable to funds obtained either by borrowing or through the issuance of stock by the mutual fund after March 24, 1971. This treatment is to apply to the first acquisition of foreign securities made by the fund with the new capital (debt or equity) as well as to any subsequent taxable acquisitions of foreign securities (i.e., rollover transactions) which are attributable to the new capital. The acquisitions by a fund which are considered to be attributable to new capital are to be determined under regulations promulgated by the Secretary or his delegate. It is intended that if a mutual fund purchases foreign securities "on margin" the acquisition is not to be considered as attributable to new borrowed funds, if a minimal borrowing is involved and if the amount of the credit extended to the fund is consistent with that extended in connection with previous purchases by the fund of foreign securities "on margin."

The amendment also provides for the termination of the special exemption if, at the close of any calendar quarter, 15 percent or more in value of the outstanding stock of a mutual funds is owned, directly or indirectly, by one person. In such a case, the election to be exempt from the tax is to be considered revoked with respect to all subsequent calendar quarters. Thus, acquisitions of foreign securities by the fund in any such subsequent calendar quarter would be subject to the tax. Once an election is revoked, no further election under the special exemption accorded pre-July 18, 1963 mutual funds may be made.

The amendment relating to acquisitions of foreign securities with new capital is to apply with respect to acquisitions made after March 24, 1971. The amendment relating to the termination of the exemption if more than 15 percent of the stock of the mutual fund is acquired by one person is to take effect on the date of enactment of the bill.

10. Debt obligations with maturities of less than a year (sec. 3(i) of the bill and sec. 4921 of the code).—Under present law, the acquisition of a debt obligation which has a maturity of less than one year is not subject to the tax. As explained in the prior part of this report, "Reasons for the bill," the committee has concluded that it is desirable to provide the President with authority to apply the tax to acquisitions of debt obligations with maturities of less than one year where he determines that this is desirable, considering economic objectives.

As a result, the committee has added an amendment to the House bill which provides that, if the President, after taking into account domestic economic objectives, balance-of-payments objectives, and other international economic objectives of the United States, determines that it is desirable to apply the tax to debt obligations with a maturity of less than one year, he may do so by Executive order.

An Executive order issued pursuant to this provision may apply the tax with respect to all debt obligations having maturities of less than one year or with respect to a classification of these obligations which is determined in accordance with specified factors. These criteria are the type of obligation, the period remaining to maturity of the obligation, the category of the obligee, the category of the obligor, the aggregate amount either subject to tax or not subject to tax, or other similar criteria. For example, it could be provided that the tax would apply to debt obligations with maturity periods of from 6 months to one year, but not to those with maturity periods of under six months. In addition, an Executive order issued under this provision is to apply for such time as the order specifies and it may be modified or terminated by a subsequent Executive order.

If the tax is applied to short-term debt obligations under this provision, the rate of the tax may not exceed that generally applicable to debt obligations with a maturity of from one to 1¼ years (which presently is 0.79 percent). An Executive order may provide a flat rate of tax (limited in the manner described) for all obligations with a maturity of less than one year to which the tax is made applicable or it may provide a sliding scale of rates based on the relative period to maturity of the obligations.

Generally, an Executive order issued under this provision is to apply to acquisitions made after the date of issuance of the order. It is provided, however, that an Executive order which either subjects to the tax previously nontaxable acquisitions, or which increases the rate of tax on acquisitions, may provide transition rules which are similar

to those which were provided in the Interest Equalization Tax Extension Act of 1967 in connection with an increase in the rate of the tax. Generally, these rules relate to situations where an acquisition is made pursuant to a pre-existing commitment or pursuant to a transaction undertaken before the issuance of the order.

The Secretary or his delegate is given the authority to prescribe regulations which are necessary to carry out the provisions of this section to the extent they are not inconsistent with the section or any prior Executive order which is in effect.

11. Penalty for failure to file quarterly return or remit tax (sec. 3(j) of the bill and sec. 6651 of the code).—Present law imposes reporting and withholding requirements on participating firms (broker-dealers agreeing to comply with prescribed recordkeeping and reporting requirements) with respect to sales effected by them where the purchaser is seeking exempt status for the transaction on the grounds of prior American ownership.

Although present law provides a penalty for failure to file a return where reporting requirements for certain members (nonparticipating firms) of exchanges and associations are not met, there is no penalty, in such situations for the failure of a participating firm to comply with the reporting and withholding requirements prescribed as to sales made in connection with exempt acquisitions. Due to the importance of these filing and reporting requirements to the proper administration of the tax, the committee agrees with the House that the failure to file the return required, or to remit the tax, should be made subject to the same civil penalty presently applicable in the case of other taxes, including the income tax. The bill provides, therefore, that the general delinquency penalty, which is applicable unless it is shown that the failure to file (or failure to remit) "is due to reasonable cause and not due to willful neglect" is to apply to the reporting and withholding requirements imposed on participating firms.

Under the bill, therefore, the failure to file the return will (unless it is shown that such failure is due to reasonable cause and not due to willful neglect) subject the firm on whom the filing responsibility is imposed, to a penalty equal to 5 percent of the amount of the tax due if the failure is not for more than one month, with an additional 5 percent for each additional month during which the failure continues, not exceeding a total of 25 percent. Also, if there is a failure to remit the amount withheld, a penalty may be imposed upon the firm failing to pay or remit the tax equal to 0.5 percent of the amount of the tax if the failure is not for more than one month with an additional 0.5 percent for each additional month the failure continues, not exceeding a total of 25 percent. (However, the two penalties do not apply to the same case for the same month).

The bill as passed by the House also specifically provided that this penalty was to apply to the failure of a U.S. person generally (i.e., a customer) to file an interest equalization tax return and to pay the tax. Since the failure to file or failure to pay in this instance presently is subject to this penalty, there is no need to alter present law in this respect.

This amendment is to apply with respect to returns required to be filed, and taxes required to be paid (or remitted), after the date of enactment of the bill.

12. Elimination of knowledge requirement regarding filing of false interest equalization tax certificates (sec. 3(k) of the bill and sec. 6681 of the code).—Present law, which exempts from tax those acquisitions of foreign securities which are made from another American person, provides several methods whereby the exemption can be established by an American who purchases foreign securities. As part of these methods a person may execute a statement as to his status as a U.S. person and ownership of stock and debt obligations.

Present law also sets forth procedures under which a participating firm (a broker-dealer complying with the documentation and auditing requirements prescribed by the Secretary or his delegate) which acquires foreign securities for a customer may furnish a clean confirmation to the customer for the purpose of establishing prior American ownership and compliance and, if the participating firm acts as the selling broker of foreign securities, it may give the buying broker a written comparison (or broker-dealer confirmation) which indicates that the securities qualify for the exemption. Further, a participating custodian (a trust company or bank which agrees to comply with the documentation and auditing requirements prescribed) may issue a transfer of custody certificate which enables U.S. persons owning such transferred securities to sell them under the exemption without the necessity of obtaining a validation certificate from the Revenue Service.

Although present law imposes a penalty, equal to 125 percent of the tax, upon persons filing false certificates of American status or furnishing false confirmation or comparison certificates, the penalty is only applicable if the false filing or furnishing was "knowingly" committed. The House was informed that in several situations the Treasury Department has been unable to assert the penalty in situations where false interest equalization tax certificates have been filed or furnished because of an inability to show that the violation was "knowingly" committed.

Because of the importance of the various forms of certificates to the administration of the interest equalization tax, the committee agrees with the House that the penalty (which is designed to enable the Government to collect the tax which was lost by reason of the false certificate plus an additional amount to discourage persons from executing false certificates) should apply where the false certificate is issued without reasonable cause as well as where it is issued knowingly. This will place a greater responsibility upon those issuing certificates of this nature in the course of their business.

For the reasons given above, the bill provides for the imposition of the applicable penalty "unless it is shown that such action is due to reasonable cause and not due to willful neglect." This change does not alter the basic character of the penalty imposed by present law as an assessable civil penalty. A person who wishes to avoid imposition of the penalty must make an affirmative showing of the facts alleged as reasonable cause for the filing of the false certificate.

This amendment is to be effective with respect to statements executed, documents furnished, transfer of custody certificates issued, and violations of the rules of an exchange or association occurring after the date of enactment of the bill.

IV. PROBLEMS WHICH CAN BE DEALT WITH ADMINISTRATIVELY

A number of problems were presented to the House for modifications of the tax which the Treasury Department has indicated it can deal with administratively.

1. Industry insurance companies.—Two of the problems presented involve the treatment of certain amounts paid to a foreign company performing an insurance function for a specific industry. One case involves an insurance company which is wholly owned by air carriers (U.S. and foreign) and which is exclusively engaged in the business of providing hull and liability insurance to air carriers. The other case involves a company formed by domestic and foreign oil companies to cover liability for pollution damages arising from oil spills from tankers. Generally two types of payments would be made by the U.S. persons involved to these insurance companies: (1) amounts representing the initial capital of the insurance company, and (2) periodic premium payments to cover claims and expenses of the company.

Concern was expressed that the periodic premium payments of this type might be considered as loans which are subject to the interest equalization tax because they are labeled assessments or additional premium guarantees. The Treasury Department has indicated that it will treat these periodic payments to these insurance type companies as premium payments and not loans which are subject to the tax.

2. Acquisitions required under foreign law.—Under present law an exclusion from the tax is provided for stock or debt obligations which a U.S. person acquires because of requirements imposed by the laws of a foreign country in which it is doing business. Concern was expressed as to whether this exclusion would apply in situations where the acquisition is required by an administrative practice of the foreign country or an informal requirement imposed by the foreign country. For example, a foreign country might informally advise a person doing business in the country that a loan of a certain amount of the profits it earned in that country to a pollution control agency would be necessary if the person were to be allowed to continue carrying on business in the country. Another example would be a situation where a company, in order to continue doing business in a foreign country, is required to sell an ownership interest in a plant facility of the company located in that country to the government of the country and to accept in payment for the interest a debt obligation of that government. The Treasury Department has indicated that it believes it is clear the exclusion provided in present law comprehends situations where the investment is required by an informal administrative practice or requirement of the foreign country as well as where it is required by the statutory law of the country and will so clarify its position.

3. Less developed country investment.—Present law provides an exclusion from the tax for acquisitions of stock or debt obligations of less developed country corporations. A company cannot qualify as one type of less developed country corporation unless at least 80 percent of its income is derived from less developed country sources. It was suggested that for purposes of this rule interest on deposits in a less developed country branch of a U.S. (or other developed country) bank should be treated as from sources within a less developed country.

Since the statute itself does not specify the source rules which are applicable for purposes of this exclusion, the Treasury Department indicated that it would change the source rule in its regulations in the suggested manner. It may be noted that the suggested source rule conforms to that which is presently provided in the case of the income tax.

4. Debt obligations acquired by commercial banks in ordinary course of business.—Under present law, debt obligations arising from loans made by a foreign branch of a commercial bank in the ordinary course of its commercial banking business are not subject to the tax.

In order to allow foreign branches of U.S. banks to compete more effectively with foreign banks which may acquire newer forms of foreign investments, such as floating rate Euro-dollar notes, it was suggested to the House that the requirement that the loans be made in the ordinary course of a commercial banking business either be eliminated or liberalized. The Treasury Department has indicated to the House that it was willing to clarify the types of loans which would be considered as made in the ordinary course of the commercial banking business to include floating rate notes if the following conditions were met:

(*a*) The notes have maturities of 10 years or less.

(*b*) The notes are not convertible.

(*c*) Subject to limited exceptions, the notes are acquired as part of an original or new issue.

(*d*) The notes and their acquisition by a commercial bank are consistent with local foreign banking practice.

(*e*) The acquisitiou of the notes is subsidiary to the regular business of the foreign banking branch.

It was suggested to the committee that allowing this treatment only in the case of notes acquired as part of an original or new issue was unduly restrictive because it prohibited foreign branches of U.S. banks from buying and selling previously issued notes (i.e., it eliminated dealing in what is referred to as the "after" market). In light of this suggestion, the Treasury Department has advised the committee that it is willing to treat acquisitions of floating-rate notes as made in the ordinary course of a commercial banking business in the additional situation where the notes are acquired in the "after" market either from a U.S. bank, or from a foreign bank if the note has been held by banks since it was originally issued.

5. Adjustment to basis for interest equalization tax.—A question has arisen as to whether the interest equalization tax paid on the acquisition of foreign stock or debt obligations, including stock obtained pursuant to options, may be capitalized and treated as part of the amount paid for the stock or debt obligations. The Treasury Department has informed the committee that amounts paid as interest equalization tax, to the extent they are not deductible, are properly capitalized and treated as part of the cost of the stock or debt obligation, including stock obtained pursuant to options, with respect to which the tax was imposed. Generally under present law, amounts paid as interest equalization tax are not deductible. There are limited situations, however, in which the tax is deductible; namely, where the person paying the tax received a reimbursement for the tax which was included in gross income and where the amount paid as tax creates amortizable bond premium (within the meaning of section 171(b) of the code).

V. EFFECT ON THE REVENUES OF THE BILL

In compliance with section 252(a) of the Legislative Reorganization Act of 1970, the following statement is made relative to the effect on the revenues of the bill. The committee estimates that the extension of the interest equalization tax for two more years (and the related minor amendments) provided by the bill will increase revenues by approximately $85 million a year. The Treasury Department agrees with this statement.

VI. 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).