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INTEREST EQUALIZATION TAX EXTENSION ACT OF 1973

MARCH 22, 1973.—Ordered to be printed

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

REPORT

[To accompany H.R. 3577]

The Committee on Finance, to which was referred the bill (H.R. 3577) 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. 3577, as agreed to by the committee, extends the interest equalization tax for 2 years or until April 1, 1975. (The House-passed bill extends the tax for 15 months, until July 1, 1974.) The tax otherwise would expire on March 31, 1973. The House-passed bill also provides for several minor modifications of the tax. The committee has accepted these with slight modifications and has adopted additional minor modifications 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 percentage 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 depending on his view of what is desirable from the standpoint of our balance-of-payments objectives.

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 on Finance is in agreement with the House that the tax should be extended. However, because of the recent changes in the international monetary system, the committee concluded that an extension of the interest equalization tax for an additional 24-month period is necessary.

The committee agrees with the three minor modications in the existing provisions of the tax contained in the House bill. The committee has also made an additional minor modification not contained in the bill as passed by the House, as well as several minor technical amendments. These features of the bill, as modified by the committee, can be summarized as follows:

(1) Present law contains a procedure which enables domestic corporations and partnerships to obtain foreign funds for use of their foreign affiliates in a manner which complies with the restrictions on foreign investment imposed by the Office of Foreign Direct Investment in the Commerce Department. Under the procedure, the domestic company or partnership elects to treat such an issue of debt as subject to the interest equalization tax. Where this procedure is elected under present law, the flat 30-percent (or a lower rate imposed by treaty) U.S. tax (generally imposed on interest and other payments by U.S. persons to foreign persons) does not apply to interest payments on debt where the election referred to above has been made and certain other conditions are met. The committee has retained the provision in the House bill which provides that in the case of debt where this election has been made and certain other conditions are met, the value of the debt is not to be included in the U.S. estate tax base of the nonresident alien holder of the debt. The U.S. estate tax base of U.S. citizens or residents remains unaffected by this provision.

(2) Under present law, the interest equalization tax does not apply to the acquisition by a U.S. person of stock or debt obligations of a less developed country corporation. Among the foreign corporations which qualify as less developed country corporations are corporations which derive substantially all of their income from the operation of ships or aircraft registered in a less developed country and whose stock is substantially owned by U.S. persons or residents of less developed countries. The House bill, which the committee in general approves, provides that this exclusion is to no longer apply to the acquisition of stock on debt obligations of less developed country shipping corporations. The committee also retains the House effective date provision which provides for the continuation of this exclusion generally where transactions involving ships were in an advanced stage of completion prior to January 30, 1973, the date on which this provision generally ceases to apply. However, the committee also provides for the continuation of the exclusion in certain other types of transactions which were also in an advanced stage of completion prior to January 30, 1973, but which were not covered by the House bill. The less developed country exemption will generally

continue to be applicable to nonshipping corporations which have significant operations within those countries.

(3) Under present law, foreign issuers or obligors generally must use foreign source funds to invest in the United States because their stock or debt obligations are subject to the interest equalization tax if acquired by U.S. persons. In order to encourage foreign direct investment in the United States, which provides jobs for American workers, the House bill provides for an exclusion from the interest equalization tax for the acquisition of new or original issues of stock or debt obligations for new or additional direct investments in the United States. However, for his stock or debt obligations to be eligible for the exclusion, a foreign issuer or obligor must satisfy the Treasury Department that he will meet certain requirements. Among these conditions are the requirement that at least 50 percent of the funds for the direct investment in the United States will come from foreign sources; second, that the investment will be for a minimum of a 10-year period; third, that during the 10-year period of the required investment no other investment in U.S. assets will be decreased; fourth, during the 10-year period, the issuer will comply with other conditions and requirements prescribed by the Treasury Department and made applicable to him; and fifth, during the 10-year period, the issuer will submit reports to the Treasury Department detailing such information as is necessary in order to substantiate that fact that the investor is complying with his commitment to make the direct investment. The committee accepted the House provision with minor technical changes.

(4) Under present law, the interest equalization tax does not apply to certain acquisitions of debt obligations arising from the sale or lease of U.S.-made property or the performance of services by a U.S. person. This exception from the interest equalization tax is generally available to debt obligations which are (1) guaranteed by the Export-Import Bank of the United States, (2) acquired by exporters who produce or sell U.S.-made property in the ordinary course of their trade or business, and (3) acquired by a commercial bank if it is an export loan. The committee's bill expands this exemption for export credit transactions to cover acquisitions by any U.S. person of a foreign debt obligation acquired in connection with the sale or lease of U.S.-made property or the performance of services by a U.S. person were reasonably necessary to accomplish the sale or lease.

The Treasury Department favors the enactment of this bill.

II. REASONS FOR THE BILL

The committee concluded 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 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 $14,076 million in the years 1950 through 1972.

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 1950–72

[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	−3,676	−3,403	−1,703
1961	−2,251	−1,348	−857
1962	−2,864	−2,650	−890
1963	−2,713	−1,934	−461
1964	−2,696	−1,534	−125
1965	−2,477	−1,289	−1,665
1966	−2,151	219	−571
1967	−4,683	−3,418	−1,170
1968	−1,610	1,641	−1,173
1969	−6,122	2,702	967
1970	−3,851	−9,839	−787
1971	[2] −22,002	−29,765	−866
1972	−13,779	−10,112	281

[1] No officially published figures on this basis available for years prior to 1960.
[2] First three quarters on a seasonally adjusted annual rate basis.

Source: Economic Report of the President, 1973, table C–87 and C–92 and Survey of Current Business.

Trends in balance of payments

Measured on a liquidity basis,[1] the deficit for an extended period of years was declining. More recently although there have been variations, the trend is toward increasing deficits. The deficit fell from an average of $3.7 billion in the period 1958 through 1960 to an average of $2.6 billion in the period 1961 through 1964. In 1965 and 1966, the deficit declined still further to an average of $2.3 billion. In 1967 it increased to $4.7 billion, but this was followed by a deficit of $1.6 billion in 1968. Then, in 1969, the deficit was back up to $6 billion, and for 1970 the deficit was $3.9 billion. In 1971 the deficit increased to $22 billion and in 1972 it was $13.8 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 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 $3.8 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, and the U.S. gold tranche position in the International Monetary Fund.

TABLE 2.—BALANCE OF PAYMENTS SUMMARY TABLE, 1961-72

[In millions of dollars]

	1961-65 Average	1966	1967	1968	1969	1970	1971	1972
Merchandise:								
Exports	23,011	29,287	30,638	33,576	36,417	41,963	42,770	48,840
Imports	17,578	25,463	26,821	32,964	35,796	39,799	45,459	55,656
Balance	5,433	3,824	3,817	612	621	2,164	−2,689	−6,816
Military transactions, investment incomes, other services and remittances, net	218	366	43	612	−12	−76	1,888	1,040
Balance on current account excluding government grants	5,652	4,190	3,858	1,223	610	2,089	−802	−5,776
Government grants and capital, net	−3,042	−3,379	−4,226	−3,866	−3,570	−3,752	−4,423	−3,575
Private long-term capital:[1]								
U.S. assets abroad	−3,631	−3,918	−4,429	−4,297	−4,855	−5,753	−6,348	−5,427
Foreign assets in the United States	193	1,363	1,517	5,495	4,805	4,355	2,268	5,534
Balance	−3,438	−2,555	−2,912	1,198	−50	−1,398	−4,079	107
Current and long-term capital accounts, net	−828	−1,744	−3,280	−1,444	−3,011	−3,059	−9,304	−9,243
Short-term non-liquid capital, net	−924	−104	−522	230	−640	−482	−2,386	−1,634
Errors and omissions	−848	−302	−881	−399	−2,470	−1,174	−11,031	−3,806
Net liquidity balance (excluding SDR allocations)	−2,600	−2,151	−4,683	−1,610	−6,122	−4,718	−22,719	−14,684
Transactions in liquid funds other than those of official reserve agencies, net	849	2,370	1,265	3,251	8,824	−5,988	−7,763	3,677
Official reserve transactions balance (excluding SDR allocations)	−1,751	219	−3,418	1,641	2,702	−10,706	−30,482	−11,007

[1] For detail see table 3.

Note: Table 1 deficit figures after 1969 are slightly lower because they include allocations of SDRs (Special Drawing Rights) and table 2 figures do not.

Source: U.S. Department of Commerce, "Survey of Current Business," December, 1972 and earlier issues.

In 1968, the trade balance declined more rapidly to about $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. In 1971, however, there was a trade deficit of $2.7 billion, the first such deficit since 1888. In 1972 the deficit increased further to almost $7 billion. This resulted primarily from a rapid increase of imports ($10 billion) because of the rapid growth of the U.S. economy and the increase of dollar import costs due to the exchange rate change in December 1971. Exports grew more slowly in large measure due to the slower rate of growth in the other major industrialized countries. The balance of trade figures presented above are on an "f.o.b." basis which does not include the cost of transportation and insurance. On a "c.i.f." basis, which takes these costs into account, the balance of trade deficit was $14.5 billion in 1972 and on this basis we have had a trade deficit since 1966. The balance of trade figures from 1960 through 1972 on both an "f.o.b." and "c.i.f." basis are shown in table 3.

TABLE 3.—U.S. TRADE AND BALANCE-OF-PAYMENTS DEFICITS, 1960–72

[In billions of dollars]

	U.S. trade position				Trade balance		Balance of payments		
	Exports (X)		Imports (M)						
	Total	Minus foreign aid	F.o.b.	C.i.f.[1]	F.o.b.	C.i.f. (M) excluding foreign aid (X)	Liquidity[2]	Official settlements	Basic balance
1960	19.6	18.0	14.7	16.2	4.9	1.8	−3.7	−3.4	
1961	20.2	18.5	14.5	16.0	5.7	2.5	−2.3	−1.3	
1962	21.0	18.9	16.2	18.0	4.8	.9	−2.9	−2.7	[3] −0.8
1963	22.4	19.8	17.0	18.6	5.4	1.2	−2.7	−1.9	
1964	25.7	22.9	18.6	20.6	7.1	2.3	−2.7	−1.5	
1965	26.7	24.1	21.5	23.5	5.2	.6	−2.5	−1.3	
1966	29.3	26.7	25.5	28.1	3.8	−1.4	−2.2	.2	−1.7
1967	30.6	28.1	26.8	29.5	3.8	−1.4	−4.7	3.4	−3.3
1968	33.6	30.1	33.0	36.0	.6	−5.9	−1.6	−1.6	−1.4
1969	36.4	35.2	35.8	39.4	.6	−4.2	−6.1	2.7	−3.0
1970	42.0	40.8	39.8	43.8	2.1	−3.0	−3.9	−10.7	−3.1
1971	42.8	40.8	45.5	50.1	−2.7	−9.3	−22.0	−30.5	−9.3
1972	48.7	46.7	55.6	61.2	−6.9	−14.5	[4] −13.1	−10.1	[4] −10.2

[1] C.i.f. imports are assumed to be roughly equivalent to 110 percent of f.o.b. imports, in accordance with a Tariff Commission study. The actual c.i.f. import values will be published monthly beginning in July 1973.

[2] The liquidity deficit for 1966–72 excludes SDR allocations.

[3] Average.

[4] January–September 1972.

Source: U.S. Department of Commerce, "Survey of Current Business" December 1972 and earlier issues.

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 have been among the more important of these. In addition, the recent devaluation of the dollar (and still more recently the floating of the currencies, relative to the dollar, of Japan and of the European countries) should also contribute to a long-run improvement in our balance of payments by discouraging imports and encouraging exports.

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 4) 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 align 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 short 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 4.—U.S. PRIVATE CAPITAL OUTFLOWS, ALL AREAS, 1962–72

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

	1962	1963 1st half	1963 2d half	1964	1965	1966	1967	1968	1969	1970	1971	1972
Total private outflow	—3, 426	—2, 781	—1, 678	—6, 578	—3, 794	—4, 310	—5, 655	—5, 383	—5, 424	—6, 886	—9, 781	—8, 339
Long term	—2, 881	—2, 314	—1, 359	—4, 431	—4, 547	—3, 895	—4, 446	—4, 296	—4, 856	—5, 753	—6, 348	—5, 427
New foreign security issues	—1, 076	—1, 000	—250	—1, 063	—1, 206	—1, 210	—1, 619	—1, 712	—1, 668	—1, 456	—1, 506	—1, 596
Redemptions	203	93	102	192	222	406	469	546	478	434	480	557
Transactions in foreign outstanding securities	—96	—151	102	194	225	323	—116	—59	—305	80	117	420
Long-term bank claims	—126	—151	—604	—941	—232	337	255	358	317	175	—565	—1, 250
Other long term	—132	3	159	—485	—88	—112	—281	—220	—424	—586	—109	—219
Direct investment [1]	—1, 654	—1, 018	—868	—2, 328	—3, 468	—3, 639	—3, 154	—3, 209	—3, 254	—4, 400	—4, 765	—3, 339
Short term	—546	—468	—317	—2, 147	753	—415	—1, 209	—1, 087	—569	—1, 132	—3, 434	—2, 912
Bank claims	—324	—325	—456	—1, 524	325	—84	—730	—105	—867	—1, 122	—2, 373	—2, 263
Other short term	—222	—143	139	—623	428	—331	—479	—982	298	—10	1, 061	—649

[1] 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 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.

In 1971, the tax was extended until April 1, 1973, and the President was given discretionary authority to apply the tax to bank loans and other debt obligations with a maturity of less than 1 year. This authority has not yet been exercised.

TABLE 5.—PURCHASES BY U.S. RESIDENTS OF FOREIGN SECURITIES NEWLY ISSUED IN THE UNITED STATES, BY AREA, 1962–72

[In millions of dollars]

	1962	1963 1st half[1]	1963 2d half[1]	1964	1965	1966	1967	1968	1969	1970	1971	January–September 1972[1]
All areas	1,076	1,000	250	1,063	1,206	1,210	1,619	1,712	1,668	1,456	1,506	1,137
IET countries, total	356	343	110	35	147	19	14	45	13	130	3	17
West Europe including United Kingdom	195	219	53	35	95	15		42	11	130		
Japan	101	107	57		52	4	14	3			3	
Other[2]	60	17							3			17
Of which:												
Exempt from IET[3]			[4] 110	20	52	10	14	3		130	3	
Subject to IET				15	95	9		42	14			17
Other countries, total (exempt)	722	656	141	1,027	1,058	1,191	1,605	1,667	1,655	1,326	1,503	1,120
Canada	458	608	85	700	709	922	1,007	957	1,270	775	790	616
Latin America[5]	119	13	23	200	36	68	140	144	32	117	33	54
Other countries	61	35	33	115	134	121	212	176	189	193	304	176
International institutions	84				179	80	246	390	164	241	376	274

[1] Not seasonally adjusted.
[2] Australia, New Zealand, South Africa.
[3] Related to the export, the direct investment, and the Japanese exemptions. The latter for $100 million per year, ran from 1965 to February 1970.
[4] Represents commitments made prior to July 18, 1963, the date of inception of the IET.
[5] Includes Inter-American Development Bank issues.

Source: Department of Commerce, Bureau of Economic Analysis; Department of the Treasury, OASIA.

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 5, fell from a total of $1 billion in the first half of 1963 to $250 million in the second half of that year. Moreover, all the issues sold in the second half of 1963 were exempt from the tax, either because purchase commitments had been made prior to the date the tax went into effect or because the issues originated in countries designated as exempt from the tax.

Since 1963, purchases by U.S. residents of new foreign securities from countries subject to the interest equalization tax have generally declined, to $13 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. In 1971, only $3 million worth of stock was purchased from countries subject to the tax (although these purchases were exempt from the tax). In the first 3 quarters of 1972, $17 million forth of stock subject to the tax was purchased by U.S. residents.

TABLE 6.—NET TRANSACTIONS IN OUTSTANDING FOREIGN SECURITIES BY U.S. RESIDENTS BY AREA, 1962–72

[Net U.S. Purchases (—) in millions of dollars]

	1962	1963		1964	1965	1966	1967	1968	1969	1970	1971	January–September 1972[1]
		1st half[1]	2d half[1]									
All areas	−96	−151	102	194	225	300	−135	−60	−305	80	117	211
IET countries, total	15	−85	85	181	234	222	−111	0	−284	120	145	228
West Europe	−16	−52	54	152	119	149	−96	−33	90	27	16	373
Japan	−23	−25	−4	----------	6	10	−5	6	−292	31	−125	−156
Canada[2]	79	7	30	17	147	68	−8	36	−82	53	247	10
Other[3]	−25	−15	5	12	−30	−5	−2	−9	0	9	7	1
Other countries, total	−13	−6	10	2	−8	26	−36	−74	−51	−53	−23	−24
Latin America[4]	−25	−3	1	−13	−13	2	−13	−72	−65	−64	−23	−18
Other countries	12	−3	9	15	5	24	−23	−2	14	11	0	−6
International institutions	−98	−60	6	11	−3	51	13	16	30	13	−3	7

[1] Not seasonally adjusted.
[2] Excludes Canadian repurchases, undertaken in 1966, 1967 and 1968 for reserve management purposes.
[3] Australia, New Zealand, South Africa
[4] 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 data show net purchases (or sales) whereas the IET applies to gross purchases. Detail may not add to total due to rounding.

Source: Department of Commerce, Bureau of Economic Analysis.

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 $17 million in the absence of the tax. If purchases from these countries had increased in 1971 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 (108 percent), the 1971 level would have been $740 million, which would represent almost a 50-percent increase in the total amount of new foreign securities purchased by U.S. residents in 1971.

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 6. 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 $61 million a year through 1971.

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 $80 million worth of foreign securities. In 1971, U.S. residents were net sellers of $117 million of foreign securities and in the period January through September 1972, they were net sellers of $211 million worth of foreign securities ($274 million on an annual rate basis).

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 4, long-term bank claims against foreigners which rose $126 million in 1962, increased by $755 million in 1963 and by $941 million in 1964. Short-term bank claims increased by $324 million in 1962, by $781 million in 1963 and by $1,524 million in 1964. Following a sharp increase in bank loans to foreigners in the final months of 1964, the President, on February 10, 1965, exercised authority granted him under the Interest Equalization Tax Act and applied the tax to commercial bank loans made to foreigners provided 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. Between 1965 and 1970, the amount of long-term bank claims fell and this, therefore, became a plus factor in our balance of payments. In 1971, however, long-term bank claims increased by $565 million and in 1972 increased by $1,250 million.

While the tax has succeeded in moderating the increase in the outflow of private long-term portfolio capital from the United States, it certainly has not eliminated it. Such investment in 1969 was about the same as during the first 6 months of 1963 (annual rate) immediately before the tax became effective and in 1970 and 1971 was significantly higher, in part due to the increase in direct investment. Direct investment by U.S. firms rose by $2.7 billion between the first half of 1963 (annual rate) and 1971 to a level of $4.8 billion (direct investments are not covered by the tax but are subject to the direct investment regulations). The income from the overseas investments of U.S. individuals and corporations, on the other hand, rose to nearly $9.5 billion in 1971. This is more than twice the 1960 level. The tax, in conjunction with the other programs has succeeded in moderating the rate of overseas investment, however, a result which is 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 $13.8 billion on a liquidity basis in 1972, 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.

It is particularly necessary to avoid a large-scale increase in capital outflows at the present time because our trade account is in deficit and cannot play its traditional role of providing a surplus to offset capital account deficits. Any increase in capital outflows would therefore directly add to our balance-of-payments deficit. The inflation in recent years in the United States has contributed, along with other factors, to the decline in our balance-of-trade surplus by making the price of imports more attractive and discouraging foreigners from buying our higher priced exports.

Extension of the interest equalization tax is also 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 7.

TABLE 7.—COMPARISON OF YIELDS ON UNITED STATES AND SELECTED FOREIGN GOVERNMENT LONG-TERM BONDS[1]

[In percent per annum]

	Yield						Foreign differential (±) over U.S. Treasury bond yield as of—					
	June 1963	December 1971	March 1972	June 1972	September 1972	October 1972	June 1963	December 1971	March 1972	June 1972	September 1972	October 1972
Western Europe (average)	5.05	7.52	7.29	7.49	7.23	7.19	1.05	1.09	1.63	1.90	1.53	1.50
Belgium	4.94	7.17	7.01	7.07	6.93	6.93	.94	1.55	1.35	1.48	1.23	1.24
Denmark	6.54	10.37	10.37	10.45	10.45	10.29	2.54	4.75	4.71	4.86	4.75	4.60
France	5.09	7.65	7.50	7.21	7.16	7.23	1.09	2.03	1.84	1.62	5.62	1.54
Germany	6.10	7.90	7.40	7.90	7.90	8.00	2.10	2.28	1.74	2.31	.22	2.31
Italy	5.38	7.97	7.67	7.25	7.33	NA	1.38	2.35	2.01	1.66	1.63	--------
Netherlands	4.12	7.17	6.47	7.10	6.25	6.42	.12	1.55	.81	1.51	.55	.73
Switzerland	3.15	4.99	4.77	5.06	4.98	5.08	−.85	−.63	−.89	−.53	−.72	−.61
United Kingdom	5.44	8.06	8.03	9.06	9.33	4.26	1.44	2.44	2.37	3.47	3.63	3.57
Norway	4.66	6.43	6.40	6.31	6.24	6.14	.66	.81	.74	.72	.54	.45
Canada	4.89	6.02	6.74	7.24	7.20	6.82	.89	.40	1.08	1.65	1.50	1.13
U.S. Treasury bonds	4.00	5.62	5.66	5.59	5.70	5.69	--------	--------	--------	--------	--------	--------

[1] Average yields to maturity on issues with at least 12 years' life.

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 7.33 percent in December 1972, the rates in foreign countries ranged from a low of 5.47 percent for Switzerland to a high of 10.40 in the United Kingdom with the rate for France and Germany at 8.30 and 8.58 respectively as shown in table 8. 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 leads 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 reduced, 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 outstanding volume of these issues, some of which are convertible into stock, is estimated to be $15.2 billion as of 1972. 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 8.—AVERAGE LONG-TERM INTEREST YIELDS ON OUTSTANDING STRAIGHT DEBT ISSUES FOR UNITED STATES AND SELECTED FOREIGN COUNTRIES

	Yields on outstanding issues		
	December 1970	December 1971	December 1972
Corporate issues[1] (in domestic markets):			
United States	7.90	7.30	7.33
Canada	8.83	8.24	8.15
France	8.83	8.69	8.30
Germany	7.77	7.59	8.58
Italy	9.74	8.46	8.67
Japan	9.20	7.38	6.75
Sweden	7.48	7.22	7.28
United Kingdom	10.84	9.19	10.40
Switzerland (in international markets)	6.09	5.42	5.47
United States	8.27	7.77	7.62
European	8.61	8.05	7.91
Foreign government issues:			
In international market	8.23	7.95	7.65
Canada in Canadian market	6.99	6.56	7.12
10 Western European countries in their markets (average)	7.58	7.27	7.28

[1] For the U.S., yields are those reflected by Morgan Guarantee index of A a utility bonds; for other countries yields are for industrial issues.

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

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 view of the pending review of international trade barriers, international cooperation is essential.

The Treasury Department has expressed the view that the recent "floating" of the dollar and other currencies should, in conjunction with negotiations on trade barriers, improve our balance of trade and overall balance of payments sufficiently so that the tax and companion measures will no longer be necessary after the end of 1974. The Treasury Department concluded an extension of the tax at this time is necessary, however, to avoid large capital outflows before the currency "float" and trade negotiations have an opportunity to correct the underlying imbalance. Moreover, removal of the tax at this time could undermine the pending trade negotiations with our major trading partners who would regard removal as premature and indicative of insufficient concern about our balance-of-payments deficits. The committee, by extending the tax until April 1975, will have an opportunity to determine whether it is in the best interests of the country to let the tax expire at that time or whether it should be further extended.

Temporary 2-year extension provided

In view of these considerations, the committee's bill provides for a two-year extension of the interest equalization tax from March 31, 1973, to April 1975.

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 April 1, 1973. The House has extended the application of this tax for a period of 15-months, or until July 1, 1974. 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. However, for the reasons indicated above, the committee has amended the House bill to provide a 2-year extension.

2. Estate taxation of debt held by foreign persons where interest equalization tax applies (sec. 3(a) of the bill and sec. 2104(c) of the code)

Present law contains a procedure which is designed to enable domestic companies and partnerships to directly obtain foreign funds for their foreign affiliates in a manner which complies with the restrictions on foreign investment imposed by the Office of Foreign Direct

Investment in the Commerce Department. This procedure allows a domestic company or partnership to elect (under sec. 4912(c)) to treat an issue of its debt which is issued to foreign persons as subject to the interest equalization tax if acquired by a U.S. person. This provides assurance that the obligations issued by the domestic company or partnership in connection with the foreign borrowing will not be acquired by U.S. persons and thus provides the necessary assurance for the foreign direct investment program that the funds obtained from the foreign borrowing will not be indirectly replaced by U.S. funds.

This procedure, which was adopted in the Interest Equalization Tax Extension Act of 1971, was in large part designed to allow domestic companies and partnerships to obtain these foreign funds directly rather than having to utilize foreign subsidiaries [1] for this purpose as had been done in the past. Since foreigners supplying funds to foreign corporations would not be subject to the flat 30-percent (or a lower rate imposed by treaty) U.S. tax on the interest income involved (generally imposed on interest paid by U.S. residents to foreign persons), Congress decided not to apply this tax to the interest paid on debt subject to the new interest equalization tax election (provided the debt has a maturity of not more than 15 years and was originally purchased by underwriters with a view to distribution through resale). In the absence of this exemption, the new procedure would not have provided a viable alternative to the past practice of using foreign subsidiaries to obtain the foreign funds, since the domestic debt issued under the new procedure would have been subject to the 30-percent withholding tax but the debt issue by the foreign subsidiaries would not have been. In the absence of this provision, therefore, it would have been substantially more attractive to foreign investors to purchase the debt obligations from foreign corporations.

At the time the new procedure was adopted in the Interest Equalization Tax Extension Act of 1971, another difference in the treatment of debt issued by a domestic company to a foreign person and debt issued by a foreign subsidiary—namely, the applicability of the U.S. estate tax to nonresident alien decedents for debt issued by the domestic company but not to debt issued by the foreign subsidiary—was not dealt with. It was then thought that this difference would not appreciably affect the marketability of debt issued by a domestic company under the new procedure. However, experience since that time has proved this was not the case. The potential applicability of the U.S. nonresident alien decedent estate tax to the debt of a domestic company apparently has made debt issued under the new procedure unattractive to many foreign investors and, this, in turn, has substantially impaired the workability and effectiveness of the new procedure.

To correct this shortcoming in the new procedure and attain the intended objectives of the new procedure, the provisions of the House bill, with which the committee agrees (with one exception noted below), provide an exemption from the U.S. estate tax imposed on nonresident alien individuals for debt obligations issued by a

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[1] Under present law, it is also possible to use for this purpose domestic financing corporations which have 80 percent or more of their gross income from sources without the United States. References hereafter to foreign subsidiaries are intended to include these domestic financing companies.

domestic company or partnership under the new interest equalization tax election procedure (secs. 861(a)(1)(G) and 4912(c)). The bill achieves this result by providing (in sec. 2104(c)) that obligations are to be treated as situated outside the United States (and thus are not subject to U.S. estate tax) when they are held by a nonresident alien individual and the election referred to above has been made. This result is to remain unaffected regardless of the rate of the interest equalization tax. This will provide these debt obligations with the same U.S. income and estate tax attributes as bonds issued by a foreign subsidiary and should make them equally attractive to foreign investors from this standpoint. The U.S. estate tax base of U.S. citizens and residents remains unaffected by this provision. This amendment is generally to apply with respect to estates of decedents dying on or after January 1, 1973.

The House provision, in addition to applying to debt obligations issued from 1973 on, also would apply to debt obligations that were issued before 1973, including debt obligations of foreign financing subsidiaries which are assumed by its U.S. parent. This assumption rule would permit foreign financing subsidiaries to reincorporate in the United States in order to avoid existing foreign income taxes.

However, the committee concluded that if this provision were to be allowed to go into effect immediately, it might have an adverse impact on the budgets of small countries where U.S. corporations have organized foreign financing subsidiaries. Therefore, the committee postponed the effective date of this provision for one year, or until January 1, 1974, but only in the case of assumptions of debt obligations of foreign financing subsidiaries in the period from January 1, 1973 to January 1, 1974.

3. Shipping companies in less developed countries (sec. 3 (b) and (c) of the bill and sec. 4916 of the code)

Under present law, the interest equalization tax does not apply to the acquisition by a U.S. person of stock or debt obligations of a less developed country corporation. Among the foreign corporations which qualify as less developed country corporations are corporations which derive substantially all of their income from the operation of ships or aircraft registered in a less developed country and whose stock is substantially owned by U.S. persons or residents of less developed countries.

The less developed country exclusion is designed to avoid cutting down the flow of private capital to those nations with chronic capital shortages, urgent development needs, and limited capability for foreign borrowing on normal commercial terms. The Congress has previously recognized that the United States has long had a responsibility for assisting these nations in their struggle to achieve improved standards of living, and therefore recognized that the application of the tax to issues of these countries would work against that objective.

The House concluded, and your committee agrees, that the less developed country exclusion which applies to shipping corporations which derive substantially all of their income from the operation of aircraft or ships registered in those countries and whose stock is substanitally owned by U.S. persons or residents of those countries does not result in significant capital investments in less developed countries. Instead it appears to have merely resulted in the registration of ships in those countries. Furthermore, it appears that this exclusion has also had the effect of encouraging the use of U.S. funds for the construction of ships in other developed countries (not the United States). Therefore, the committee agreed with the provisions of the House bill which provide that this exclusion is no longer to apply to the acquisition of stock or a debt obligation of a less developed country shipping corporation which was issued on or after January 30, 1973. The committee wants to make it clear that the less developed country exemption will generally continue to be applicable to nonshipping corporations which have significant operations within those countries. For example, the acquisition of stock or a debt obligation of a foreign corporation which derives substantially all of its income from the active conduct of a ship building business in a less developed country will generally continue to be exempt from the interest equalization tax.

Preexisting commitments.—The House recognized that there may be preexisting commitments already outstanding on January 29, 1973, under which stock or debt obligations would subsequently be acquired. Therefore, the House bill provides that this exclusion continues to apply to an acquisition made pursuant to an obligation to acquire stock or debt obligations which, on January 29, 1973, was unconditional or was subject only to conditions contained in a formal contract under which partial performance had occurred. The committee concurs with this provision.

Under the House bill, the exclusion also continues to apply to acquisitions as to which on or before January 29, 1973, the acquiring U.S. person, (or, in a case where two or more U.S. persons are qualifying as part of a single transaction, a majority in interest of such persons) had taken every action to signify approval under the procedures ordinarily employed by such person (or persons) in similar transactions and satisfied one of two conditions. Under a committee amendment, a predecessor in interest may also be eligible for the exclusion where he took the actions referred to above.

Under both the House and committee versions of the bill, for this provision to apply the acquiring U.S. person must have satisfied the Treasury Department that he sent or deposited for delivery to the foreign issuer or obligor written evidence of such approval in the form of a commitment letter or other signed document setting forth the principal terms of the acquisition, subject only to the execution of formal documents evidencing the acquisition and to customary closing conditions.[1] (Under the committee version of the bill, the foreign issuer or obligor includes a person owning at least 80 percent of each class of stock of the foreign issuer or obligor on the date of the acquisition, or the agent or representative of that person.) In order for the House or committee provision to apply, however, the acquiring U.S. person must have both approved the acquisition and sent or

[1] Any transactions in which a U.S. person purchases from a foreign corporation a ship built outside the United States and leases it back on a bareboat charter to that corporation is subject to U.S. Maritime Administration approval. Maritime Administration approval of such a transaction is an example of a "customary closing condition." Similarly, a contingency of a favorable Internal Revenue Service ruling with respect to the nonapplicability of the interest equalization tax based upon the exclusion for less developed shipping corporations is an example of a "customary closing condition."

deposited the requisite commitment letter or similar document on or before January 29, 1973. In lieu of the first condition described above (relating to the commitment letter), the acquiring U.S. person may establish that he had received from the foreign borrower, prior to January 30, 1973, a memorandum of terms, draft purchase contract, or other document setting forth the principal terms of the acquisition, subject only to the execution of formal documents evidencing the acquisition and to customary closing conditions.

For this exclusion to apply where two or more U.S. persons acquire stock or debt obligations in a single transaction, under both versions of the bill more than 50 percent of the actual value of the stock or debt must have been subject to the commitment letter or other document setting forth the principal terms of acquisition on or before January 29, 1973. A person who entered into a short sale contract on or before January 29, 1973, generally will be considered subject to a preexisting commitment because, in effect, such person is unconditionally obligated to make an acquisition to cover the short sale.

Another type of preexisting commitment brought to the attention of the committee involves the situation where it is a normal business practice of some businessmen to give oral rather than written commitments for financing the acquisition of ships (as discussed above, the House bill requires written commitments). As a result, the committee has provided in addition to the present preexisting commitment provisions contained in the House bill, that this exclusion is to continue to apply to an acquisition if it meets three conditions: (1) within 60 days prior to January 30, 1973, a request for a ruling under this exclusion had been filed with the Internal Revenue Service in connection with the transaction; (2) prior to January 30, 1973, the U.S. person financing the transaction (or a majority of the U.S. persons participating in financing the transaction) had approved (or given a commitment to participate in) the transaction, either orally or in writing, subject to customary conditions; and (3) the vessel to be acquired in the transaction is delivered on or before March 1, 1973.

Construction commenced by announcement date.—The committee further amended the bill to provide that the exclusion is to continue to apply to an acquisition of a debt obligation of a less developed country shipping corporation if it was issued in connection with the purchase or lease of a ship if three conditions are met: (1) the construction of the ship was begun on or before January 29, 1973; (2) the acquisition met the requirements of the preexisting commitment provisions of the House bill (described above) except that the acquiring U.S. person must have taken every action to signify approval of the acquisition prior to May 1, 1973 (instead of prior to January 30, 1973); and (3) the contract for the construction of the ship was entered into by the U.S. person, or its related less developed country shipping corporation, which purchases or leases the ship.

Public offering registered by announcement dates.—The House bill, in addition to the commitment letter approach, provides that the exclusion is to continue to apply to an acquisition of the stock or a debt obligation of a less developed country shipping corporation if three conditions are met: (1) a registration statement (within the meaning of the Securities Act of 1933) had been in effect, with respect to the stock or debt obligation acquired, at the time of its issuance; (2) the registration was first filed with the Securities and Exchange Commission on January 29, 1973, or within 90 days before that date; and (3) no amendment was filed with the Securities and Exchange Commission after January 29, 1973, and before the acquisition which had the effect of increasing the number of shares of stock or the aggregate face amount of the debt obligations covered by the registration statement. For purposes of this provision, the committee intends that securities which may be issued without liability for the interest equalization tax because of the application of the public offering provision provided in the House bill and subsequently are resold under another registration statement may be acquired without liability for the tax.

Existing options and foreclosures of existing instruments.—Both the House and the committee versions of the bill also provide that the exemption is to continue to apply to an acquisition of stock of a less developed country shipping corporation pursuant to the exercise of an option or similar right or of a right to convert a debt obligation into stock of the same issuance if the option or right was held on January 29, 1973, by the person making the acquisition or by a decedent from whom the person acquired the right to exercise the option or right by bequest or inheritance or by reason of the decedent's death.

Both versions of the bill further provide that the exclusion is to continue to apply to an acquisition of stock or a debt obligation of a less developed country shipping corporation as a result of a foreclosure by a creditor under the terms of an instrument held by the creditor on January 29, 1973.

4. Exclusion for original or new issues to finance direct investment in the United States (sec. 3(d) of the bill and new secs. 4922 and 6689 of the code)

At the present time, foreign issuers or obligors wishing to make direct investments in the United States cannot raise funds from U.S. persons for such direct investment generally without the U.S. person being subject to the interest equalization tax on the direct investment. The House concluded, and the committee agrees, that this restriction limiting the amount of new capital which the foreign person may raise in the United States in order to make a direct investment here, has the effect of discouraging the foreigner from making the basic investment here.

In view of these circumstances, both versions of the bill provide a procedure under which a foreign person who wishes to make a direct investment in the United States may obtain some of the funds for the direct investment from U.S. persons without subjecting the acquisition (of the foreign person's securities) by the U.S. persons to the interest equalization tax. The House and the committee believes that this exclusion is appropriate, however, only in situations where the funds being raised in the United States will remain as investments in the United States. In addition, for such an exclusion to apply, the House and the committee believe that the foreign source funds to be invested here should be of a type which will result in the creation of new jobs in the United States.

For the reasons given above, the committee is in agreement with the provisions of the House bill which provide that the acquisition of stock or a debt obligation of a foreign issuer or obligor which is part of a new or original issue, issued for the purpose of financing new or additional direct investments in the United States, is not to be subject to the interest equalization tax. However, this exclusion is not to apply unless the foreign issuer or obligor demonstrates to the Treasury Department's satisfaction, prior to the date of the issuance of the stock or debt obligations involved, that certain conditions will be met. This exclusion is to apply only to the first acquisition of the stock or debt obligations. However, generally a subsequent acquisition of these stock or debt obligations would be exempt from the tax, since in most cases, the acquisitions would be eligible for the exemption for prior American ownership and compliance (under sec. 4918).

As explained above, this exclusion, under both versions of the bill, applies to the acquisition of a new issue of stock or debt obligations of a foreign issuer or obligor to finance new or additional investment in the United States. For this purpose, direct investment which is new or additional means an investment which is primarily for land, buildings, and equipment. However, it also includes sufficient capital to operate the business. For instance, direct investment which is new or additional includes the building of a new plant for the purpose of manufacturing in the United States, and, also, sufficient operating capital to run the plant. A new direct investment would also include the purchase of such stock which constitutes not less than 10-percent of the total combined voting power of all classes of stock of a corporation if that purchase was of the authorized but unissued stock or treasury stock of the corporation (for this purpose, purchases of stock from other stockholders is not to be considered a new or additional direct investment). Investments in service industries may qualify. However, not intended to be included is new direct investment for the acquisition and exploitation of natural resources. Furthermore, this term does not include the purchase of capital equipment for use directly or indirectly in a foreign country. Nor does it include any funds invested by, or for the operation of, a stock brokerage house, investment company, or a bank. It is contemplated that the Treasury Department will issue guidelines to more fully define the direct investment which will be considered acceptable under this exclusion. In doing so, it is expected that a major consideration to be taken into account by the Treasury Department is the likelihood that a proposed investment here by a foreigner will create new jobs in the United States. As a result, it is expected that the exclusion generally will be applicable only to new investments with respect to which new jobs are being created in the United States. This, of course, means that the purchase of existing facilities generally will not qualify.

The direct investment may be made directly by the foreign issuer or obligor in such assets as plants, machinery, equipment, and supporting production facilities in the United States, or indirectly by a U.S. corporation (controlled by the foreign issuer or obligor) which will make the capital investment in the above-described assets.

Both the House and committee versions of the bill provide that the foreign issuer or obligor must satisfy the Treasury Department that he will meet certain conditions before the exclusion applies to an acquisition of stock or debt obligations. First, generally, he must establish that at least 50-percent of the funds required for the direct investment in the United States will come from foreign sources. (The committee intends that the 50-percent foreign source funds requirement be applied on an issue-by-issue basis. The U.S. source funds are not applied ratably to all the issues of the foreigner in determining if the test is met.)

Second, he must establish that the investment will be for a minimum of a 10-year period.

Third, the foreign issuer or obligor must establish that during that 10-year period the aggregate amount of all of the foreign investments in the United States made by him will, at no time, be reduced below the aggregate amount of all his direct investment in this country, as determined immediately after the investment to which the exclusion applies. For example, if the foreign issuer or obligor had $1 million invested in the United States immediately before the investment to which the exclusion applies, and he makes an additional investment of $2 million in the United States (of which $500,000 came from U.S. sources under this exemption), that foreign issuer or obligor must maintain at least $2 million of investments at all times in the United States during the 10-year period (the $1 million previous investment, the $500,000 of U.S. source funds, and $500,000 of foreign source funds). Minor reductions in this required amount of aggregate investment may be allowed at the discretion of the Treasury Department if they are of a temporary nature.

Fourth, the foreign issuer or obligor must during the 10-year period comply with all other conditions and requirements the Treasury Department prescribes. For purposes of this requirement, it is contemplated that the Treasury Department may prescribe certain requirements for one foreign issuer or obligor which may not be prescribed with respect to another issuer or obligor. For example, if a foreign issuer or obligor has no significant investment in the United States, he may be required to enter into a bond, deposit funds in special bank accounts in the United States, or purchase special Treasury notes in the amount of the interest equalization tax which would be imposed but for this exclusion. However, it is contemplated that once he has established that he has made such a significant investment, such special requirements as these will no longer be imposed. However, other requirements may continue to be imposed where appropriate.

Fifth, the foreign issuer or obligor must establish that during the 10-year period he will submit to the Treasury Department any reports and information required in order to substantiate compliance by him with the preceding conditions. He must also keep sufficient records in the United States to substantiate compliance. After the foreign issuer or obligor satisfies the Treasury Department that he will meet the conditions described above, the stock or debt obligations may be issued. Any acquisition of these stock or debt obligations as part of a new or original issue is excluded from the interest equalization tax.

The committee, while agreeing with the House provision, has made certain minor technical modifications which are discussed below.

Stock issued without payment of additional consideration upon the conversion of a debt obligation (which itself was acquired without liability for the interest equalization tax by reason of the exclusion for original or new issues to finance direct investment in the United States) may also be acquired without liability for the tax. However, stock issued upon the exercise of a warrant is considered as an issue of new stock and must meet all of the requirements of this provision of the House bill.

A debt obligation issued for the purpose of refunding or refinancing a debt obligation which was eligible for this exclusion may be acquired without liability for the tax by reason of this exclusion if the amount of the debt is not increased.

Imposition of tax on failure to comply with conditions.—Both the House and the committee versions of the bill also contain rules providing for the loss of the exclusion in the case of subsequent noncompliance by the foreign issuer or obligor. If the foreign issuer or obligor subsequently fails to comply with any of the conditions applicable to him under this exclusion at any time during the 10-year period, liability for the interest equalization tax will be imposed upon that foreign issuer or obligor at the time his failure to comply occurs. The amount of tax due in the case of noncompliance will be equal to the amount of tax which would have been due (determined as if this exclusion had not applied to the acquisitions) at the time the stock or debt obligations entitled to the exclusion were acquired by U.S. persons as a new or original issue. However, in no case will liability for the interest equalization tax be imposed upon a foreign issuer or obligor under this provision if the tax itself has expired. The amount of tax is to be determined under the rates applicable at the time of the acquisition of the stock or debt obligations as a new or original issue and not at the time of the failure of the foreign issuer or obligor to comply with the conditions. If the exclusion applied, a United States purchaser of the foreigner's stock or debt obligations will not become liable for the tax because of the failure of the foreign issuer or obligor to comply with the conditions applicable to him.

Penalty for failure to comply with conditions.—If a foreign issuer or obligor fails to comply with the conditions imposed upon him, as described above, both the House and the committee versions of the bill, in addition to any other penalties imposed by law and in addition to the tax imposed upon him by reason of the operation of these provisions, subjects him to a penalty equal to 25 percent of the amount of the tax which is imposed upon him by reason of his failure. This penalty is not to apply if the failure was due to reasonable cause and not due to willful neglect.

In any case in which the interest equalization tax (or any penalty in respect to it) is imposed on the foreign issuer or obligor by reasons of the provisions relating to the exclusion for direct investment in the United States, the usual filing, payment, and other requirements with respect to the interest equalization tax are to apply.

The exclusion for new or original issues of stock or debt obligations for new or additional direct investment in the United States, and the relating provisions, are effective upon the date of the enactment of this bill.

4. Corporations formed to acquire foreign securities (sec. 3(e) of the bill and sec. 4912(b)(3) of the code)

Under present law, if a domestic corporation or partnership acquires foreign securities, generally, it is subject to the interest equalization tax on those acquisitions. In addition, if it is found that the corporation or partnership is formed or availed of for the principal purposes of acquiring foreign securities, the shareholders or partners are taxed on their stock or interest as if the corporation or partnership was foreign. In this case, a credit for their taxes is given to the corporation or partnership. If an investment company acquires more than a *de minimis* amount of foreign investment, the Internal Revenue Service has held that the entire issue of the shares of the investment company may be subject to the interest equalization tax at the full rate in the hands of the investment company shareholders.

The committee believes that taxation at the shareholder level does not serve a useful purpose, except in limited situations, and creates an unnecessary degree of complexity. Therefore, the committee has amended the House bill to provide that the interest equalization tax is to be imposed at the corporate level, rather than the shareholder level, where all the foreign investments of the domestic corporation were taxable or were exempt from taxation by reason of the exclusions relating to less developed countries, the Canadian exemption, the exemption for prior American ownership and compliance, or as foreign stock treated as domestic. Acquisitions which would be excluded from tax under other provisions, such as the direct investment exclusion, would be taxable under the present rules at the shareholder level with a credit to the corporation.

5. Extension of credit for export financing (secs. 3(f), (e), and (g)(1) of the bill and secs. 4914(c)(1), 4912(b)(3), and 4915 (e)(1)(A) of the code)

Under present law, the interest equalization tax does not apply to the acquisition by a U.S. person of debt obligations in connection with certain export credit transactions. This exception is provided in present law in order not to impose an impediment upon the sale or lease of U.S. made goods. These rules vary in scope, however, depending upon the nature of the transaction and the U.S. person acquiring the foreign debt obligation. Thus, for example, a commercial bank may acquire a foreign debt obligation (without liability for the interest equalization tax) arising out of the sale or lease of personal property or services if not less than 85 percent of the amount of the loan is attributable to the sale or lease of U.S. made goods or the performance of services by U.S. persons, if the extension of credit and the acquisition of the debt obligation is reasonably necessary to accomplish the export transaction and the terms of the foreign debt obligations are not unreasonable. Further, any U.S. person may generally acquire a foreign debt obligation which is guaranteed or insured by an agency such as the Export-Import Bank of the United States. There are additional circumstances under which a U.S. person may acquire a foreign debt obligation (without liability for interest equalization tax) in connection with the sale or lease of U.S. made goods or the performance of services by a U.S. person. These additional rules, however, are limited to cases where the U.S. person acquiring the foreign debt obligation, manufactured the goods (or the goods were manufactured by an affiliate of the U.S. person) or the sale or lease was made in the ordinary course of the U.S. person's trade or business, or a debt obligation was first acquired by either the manufacturer or exporter and was later transferred to any other U.S. person.

It has come to the attention of the committee that the limitations in the above rules have prevented some U.S. persons from acquiring foreign debt obligations (without liability for interest equalization tax) in cases where the U.S. person has acquired foreign debt obligations in an export credit transaction which have a favorable balance of trade impact. Therefore, the committee has liberalized the restrictions in these types of situations previously applicable to the acquisition of a foreign debt obligation in connection with an export credit transaction.

Expansion of export credit exemption (sec. 3(f) of the bill and sec. 4914(c) of the code).—The committee's amendment provides that the interest equalization tax is not to apply to the acquisition of a debt obligation of a foreign issuer or obligor arising out of the sale or lease of tangible personal property or services (not including functions performed as an underwriter) if not less than 85 percent of the amount of the loan is attributable to the sale or lease of U.S. made goods (whether or not produced by a U.S. person) or to the performance of services by U.S. persons. In order for this exception to apply, the acquisition of the debt obligation must be reasonably necessary to effectuate the sale or lease of the property or services out of which the debt obligation arises, and the terms of the debt obligation must not be unreasonable in light of the credit practices in the business in which the person selling or leasing the property or services is engaged. In addition, the refunding or refinancing of a debt obligation may qualify for the export credit exemption. In order for the refunding or refinancing to qualify, the amount of the new debt obligation may not exceed the amount of the previous debt obligation. Further, the previous debt obligation must be one which, if it arose at the time of the refunding or refinancing, would qualify for an exemption from the interest equalization tax as an export credit transaction. Finally, the terms of the refunding or refinancing must not be unreasonable in light of credit practices in the business in which the person who is providing the refunding or refinancing is engaged and the refunding or refinancing must be in a transaction in which the refunding or refinancing is not unusual. Thus, for example, if the sale of a ship with a 20-year life was financed by debt obligations having a 5-year life to maturity, the refunding or refinancing of the original debt obligations for an additional 5-year period will qualify for an export credit exemption if the original debt obligation could qualify under the export credit exemption provided in the committee's version of the bill at the time of the refunding or refinancing.

Loans to U.S. persons to finance export transactions (sec. 3(e) of the bill and sec. 4912(b)(3) of the code).—A domestic corporation or partnership which lends funds to a foreign person may be treated as being formed or availed of for the principal purpose of obtaining funds for a foreign issuer or obligor. However, this loan may be exempt from the interest equalization tax if it is an export credit transaction. It has come to the attention of the committee that if another corporation invests in the stock of, or makes a loan to, this corporation or partnership in order for it to enter into an exempt export credit transaction with a foreign borrower the other corporation may be subject to the tax (since it is treated as acquiring the debt obligation of the foreign borrower).

Accordingly, the committee has amended the House bill to provide that an acquisition which satisfies the requirements of being an export credit transaction and is, therefore, without liability for interest equalization tax is not to be taken into consideration in determining whether a domestic corporation or partnership is formed or availed of for the principal purpose of obtaining funds for a foreign issuer or obligor.

Exclusion for acquisitions by QLFCS to finance exports (sec. 3(g) (1) of the bill and sec. 4915(e) (1) (A) of the code).—Under present law, investments in a QLFC (qualified lending and finance corporation) or domestic lending and financing corporation may not be used to acquire stock or debt obligations of foreign issuers or obligors unless the U.S. person making the investment obtained the funds for his investment from sources outside the United States. The committee does not see why a QLFC or domestic lending and financing corporation should not use domestic funds to acquire a foreign debt obligation when the acquisition arises out of an export credit transaction which is exempt from the interest equalization tax. Accordingly, the committee has amended the House bill to provide that a QLFC or domestic lending or financing corporation may use domestic source funds to lend for qualified export credit transactions or to buy U.S. made goods for leasing outside of the United States.

6. Participating firms trading for their own accounts (sec. 3(h) of the bill and sec. 4918(e) of the code)

Under present law, there are a number of circumstances under which a participating firm may issue a broker-dealer confirmation indicating that the securities it is selling are exempt from tax. However, present law does not specifically provide for the issuance of a confirmation where a participating firm sells securities it purchased for its own account and pays the tax itself. Regulations dealing with this problem have not been issued since these provisions were enacted in 1967. Despite this, the Treasury Department has indicated in a technical information release that in these situations a confirmation will be considered to be valid. The validity of a confirmation is important mainly because if a firm issues a false confirmation the law provides a penalty of 125 percent of the tax that otherwise would be payable.

The committee has amended the House bill to make it clear that a participating firm may issue a valid broker-dealer confirmation if it sells securities for its own account and pays the tax by the date it would have had to deposit the funds in a separate account if it had been acting for a customer instead of for itself. However, the 125 percent penalty will continue to apply to all tax avoidance cases. Additionally, the rules applicable to these transactions remain unchanged (including the rules relating to the requirements of making returns, to the time for filing returns, and to interest and penalties).

Since it is the opinion of the committee that this rule relating to participating firms trading for their own account is declarative of existing law, this amendent to the House bill has been made retroactive to the date of the original adoption of the participating firm rules (i.e., it is to apply to acquisitions of foreign securities made after July 14, 1967).

7. Interest equalization tax refunds (sec. 3(i) of the bill and sec. 4919 and 6611(e) of the code)

Under present law, an underwriter or dealer in securities which acquires foreign securities generally is subject to the interest equalization tax upon that acquisition. However, the firm is generally allowed a credit or refund of the tax to the extent the foreign securities are resold to foreigners. An interest equalization tax return is required to be filed by the firm for each calendar quarter during which it incurs liability for the tax. If the firm does not resell the foreign securities until after the elapse of a 2-day period in the case of stock or a 90-day period in the case of debt obligations, it is required to pay the tax. If the due date for the quarterly return falls in this period, a tax must be paid even though subsequently if it resells the foreign securities to foreigners it may claim a credit or refund of the tax paid. However, under present law, the firm is not entitled to interest on a refund regardless of the length of time the Internal Revenue Service takes to process the claim for refund.

It has come to the attention of the committee that the processing of the types of refunds referred above may in some cases take the Internal Revenue Service up to two years. It is the opinion of the committee that such a delay is excessive. Therefore, the committee has amended the House bill to provide that a firm in this situation is to be entitled to interest on a refund which is not paid within 45 days after the date on which the claim for refund is filed for an overpayment in a prior quarter.

8. Foreign lending or finance businesses (sec. 3(j)(1) of the bill and sec. 4926(a)(3A) of the code)

Present law provides an election for a U.S. corporation which, in effect, exempts it from the interest equalization tax, if it (together with any subsidiaries) is primarily engaged in a lending or finance business (making loans for 48 months or less) through offices located outside the United States and holds itself out in the ordinary course of its foreign lending or finance business as lending money to the public generally. This result is accomplished by permitting the U.S. companies meeting these tests to elect to be treated as foreign corporations for purposes of this tax.

As stated above, in order for the tax not to apply, a U.S. corporation making this election must be "primarily" engaged in a lending or finance business. If a U.S. corporation borrows funds abroad and loans these funds to its foreign subsidiary which makes loans to foreigners, it may be considered "primarily" engaged in the finance business. However, if this procedure is followed, it may in certain circumstances, violate the thin capitalization rules of the Internal Revenue Service. If the thin capitalization rules would be violated by a loan, corporations generally would make an equity investment in the subsidiary in order to provide it new funds with which to operate. On the other hand, if the U.S. corporation makes an equity investment in its foreign lending and finance subsidiary, it may be subject to the interest equalization tax even though only foreign funds are used for this equity investment, since it may no longer be considered as being "primarily" in the lending or finance business.

It is the opinion of the committee that this restriction on the equity investments of electing U.S. corporations in their foreign lending or finance subsidiaries is unduly burdensome and serves no U.S. balance of payments purpose if foreign funds are used for the investment. Therefore, the committee has amended the House bill to provide that a U.S. corporation which would otherwise be treated as primarily engaged in the foreign lending or finance business is to be allowed to make equity contributions to foreign lending and finance corporations which are members of the same affiliated group without being considered not "primarily" engaged in a lending or finance business. Only foreign source funds may be used for this type of investment.

The committee has also amended the House bill to change the rule discussed above providing that in order for a corporation to be considered as primarily engaged in a lending or finance business, it may make only loans of 48 months or less. While this maturity was the trade practice when this provision was originally enacted, it is now the trade practice to regularly make loans for periods of up to 60 months. Therefore, the committee has provided that the 48-month rule be extended to 60 months.

9. Funding of stock options by foreign corporations treated as domestic (sec. 3(j)(2)(A)–(F) of the bill and sec. 4920(b)(2) of the code)

Under present law, certain foreign corporations are considered as domestic issuers and, thus, the acquisition of their stock by a U.S. person is not subject to interest equalization tax. Generally, if at least 65 percent of the stock of a foreign corporation was held by U.S. persons at the time of the original enactment of the interest equalization tax, or if the stock was principally traded on a U.S. stock exchange and if at least 50 percent of the stock was held by U.S. persons, the foreign stock is treated as the stock of a domestic corporation for purposes of the interest equalization tax. The committee has noted that certain of these specially treated foreign corporations desire to grant their employees an option to buy their stock. If these employee stock options are granted with respect to a new class of stock issued after November 10, 1964, their exercise generally will result in the interest equalization tax being imposed on the acquisition of the stock.

The effect of this provision is to exempt some option stock from the interest equalization tax while imposing the tax on others, solely on the basis of whether or not the stock was outstanding at the time of the original enactment of the interest equalization.

To remove this difference in treatment, the committee has amended the House bill to provide that stock acquired by U.S. employees upon the exercise of their stock options is to be exempt from the tax where certain conditions are met. These conditions are: (1) the stock must be held (as shown on the records of the corporation) by more than 250 shareholders on the corporation's last record date before either July 19, 1963, or the date of the issuance of the additional shares; (2) the stock must be issued pursuant to an option plan which is not transferable other than by will or similar means and which is exercisable only by the U.S. employee during his lifetime; (3) no stock may be issued to an employee who owns more than 5 percent of the stock of the corporation; and (4) the options granted in a year do not represent more than 1 percent of the outstanding stock of the corporation. This provision applies to stock issued after January 29, 1973, and it includes both stock issued under a qualified stock option plan (under section 422) and under a nonqualified plan. The number of shares of stock is to be adjusted to reflect recapitalizations and stock dividends during the year.

Another related problem presented to the committee involved situations where stock had already been issued to employees after November 10, 1964, under a stock option plan. This stock when acquired by employees who are U.S. persons was subject to interest equalization tax. In such cases the marketability of the stock issued after November 10, 1964, has been seriously restricted since it must bear a legend that it may be subject to the interest equalization tax if acquired by a U.S. person. The committee concluded that it was unfortunate to restrict the sale of the stock in this manner in the case of these U.S. employees. As a result, the committee amended the House bill to provide that stock acquired by an employee upon the exercise of an employee stock option which is issued to the employee by his employer after November 10, 1964, and prior to January 30, 1973, is to be exempt from the tax if the tax was paid in any prior acquisition of the stock in those cases where the stock was issued pursuant to the exercise of an employee stock option. This rule is not needed for stock issued after January 30, 1973, since it is expected that stock (issued pursuant to the exercise of employee stock options) after that date will generally come within the provisions of the stock option rules discussed above.

10. Foreign corporations treated as domestic in reorganizations (sec. 3(j)(2)(G) of the bill and new sec. 4920(b)(2)(F) of the code)

Under present law, a foreign corporation whose stock is treated as domestic stock (meeting the general tests set out in No. 9 above) can issue new stock after November 10, 1964, without payment of interest equalization tax if all of the additional stock is issued in exchange for shares of a domestic corporation which is engaged in the active conduct of a trade or business immediately before the exchange. However, this rule does not apply if the stock is issued for the stock of a foreign corporation. The committee concluded that this rule which distinguishes between stock acquisitions of corporations solely upon the basis of where the acquired corporation is organized, is overly restrictive and can unduly retard the growth of business predominantly owned by U.S. persons.

As a result, the committee has amended the House bill to permit the issuance of stock as consideration for the acquisition of stock of a foreign corporation if immediately after the acquisition the issuer owns more than 50 percent of the stock of the acquired corporation. Alternatively, stock may be issued as consideration for the acquisition of more than 50 percent of the assets of a foreign corporation. It is common for these acquisitions to be effected by using either stock or convertible debt obligations as consideration. Therefore, stock may be issued upon conversion of debt obligations, or in connection with the prior conversion of debt obligations (such as to repay a loan of exempt shares used to convert such debt obligations), which were the consideration for the acquisition of stock or assets. However, for interest not to apply if these corporations acquire other corporations in this manner, they must meet the following tests. The acquired corporation must be engaged in the active conduct of a trade or business other than as a dealer in securities, immediately before the acquisition. Further, the stock of the acquiring corporation must have been held by more than 5,000 persons on the corporation's last record date before January 1, 1973. During the period beginning January 1, 1973, and running through the date of the acquisition, the acquiring corporation's stock must have been traded on a U.S. stock exchange, it must have had its principal office in the United States, and it must have been engaged in business in the United States. Additionally, the acquiring corporation must have been actively engaged in a trade or business on July 19, 1963, shares of the class of stock must have been held by more than 250 shareholders on the corporation's last record date prior to that date, and prior to the issuance of the additional shares the percentage requirements (65 percent or 50 percent) must have been met. Lastly, the corporation may not issue more than 5 percent of its stock for this purpose. In determining whether the 5 percent requirement has been met, the stock issued for the acquisition is added to other stock issued for this purpose during the preceding 5 years. The number of shares issued during the preceding 5 years is to be adjusted to reflect recapitalization and stock dividends during those years.

11. Qualified lending and financing corporations (QLFCs) (sec. 3(g)(2) and (j)(3)-(6) of the bill and sec. 4920(d) of the code)

Present law contains a procedure whereby a U.S. person may make a direct investment in a foreign corporation (or in an electing domestic corporation) if certain conditions are met. Corporations which satisfy the conditions are referred to as qualified lending and financing corporations (QLFCs). The conditions which a corporation must meet are: First, the business activities of the corporation must be the making of loans, the acquiring of accounts receivable, the leasing of tangible personal property and the servicing of debt obligations. Second, loans made to foreign persons (and foreign made tangible personal property used in the leasing business) must be made with foreign funds from specified foreign sources. These foreign source funds include loans from unrelated foreign persons, earnings from the foreign lending or financing business, and contributions to capital or as payment for its stock where the funds are derived from the sale of debt obligations by a related company to the specified types of foreign persons. The committee has become aware of the fact that there are a number of limitations as to what a QLFC may do and still retain the exemption from the interest equalization tax. In order to permit a QLFC to finance the sale or lease of U.S. made goods and to compete more effectively with foreign competitors, the committee has made a number of minor modifications which do not adversely affect the U.S. balance of payments.

Exclusion for acquisitions by QLFCs to finance exports (sec. 3(g)(2) of the bill and sec. 4920(d)(2) of the code).—Under present law, a QLFC may use its own domestic earnings to acquire U.S. made goods for leasing outside the United States. However, a QLFC may not use domestic funds to finance the sale of property manufactured in the United States. The committee is of the opinion that the differing results in these transactions cannot be justified. Accordingly, the committee has amended the House bill to permit a QLFC to use domestic source funds to finance the sale of U.S. made goods.

Foreign source borrowing by QLFCs from related corporations (sec. 3(j)(3) of the bill and sec. 4920(d)(2)(A)(iii) of the code.—Under present law, if a QLFC borrows foreign source funds from a related foreign corporation, these funds are treated as being from qualified foreign sources only if the related foreign corporation has given prior notice of its intent to borrow from nonrelated foreign sources and to use these funds to lend to a related QLFC.

The committee believes that these prior notice and tracing requirements are unnecessary where a related commercial bank makes a loan to a QLFC. Furthermore, it is not practicable to trace the source of the funds to the bank's depositors. The committee also believes that these requirements are too restrictive in that they prevent a related commercial bank from lending to a related QLFC which relends the funds to a second related QLFC.

For these reasons, the committee has amended the House bill to permit a related commercial bank to make a loan to a related QLFC without having to comply with the prior notice and tracing requirements. In addition, the committee's bill permits a related QLFC to make a loan to a second related QLFC (currently the second QLFC is generally required to obtain the funds from unrelated sources).

Percentage of stock owned by parent corporations of QLFC (sec. 3(j)(4) of the bill and sec. 4920(d)(2)(B) of the code.—Under present law, a QLFC may only make loans to foreign persons out of the proceeds of the payment for its stock or contributions to its capital, if these proceeds were derived from the sale to unrelated foreign persons of securities by a more than 50 percent related corporation. Therefore, the funds obtained by a QLFC from a 10 percent direct investor in a QLFC may not be loaned to foreign persons. The committee is of the opinion that any investment which qualifies as a direct investment under the interest equalization tax provisions should be able to qualify as a source of funds which may be lent to foreign persons. Accordingly, the committee has amended the bill to reduce the more than 50 percent ownership requirement to a 10 percent or more ownership requirement in determining whether proceeds of the payment for stock or contributions to capital of a QLFC may be lent to foreign persons.

Source of funds for QLFCs (sec. 3(j)(5) of the bill and sec. 4920(d)(1) of the code).—Under present law, a QLFC may obtain foreign source funds by borrowing from related foreign corporations or certain related domestic corporations which are treated as foreign. It would appear that from the standpoint of the effect on our balance of payments an equally acceptable source of foreign funds are funds obtained from a related domestic corporation which obtains these funds from the proceeds of the sale of its debt obligations which the related domestic corporation has elected to be treated as subject to interest equalization tax (these debt obligations are in effect treated as the obligations of a foreign issuer). As a result, the committee has amended the bill to provide that the proceeds from the sale of debt obligations by a domestic corporation which has made an election to treat the debt obligations as foreign is to qualify as a source of funds to be loaned to foreign persons by a QLFC if the proceeds are directly transferred by the foreign lenders to the QLFC. In this case the debt obligations must be sold to unrelated foreign persons.

Equity investments of QLFCs (sec. 3(j) (6) of the bill and sec. 4920 (d) (3) of the code).—Under present law, QLFCs generally are not permitted to own stock of other corporations. It has come to the attention of the committee, however, that there are a number of valid business reasons for a QLFC to make an equity investment in another corporation. For example, obtaining the stock of a borrower may be the most effective means a QLFC may have of foreclosing on a loan. Also, a QLFC may need to make an investment in a second QLFC in order to participate in an investment in certain foreign countries. Finally, a QLFC may, as part of a financing transaction, take back shares of a foreign issuer or obligor.

Since foreign funds are used for these acquisitions and they are customary transactions in the lending and financing business, the committee concluded that QLFCs should be able to make these types of investments. Accordingly, the committee amended the bill to provide that a QLFC may (1) make a 10 percent or more equity investment in another QLFC or in a partnership which would generally satisfy the requirements of being a QLFC; (2) acquire stock by foreclosure if the stock is disposed of within a ninety day period beginning on the day after the date of the foreclosure (or such additional 90 day periods as the Treasury Department determines are needed to dispose of the stock); or (3) acquire stock of a foreign corporation if it is in connection with, and incidental to, a financing transaction, but only if the stock does not have a value in excess of 10 percent of the value of the debt obligation and the terms of the debt obligation are not unreasonable in light of the credit practices in the business in which the person acquiring the debt obligation is engaged.

12. Stock dividends by certain mutual funds (sec. 3(j)(7) of the bill and sec. 4920(e) of the code)

Under present law, a qualifying domestic mutual fund which is investing in foreign securities may elect to be treated as a foreign issuer with respect to any acquisition of its stock.

A problem exists in this case where a domestic mutual fund which has elected to be treated as a foreign issuer for purposes of the interest equalization tax issues a stock dividend to shareholders who have the option to receive a cash dividend. In this case, the stock dividend is subject to the interest equalization tax in the hands of the shareholders, since the shareholders are treated as receiving interests in stock in foreign corporations.

Since the availability of such an option to the shareholders does not contribute to any adverse effect on the U.S. balance of payments, the committee amended the House bill to allow stock dividends to be distributed to the shareholders without the imposition of an interest equalization tax in the case of mutual funds which have made the election referred to above.

13. Report by Secretary of Treasury (sec. 4 of the bill)

Under present law, there is an exclusion for new or original issues where the President of the United States determines that the imposition of the interest equalization tax will have consequences for a foreign country which imperil or threaten to imperil the stability of the international monetary system. At the present time an Executive order is in effect determining that the imposition of the interest equalization tax would have such consequences in the case of Canada. Questions have arisen as to whether under this standard there continues to be a need for this exclusion for Canadian issues. As a result, the committee has added a provision to the House bill requiring the Secretary of the Treasury to study the effect of the Canadian exemption on international monetary stability and report to the Congress not later than September 30, 1973. The report is to contain the results of his study and his conclusions as to whether termination would imperil or threaten to imperil the international monetary system, together with any recommendations he may have, including those involving legislation.

IV. EFFECT ON THE REVENUES OF THE BILL AND VOTE OF THE COMMITTEE IN REPORTING 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 this bill. Your committee estimates that the extension of the interest equalization tax (and related minor amendments) provided by the bill will result in a revenue gain of $85 million for a one-year period. The Treasury Department agrees with this statement.

In compliance with section 133 of the Legislative Reorganization Act of 1946, the tabulation of the roll call vote to report the bill is as follows:

In favor—9 (Messrs. Long, Byrd, Bentsen, Bennett, Curtis, Fannin, Hansen, Packwood, and Roth)

In opposition—0

V. CHANGES IN EXISTING LAW

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

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