EXTENSION OF THE INTEREST EQUALIZATION TAX

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-SECOND CONGRESS

FIRST SESSION

ON

H.R. 5432

TO PROVIDE AN EXTENSION OF THE INTEREST EQUALIZATION TAX, AND FOR OTHER PURPOSES

MARCH 15, 1971

Printed for the use of the Committee on Finance

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EXTENSION OF THE INTEREST EQUALIZATION ACT

MONDAY, MARCH 15, 1971

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

The committee met, pursuant to notice, at 10:05 a.m., in room 2221, New Senate Office Building, Senator Russell B. Long (chairman) presiding.

Present: Senators Long, Anderson, Byrd, Jr., of Virginia, Bennett, Curtis, Miller, Jordan, and Hansen.

The CHAIRMAN. The meeting will come to order.

This morning the committee is holding hearings on H.R. 5432, a bill to extend the interest equalization tax for a period of 2 years, through March 31, 1973. Also included are minor technical and corrective amendments to the existing statute. The bill passed the House on March 10 by a vote of 392 to 5.

We will include at this point in the record our press release announcing this hearing and a copy of the bill, H.R. 5432.

(The material referred to follows. Hearing continues on page 18.)

PRESS RELEASE

FOR IMMEDIATE RELEASE
March 9, 1971

COMMITTEE ON FINANCE
UNITED STATES SENATE
2227 New Senate Office Bldg.

HEARINGS ANNOUNCED ON INTEREST EQUALIZATION TAX

The Honorable Russell B. Long (D., La.), Chairman of the Committee on Finance, announced today that the Committee would hold a one day hearing Monday, March 15, 1971 on H.R. 5432, a bill to extend the interest equalization tax for two years (until March 31, 1973). The hearing will be held in room 2221 New Senate Office Building, and will begin at 10:00 A.M.

The interest equalization tax is an important part of the Administration's balance of payments program. The tax, in effect, provides an equivalent of a three quarters percentage point per annum rise in interest costs for foreigners obtaining capital from U.S. sources whether in the form of debt obligations or equity capital.

The Honorable Paul A. Volcker, Under Secretary of the Treasury for Monetary Affairs, will be lead-off witness and will present the Administration's case for this legislation.

Requests to be Heard. -- Senator Long stated that those individuals who desire to testify on March 15 should make their request to Tom Vail, Chief Counsel, Senate Committee on Finance, 2227 New Senate Office Building, no later than noon Friday, March 12. Persons scheduled to appear must submit 25 copies of their statement to the Committee not later than the close of business on Friday, March 12. Statements should be on double-spaced, letter-size pages (not legal size), and each statement must be preceded by a summary of the principal points presented by the witness. The Chairman emphasized that pursuant to the requirements of the Legislative Reorganization Act of 1946, witnesses will be expected to limit their oral presentation to brief summaries of their statement. He urged those with similar views to coordinate their oral statements in order to prevent duplicative and repetitive testimony.

Senator Long said that the Committee would welcome written comments on H.R. 5432; five copies of these comments should be sent to Mr. Vail by the close of business on Tuesday, March 16. He indicated that these written comments would be given the same close consideration as though the writer had testified orally.

P.R. #4

92D CONGRESS
1ST SESSION

H. R. 5432

IN THE SENATE OF THE UNITED STATES

MARCH 11, 1971

Read twice and referred to the Committee on Finance

AN ACT

To provide an extension of the interest equalization tax, and for other purposes.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 **SECTION 1. SHORT TITLE, ETC.**
4 (a) SHORT TITLE.—This Act may be cited as the "In-
5 terest Equalization Tax Extension Act of 1971".
6 (b) AMENDMENT OF 1954 CODE.—Whenever in this
7 Act an amendment is expressed in terms of an amendment
8 to a section or other provision, the reference is to a section or
9 other provision of the Internal Revenue Code of 1954.
10 **SEC. 2. EXTENSION OF INTEREST EQUALIZATION TAX.**
11 Section 4911 (d) is amended, effective with respect to

II

1 acquisitions made after March 31, 1971, by striking out
2 "March 31, 1971" and inserting in lieu thereof "March 31,
3 1973".

4 **SEC. 3. OTHER AMENDMENTS.**

5 (a) TREATMENT OF DEBT OBLIGATIONS OF COR-
6 PORATIONS OBTAINING FUNDS FROM FOREIGN PERSONS
7 AS TAXABLE.—

8 (1) Section 4912 (b) is amended by redesignating
9 paragraph (4) as paragraph (5), and by inserting after
10 paragraph (3) the following new paragraph:

11 "(4) SPECIAL ELECTION TO SUBJECT DEBT IS-
12 SUES OF A UNITED STATES CORPORATION TO TAX.—
13 Any domestic corporation may elect to have any class
14 of its debt obligations which is an original or new
15 issue (and any class of stock into which such debt
16 obligations may be converted) deemed to be debt obli-
17 gations (or stock) of a foreign obligor (or issuer) the
18 acquisition of which by a United States person will
19 be subject to the tax imposed by section 4911, not-
20 withstanding any other provision of this chapter other
21 than section 4911 (d), at the rate provided on the
22 acquisition of stock under section 4911 (b). The docu-
23 ments evidencing such debt obligations (and the cer-
24 tificates evidencing any stock into which such debt
25 obligations are converted) shall clearly indicate that

1 their acquisition by a United States person is subject
2 to the tax at such rate. Notice of an election under this
3 section shall be given to the Secretary or his delegate
4 prior to the issuance of the debt obligations with respect
5 to which the election is made. Any such election shall
6 be effective as of the date of issuance of the debt obliga-
7 tions with respect to which the election is made and shall
8 be irrevocable. The Secretary or his delegate shall pre-
9 scribe such regulations as he may deem necessary to
10 carry out the provisions of this paragraph."
11 (2) The amendments made by paragraph (1)
12 shall apply with respect to debt obligations issued after
13 the date of the enactment of this Act.
14 (b) ACQUISITIONS IN CONNECTION WITH NATION-
15 ALIZATION, EXPROPRIATION, ETC.—
16 (1) Section 4914(b) is amended by adding at the
17 end thereof the following new paragraph:
18 "(16) ACQUISITIONS OF STOCK OR DEBT OBLIGA-
19 TIONS IN CONNECTION WITH NATIONALIZATION, EX-
20 PROPRIATION, ETC.—Of stock or debt obligations of a
21 foreign issuer or obligor, where such acquisition is
22 required as a reinvestment in connection with an actual
23 or threatened nationalization, expropriation, or seizure
24 of property, to the extent provided in subsection (k)."

1 (2) Section 4914 is amended by adding at the end
2 thereof the following new subsection:
3 "(k) ACQUISITIONS OF STOCK OR DEBT OBLIGATIONS
4 IN CONNECTION WITH NATIONALIZATION, EXPROPRIA-
5 TION, ETC.—The tax imposed by section 4911 shall not
6 apply to the acquisition by a United States person of stock
7 or a debt obligation of a foreign issuer or obligor, to the ex-
8 tent that such acquisition is required as a reinvestment with-
9 in a foreign country by the terms of a contract of sale to, or
10 a contract of indemnification with respect to the nationaliza-
11 tion, expropriation, or seizure by, the government of such
12 country or a political subdivision thereof, or an agency or in-
13 strumentality of such government, of property owned within
14 such country or such political subdivision by such United
15 States person, or by a controlled foreign corporation (as de-
16 fined in section 957) more than 50 percent of the total com-
17 bined voting power of all classes of stock entitled to vote of
18 which is owned (within the meaning of section 958) by such
19 United States person, but only if such contract was entered
20 into because the government of such country or political
21 subdivision, or such agency or instrumentality—
22 "(A) has nationalized or has expropriated or
23 seized, or has threatened to nationalize or to expro-
24 priate or seize, a substantial portion of the property
25 owned within such country or such political subdivision

1 by such United States person or such controlled foreign
2 corporation; or
3 "(B) has taken action which has the effect of
4 nationalizing or of expropriating or seizing, or of
5 threatening to nationalize or to expropriate or seize, a
6 substantial portion of the property so owned.
7 For purposes of this subsection, an instrumentality of the
8 government of a country or a political subdivision thereof
9 includes a corporation or other entity with respect to which
10 such government, or any agency of such government, owns
11 more than 50 percent of the total combined voting power
12 of all classes of stock entitled to vote or, in the case of a
13 corporation or other entity not issuing shares of stock, has
14 the authority to elect or appoint a majority of the board of
15 directors or equivalent body of such corporation or other
16 entity."
17 (3) Section 4916(a) is amended—
18 (A) by inserting "or" after the semicolon at
19 the end of paragraph (2);
20 (B) by striking out "; or" at the end of para-
21 graph (3) and inserting in lieu thereof a period;
22 and
23 (C) by striking out paragraph (4).
24 (4) The amendments made by this subsection shall

1 apply with respect to acquisitions made after the date
2 of the enactment of this Act.

3 (c) FOREIGN MINERAL FACILITIES.—

4 (1) Section 4914 (c) (5) (B) is amended by strik-
5 ing out "a substantial portion of which is extracted" and
6 inserting in lieu thereof the following: ", where a sub-
7 stantial portion of the ores or minerals (or derivatives
8 thereof) to be stored, handled, transported, processed,
9 or serviced in or through such facilities, or in or through
10 all of the facilities of the obligor for the storage, han-
11 dling, transportation, processing, or servicing of the same
12 types of ores or minerals (or derivatives thereof), is
13 extracted".

14 (2) The last sentence of section 4914 (c) (5) (B)
15 is amended by striking out "such facilities" the first
16 place it appears and inserting in lieu thereof "the facil-
17 ities with respect to which the loan is made".

18 (3) The amendments made by this subsection shall
19 apply with respect to acquisitions made after the date of
20 the enactment of this Act.

21 (d) SALES OR LIQUIDATIONS OF FOREIGN SUBSIDI-
22 ARIES.—

23 (1) Section 4914 (g) (1) is amended—

24 (A) by striking out "all of the outstanding
25 stock, except for qualifying shares, of a foreign

1 corporation" in subparagraph (A) and inserting
2 in lieu thereof "all of the outstanding stock of a
3 foreign corporation held by such United States per-
4 son (and such includible corporations)";

5 (B) by striking out "all of the outstanding
6 stock of which, except for qualifying shares, is
7 owned by such United States person (or by one or
8 more such includible corporations)" in subpara-
9 graph (B); and

10 (C) by adding at the end thereof (after and
11 below subparagraph (C)) the following new
12 sentence:

13 "Subparagraph (A) or (B) shall apply only if, immedi-
14 ately prior to the sale or liquidation involved, the United
15 States person (or one or more includible corporations in
16 an affiliated group, as defined in section 1504, of which
17 such person is a member) owns (directly or indirectly)
18 10 percent or more of the total combined voting power
19 of all classes of stock of the foreign corporation; and, for
20 purposes of this sentence, stock owned (directly or indi-
21 rectly) by or for a foreign corporation shall be consid-
22 ered as being owned proportionately by its shareholders."

23 (2) (A) Section 4914(b)(10) is amended by
24 striking out "WHOLLY OWNED" in the heading, and by

1 striking out "a wholly owned foreign corporation" and
2 inserting in lieu thereof "a foreign corporation".
3 (B) Section 4914(g) is amended by striking out
4 "WHOLLY OWNED" in the heading.
5 (3) The amendments made by this subsection shall
6 apply with respect to acquisitions made after the date of
7 the enactment of this Act.
8 (c) INVESTMENTS BY FINANCIAL INSTITUTIONS
9 IN CORPORATIONS ENGAGED IN FINANCE BUSINESS
10 ABROAD.—
11 (1) Section 4915 is amended by adding at the end
12 thereof the following new subsection:
13 "(e) SPECIAL RULE FOR INVESTMENTS BY FINAN-
14 CIAL INSTITUTIONS.—
15 "(1) For purposes of section 4912 and this section,
16 a corporation which is—
17 "(A) a domestic corporation described in sec-
18 tion 4920(a)(3)(C), or
19 "(B) a foreign corporation which is primarily
20 engaged in the lending or finance business outside
21 the United States,
22 shall be treated as a foreign corporation which is not
23 formed or availed of for the principal purpose described
24 in subsection (c)(1) with respect to an acquisition of
25 stock from such corporation (whether or not as a result

1 of a contribution to capital) by a corporation which is
2 (or is affiliated with) a financial institution and which is
3 affiliated with such domestic or foreign corporation, but
4 only upon compliance with paragraph (2).
5 "(2) Paragraph (1) shall apply only if it is estab-
6 lished to the satisfaction of the Secretary or his delegate,
7 pursuant to rules and regulations promulgated by the
8 Secretary or his delegate, that the amounts received by
9 the domestic or foreign corporation as a result of the
10 acquisition will not be used to acquire stock of foreign
11 issuers or debt obligations of foreign obligors or utilized
12 in any other way outside of the United States.
13 "(3) For purposes of this subsection, two corpora-
14 tions are 'affiliated' with each other if they are members
15 (or would be members if they were both domestic cor-
16 porations) of the same affiliated group (within the
17 meaning of section 48(c) (3) (C)).
18 "(4) In any case where a domestic or foreign cor-
19 poration has been treated as a foreign corporation which
20 is not formed or availed of for the principal purpose
21 described in subsection (c) (1) with respect to an acqui-
22 sition of stock by another corporation as provided in
23 paragraph (1) of this subsection, but the amounts re-
24 ceived by such domestic or foreign corporation as a result
25 of such acquisition are (before the termination date speci-

1 fied in section 4911 (d)) used to acquire stock of foreign
2 issuers or debt obligations of foreign obligors or utilized
3 in any other way outside of the United States in viola-
4 tion of the rules and regulations promulgated under para-
5 graph (2), then liability for the tax imposed by section
6 4911 shall be incurred by the acquiring corporation (with
7 respect to such acquisition) at the time such amounts are
8 so used; and the amount of such tax shall be equal to the
9 amount of tax for which the acquiring corporation would
10 have been liable under such section upon its acquisition
11 of the stock involved if such domestic or foreign corpora-
12 tion had not been so treated."
13 (2) The amendment made by paragraph (1) shall
14 apply with respect to acquisitions made after the date
15 of the enactment of this Act.
16 (f) EXTENSION OF RESALE PERIOD FOR DEALERS IN
17 FOREIGN SECURITIES.—
18 (1) Section 4919(a) is amended by adding at the
19 end thereof the following new sentence: "The President
20 may by Executive order (which shall be applicable for
21 such period and subject to such conditions as may be
22 specified therein) extend the period of two business days
23 specified in subparagraphs (A) and (B) of paragraph
24 (3) to not to exceed 13 calendar days in the case of
25 acquisitions made for customers and not for investment

1 purposes, but any such extension shall be applicable
2 only in cases where the acquiring dealer has submitted
3 to the Secretary or his delegate in advance a satisfactory
4 procedure for identifying which of his acquisitions are for
5 customers and which are for investment purposes."
6 (2) Section 4919(b)(1) is amended—
7 (A) by striking out the period at the end of
8 clause (B) and inserting in lieu thereof ", and"; and
9 (B) by inserting after clause (B) the follow-
10 ing new clause:
11 "(C) in any case to which subparagraph (A)
12 or (B) of subsection (a)(3) applies and which
13 involves a sale or acquisition occurring after the
14 expiration of the two-business-day period specified
15 therein, establishes that the sale or acquisition com-
16 plied with the applicable Executive order issued
17 under the last sentence of subsection (a) and that
18 the procedure submitted under such sentence was
19 followed."
20 (3) The amendments made by this subsection shall
21 apply with respect to acquisitions made after the date
22 of the enactment of this Act.
23 (g) FAILURE OF FOREIGN CORPORATION TO FILE
24 NOTICE RESPECTING ISSUANCE OF ADDITIONAL SHARES.—
25 (1) Section 4920(b)(2) is amended by adding at

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1 the end thereof the following new sentence: "Upon
2 application by the issuing corporation within 2 years
3 after the date on which additional shares described in
4 the second sentence of this paragraph were issued, the
5 Secretary or his delegate may waive the 15-day require-
6 ment set forth in subparagraph (D) (v) with respect to
7 such additional shares if it is shown that the issuing
8 corporation failed to file the notice required by such sub-
9 paragraph due to inadvertence and not with an intent to
10 avoid the requirements of this chapter."

11 (2) The requirement in the last sentence of sec-
12 tion 4920(b) (2) (as added by paragraph (1) of this
13 subsection) that the issuing corporation make its ap-
14 plication within 2 years after the date on which addi-
15 tional shares were issued in order to qualify for a
16 waiver shall be deemed satisfied, in any case where
17 more than 2 years has elapsed after such date, if
18 the issuing corporation involved makes the application
19 within 60 days after the date of the enactment of this
20 Act.

21 (3) The amendment made by paragraph (1) shall
22 take effect on the date of the enactment of this Act.

23 (h) BORROWINGS BY MEMBER OF AFFILIATED GROUP
24 WHERE CORPORATION IS ENGAGED IN CERTAIN FINANC-
25 ING OPERATIONS.—

26 (1) Section 4920(d) (3) (A) is amended by

1 striking out "owns all of the stock of such corporation"
2 in the matter preceding clause (i) and inserting in lieu
3 thereof "is an includible corporation in an affiliated
4 group, as defined in section 48(c)(3)(C), of which
5 such corporation is a member".
6 (2) The amendment made by paragraph (1) shall
7 take effect on the date of the enactment of this Act.
8 (i) PENALTY FOR FAILURE TO FILE QUARTERLY
9 RETURN OR REMIT TAX.—
10 (1) Section 6651 is amended by adding at the end
11 thereof the following new subsection:
12 "(e) INTEREST EQUALIZATION TAX.—The provisions
13 of this section shall apply with respect to returns required
14 under authority of section 6011(d)(1) (relating to interest
15 equalization tax returns) and section 4918(e) (relating to
16 returns by participating firms with respect to money with-
17 held) in the same manner and to the same extent as they
18 apply with respect to returns specified in subsection (a)."
19 (2) Section 6680 is amended—
20 (A) by inserting "(a) IN GENERAL.—" im-
21 mediately before "In addition"; and
22 (B) by adding at the end thereof the following
23 new subsection:
24 "(b) CROSS REFERENCE.—

"For additions and penalties in case of failure to file interest equalization tax returns or pay or remit, see section 6651(e)."

1 (3) The amendments made by this subsection shall
2 apply with respect to returns required to be filed on or
3 after the date of the enactment of this Act.
4 (j) ELIMINATION OF KNOWLEDGE REQUIREMENT
5 REGARDING FILING OF FALSE INTEREST EQUALIZATION
6 TAX CERTIFICATES.—
7 (1) Section 6681 (a) is amended—
8 (A) by striking out "knowingly"; and
9 (B) by striking out "shall be liable" and insert-
10 ing in lieu thereof "shall, unless it is shown that such
11 action is due to reasonable cause and not due to
12 willful neglect, be liable".
13 (2) Section 6681 (b) (1) is amended—
14 (A) by striking out "A participating firm"
15 and inserting in lieu thereof "Unless it is shown that
16 such action is due to reasonable cause and not due
17 to willful neglect, a participating firm"; and
18 (B) by striking out "knowingly".
19 (3) Section 6681 (b) (2) is amended—
20 (A) by striking out "A participating firm"
21 and inserting in lieu thereof "Unless it is shown
22 that such action is due to reasonable cause and not
23 due to willful neglect, a participating firm"; and
24 (B) by striking out "knowingly" each place
25 it appears.

1 (4) The amendments made by this subsection shall
2 apply with respect to actions occurring after the date
3 of the enactment of this Act.

Passed the House of Representatives March 10, 1971.

Attest: W. PAT JENNINGS,

Clerk.

The CHAIRMAN. The interest equalization tax was instituted in 1964—on a retroactive basis to 1963—to lessen the flow of U.S. capital into foreign investments. It applies to long-term loans to foreign persons as well as to the purpose of foreign securities. Thus far, the tax has contributed to a reduction in the flow of dollars outward from this country, thus improving our balance of payments position. However, the balance of payments deficit remains large—$10 billion in 1970 on an official settlements basis of measurement—and the prospects are for another large deficit this year. To some extent the interest equalization tax hides the real size of our fundamental deficit position.

The present interest equalization tax is equivalent to a rate of three-fourths of 1 percent per annum in interest costs for foreign persons who obtain capital from U.S. sources. The statute gives the President discretionary authority to vary the tax rate from zero to 1½ percent. From time to time the President has exercised his authority, most recently in April 1969, when the current rate of approximately three-fourths of 1 percent per annum was set. I hope the Secretary will address himself to the question of whether 1½ percent is sufficient to close the gap in interest roles between this country and the other leading money markets, particularly in view of recent developments.

The administration has requested that the legislation before us today be passed. The Honorable Paul Volcker, Under Secretary of the Treasury for Monetary Affairs, will present the administration case.

Mr. Volcker, I suggest you proceed.

STATEMENT OF HON. PAUL A. VOLCKER, UNDER SECRETARY OF THE TREASURY FOR MONETARY AFFAIRS

Mr. VOLCKER. As you indicated, under the present legislation, the interest equalization tax expires on March 31 of this year. This tax, effective since July 1963, has been adopted and maintained as a means of reducing the outflow of portfolio capital from the United States to developed countries. It has been extended on three occasions, with small modifications and I am here to urge that it be extended for another 2 years and you can do that by adopting H.R. 5432.

The effect of the tax is to raise the cost to foreigners in developed countries of borrowing or raising equity funds in the United States. The tax rate may be varied by the President between the equivalent of an effective annual rate of zero and 1½ percent per annum. At present, it is three-fourths percent.

The tax provides important protection for our balance-of-payments position, particularly during a period when interest rates are relatively low in the United States as compared to most other advanced countries. That is the case at present.

The tax directly discourages foreign borrowing in our market. It also complements and supports the Commerce Department program designed to limit the balance-of-payments cost of direct investment abroad and the Federal Reserve program designed to limit outflows of funds from banks and other financial institutions. The three programs are mutually reinforcing in holding in check the volume of dollars that move into foreign hands through outflows of U.S. capi-

tal. Without the interest equalization tax, the remaining programs—particularly the Commerce program that encourages U.S. firms to finance a portion of their overseas expansion in foreign markets—would be substantially weakened.

The President has stated his intention to relax these programs as soon as the balance-of-payments situation permits. I wish I could report to you today that the need for these restraints was no longer necessary. However, after full review within the administration, the conclusion was reached that these programs must be maintained for a further period with little change.

Although no single measure can reflect all aspects of the situation, our balance-of-payments position continues to be plainly unsatisfactory.

On the official settlements basis, our deficit reached almost $10 billion in 1970, even after allowing for our allocation of special drawing rights. That result was heavily influenced by the sharp easing of American money markets at a time when rates are still high in many foreign countries. We benefited from large inflows of interest-sensitive short-term capital in 1968 and 1969, when our domestic markets were extremely tight. Now those flows have sharply reversed.

These flows of short-term capital, disturbing as they are, do not reflect our underlying position. Indeed, our total current account position improved last year. However, this improvement, while welcome, must also be discounted to some extent. Cyclical conditions, here and abroad, were exceptionally favorable for our exports. Even so, as table I, attached to my statement shows, our current account surplus was well below the levels recorded earlier in the 1960's. It failed to cover exports of long-term capital and aid flows by a large margin. As a consequence, our so-called "basic balance" on trade, other current items, and long-term capital remained in sizeable deficit.

Partial data for January and February show the situation has not improved. We continue to face a major challenge in bringing our position into a sustainable equilibrium. Neglect of this problem would simply be inconsistent with maintaining a framework of international monetary stability so important in facilitating flows of trade and investment.

Dealing with that challenge in a responsible way demands that we not prematurely remove the limitations imposed on capital outflows, including the interest equalization tax. Action has been taken from time to time to ease the administration of these programs and the difficulties of businesses in complying. But we do not believe, in the light of present balance-of-payments circumstances, that further relaxation can be justified at this time.

The interest equalization tax has been effective in substantially reducing the volume of securities offered in the United States by countries subject to the tax. Since 1963, annual offerings of developed countries—apart from Canada, for which there is a special exemption—have generally been very small, as may be seen in table II. Similarly, there is evidence to indicate that the tax has substantially inhibited U.S. purchases of outstanding foreign securities (see table III). As a result, more of the burden of foreign financing has properly shifted to other countries in a stronger balance-of-payments position.

While we have found it necessary to maintain special measures of restraint such as the interest equalization tax, the basic approach toward strengthening our international financial position must be along different lines. Most fundamentally, we must restore a healthy economic climate at home. Orderly growth, increasing productivity, and price stability must be sought hand in hand. In this respect, our balance-of-payments and domestic aims broadly coincide.

I would emphasize that, even if it were acceptable on domestic grounds, there is no salvation for our balance of payments in a sluggish domestic economy. As we can see now, such an economy is prone to export capital abroad, and it does not encourage long-term capital inflows. Temptations to embark on self-defeating protectionist measures would be stronger and growth in the world economy would be retarded.

What is essential is that, as economic growth resumes with more vigor, we continue and build upon the progress already made against inflation. The stability of the dollar at home is fundamental to its stability internationally and to the stability of the world monetary system. Only with the achievement of relative price stability can we hope to restore our trade and current account position to the point where it can fully support our policies of aid, defense, and unrestricted flows of private investment.

There are more specific measures that we can and must take as well.

We must also keep our export credit facilities in line with those of other countries and insure that our tax system does not discriminate against exports as compared with direct investment abroad. In that connection, I hope this committee will, upon further review, support the proposal for a Domestic International Sales Corporation.

I think it is apparent there is no quick or easy answer to our balance-of-payments problem. Domestic inflation and overheating in the late 1960's set back our efforts, and we are still struggling with the distortions and imbalances that developed as a consequence of that period. It is essential to demonstrate that we are coping with these problems and are willing to maintain the special measures required to protect our balance-of-payments position—including continuation of the interest equalization tax.

The Treasury has no problems with the modifications to the present legislation which are contained in the House bill. To provide consistent treatment, we would also be glad to see a further provision to assure that certain domestic mutual funds treated as foreign for the purposes of the interest equalization tax not be permitted such treatment on new issues. More importantly, we urge that you extend this legislation for another 2 years.

Thank you, Mr. Chairman.

(Tables attached to Mr. Volcker's statement follow:)

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TABLE I.—*U.S. balance of payments, 1961–70*

[In billions of dollars]

	1961–65 average	1966	1967	1968	1969	1970 [1] (3 qtrs., s.a. annual rate)	1970 (actual)
Merchandise trade balance	5. 4	3. 9	3. 9	0. 6	0. 6	2. 7	(2. 2)
Exports	23. 0	29. 4	30. 7	33. 6	36. 5	42. 1	(42. 0)
Imports	−17. 6	−25. 5	−26. 8	−33. 0	−35. 8	−39. 4	(−39. 9)
Investment income balance	3. 5	4. 1	4. 5	4. 8	4. 4	4. 3	
Receipts from U.S. investments abroad	4. 9	6. 3	6. 9	7. 7	8. 8	9. 6	
Payments on foreign investments in United States	−1. 3	−2. 1	−2. 4	−2. 9	−4. 5	−5. 3	
Balance on other services	−2. 5	−2. 7	−3. 2	−2. 9	−3. 1	−3. 1	
Balance on goods and services	6. 5	5. 3	5. 2	2. 5	1. 9	3. 9	
Unilateral transfers, excluding Government grants	−0. 8	−0. 9	−1. 2	−1. 1	−1. 2	−1. 3	
Balance on current account, excluding Government grants	5. 7	4. 4	4. 0	1. 4	0. 8	2. 6	
U.S. Government economic grants and credits [2]	−3. 7	−3. 9	−4. 2	−4. 2	−3. 7	−3. 4	
Balance on private direct investment	−2. 2	−3. 6	−2. 9	−2. 9	−2. 2	−3. 8	
Balance on securities transactions	−0. 8	0. 4	−0. 3	3. 1	1. 6	1. 0	(1. 3)
Balance on various other long-term capital transactions [3]	−0. 5	0. 6	0. 2	0. 9	0. 7	0. 3	
Balance on current and long-term capital accounts [4]	−1. 4	−2. 0	−3. 1	−1. 7	−2. 8	−3. 3	
Balance on various other capital transactions: Short-term, other than liquid liabilities; long-term bank liabilities to foreign official agencies; nonmarketable U.S. Government liabilities; unscheduled debt payments on U.S. Government credits; and Government sales of foreign obligations to foreigners		1. 2	0. 6	2. 3	−1. 3	0. 1	
Errors and omissions	—0. 9	−0. 5	−1. 1	−0. 5	−2. 8	−2. 0	
Allocation of Special Drawing Rights						0. 9	(0. 9)
Balance on liquidity basis	−2. 3	−1. 4	−3. 5	0. 2	−7. 0	−4. 4	(−3. 9)
Less							
Certain nonliquid liabilities to foreign official agencies	0. 1	0. 8	1. 3	2. 3	−1. 0	−0. 2	(−0. 3)
Plus							
Liquid liabilities to private foreigners and international organizations	0. 7	2. 4	1. 5	3. 8	8. 7	−4. 5	(−6. 2)
Balance of official settlements basis	−1. 8	0. 3	−3. 4	1. 6	2. 7	−8. 7	(−9. 8)

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

NOTE.—Details will not necessarily add to totals due to rounding.

TABLE II.—*New issues of foreign securities purchased by U.S. residents, by area, 1962–70*

[Balance of payments basis, dollars in millions]

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

[1] Not seasonally adjusted.
[2] Australia, New Zealand, South Africa.
[3] Related to the export, the direct investment, and the Japanese exemptions.
[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, Office of Business Economics.

TABLE III.—*Net transactions in outstanding foreign securities by U.S. residents, by area, 1962–70*

[Balance of payments basis, dollars in millions, net U.S. purchases (−)]

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

[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.

Source: Department of Commerce, Office of Business Economics.

The CHAIRMAN. Thank you, Mr. Volcker. Let me just get a couple of matters straight.

Under the Constitution, Congress has the power and, indeed, the duty, to create currency and to regulate the value of it, don't we.

Mr. VOLCKER. Yes, sir.

The CHAIRMAN. And I wonder if you agree with me that in modern day economics that the Constitution puts the ultimate responsibility on the Congress to see that the level of interest rates that people have to pay in order to obtain money or credit would be on terms that the Congress thinks in the national interest.

Mr. VOLCKER. Well, I think that is broadly correct, Mr. Chairman. I would just make two comments. Congress has, of course, delegated some of its regulatory authority in this area to the Federal Reserve. The other comment I would make is that markets have a will of their own and a mind of their own and you can't set the level of interest rates sometimes where we would like to. You have to respect the market developments which give rise to a particular level of interest.

The CHAIRMAN. Well, in the last analysis aren't those factors that we should take into account in the exercise of our duties and our responsibilities.

Mr. VOLCKER. I think that is right, yes.

The CHAIRMAN. So that while we can, and do, delegate some of the responsibility that is vested in the Congress under the Constitution, the final responsibility still lies with the Congress.

Mr. VOLCKER. That is certainly true. When you delegate you can take back.

The CHAIRMAN. Well, but even though you delegate you cannot escape the responsibility for having delegated it.

Mr. VOLCKER. Right.

The CHAIRMAN. And the final authority is still with the Congress.

Mr. VOLCKER. I quite agree.

The CHAIRMAN. If it is not being used the way the Congress thinks it should be used then it is the responsibility of Congress either to withdraw the delegation of authority or, by law, require the person to whom the authority has been delegated to do that which you think is in the national interest.

Mr. VOLCKER. I think that is proper, yes.

The CHAIRMAN. What we are concerned with here is that we have a level of interest rates in this country below the level of interest rates of our trading partners, and that if we do nothing to restrain the free flow of capital from one nation to another, then the credit and the money that is created for our economy flows abroad into other areas where those people are willing to pay a higher price for money than people pay in this country.

Mr. VOLCKER. That is right. I would, if I may, just add one further thought here, Mr. Chairman. I would like to be in a position where a portion of our money could flow abroad for various investment activities overseas, as it does even now——

The CHAIRMAN. Yes.

Mr. VOLCKER (continuing). But this would be a contribution to world economic development if our overall position were such that this was desirable. The difficulty is that our trade position, our current

account position, our overall balance-of-payments position, is not strong enough to permit as large a capital outflow as you might like from some other point of view.

The CHAIRMAN. It is already flowing abroad to a greater extent than we thing is desirable now; is that correct?

Mr. VOLCKER. Yes.

The CHAIRMAN. And with the lower interest rates and freer availability of credit, as has been the case recently, it is most desirable that we try to make it available for housing and for needs of the American economy, not simply needs for investment abroad, as desirable as that may be.

Mr. VOLCKER. Yes, sir.

The CHAIRMAN. I personally am very happy about the fact that interest rates are now very much lower than they were a year ago. Does this reduction in interest rates in this country place an even heavier burden on Congress to pass this bill?

Mr. VOLCKER. There is no question it does. The interest rates are lower relative to foreign interest rates this year than they were last year and than they were 2 years ago. It is not unprecedented to have this kind of a relationship, but it is more urgent now, I would think, than for sometime.

I might add just one further thought, that this tax only covers medium- and long-term securities. It does not cover securities under 1 year, and a good part of the current outflow and a good part of the current problem revolves around very short-term capital. But we have to be prepared, I think, for some short-term capital to go in and out as circumstances change.

The CHAIRMAN. Well now, that gets me to my final question. Is this bill adequate to meet the problem or should we amend this bill to protect us against a higher differential of interest rates, and to do something about the short-term flow of capital?

Mr. VOLCKER. Well, so far as the margin of flexibility is concerned, I think that is ample at present for the area that is covered. It is set at three-quarters of a percent now, as you know, and in the areas covered by the bill there has not been any substantial foreign borrowing in this market. The precise interest rate comparison varies from country to country but, by and large, I think that three quarters of a percent is an adequate deterrent for the time being.

The other part of the question—when you get into the shorter term area—has been looked at at times in the past. It has been our conclusion, and it has been the Treasury's conclusion, that this particular approach is much more difficult to apply to the very short area of the market because there are so many different channels by which funds can move. You get so closely involved in ordinary commercial transactions and ordinary trading transactions that it has been impractical and undesirable to move the authority down to shorter maturities.

The CHAIRMAN. Mr. Secretary, if this is not adequate, I think you ought to be recommending amendments to this bill making it adequate and I have in mind not for the circumstances of the day but for the circumstances that you can foresee during the next 2 years, and I want to know if you think this bill is adequate to meet the problem.

Mr. VOLCKER. We think this bill is, in a sense, not adequate to meet the problem—I suppose so long as we have outflows—but this particular approach goes as far as it properly should, and we are not prepared to recommend that this particular approach be extended any further.

The CHAIRMAN. Well, let me make it clear if we pass this bill, I want to hold you responsible for what happens. I don't have in mind that this bill is going to create a problem. The question is whether by failure to go far enough with it that the problem gets out of hand. I don't want to have it said that we didn't adequately provide you the tools to meet the capital outflow problem in this country.

So if you are going to need something else I think you ought to ask for it and now would be a good time to do it.

Mr. VOLCKER. I understand your reasoning very well, Mr. Chairman. But we are not prepared to ask for anything more at this time.

The CHAIRMAN. Thank you very much.

Senator Anderson.

Senator ANDERSON. On page 7 you say "Certain domestic mutual funds treated as foreign for the purposes of the interest equalization tax not be permitted such treatment on new issues. More importantly, we urge that you extend this legislation for another 2 years."

I am sure the chairman asked a question about that but I want to have you answer. Why do you think 2 years for this is appropriate? Why do you think this is enough?

Mr. VOLCKER. This tax has been renewed, I guess, on three occasions already, Senator. We like to think of it, and still do think of it, as a temporary tax. Given the circumstances in which we find ourselves we do think it is necessary to continue the tax, but I wouldn't want to propose any longer period of time because I think we should review this at intervals not too far apart. The burden of proof, in effect, should be on us to demonstrate that the circumstances are such that require its continuation, and I think we should accept that burden and that responsibility, and I, in effect, don't think you ought to give us the power to keep this tax on indefiintely because it is an extraordinary kind of thing. We should come back and justify it if we have to continue it.

Senator ANDERSON. But you said more importantly, we urge that you extend this for 2 years more. How about 4 more years or 5 more years or 6 months.

Mr. VOLCKER. Well, this is a balanced view. We say 2 years for the reasons that I suggested. We don't think it should go too long without congressional review. On the other hand, sitting where we now sit, 6 months seems clearly too short a period of time. If we need it now, we are likely to need it 6 months from now. I don't think we want to necessarily review this every year. Two years is an arbitrary length of time but it seems to be a reasonable compromise.

Senator ANDERSON. I don't have any questions but I do think it is strange that we get these solutions all the time and we have to get them going in the same old place. Many of us didn't want to see them 2 years ago. I don't have any more questions.

Mr. VOLCKER. In terms of making the extension shorter, I think it is relevant to emphasize that should the situation change we are able to reduce the rate to zero, and one of the criteria for setting the rate

is to rely upon this tax just as little as we have to. So, should a judgment be arrived at, that this tax could, in effect, be abandoned we could, without further legislative authority, reduce the rate to zero.

Senator ANDERSON. I am just trying to make sure that you people are in position to say this needs to be 2 years time. I think some may want it 6 months or 1 year. But 2 years is a long time.

Mr. VOLCKER. Well, I can only say in response to that that we can remove the tax as soon as circumstances justify regardless of the time limit specified here by reducing the rate to zero.

Senator ANDERSON. But you don't think it would be possible to do that do you?

Mr. VOLCKER. Pardon me.

Senator ANDERSON. You don't think there would be a possibility of doing that?

Mr. VOLCKER. Yes; it is possible within the terms of the limitation.

Senator ANDERSON. I have nothing further.

The CHAIRMAN. Senator Curtis.

Senator CURTIS. Thank you, Mr. Chairman.

What do the House amendments do to this bill. You alluded to them.

Mr. VOLCKER. Yes, sir; a series of more or less technical amendments, as the chairman said, which take care of a number of particular kinds of frictions that have developed over time in the application of the tax. None of them is of profound importance from a national viewpoint but they tend to make the administration of the tax a little more orderly and equitable.

Senator CURTIS. In other words, it does not materially change this program.

Mr. VOLCKER. That is correct; it does not.

Senator CURTIS. So in reality we have just a 2-year extension?

Mr. VOLCKER. That is, the basic bill is, a 2-year extension.

Senator CURTIS. Just briefly, how is this tax administered. Is it levied upon the brokerage house that sells the security or how is it administered?

Mr. VOLCKER. Well, the brokerage house or a financial intermediary of some sort would often be the first purchaser and the tax is levied on the first American purchaser of the foreign security. If it does go through a brokerage house or an underwriter the underwriter on the new issue would be the man who paid the tax, and once the tax has been paid on a foreign security purchased from a foreigner, you can attach to the security a certificate of American ownership so it can be traded freely subsequently in our market.

Senator CURTIS. Well, that answers my second question. The tax is just applied once.

Mr. VOLCKER. It is applied once. It is a percentage of the capital value of the security. The percentage is determined so that it is equivalent to an annual interest rate currently of three-quarters of 1 percent.

Senator CURTIS. So a tax on a security of $100,000, a foreign security, subject to this law that ran for 5 years would have a different rate than a tax on a security of $100,000 that ran for 10 years.

Mr. VOLCKER. That is precisely right. The tax is graduated so that it is equivalent to the same interest rate for both of those maturities, but the capital value of the tax is different.

Senator CURTIS. And the amount you collect is the equivalent of a three-quarters of 1 percent interest rate each year——

Mr. VOLCKER. That is correct, over the life of the security.

Senator CURTIS. Suppose the security is sold back to the country from which it came.

Mr. VOLCKER. If it is sold back to a foreigner, then taxes will be collected again if it is bought by an American. In other words, once it passes out of American ownership then it will again be subject to tax. The tax is on a foreign security purchased from a foreigner.

Senator Curtis. But when it is sold back do you have to make a refund, if it is sold back?

Mr. VOLCKER. No; there is no provision for a refund. We don't have provision for refunds of taxes for purchasers.

Senator CURTIS. That is all.

The CHAIRMAN. Senator Jordan.

Senator JORDAN. Mr. Secretary, how much does the interest equalization tax yield?

Mr. VOLCKER. It has jumped around a bit from year to year. In the last calendar year 1970, it yielded just under $50 million, $47.5 million. In 1969, again the calendar year, $125.8 million. That was by all odds the largest year of revenues. We have projected for the next fiscal year $85 million, which is rather in the middle of these last 2 recent calendar years.

Senator JORDON. The amount of receipts fluctuates widely even though the rate remains constant at three fourths of 1 percent?

Mr. VOLCKER. The amount of receipts is determined both by the rate, which has changed in the last couple of years, and by the amount of foreign securities purchased. Most of the receipts have come from purchases of foreign stocks rather than new issues of bonds through the years, and at times there has been considerable interest by Americans in buying foreign stocks and paying the tax. Now that comes in waves, and last year it was much reduced from the previous year.

Senator JORDAN. You said in your statement that last year, 1970, our deficit in balance of payments was $10 billion. What would it have been if we hadn't had the interest equalization tax.

Mr. VOLCKER. I wish I could give you a precise answer to that question but I can't. It involves a judgment as to what these purchases would have been and what other elements in the accounts would have been affected.

It also involves a further judgment as to the direct investment program administered by the Department of Commerce, which is very important in this connection.

The Commerce program encourages American firms making direct investments abroad, to borrow abroad to finance those investments.

Senator JORDAN. Yes.

Mr. VOLCKER. And when they borrow abroad, if it is an American subsidiary, their securities are subject to the interest equalization tax. That, in effect, is a method of assuring that when they borrow abroad in the first instance the borrowing doesn't simply come back to the United States through another channel.

So we have two important impacts from the interest equalization tax. We have the direct kind of restraint on foreign borrowing. You can judge its effectiveness, I think, to some degree, by looking at the

falling percentage of international borrowings, foreign borrowing that is done in the U.S. market as compared to other markets now relative to the early 1960's before the tax was in effect.

It used to be more than 50 percent of all the international borrowing was done in the international market. Now I think it is down to 20 percent or 20 to 30 percent so it has been cut very substantially.

The other part is these billions of dollars of securities that American firms have issued aboard. They are, in large part, held abroad by virtue of this tax being in effect. Now that could be a once and for all effect but if this tax were removed in the short run it is possible that several billion dollars worth of securities would come back into this market.

Senator JORDAN. Does this tax apply only to foreigners who come into this country to borrow or does it apply to U.S. businessmen who take American capital out of this country to invest in foreign lands?

Mr. VOLCKER. It applies to both, with two important exceptions. It does not apply to lending by Americans in less developed countries or by borrowing by less developed countries in our market and it does not apply to direct investments. So if an American company makes a direct investment abroad, builds a plant, or supplies further funds to an operating subsidiary abroad, the tax does not apply. That kind of foreign investment is governed by the Commerce program on direct investment.

Senator JORDAN. Have any of our trading partners in foreign lands retaliated with an investment equalization tax of their own.

Mr. VOLCKER. No, sir. A number of countries have restraints or controls of one sort or another on the flow of capital out of their own country, but there has been nothing in the sense of any kind of retaliation to this action.

Senator JORDAN. In the last several months the prime interest rate has dropped from 8½ to a little over 5 percent in this country, and yet your investment equalization tax has remained constant. Is there any relation between the two. If so, why have you not invoked a higher investment equalization tax than the constant three-fourths of 1 percent?

Mr. VOLCKER. Well, there is some relationship between the particular rate you cited and this tax. I think more relevant probably for the bulk of the kind of transactions covered, are the rates for long-term bonds where the difference has not been as great as implied by the change in the prime rate. But there certainly has been a change. The long term bond rates in this country have come down significantly more than abroad.

I think the best answer I can give you to that question is that we have not detected any increased borrowing by foreigners with the three-quarters percent tax rate even given the easing in the American market for the types of lending and borrowing covered by this tax. There has been a great deal of flow in the very short area but not in the areas covered by this tax.

I think it is probably fair to say that the tax inhibits this activity not simply because of the rate but people have some resistance to paying the tax, whatever the rate level is, and this may account for the fact that a fine tuning of the rate, so to speak, has not been necessary.

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Senator JORDAN. Mr. Secretary, how important do you think the balance of payments really is. If we can tolerate a $10 billion deficit in our balance of payments without any undue effects on the economy, why do we worry about a balance of payments at all. Some economists say we should forget about it. What do you think about this.

Mr. VOLCKER. I don't find myself at all in agreement with those economists. I think our balance of payments is extremely important. The United States is obviously by far the largest economy in the world. Our currency is the most important currency for conducting the world's business, and it is a very important component of other country's reserves. The stability of our currency is important, therefore, to the stability of the whole international monetary system. We tend to take the stability of the monetary system for granted when it is operating well, and it is operating with reasonable stability at the time. If it was not operating well, and it comes under great strain and pressure, we would realize that flows of trade and investments would rapidly become very distorted to the detriment of us all.

Our balance of payments over a period of time is, and does have, an important bearing on the stability of the whole system.

Senator JORDAN. At what point does a deficit in balance of payments become intolerable. If $10 billion in 1 year is tolerable, would $10 billion in 2 successive years or 3 successive years be intolerable. If so, what do you do to correct it.

Mr. VOLCKER. I think that is right. I think you put your finger on it precisely. Let me put this $10 billion figure in perspective. It is a terribly large figure and I am not at all happy with it, but that figure was affected by very large short-term capital outflows, and I think people recognize, and can to some degree accommodate themselves to, large swings in short term capital which are felt to be temporary. The $10 billion deficit on that basis followed 2 years of surplus on that same basis when we were bringing in short-term money.

Now, I think these big flows back and forth create problems in and of themselves, but so long as they are short term flows and go in both directions, it doesn't have the same significance as a persistent large deficit over a long period of years.

Now, it so happens we have a persistent underlying problem here, too, but it is not measured by $10 billion. It is more in the order of $3 or $4 billion in a more fundamental sense. That is bad enough, and that is what we have to work on and try to correct. But this $10 billion figure puts it a bit out of perspective and $10 billion year after year would not be a sustainable situation.

Senator JORDAN. The summary of your testimony is something like this—in essence you need the extension of the interest equalization tax as one tool to help defend the dollar?

Mr. VOLCKER. It is only one tool, and it is not, in my opinion, a desirable kind of tool. I would like to get rid of this entirely if our basic position were in better shape.

But I have to recognize that our basic position is not in better shape.

Senator JORDAN. Thank you. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Byrd.

Senator BYRD. Thank you, Mr. Chairman. I support the Treasury's position and I have only one question, Mr. Secretary.

Is it true that if one were to buy the Japan Fund that one would pay one interest equalization tax but if one were to buy shares in the Pan-Australian Fund one would pay two such taxes, is that correct and, if so, why?

Mr. VOLCKER. Well, there is a difference of treatment here, Senator Byrd, and I made a too subtle allusion to this in the next to last sentence in my statement. The Japan Fund was in existence at the time the tax was passed, and a special provision was put in the tax to cover this kind of situation. That provision, in effect, said that this domestic fund can call itself foreign and, therefore, within the portfolio of the fund it could trade in and out of foreign securities without paying any tax. Now that was a grandfather clause, in effect, and other funds are not eligible for that kind of treatment.

I think it could be argued that there is an inequity here to the extent that a fund like the Japan Fund could issue additional securities to Americans, and they would then pay the tax once, as you suggest, but then with that additional money they would be free to switch in and out of foreign securities. Other American funds could not do that. Therefore, what I, in effect, suggest in the statement is that this inequity might be cured by making it clear that a fund in the position of the Japan Fund, while it has the privilege that it has because it was blanketed in at the time the tax was adopted, should not have the privilege of issuing additional securities to American shareholders and only paying the tax once, whereas other funds don't have that privilege.

Senator BYRD. You recommend that in your legislation?

Mr. VOLCKER. We would think that that would be a desirable change if the committee wants to make it in the interests of equity among these funds.

Senator BYRD. Thank you, Mr. Secretary. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Hansen.

Senator HANSEN. Thank you, Mr. Chairman.

Mr. Secretary, foreign countries have about four times, so I am told, as many dollars in their possession as we have gold. Do you think there is any danger that these countries will begin to cash in their dollars against the gold and, if they do, what would be the response of our Government?

Mr. VOLCKER. Well, let me put the four times figure in a little perspective too. The only people who can cash in for gold are foreign central banks and governments. They hold $20-some-odd billion which is still in excess of our gold stock and still in excess of our total reserves. But we have resources other than our gold stock, too. We have other reserve, we have special drawing rights and a gold tranche position in the fund, totaling about $3 billion between those two assets. We have considerable facilities either through the fund or outside the fund for borrowing foreign currencies, and all of this provides protection for our position and it is a good deal stronger than the comparison that you suggested implies.

We do stand ready when foreign countries request gold or other reserve assets to pay them out. Apart from our allocation of special drawing rights, we paid out something approaching $3½ billion of various assets last year, and if we get requests we will continue to pay

them out, and if we have a serious balance-of-payments deficit we will have some requests.

Now, I don't think I can speculate beyond that. We have considerable resources at our disposal. And this is one of the reasons why it is important we not neglect our balance-of-payments problem and take what measures we responsibly can to deal with the basis of the problem which is a balance-of-payments deficit.

Senaton HANSEN. While it is true, as you point out, Mr. Secretary, that the total dollar holdings in the hands of individuals that go to make this total of what I understand is about 4 times the amount of gold we have, isn't it also true that in the event there was a loss worldwide of confidence in the dollar that it would be expected that these American dollars in the hands of foreigners would go into central banks and into governments and that they would indeed become requests upon our Government for gold.

Mr. VOLCKER. I think this is why it is so incumbent upon us to maintain the kind of confidence which is necessary. The dollar is a very useful asset to foreigners whether they are governments or private citizens. They can use it to make all sorts of payments, and they earn interest on it at the same time. But it is true if they lose confidence in the stability of our economy and the stability of the dollar we would be in real trouble, and I think we must conduct our policies in a way that sustain that confidence. There is no question whatever in my mind that the most fundamental responsibility we have, far beyond the kind of action we are considering here today, is to maintain the stability of the dollar at home, and that is the essential thing for maintaining its international stability.

We haven't done as good a job on that score as we should have done. We live in a world in which inflationary pressures are not unique to the United States, so relatively we haven't done as poorly as it looks in absolute terms.

It is fortunate—and we must capitalize on the circumstances—that we are somewhat further ahead, I think, in dealing with our inflationary problem than a good many foreign countries. We have had a considerable cost in terms of unemployment and slower growth in the process as well. But we have bought something here in terms of progress on the inflationary front, and particularly progress relative to what other countries are doing, and we must continue to move in that direction precisely because of some of the dangers that you are looking at here.

Senator HANSEN. Well, I share the concern that has already been expressed by questions as to the adequacy of the three fourths of 1 percent, and I think your testimony is quite precise on that point.

I gather from what you have said that you do not find it desirable to recommend a higher interest equalization rate at this time.

Mr. VOLCKER. I think if you will look at table II on that point, Senator Hansen, you will see that essentially the second line there—i.e., the countries to which the tax applies—indicates their total new security offerings in our market have been quite low. Now there was a $130 million outflow you see there for 1970. That happened to be a transaction that was exempt from tax. It was a simple exchange of securities in a direct investment transaction where some American securities were exchanged for some foreign securities, and it was not subject to tax.

Essentially there were no taxable transactions in this area at all last year.

The rate differentials may be slightly greater now than on the average last year, but we just have not seen any real pressure on the types of transactions that are subject to the tax. If that did develop obviously we would have to review the rate and that is within the President's discretion.

Senator HANSEN. I have one more question, Mr. Chairman. I am just trying to find in the Secretary's testimony a reference to our trade balances, and I don't happen to find it or see it.

Mr. VOLCKER. There is a table which will show that, table I, which is in rather small print, which does show our trade balance, the very first line on that table, and it brings out what has been, I suppose, the major element in our underlying problem.

Apart from the short-term capital flows, the principal element in our problem in recent years has been that our trade balance has deteriorated. You can see on that table in the first half of the 1960's it averaged almost $5½ billion a year surplus and that was a period when we were having quite good growth but we had exceptionally good price performance. Then as we got into the inflation in the later 1960's, in the overheating of the later 1960's, that performance steadily deteriorated, and our trade balance almost disappeared in 1968 and 1969. We made some recovery in 1970, back to $2.2 billion which is gratifying.

At the same time, I think we have to recognize that recovery was as much as it was because our economic activity had slowed down exceptionally last year. So we have a very major challenge in that area, and I think that is the heart of our problem.

Senator HANSEN. I guess I was trying to find the language contained in the concluding paragraph, I mean the concluding sentence in the first paragraph, on the top of page 6. You are speaking here about the balance of payments, and "I would emphasize that, even if it were acceptable on domestic grounds, there is no salvation for our balance of payments in a sluggish domestic economy. As we can see now, such an economy is prone to export capital abroad, and it does not encourage long term capital inflows."

Then you say "temptations to embark on self-defeating protectionist measures would be stronger and growth in the world economy would be retarded."

I would like to ask, Mr. Secretary, what is your position with respect to a proposal such as has been made by the Japanese on textiles.

Mr. VOLCKER. Well, I think the President has spoken rather clearly and fully on that subject, Senator, and I plainly don't have anything to add to his statement on that score.

Senator HANSEN. I assume that you agree with his statement?

Mr. VOLCKER. I support the President, yes, sir.

Senator HANSEN. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Miller.

Senator MILLER. Mr. Secretary, on page 2 of your statement you refer to the Commerce Department's program that is supposed to encourage U.S. firms to finance a portion of their overseas expansion in foreign markets, and then you say that without the interest equalization tax, programs such as this would be substantially weakened.

Can you give us a picture of what the result has been over the last 4 or 5 years on this policy to encourage U.S. firms overseas to finance a portion of their overseas expansion in foreign markets.

Mr. VOLCKER. Yes. I can, I am sure, give you some data here. But essentially there has been as a result of this program a sharply increased emphasis on borrowing abroad in order to cover expenditures incurred abroad and in making plant and equipment investment and other investment abroad. This has, in the early years of that program, amounted to several billion dollars a year so we covered a large portion of the direct investment outflow, in effect, by borrowing abroad. It had a particularly strong effect the first year or two.

Now, that effect, as they built up a backlog of foreign borrowings, perhaps has not been as pronounced in the last couple of years, but American companies have borrowed something like $10½ billion in the Euro-bond and Euro dollar market by this time, and a very large proportion of that borrowing, I am sure, was, in effect, induced by this Commerce program.

Senator MILLER. Do you have any figures which would enable us to draw the conclusion that a good chunk of this $10½ billion was attributable to the interest equalization tax. For example, do we have comparable figures of how much these American companies have been borrowing in previous years in the international markets so that we can see the contrast.

Mr. VOLCKER. I think I can supply you with some figures for the record, if we don't have them right here.

Senator MILLER. If you don't have them here why don't you provide them for the record and let us see what the picture looks like for, say, a year or two before the interest equalization tax went on the books so that we can see the contrast.

(Information supplied by the Department of the Treasury appears on the opposite page:)

U.S. direct investment

[Millions of dollars]

	1965	1966	1967	1968	1969	[1] 1970
Net capital transfers from United States [2]	3,101	3,452	3,327	2,261	2,955	3,500
Use of funds borrowed abroad [3]	104	638	542	2,161	2,560	2,500
Use of U.S. source funds	2,997	2,814	2,785	100	[4] 395	[4] 1,000

[1] Estimate.

[2] To countries other than Canada (which is exempt from the Foreign Direct Investment program restrictions). Includes certain debt repayments and certain indirect transfers of capital which have been relatively small.

[3] Includes use of proceeds from foreign borrowing by overseas finance subsidiaries, such as those in the Netherlands Antilles; also, beginning with 1969, includes some unknown amount of foreign borrowing allocated to offset reinvested affiliate earnings.

[4] Understated by amount referred to in latter part of footnote 2.

NOTE.—The above data differ from data collected by the Office of Business Economics, Commerce Department, and published periodically in the "Survey of Current Business." Differences relate to the number of reporting firms, the definitions used, and the nature of the reports.

Source: Office of Foreign Direct Investment, Commerce Department.

CLERK'S NOTE: It is understood that the mandatory direct investment program went into effect in 1968. This table therefore shows the effect of the mandatory program on foreign borrowings before and after it went into effect.

Mr. VOLCKER. That will come out quite clearly. But let me just clarify one point. Their inducement to borrow abroad for that purpose comes from the Commerce program, not the interest equalization tax. The interest equalization tax in itself does not cover direct investment. What the interest equalization tax does is keep abroad these securities which they sold abroad because when those securities are sold by a subsidiary—a finance subsidiary—of an American company they become a foreign security, and the tax would apply to those securities if they were resold to an American.

You have a kind of a complementary program here where the incentive to borrow abroad comes from the Commerce program, but the interest equalization tax prevents the buyer of those securities abroad from selling them back to an American.

I, for some reason, haven't got the figure right here on the amount of borrowings but it is reflected in a difference between two figures.

Senator MILLER. Maybe, Mr. Secretary, this will help. On page 12 of the House Ways and Means Committee report there is a statement that "the currently outstanding volume of these issues, some of which are convertible into stock, is $5.6 billion."

Mr. VOLCKER. It is about $10½ billion in total over there.

Senator MILLER. I can understand that this is a rather complicated question or at least it would require putting some bits and pieces together to give us a complete picture but I would hope you can do that for the record.

Mr. VOLCKER. Yes; I think I can give you some figures that will get at the point you are at. The direct investment abroad in the early 1960's ran: 1952, $1.6 billion; 1963, $2 billion; 1964, $2.3 billion. It averaged during those years about $2 billion. This was all reflected in flows of money out of the United States. Then——

Senator MILLER. Well, pardon me, are those flows of the kind that we are talking about here, namely, financing overseas expansion.

Mr. VOLCKER. Well, they weren't at that time. These programs were not in effect then, so that, the total direct investment flow was financed straight out of the United States. These are the figures I just gave you.

Now when these programs went into effect the total amount of investment overseas, direct investment overseas, was running at a higher level of about $3½ billion, by and large, in the second half of the 1960's.

But the actual outflow of U.S.-source funds was smaller than that. The total direct investment outflow was $3.7 billion in 1966. The outflow of U.S.-source funds, however, was considerably less—about $500 million less due to use of the proceeds of bonds sold abroad and several hundred million dollars less due to use of the proceeds of foreign bank loans. In 1967 it was about $300 million less due to the bond proceeds and about the same amount less due to foreign bank loans.

Senator MILLER. On that point does that mean profits made overseas were then plowed back in.

Mr. VOLCKER. Reinvested earnings don't enter into any of these figures. That is——

Senator MILLER. That would account for the difference, however, would it not?

Mr. VOLCKER. No, this difference I am talking about is accounted for by foreign borrowing by the U.S. direct investor. In 1968 the difference

was $800 million due to use of the proceeds of bonds issues alone. In 1969 the difference due to these issues alone was $600 million. Now there are other technical adjustments but essentially that difference reflects the fact they were induced to borrow abroad to finance part of their direct investments overseas. One form of borrowing overseas reflects the borrowing through bond issues abroad by so-called Delaware subsidiaries which, for this purpose, are considered foreign. They are subsidiaries set up for the specific purpose of financing overseas investments, and for purposes of the interest equalization tax these subsidiaries are considered foreigners. Now there was additional borrowing by the U.S. direct investor from banks overseas.

Senator MILLER. All right.

Now, one more area of questioning. On table II you show international institutions, $241 billion, or is that million—I don't know, I assume that is million dollars, $241 million.

Mr. VOLCKER. Yes, these are millions of dollars in 1970.

Senator MILLER. What is the significance of that item.

Mr. VOLCKER. These are essentially borrowings by the World Bank and other such institutions in our market, and, as you can see, they were running at a low level in the early half of the 1960's. They didn't need to borrow so much in view of their operations and there was a great effort to maximize their borrowings abroad.

Now we have continued to insist that these institutions raise a substantial portion of their funds in other markets, but as their total needs have increased we have felt it appropriate that they borrow some portion of their needs in our market, and those borrowings are not subject to tax. They do have to get approval from us so they are under control. But this——

Senator MILLER. How much of a push does that $241 million represent?

Mr. VOLCKER. In that particular year my recollection is that that probably is close to half. In 1969 it was substantially less than half, in my recollection. My recollection is about half of their long-term borrowing. They may have borrowed some short term abroad in addition to that. This is a matter of judgment, how much to permit them to borrow.

Senator MILLER. One last question; table II shows under Canada $1.2 billion for 1969, $776 million for 1970, is that a net figure or is that a gross figure. In other words, do we have some——

Mr. VOLCKER. This is a gross figure.

Senator MILLER. This means, as I understand it, that Canada floated investment issues in this country.

Mr. VOLCKER. In that amount.

Senator MILLER. But that some of our people float some issues in Canada which would offset that.

Mr. VOLCKER. Well, there isn't much, there may be a little of the latter but not much. This is their gross sales of new issues in the American market. The principal offset to that is they have sizable redemptions of securities that were sold earlier in the American market and they run over $200 million a year currently, as I recall it. So the net sales of Canadian issues in our market are significantly below those figures mainly because of their own large redemptions.

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Senator MILLER. Thank you very much.

Thank you, Mr. Chairman.

Mr. Chairman, the staff has asked for one more question.

Mr. Secretary, can you tell us what the U.S. trade and balance-of-payments position is with Canada?

Mr. VOLCKER. Yes, I can.

Senator MILLER. As you know, Canadian securities are exempt from this tax.

Mr. VOLCKER. Yes.

Senator MILLER. But there was no understanding that Canadians would use this exemption to increase their international reserves. What has happened to their international reserves?

Mr. VOLCKER. Well, our bilateral position with Canada has deteriorated. Our trade position which used to be in substantial surplus has now turned into a substantial deficit. The overall Canadian position has very substantially improved. Their trade position with the whole world has improved very sharply through the years. Their total balance-of-payments position has improved. In the latter part of 1969, early 1970, their reserves began increasing very rapidly. Now since that time they have been on a floating exchange rate, as you know, and the increase in their reserves has essentially halted and, at the same time, they have reduced rather sharply the volume of their borrowings in this market.

I think the implication of your question is quite true. They are in a much stronger position now and, for balance of payments reasons, much less heavily reliant on our market, and we would expect that phenomenon to be reflected in their volume of their borrowings in the future.

Senator MILLER. Are you suggesting that this understanding that the Canadians would not use the exemption to increase their international reserves has been winked at?

Mr. VOLCKER. I have no real problem in terms of the behavior of their reserves. I think more importantly is the question of whether the exemption for Canada opens an avenue by which funds can pass through Canada to third countries, and there have been certain understandings with the Canadians that they would take measures to prevent so-called pass-through of funds to third countries.

It is not always easy to identify and control, but there are certain guidelines that are applicable to Canadian banks and financial institutions, and so far as I know I think these guidelines have been reasonably observed. So——

Senator MILLER. Do you have any evidence of a substantial amount passing through?

Mr. VOLCKER. We do not certainly in terms of the behavior of their financial institutions. Statistically and otherwise it is not possible to trace every kind of avenue as fully as one might wish, and I think the basic answer to this kind of problem has to be that in terms of their overall balance-of-payments position they are less heavily dependent upon our market at present. That should be reflected in actual developments, as time passes; and, in fact, the level of Canadian borrowing in our market has been rather low ever since their reserves went up. It has, I think, amounted to something like $350 million in the past 9 or 10 months, which is a substantially lower rate than it has run for many

years, and actually that particular rate of borrowing isn't a great deal higher than the rate of redemption so on a net basis their call on our market has been much reduced in the past 9 or 10 months.

Senator MILLER. What I guess you are saying is that in view of the trend and the present situation and the willingness of Canada to cooperate on the pass-through problem that you don't have any reason to ask for a change in this exemption at this time.

Mr. VOLCKER. No. This exemption is part of the flexible authority that you have given to the President. But I haven't any recommendations for him or for you to change it at this time. It is a situation that bears watching obviously.

Senator MILLER. Thank you, Mr. Secretary.

The CHAIRMAN. I want to ask one more thing, Mr. Secretary.

You can check me with this and see if my memory is correct.

The administration, and I am speaking now of the Democratic administration, your predecessors, did not ask that we close that loophole about bank loans. I believe they didn't ask that we shorten the period down below 3 years, but we did that anyway. The bank loan amendment was on a discretionary basis and it was found that plugged up a loophole without which this would not nearly have been the effective tool that it was intended to be.

If this committee should see fit to write a discretionary provision giving you the authority to act in the area of short-term credit, less than 1 year; what would be your position with regard to that?

Mr. VOLCKER. Well, I suppose one could follow the theory that it never pays to turn down discretionary authority, but we have not in the past felt that this tax could be equitably and efficiently applied in that area of the market, and we, of course, would be reluctant to move in a direction that increased the complexities and difficulties involved here rather than in the direction of simplifying and easing the administration and application of the tax, which is the direction in which we have been trying to move. We have found our ability to move in that direction sharply circumscribed by our balance-of-payments situation.

The CHAIRMAN. Well, the same argument was advanced with regard to the bank loan problem. I personally think if we hadn't given those who had this responsibility, which will be yours, the power to act in that area that the tax would have been a very ineffective weapon. You would have had a big loophole with the bank loans effectively preventing you from administering this law. I don't like to pass a bill that has a possibility of your saying that the situation got out of hand because of a loophole we left in the law—that you would have done something about it but you didn't have the authority. I raise that question because I would intend to raise it with the committee when we meet.

I would feel that in view of the kind of thing that we have encouraged, the free flow of trade and the free flow of capital between friendly nations, that we must retain the authority somewhere in this Government, and it must be in such fashion that it can be used, that we can still provide for the interest of the people of this country and assure that the expansion of credit here for the purpose of trying to provide opportunity and employment and investments within this country, is not used instead simply to build more plants to put more people out of jobs by expanding production in Japan, Korea, Europe, and elsewhere.

I am all for those people making a big success out of their economy but I haven't forgotten who I am supposed to be representing here, whether other people have or not. It seems to me that our primary duty is to the States, and although it may be old fashioned, I still recognize the fact that I represent a State here.

They send me here to represent them. They may not be everything that somebody from Washington or New York would like for them to be, but they are still entitled to have two Senators and the same thing is true of every other State in the Union.

So when we give you the authority to protect the credit and the interest of the American people, I would hope that we would give you enough authority that you can do a job.

Then having done that if you don't do a job we can blame you. If we don't give you adequate authority it seems to me as though the blame must lie with us.

Mr. VOLCKER. I wouldn't want to leave you with the impression that, in my opinion, this tax could be easily administered or perhaps administered at all in a way that can make a large impact on very short-term capital flows without getting into a degree of control of individual transactions that I wouldn't like to see.

The basic problem there is there are so many different channels by which short-term money can go, and essentially a good deal of it can be tied up with completely normal commercial trade transactions, so that attempting to apply a tax of this sort in that area effectively would raise very grave administrative difficulties. It would not easily be effective.

The CHAIRMAN. Mr. Secretary, I can recall the days under a previous administration which had committed itself to make credit more freely available and interest rates lower. We were told that we couldn't carry out that program because all the money would flow out to the nations abroad if we did.

Then when the administration finally decided it did want to do something about it they recommended this bill for which you are testifying now, and they demonstrated that they could do something about that problem if they wanted to, and if we would give them the authority to act.

Now it may be that you can't close that loophole if they should exploit it.

Mr. VOLCKER. I don't think we can cure our problems with this kind of action. It can be helpful in preventing some types of flows to temporarily bolster our position but I wouldn't want to leave you with the impression that this kind of action can protect our position regardless of what we do at home and regardless of what these relationships are.

We have a very real problem here that we have to grapple with. These short-term capital flows would not bother me so much if I thought our basic position was in good shape.

Now I think we are improving our basic position and that is the direction in which we have to continue to move. I think we can take large fluctuations in short-term money in or out and adapt our internal policies so that they don't inhibit us unduly. I think other countries can adapt if they are fluctuations around a basically improving trend

and it is that trend we have to keep our eye on. I don't think we can be misled into thinking this kind of action by itself is going to produce the fundamentally better situation that we need.

The CHAIRMAN. Well, when a situation begins to get out of hand, and you can't do anything about it, I, at least, would like to have you report that you tried. If we don't give you the power to even try, I feel then that it leaves us in a position of simply standing up there and issuing anguished cries of alarm and concern where nothing can be done about it because there is no act on the books and we then may not be able to get an act to do it.

You are aware of this, Mr. Secretary, there are some people who seem to feel they are so much at variance with what this administration is trying to do with regard to foreign policy, such as the war in Vietnam, that they think it advances their argument to vote against every appropriation, vote against every tax, and to vote against raising the debt limit to pay for anything on the theory that if they make it difficult enough for you to operate the Government you will do what they want you to do.

Now, I am one who is inclined to think you are doing the best you can with the situation which you find. I just think that when we look at matters of this sort we ought to give you enough authority where you can save this Nation even though some people might not want it done that way.

Mr. VOLCKER. I can understand your point of view, Mr. Chairman, but I think basically our feeling has been, and remains, we want to move away from this kind of special control, and I don't want to give you or anyone else any illusions that we think that this kind of power could effectively be used, that we want it or that we would apply it.

The CHAIRMAN. I think your position is clear on that.

Any further questions, gentlemen?

Thank you very much, Mr. Secretary and members.

Now, I am now going to call the next witness, Mr. Ralph E. Purvis of Silverdale, Wash.

Mr. Purvis, as I understand, you are testifying for an amendment that you have testified to in earlier days. I believe this committee tried to help you but the House would not agree with that. I was under the impression that you did not ask for help the last time you had an opportunity because you felt that the House would take care of your problem when they initiated legislation this year.

What is your problem now?

STATEMENT OF RALPH E. PURVIS, ATTORNEY, SILVERDALE, WASH.

Mr. PURVIS. Well, Mr. Chairman, I want to briefly—I am not going to read my statement at all. But there are a few remarks I want to make and this is one of them.

The first page in my statement is in error in that it states that the amendment which I propose was adopted by this committee and the Senate in 1967 and 1969. It was not adopted in 1969. It was not before this committee in 1969. The reason it was not, Senator Magnuson had filed a bill to accomplish the amendment; a Senate bill.

The reason it did not come before the committee, we made no effort in the Senate that year, is because the tax had already expired by the time the House got the bill over here in 1969 and we didn't want to play around with a situation like that where the tax had already expired. We wanted an opportunity to have it considered and heard in time.

I did, Mr. Chairman, submit this proposal again in the House Ways and Means Committee on February 22 of this year, and made an oral statement as well, and I do not know what happened in the committee exactly but I am informed that I had considerable support, and I am also informed that there was really no logical argument against my proposal, but the main argument seemed to be that the chairman of that committee felt that I had had my chance in 1967 and I wasn't entitled to another chance.

Now, I am a lawyer and I know that you can only go to court once. Once you have had a trial you are through, but I certainly would hope that I have a second opportunity here, Mr. Chairman, in the Congress to get this accomplished.

Now, Senator Magnuson filed, is filing, another bill in order to indicate to you gentlemen that he still feels my proposal has merit, and it will be filed tomorrow as a separate bill. It is being done only to tell you that he still believes that an injustice was done, and Senator Jackson also supports him in that.

There are a few, there are only about eight, people that I know of in my State, and they are listed in my statement, who are affected as I am.

The best way to explain this briefly is that this amendment would remove the hardship created by the retroactive feature of the act. The act was first proposed on July 18, 1963, wasn't adopted until 14 months later on July 2 or September 2, 1964, and it made no distinction between purchases of foreign securities made with funds exported out of the country after July 18, when it was first proposed, 1963, and funds that were already out of the country before the act was ever proposed.

Now just to show you what happened, we are in a border State with Canada and for many years I had investments in Canadian securities, stocks, I had cash in Canada. I had the ability to borrow money in Canada on those securities from a broker in order to buy other securities.

So this was proposed in July 18, 1963. My funds that I am talking about had been out of the country for a long time before such a proposal was ever made. The act wasn't passed until 14 months later. I had no idea whether it would have been passed, whether it would contain any exemptions for Canada, what the interest tax rate would be, or anything else, so all I can do as a prudent man was to continue to manage my investments in Canada with the money I already had there. In other words, this situation is I bought other securities with money that was in Canada before July 18, 1963. And I did this before the act was enacted on September 2, 1964, and credited to pay this tax.

Now I wouldn't complain paying the tax after the law was enacted on September—if I made purchases after September 2, 1964, and exported capital. But I did not export capital, and this is a glaring defect in the act. They failed to take that situation into consideration.

In 1967, Mr. Chairman, I appeared before this committee and this committee was very sympathetic and felt that we were right. Now since then, however, in 1967 the committee did put a restriction on it to purchases of Canadian securities and also denied any interest on the refund that we would get back.

Now, Mr. Chairman, since then I want to point out that if you adopt my amendment you should not restrict it to Canadian securities because since then I have gained quite powerful support in the House from Congressman Spark Matsunaga, who is a member of the Rules Committee, and he filed a statement with the House committee on February 22 urging this same amendment because, and he said that he has no idea how many Hawaiians were trading in Japanese securities during this retroactive period, but he said at the time the law was enacted in 1964 there were approximately 10,000 U.S. persons in Hawaii that held securities to the value of approximately $20 million in Japan.

He has no idea how many were affected but he feels that there must be quite a number who were the victims of circumstance here just like I was.

So I want to point out that if you do adopt the amendment it should not be restricted to Canadian securities because it should take care of these Hawaiians, and I would hope the two Senators from Hawaii would learn that Congressman Matsunaga is in favor of this and did what he could in the House Ways and Means Committee.

The other thing, I don't think, if you pass it you shouldn't deny us interest because, after all, it is a penalty tax. It was not a revenue-raising tax. The Government just reached its hand in my pocket and took this money out when I didn't even export any capital, and I think we certainly should have interest.

So it shouldn't be limited to any one country and it shouldn't deny us interest.

Now, I was impressed with the statement that Secretary Connally made a couple of days ago in the press. He said that tax laws of the country ought not to be used for other than revenue purposes. As I say, this is a penalty tax, and this problem I have illustrates the dangers that come up, the problems that are presented, when you have a penalty tax other than a revenue-raising measure. I think, Mr. Chairman, that that is all I care to say in addition to my statement. But I appreciate the sympathy that I had previously and I hope you see fit to do the same thing again.

(Mr. Purvis' prepared statement follows:)

STATEMENT OF RALPH E. PURVIS, SILVERDALE, WASH.

My name is Ralph E. Purvis. I am from the State of Washington and am a member of the Bar of that State. I appear here representing myself as an individual investor.

The House passed bill to extend the Interest Equalization Tax, H.R. 5432, contains several technical amendments. The reason given for these amendments is to "eliminate unintended hardships."

My purpose in submitting this statement is to eliminate a hardship which the Treasury Department and the House have overlooked. The substance of the hardship of which I speak was dealt with in S. 2438, introduced in 1969. Senator Warren Magnuson introduced an identical bill last week. The Magnuson Bill is identical to the proposal set forth below and identical to the proposal approved and passed by the Senate Finance Committee and the Senate as an amendment

to the Interest Equilization Tax Extension Acts of 1967 and 1969. Although approved by the Senate, this amendment was not contained in the bill reported out of the Conference Committee either year.

My proposal would add a new subsection which would exempt from taxation purchases made during the initial retroactive period of July 18, 1963, to September 2, 1964, *if and only if purchases of securities were made with funds held by United States taxpayers outside of the United States on July 18, 1963.* In such instances, there was no export of capital from the United States, and the purpose of the Interest Equalization Tax—namely to prevent future outflows of capital after July 18, 1963—was not violated.

The following is the text of the new subsection:

That (a) section 4914 of the Internal Revenue Code of 1954 (relating to exclusion for certain acquisitions) is amended by adding at the end thereof the following new subsection:

"(k) certain acquisitions before September 2, 1964.—The tax imposed by section 4911 shall not apply to an acquisition made before September 2, 1964, by a United States person of stock or a debt obligation if such acquisition was made—

"(1) from funds held by such person on July 18, 1963, and,

"(2) from funds held by such person on July 18, 1963, which were on deposit outside the United States with persons carrying on the banking business, and,

"(3) from the proceeds of the disposition of stock of foreign issuers, or debt obligations of foreign obligors, held by such person on July 18, 1963, and,

"(4) from the proceeds of the disposition of stock of foreign issuers, or debt obligations of foreign obligors, acquired by such person after July 18, 1963 in an acquisition to which paragraph (3) applied, or

"(5) from credit obtained in a foreign country."

(b) The amendment made by subsection (a) shall apply with respect to acquisitions of stock and debt obligations made after July 18, 1963.

TAX IMPACT

During the retroactive period many persons, like myself, who had funds invested in foreign securities for many years prior to July 18, 1963, continued to manage those investments by making sales and purchases, not knowing whether the Interest Equalization Tax would ever actually be enacted, what countries would be exempted, and what rates of tax would apply if it ultimately did become law. Since there was no actual prohibition of trading in foreign securities, and no tax actually enacted, as I say, many persons consummated purchase transactions prior to enactment and with funds located outside the United States prior to July 18, 1963.

Some persons in this category, like myself, no doubt assumed the tax would not apply in those instances where no capital was exported after July 18, 1963. Not until shortly after the act became law did they realize that such transactions were taxable not only in those instances where capital was exported, but also in those instances where capital was not exported. I fit the second category.

For many years prior to July 18, 1963, I had funds in Canada and funds invested in Canadian securities, and had actively traded in listed stocks on Canadian exchanges. I was, of course, aware of President Kennedy's request that Congress enact this tax retroactively, but assumed it would not apply to my funds located outside the United States prior to July 18, 1963. As I understood it, the purpose of the Interest Equalization Tax was to curb the further transfer of capital, not to penalize those persons who had relied on existing law for many years.

As a consequence, I continued to manage my investment portfolio in Canadian securities during the retractive period, and made some purchases during that period, *but with funds located outside the United States prior to July 18, 1963.* In other words, I did not export any capital, yet the tax was applied to the same extent as if there had been a direct transfer of capital.

The following is a list of persons in Washington state who have paid retroactive taxes in the amounts indicated opposite the name of each. In all of these instances the purchases of foreign securities were made between July 18, 1963, and September 2, 1964, and the purchase price was paid with funds or credits located *outside* the United States prior to July 18, 1963. No capital was exported within the period in order for these persons to consummate the purchases:

Ralph E. Purvis, Box 578, Silverdale	$14,737.12
Arthur Ward, 6535 18th Ave. NE., Seattle	11,461.00
Dr. C. E. Marshall, 1221 Minor, Seattle	833.97
Eugene Vallat, Box 1010, Port Angeles	1,825.06
John Harkoff, Box 709, Lynden	7,135.01
Marianne Harkoff, Box 709, Lynden	299.94
Helen Sue Harkoff, Box 709, Lynden	299.94
Martin H. Jensen, Lynden	1,454.04
Erling Crabtree, Lynden	876.00

Adoption of my proposed new subsection would enable myself and other persons in the same very limited category to obtain refunds of such taxes paid.

LEGISLATIVE HISTORY

President Kennedy in an effort to stem the further flow of capital to foreign countries, proposed the Interest Equalization Tax on July 18, 1963. Following more than a year of consideration, Congress enacted the tax on September 2, 1964. The tax on the purchase of foreign securities was made retroactive to July 18, 1963, and applied to all purchases subsequent to that date. With regard to purchases within the retroactive period of 13 months the act makes no distinction between purchases financed with capital already located outside the United States prior to July 18, 1963, and purchases made with capital exported from the United States between July 18, 1963, and September 2, 1964.

I have carefully searched the record of the legislative hearings in connection with the original Interest Equalization Tax, and I am certain the impact on the retroactive feature with respect to instances of purchases made within that period, and with funds located outside the United States prior to the effective date, was never discussed or considered by any Committee of Congress.

The ostensible purpose of the tax, as expressed by President Kennedy when first suggested, and the act itself, was to prevent any further outflow of dollars after July 18, 1963.

CONCLUSION

I respectfully submit that there was both Executive and Congressional oversight of this matter when the legislation was first considered. I would hope that the Committee and the Congress would agree that unintended inequities have resulted and would see fit to adopt the suggested proposal set out above or a similar proposal to provide relief.

The CHAIRMAN. Thank you very much.

Our next witness is Mr. Laurence Levine in behalf of Pan Australian Fund, Inc., of New York.

I think I should ask you whether you have registered under the foreign acts registration law.

STATEMENT OF LAURENCE LEVINE, ON BEHALF OF PAN AUSTRALIAN FUND, INC., OF NEW YORK

Mr. LEVINE. Mr. Chairman, I think I have taken the steps that are necessary. I had written to the Department of Justice about this. I represent an American mutual fund and if any legislation is enacted it is for the benefit of U.S. people not any foreign country or persons.

The Justice Department has not ruled on this formally but they have told me to advise you that, in their opinion, from the facts I have given them, I have no problem and don't have to register. So I am making this statement now.

The CHAIRMAN. If the Justice Department advises you to the contrary, I take it you will register.

Mr. LEVINE. Oh, yes; if the Justice Department advises me to the contrary, I will register. I have no hesitation registering but this

affects U.S. legislation as it will affect U.S. citizens and not foreigners.

I appreciate the opportunity of testifying here and I would like to make this as simple and as practical as I can. I testified before the House Ways and Means Committee and this is something rather new, and I don't think the Treasury Department really had an understanding of it until we brought it to their attention, and I noticed Senator Byrd asked a question about it which Treasury answered.

I am asking you to eliminate an inequity in this tax which imposes not one, that is, tax, but a tax from two to a hundred times on one transaction. We don't believe this was intended, and we don't think it has ever come up because the opportunity has never presented itself.

If I told you Senators that if you bought shares today on the New York Stock Exchange in the Japan Fund you would then make out a check to the Treasury Department for 11¼ percent and that would be the end of it, but if you bought shares in the Pan Australian Mutual Fund, U.S., which we are organizing here on a very limited basis because the IET tax makes it impossible to operate, you would pay two taxes, you would write out your check for 11¼ percent to the Treasury, and then each time the Australian Fund—a U.S. corporation—purchased an Australian stock it would pay the tax again on every single transaction, you might not believe me. That does not occur in the Japan Fund.

You pay the tax once; the fund does not pay it again. Now we are not asking to prejudice the Japan Fund. We are just simply asking that since Australia is a friend and an ally and, by the way, is a net purchaser of $1 billion, over a billion dollars, a year from the United States, that they should be given the same exemption.

We believe that the time has come in American history that if we are to keep a good ally and not make a financial mistake again to put Australia, one of our allies and one of the greatest potential customers of the United States for heavy machinery, lead, oil, and raw materials on at least a par with the Japan Fund. So that we don't make Americans who want to invest in Australia pay the tax twice.

Since this law was enacted in 1964 there have been no investment companies or mutual funds organized in the United States to invest in Australia, simply because this double tax exists.

The result really discriminates in favor of the investment companies entitled to the grandfather clause and it does not appear justified as regarding Australia by any public policy considerations.

I might add that when this law was passed the only fund that existed then, American fund, for investment in foreign shares was the Japan Fund. Now Australia is booming, there is tremendous American investment, and the opportunity exists for a good mutual fund or set of mutual funds to start investing in Australia.

Now let me explain to you quickly why this amendment will help our balance of payments.

We think if this amendment is permitted there will be such an enormous flow of money into this country for investments into Australia that we can't make an estimate really. Let me explain why. Securities of the domestic regulated investment company investing in Australian securities will be appealing to foreign investors desiring to have the advantages afforded by an SEC regulated company and

portfolio managements here in the United States. A good deal of additional foreign investment will come here to go out to Australia. Both United States and foreign investors will finally have a proper channel. Once a fund is organized here—there are none—under the jurisdiction of the Securities and Exchange Commission, we think that as interest rates go down, even aside from that, there are tremendous dollar holdings outside of the country that are now being invested in offshore funds that do not have the protection of the Securities and Exchange Commission.

In addition to that a lot of Europeans like to buy American mutual funds. If you look at the figures you will see a great deal of European funds in the Massachusetts Investment Trust and other funds. If there is an existing regulated registered U.S. fund for investment in Australia we think enormous amounts of money, maybe $200, $300 million will come into the United States very quickly.

I saw in the paper Friday where the interest rates on Euro dollars are down so that as these interest rates go down more money will come into U.S. mutual funds and are coming into U.S. mutual funds.

A second important reason to help our balance of payments, we Americans are very severely criticized for our dominance and control of foreign companies. We end up buying them outright. Friday in the New York Times there was a story that the Canadian Government was thinking of buying Home Oil because a U.S. company was going to buy it.

If mutual fund companies can invest in Australian shares, they are not buying the companies, they are investing indirectly in these companies, and, therefore, we can't be criticized. We are thus investing indirectly in their companies not ours.

As additional help to the United States this will assist banks and financial institutions to invest wisely in Australia. Another reason, there is a lot of leakage out of the United States for investment in Australian stocks. People are investing in London, money is finding its way out. If you have a properly regulated or a group of properly regulated U.S. mutual funds in this country for investment in Australia, you will have professional management, and you will keep the money here in this country.

We think that funds such as this can help with the exports of U.S. goods to Australia by funds taking positions in companies that either need U.S. goods or in financial houses that would have a direct interest in promoting U.S. exports.

I might add that Australia is a friend and an ally. There is no secret that Australia has been very helpful to the United States and that we have a great influence out there and are extending our influence, and we would like to extend our hand to show that influence.

This can assist long term U.S. policy because it will show an economic interest by the United States in developing in Australia in a way she likes, not by buying her companies but by indirectly investing in the stocks of her companies.

I might also add that a fund or group of funds in the United States to invest in Australian shares will create an orderly U.S. market for Australian securities and provide additional jobs in an industry that probably can use them after what has happened in the last year.

We all know the Australian economy is booming. We noted that the Ford Motor Co. announced that its new Asian factory will be built in Australia.

I also noted last week that the Export-Import Bank made a direct loan to a group of Australian banks who then can reloan that money to buy U.S. machinery and goods.

Now, if the Export-Import Bank has that vision, I think the Treasury Department should have that vision because we will not be lending money, we will be purchasing shares in their companies that will then be buying U.S. goods.

There are a couple of other things that will happen. After American interest is shown in Australia we think many Australian companies will be sending officers here to the United States.

If you have seen what is happening since the Japan Fund was organized, many of the major cities in the United States have offices of almost all of the Japanese companies. We think that hundreds of Australian companies will then come to the United States and open up all offices and perhaps even open up banks.

Another factor that will happen there will be an increase in Australian interest in American securities. They are very investment minded but the bridge really doesn't exist yet, and a mutual fund or a group of mutual funds is a way of creating an interest in that bridge.

In conclusion, the change that we are asking, which is really not a very big change, and it is one that I don't think Treasury ever understood before because the question had never been brought up, will provide new opportunities for U.S. financial institutions, particularly mutual funds, to augment their role and importance and participation in the growing Australian markets and, in turn, this will assist U.S. exports of heavy machinery which are needed. It will not cost the United States anything and it might bring anywhere from $200 million to $500 million worth of foreign money into the United States to be invested in the SEC regulated funds which Europeans like.

The change will also cure the discriminatory effect of the 1964 grandfather clause which has permitted in effect only one large fund, the Japan Fund, to exist without this double taxation, a situation which nobody intended.

We are asking only that you permit an American investment in Australia on the same ground that you permit the Japan Fund to exist.

We will pay the tax but why should we pay it twice when Americans want to invest in Australia and they pay it once because they invest in Japan?

Thank you.

(Mr. Levine's prepared statement follows. Hearing continues on p. 51.)

STATEMENT OF PAN AUSTRALIAN TRUST & SOUTHERN CROSS MANAGEMENT CO., NEW YORK, N.Y., BY LAURENCE W. LEVINE, ESQ., IN FAVOR OF GRANTING AMERICAN MUTUAL FUNDS REGISTERED WITH THE SECURITIES AND EXCHANGE COMMISSION (WHO WISH TO INVEST IN AUSTRALIAN SECURITIES) RELIEF FROM THE DOUBLE INTEREST EQUALIZATION TAX IMPOSED ON COMPANIES REGULATED UNDER THE INVESTMENT COMPANY ACT OF 1940—AND GRANTING THEM THE SAME PROVISIONS THAT EXIST UNDER THE "GRANDFATHER CLAUSE" OF THE 1964 BILL [1]

My name is Laurence W. Levine. I am a graduate of Union College and Harvard Law School, am a lawyer practicing at 64 Wall Street, New York City, am General Counsel in the United States for Argentine Airlines and a director of the New York Venture Fund.

I am privileged to appear before you and I do so on behalf of a group of English Mutual Funds and an American who invest solely in Australian securities—a nation that is our friend and ally and potentially one of our biggest customers. They and I are asking your assistance in eliminating an inequity which imposes *not one IET tax but two IET taxes* on the same transaction—which we don't believe was intended to exist—but has never come up because the opportunity has never presented itself.

If I told you that if you Senators bought shares in The Japan Fund you paid one IET tax, but if you bought shares in Pan Australian Fund U.S. you would pay two IET taxes—you would blink as I did. But it's true under the law you passed. This law which permits one large Japanese fund to exist here, but effectively prohibits an American fund organized to invest in Australia—prejudices our relations, foreign and economic, hurting, not helping, our balance of payments and making us look silly.

I hope nobody will take offense, but I must be permitted to question the Treasury Department which only a year ago said no increase in the money supply and high interest rates and reversed itself a year later.

We believe the time has come in American history that if we are not to lose a good ally nor make another dreadful financial mistake in finance—to at least put Australia—a great ally and potential purchaser of our goods at least on a par with Japan and maybe on a par with Canada which is totally exempt from the IET. We are not asking for the elimination of the IET—just don't make Americans who want to buy an American Mutual Fund that wants to buy Australian shares pay the tax *twice*. Make Australia equal to the Japan Fund. Ask Treasury why Japan should be treated better than Australia!

Let me explain.

Since the law was enacted in 1964, investment companies formed in the United States and registered under the Investment Company Act of 1940 are unable to be formed on a commercial basis to invest in Australian securities. There was only one large fund at the time this law was passed that could take advantage of the law and that was the Japan Fund. In the case of an investment company not qualifying under the "grandfather clause" of the 1964 IET bill, the interest equalization tax was imposed at two levels: (1) a United States citizen acquiring the securities of an investment company is subject to the IET on the acquisition of the fund shares; (2) the investment company or mutual fund, under the present law, would be subject to the IET on each purchase of foreign securities with a credit given once for the tax paid by the shareholders of the fund. After that, the company pays another 11¼% tax on every share it purchases in a foreign security. Consequently, an investment company that does not qualify under the "grandfather clause" of Section 4920(a)(3)(B) is subject to such excessive IET that as a practical matter it cannot operate. This result, which discriminates in favor of those investment companies entitled to the "grandfather clause" benefits, does not appear to be justified by any public policy considerations when related to Australia.

[1] Practically translated: To allow American Mutual Funds to invest in the shares of companies in Australia—an ally and friend—and to eliminate the double interest equalization tax which nobody intended and which effectively prohibits this.

The proposed change would permit investment companies formed after July 18, 1963, for Australian investment, to make the same election as was available to such companies existing on that date. U.S. citizens acquiring the shares of such American company would pay the interest equalization tax. We don't want to pay it twice!!

As regards the balance of payments objectives of the IET, which by the way, expire on March 31, 1971, they would be either neutral or else help our balance of payments. Purchases by U.S. citizens of the company's securities are subject to the IET. The fact that the investment company could trade freely in its foreign security portfolio of Australian stocks by substituting one foreign security for another would involve no outflow of U.S. dollars. Japan Fund does this.

The reasons I believe this amendment may help our balance of payments and certainly would not hurt it, are as follows:

(1) Under present law, a U.S. investor desiring to invest in a diversified and professionally managed portfolio of Australian securities finds such opportunities limited to U.S. investment companies that were entitled to the benefits of the "grandfather clause" of the 1964 law. With the exception of a few, principally Canadian funds and the Japan Fund, *no foreign Australian investment companies have been registered under the Investment Company Act.*

(2) Securities of a domestic regulated investment company investing in Australian securities will be appealing to foreign investors desiring to have the advantages afforded by an SEC regulated company and portfolio management in the United States. A good deal of additional foreign investment will be channelled here. Both U.S. and foreign investors will have a proper channel in which to invest.

(3) This will assist mutual funds or investment companies to invest in Australia, whose imports from the United States have increased about 10% a year and are now 1.12 billion dollars a year and permit wise investments in Australia and stop a good deal of speculation now going on.

(4) American investment in Australia is occurring at a rapid rate. In order to see to it that a proper, well managed vehicle for that investment is around, rather than a poor vehicle where people will lose their investment—funds managed by successful people in the field, based in the United States, under the strict supervision of the SEC—should be allowed.

(5) A fund such as this will be in a position to increase U.S. exports to Australia, by taking a position in companies that either need U.S. machinery or in finance houses and banks that would have a direct interest in promoting U.S. exports. This is easy to see. Companies that this fund invests in will need machinery. That machinery cannot be purchased without funds.

(6) Australia is a friend and an ally, and that must continue. In years to come as Chinese and Japanese dominance expand in Asia—Australia may be lost to the United States as a means of an export market for our industry.

There is no secret as to what Japan is doing in Australia. In addition to contracting for over 1 billion dollars in ore in the next 20 years . . . Japan is rapidly expanding her dominance in the trade pattern of Australia. If United States prestige, influence, and export markets are to be extended to this potential giant of a purchaser, then we must have a presence and an influence there, and we must extend our hand to show our interest.

In a major way, funds such as this can assist long-term United States policy because it will not only show an economic interest from whence exports will flow, but it will evoke many Americans to feel a bond to the country of Australia. We are impressed with the fact that the Japan Fund not only created capital to invest in Japan but it politically assisted the United States by showing the Japanese our interest at a time when they needed it. In future years, as America moves troops out of Asia, this interest in Australia is essential by the American public.

Politically as Australia becomes one of our major allies in Southern Asia, it is important to concentrate on building this type of a bridge.

(7) A proper fund will offer a means for some American banks and institutions to channel money into Australia wisely. Many large American banks and brokerage houses are "speculating" in matters they lack expertise in. Funds will assist these people to invest wisely.

(8) Australian funds—as The Japan Fund did—will not only help create an orderly U.S. market for Australian securities, but will provide jobs in an industry that has virtually gone through bankruptcy this past year. We believe that a good number of people will develop houses for the trading of Australia's securities—not only creating employment here—but keeping smaller investments from

going to London to buy these shares. We note the active interest in Australian shares in New York already—and a very active interest by Americans in London. That money should stay here,

(9) The Australian economy is booming and Australia is being used as the base from which to export to Asia. American participation in that trade is essential. Only recently we have seen Ford Motor Co. announce its new factory in Australia—to make autos for the entire Asian market. We think hundreds of these opportunities will occur—where U.S. plants will use Australia as their base—increasing U.S. exports—dollar returns, etc. to the U.S.

(10) We believe that in time, after American interest is shown in Australia—that two other major events will occur to assist our balance of payments and economy—one will be the sending to the U.S. of many people and the opening of offices of many Australian companies in New York and Washington and San Francisco.

Only recently—this month—has another air carrier been certified to fly to Australia. Twenty years ago only Northwest and Pan Am flew to Japan. The increased Japanese need for the U.S. and the Japanese came here in high numbers.

The only Japanese Bank in New York 10 years ago was the Bank of Tokyo. Today every major Japanese bank and Japanese company has an office in New York. We believe that funds such as this could be a catalyst—as was the Japan Fund—to the same result occurring in the U.S.

The second major event will be interest by Australians in American securities. Australians are young—there is no bad history of Australian-American relations as there was with Japan. Australians remember America from W.W.II and are friends, not former enemies. Australians have no traditional ties such as airlines or steamship companies with a history here. That is just starting. We look at these funds as the major catalyst to bring Australian money into the U.S. market in substantial sums.

(11) And lastly, and this is very important, we Americans are severely criticized for our dominance of control of foreign companies. We end up buying them outright. If Mutual Fund Companies can invest in Australian shares, they are investing indirectly and thus we cannot be criticized. We are investing in their companies, not ours.

In conclusion, this change will tend to provide new opportunities for United States financial institutions, particularly mutual funds, to augment their role and importance and participation in the growing Australian markets, and in turn this will assist United States exports of particularly heavy machinery which is needed in this area by injecting some money into the shares of companies that need capital. It will not cost the U.S. anything. I noted that very recently, the Export-Import Bank granted a loan to an Australian financial organization who in turn may relend these funds out, with EX-IM approval—for the purchase of United States machinery. We want to do the same thing.

This change will also cure the discriminatory effect of the 1964 "grandfather clause" which has permitted, in effect, only one large fund, the Japan Fund, to exist without this double taxation—a situation which was not intended and should not exist.

We are asking that you permit American investment in Australia on the same grounds that you permit the Japan Fund to exist in the U.S. We will pay the tax, but why should we pay it twice because we want to invest in Australia and they pay it once because they invest in Japan.

The CHAIRMAN. Let me ask you, give me just some illustrations about how this thing is supposed to work. You understand the purpose of this bill is to keep American capital from flowing overseas?

Mr. LEVINE. Right.

The CHAIRMAN. And, of course, what you are speaking of is having American capital flow overseas, as I understand it.

Now, explain to me what this does, why this amendment is necessary to do what you want to do.

Mr. LEVINE. All right.

The CHAIRMAN. What happens now with this tax that keeps you from doing what you want to do, and how this Nation will benefit from your amendment? Just fire me one illustration, if you want to.

Mr. LEVINE. Fine.

Let us suppose this company went into business tomorrow and sold shares to anybody in this room. When you receive the shares of the Pan Australian Mutual Fund, United States, you would make out a check for 11¼ percent of the gross amount of your purchase. If it were $1,000 you would write out a check to the Treasury Department for 11¼ percent of that.

Then the fund would get the money and would buy an interest in Australian securities.

The fund would then pay the tax again. If it bought a hundred shares of a mining company it would automatically have to pay another tax again to the Treasury and it would have to do that on every transaction that the fund made so that we are paying the tax twice. In the Japan Fund, you only pay the tax once when you buy the stock of the fund. When the fund buys Japanese securities it does not pay the tax again on each transaction.

Now, this has prohibited the formation of any American mutual fund for investment in Australia.

There are none because of this double tax.

If that fund had the same provision that the Japan Fund had, that you pay the tax when you received the stock of the mutual fund but the fund does not pay the tax again on each transaction, and you had a fund registered under the investment act governed by the SEC, I can virtually assure you you would have $40 to $50 million of foreign money coming in to invest in that fund and buy the shares here within a week.

There are several——

The CHAIRMAN. Now, that wouldn't benefit the United States on its balance of payments though, the money comes in and goes right back out again. Where are we better off?

Mr. LEVINE. No, if the foreigners purchased the securities of the mutual fund——

The CHAIRMAN. I can't see that it benefits us to say the money passed through here on its way to Australia. What difference does it make whether it goes this way or it goes around the world in the other direction? What difference would it make?

Mr. LEVINE. The owner, the purchaser, of the fund securities here would pay the 11¼-percent tax. We are not asking for that elimination. The tax would be paid by anybody who bought the shares in the U.S. mutual fund. So we would be getting an additional 11¼-percent tax and money that we don't receive it from now. If a man in Bermuda came over here and bought $10,000 worth of this fund, this tax would be paid.

The CHAIRMAN. Well, do you think most of the money is going to come from foreign countries into this country and then back out again to Australia, is that the idea?

Mr. LEVINE. No; I think some of it will come, I think some of it will come, from the United States. People now are not buying Australian securities so the Treasury is not receiving that tax. If Americans were to buy $20 million worth of the fund's shares 11¼ percent of $20 million would immediately be paid to the Treasury which it is not receiving now.

The CHAIRMAN. Yes; that is the case but insofar as you make it more practical and a better investment for Americans to export their

money you are expediting the flow of our funds into Japan—I mean Australia—and while that is a good friendly country and I think the world of them that is just expediting what we are trying to keep from happening with this bill. That is, America's money flowing out any worse than it is already.

Mr. LEVINE. Mr. Chairman, I think in the beginning you are a hundred percent right, there would be an outflow of money. I think, though, that within a very short amount of time you would be getting that money back plus in the form of services and goods and machinery and equipment that would be bought here in this country.

The CHAIRMAN. Well, suppose we amended your proposition to say that to the extent that a fund brings in money from a foreign country to be invested here in the United States that they could have the benefit of this, but to the extent it is just a matter of exporting our money on out that they wouldn't have the benefit of it. In other words, give you a credit to the extent that you bring money in for investment into the United States.

Mr. LEVINE. I don't think a mutual fund could really do that under the investment act under which it is incorporated, and I can't prove to you that, right now that, more money will come in. But historically if you have seen the trend in the Japan Fund, if $20 million goes out the tax is automatically paid to the Treasury here, then after a while those Japanese companies came to the United States and started using that money here.

Now I can't prove to you that all of that is going to come back here. But historically a lot of it does.

Also Australia is increasing its purchases here in this country by 10 percent a year. So that she now has a net deficit of about $1.12 billion. We think when this interest is shown it will start building a bridge and that money will come back, when it goes out it will come back, in a greater amount than it goes out.

The CHAIRMAN. I hope you are right. But so far about all you have convinced me of is that this would help to ease the flow of money from the United States to Australia. I don't see that is what we are trying to do with, to begin with, with this bill.

Here is how Treasury suggests that you remove the discrimination. They say "to provide consistent treatment we would also be glad to see a further provision to assure that certain domestic mutual funds treated as foreign for the purpose of interest equalization tax not be permitted such treatment on new issues."

The Japan Fund is what they have in mind, as I understand it, when they make that statement so they want to eliminate the discrimination by saying Japan doesn't get it. That being the case rather than giving it to both of you they say don't give it to either one. Then there would be no discrimination.

Mr. LEVINE. I think it is shortsighted. I had not seen that, by the way, I just heard about it this morning.

The CHAIRMAN. Here it is.

Mr. LEVINE. I am going over to the Treasury to pick it up but I had no intention of trying to cut off the Japan Fund's operations because we asked for some kind of an exemption for Australia.

I think that in the long run an exemption like this will not cost the United States anything but it will bring in a lot of money, a lot

of money. We are not talking about Australian funds of $1 billion. The Australian stock market can't take substantial amounts of money. You are talking maybe $20, $30, $40 million if you are going to do it properly. Right now you have a lot of people making indirect investments in Australia through people that don't know how to manage investments over there and a lot of them are going to lose it.

If you have a registered company here that is properly regulated by the SEC, I would make a prediction that you will get more European money into this country than American money that will go out. I can't prove it, I just have a feeling about it.

The CHAIRMAN. I think you made your point.

Senator Anderson.

Senator ANDERSON. You mention this on mutual funds. Why mutuals as against stock companies?

Mr. LEVINE. I beg you pardon?

Senator ANDERSON. You mention here mutual companies, why mutual companies in preference to stock companies.

Mr. LEVINE. Well, the law as it now reads we did not want to change so that all stock purchases would be exempted from the tax. We are willing to pay the tax once. If I bought shares tomorrow in Australian stock I would pay the tax to Treasury. If the mutual fund is formed the shares of the mutual fund that anybody would buy would pay the tax to the Treasury. It was a practical way of doing it this way. In other words, we want to pay the tax once, not twice.

Senator ANDERSON. Is that why it is done in the case of the mutual fund?

Mr. LEVINE. The owners of the mutual fund shares will pay the tax on receipt of their stock certificate.

Senator ANDERSON. Are you familiar with investment generally in Australia?

Mr. LEVINE. Well, a little bit, not a great deal. I am familiar with some of them.

Senator ANDERSON. There has been some oil development over there. Who is handling the oil development?

Mr. LEVINE. There are several American companies. Mobil Oil has a large tract of land in the northwest section of Australia, there are several American companies prospecting for oil in Australia and there have been oil wells brought in, yes. We think, I should say the managers of the fund who have been managing the English funds for 5 years and know Australia quite well, tell me there are going to be large oil finds in Australia, in the northwest section.

Senator ANDERSON. They now have found oil there.

Mr. LEVINE. There have been a good number of oil wells drilled in Australia.

Senator ANDERSON. Are you changing the provision about that at all?

Mr. LEVINE. No.

Senator ANDERSON. Why not?

Mr. LEVINE. Have I seen any provisions? This fund will ultimately, as part of its investment, as the English funds do, invest in companies in Australia that are drilling for oil. The American companies have ordinary American subsidiaries in Australia, the large American oil companies.

Senator ANDERSON. Yes.

Mr. LEVINE. And they are drilling very rapidly, and some of them have hit oil in Australia.

Senator ANDERSON. Yes. What is wrong with that?

Mr. LEVINE. Nothing.

Senator ANDERSON. Why do you want to change it?

Mr. LEVINE. No, no; we don't. This would not affect them at all. This legislation would not affect them at all.

Senator ANDERSON. I can't see why it wouldn't affect them at all when it is so important.

Mr. LEVINE. This legislation would only affect mutual fund companies that are set up here to sell shares in mutual funds to Americans. That fund would then take its money and invest in Australian companies and, as it is now, there would be two taxes to be paid and we are asking that only one be paid.

The CHAIRMAN. Senator Bennett.

Senator BENNETT. I unfortunately was not able to get here in time to hear the testimony or to read it so I have no questions.

The CHAIRMAN. Senator Jordan.

Senator JORDAN. I have no questions.

The CHAIRMAN. Senator Hansen.

Senator HANSEN. No questions.

The CHAIRMAN. Thank you very much, sir.

Mr. LEVINE. Thank you.

Senator HANSEN. If Mr. Levine would submit to just a question, what is the situation with respect to Japan's balance of trade with the United States at the moment, do you know?

Mr. LEVINE. I don't know.

Senator HANSEN. Do you know if they have a favorable balance of trade or an unfavorable balance.

Mr. LEVINE. I don't know.

Senator HANSEN. You do not——

Mr. LEVINE. I don't know about the Japanese balance.

Senator HANSEN. You defended this arrangement that Japan has or do you think that we might look at that and instead of trying to bring about the same sort of arrangement with Australia that—I mean—let me phrase it differently. It is your recommendation that we give to Australia the same treatment that Japan presently has.

Mr. LEVINE. Right.

Senator HANSEN. But you do not know whether Japan has a favorable or an unfavorable balance of trade with the United States?

Mr. LEVINE. I do not, Senator.

Senator HANSEN. Would it make any difference, in your judgment, whether it did have or not?

Mr. LEVINE. No. I don't want to cause any problems in an area that I am not familiar with. I didn't ask or don't want to ask that the Japan Fund have the privilege that was given to them in 1964 taken away. That is not my purpose.

Senator HANSEN. Does the loss of jobs in American textile mills concern you?

Mr. LEVINE. Yes. If you are asking me as an individual, I would have an answer.

Senator HANSEN. May I ask you as an individual.

Mr. LEVINE. Yes. I think that the time has come personally, Japan is a very developed nation today, not an underdeveloped nation, and I think that personally the time has come, that we have to watch some of the imports into this country because I think they are seriously affecting U.S. production and employment.

Senator HANSEN. Well, it is my understanding that Japan does have a favorable balance of trade with the United States. If you were willing to accept my statement as a fact, would it be your recommendation that we continue to extend this preferential treatment to Japan or do you think it might be desirable to cancel out the treatment that we accord Japan under this Japanese fund.

Mr. LEVINE. I think it would be a mistake to cancel out the treatment given to Japan.

Senator HANSEN. Why do you say that?

Mr. LEVINE. Well, I live and worked in New York and I helped build many years ago a Japanese restaurant that several of the Japanese companies invested in so I have watched the growth in New York of the Japanese business community, and I think they bring enormous amounts of money into the United States.

I think their stock market creates enormous employment in the United States, in New York particularly, and I think their influence brings in more money by having their companies in the States than by having them out of the States, and I think you would create tremendous problems on the Japanese, in the Japanese economy, if this Japan Fund were in any way prohibited further than they are now from making the investments that they do.

The holders of the Japan Fund of the United States pay the tax on their certificates when it is sold. The Japan Fund does not pay the tax again on each transaction.

Senator HANSEN. If you were willing to assume that my statement is correct——

Mr. LEVINE. I do.

Senator HANSEN (continuing). That Japan has a favorable balance of trade with the United States, and if I could submit further that Secretary Stans testified, I think, or rather in an informal background briefing session said, that if we get down to the actual real balance of trade that this country has with nations throughout the world, and instead of there being reflected a surplus last year of around $1 billion, I think, maybe slightly less, if we were to exclude from that favorable balance of trade foreign aid, and Public Law 480 funds which account for purchases by foreign countries of American products, that instead of having a favorable balance of trade we would have an unfavorable balance in the magnitude of around $5 billion.

Then my question is, while I appreciate your concern for the welfare of the Japanese, would you say that our first concern should be for the protection of American jobs, or should it be for the Japanese.

I think Secretary Stans has said if we were to manufacture in this country all of the things that were imported last year, or maybe the year before, that it would require the fulltime work of some 2½ million Americans. Would this not properly be of real concern to us with our unemployment now ranging up around 6 percent?

Mr. LEVINE. I would agree with you on that. I think the primary concern of the U.S. Congress and Senate is with the United States.

Senator HANSEN. Is yours as an individual?

Mr. LEVINE. Mine is as an individual.

Senator HANSEN. Yes.

Mr. LEVINE. And I think the problem that has come up now with the textiles quotas is a very serious problem. I happen to agree with the President on that, but I think it is different from this interest equalization tax which was put on as a temporary means in 1964, and has been extended every 2 years since. I think the two problems are different.

Senator HANSEN. But isn't your main justification for extending to Australia a treatment similar to that of the Japanese that you say the Japanese fund does not require this double payment of the interest equalization tax and that presently investors in Australian mutual funds have to pay it. So you are saying let's afford Australia the same treatment we give Japan; is that not right?

Mr. LEVINE. Yes, but that is not my primary reason.

Senator HANSEN. What is your primary reason?

Mr. LEVINE. My primary reason is Australia is an ally, a friend, and one of the strongholds of U.S. interests developing in Southeast Asia and these funds will help the development of Australia and help the U.S. interests in Australia.

Senator HANSEN. And Japan is not, you mean to imply?

Mr. LEVINE. Yes, Japan is, but it is a different sector of the Pacific, and it already has a very favorable economy. Australia is developing an economy and needs additional U.S. money, and I think funds like this can provide some of that money in a way that will help them and that they will like and that will assist the United States and its people and economy—our most important concern.

Senator HANSEN. When you speak of a sector of the Pacific, would you identify that part of Asia that you think is of exclusive concern to Australia and not of interest to Japan.

Mr. LEVINE. Well, I think American companies——

Senator HANSEN. I mean countries.

Mr. LEVINE. I think American companies in the United States are developing factories in Australia for primary minerals which Japan does not have, so that most exploration in Australian development is for the minerals, oil, gas, aluminum, lead, and, secondly, they are building factories there to supply countries like Singapore and Malaysia and they are not building factories in Japan to distribute in Singapore and Malaysia so that Australia is being developed: (*a*) primarily for mineral resources and, (*b*) as a distribution center to Southeast Asia whereas American companies in Japan are just not being developed for that purpose.

Senator HANSEN. It is my understanding that Japan has a rather significant volume of trade and is increasing with Singapore. Do you mean to imply that is not so.

Mr. LEVINE. No. American companies—Japan is very well developed. Australia has not reached the point of development that Japan has, and I am saying these funds are creating a vehicle to get American companies into Australia to create the kind of economy that Japan now has. I think American companies now are going into Australia the very same way that they went into Japan 20 years ago and American mutual funds that will invest in Australia will help the U.S. economy.

Senator HANSEN. Is this a greater concern to you than the employment of Americans in American jobs.

Mr. LEVINE. No.

Senator HANSEN. I have no further questions, Mr. Chairman.

The CHAIRMAN. Well, thank you very much, sir. I appreciate your testimony.

Mr. LEVINE. Thank you.

The CHAIRMAN. We will now call for Mr. Crane Hauser in behalf of the Overseas Industries, S.A.

Mr. Hauser, you have had some distinguished service with Government. I think I should ask you the same question I asked the previous witness. Do you feel that you are under a burden to register under the Foreign Agents Act?

STATEMENT OF CRANE C. HAUSER, WINSTON, STRAWN, SMITH & PATTERSON, CHICAGO, ILL., ON BEHALF OF OVERSEAS INDUSTRIES, S.A.

Mr. HAUSER. Mr. Chairman, I just became aware of this communication from the committee's chief counsel this morning, and I think, while I am technically here representing a Luxembourg corporation, actually the legislation which we want to recommend has to do principally with the U.S. people that own the stock in that corporation, and the problems of transferability of their shares. I don't think there is anything really foreign involved.

Senator ANDERSON. You are not trying to separate the individual stockholders against the entire area, are you?

Mr. HAUSER. The amendment which we are suggesting is simply an amendment which would exempt this particular class of stock, since it is 95 percent U.S. owned, from the procedural requirements of the act on transfers of shares by the U.S. shareholder.

Senator ANDERSON. The chairman asked what about this presence as a lobbyist. He asked you if you need to register as a lobbyist? Have you done that?

Mr. HAUSER. No; I am not registered as a lobbyist for a foreign principal. I think I am actually here representing the U.S. shareholders of the corporation.

Senator ANDERSON. Do they have the necessary resolutions for you to appear here?

Mr. HAUSER. What was that?

Senator ANDERSON. They have to take action to send their representation here. Have they asked for it?

Mr. HAUSER. I am afraid I don't understand the question. If I am required to register under this act I would certainly be happy to but I don't believe in the context of our proposed amendment that it is required.

The CHAIRMAN. Why don't you discuss this matter with the Justice Department? They have the burden of administering this law. Seek their judgment as to whether they think you ought to register.

Mr. HAUSER. All right.

The CHAIRMAN. And if they think so I should think you would want to register.

Mr. HAUSER. Certainly.

The CHAIRMAN. Then go right ahead.

Mr. HAUSER. As I said, I am appearing on behalf of Overseas Industries, S.A., a Luxembourg corporation, and with me this morning is Mr. Dale Miller who is Washington consultant for the corporation.

This corporation, Overseas Industries——

The CHAIRMAN. You see the reason I asked the question is that the primary beneficiary here would seem to be a Luxembourg corporation. You are speaking, as I take it, in the interests of shareholders, of American shareholders in that corporation.

Mr. HAUSER. Yes, the amendment which we are talking about goes solely to the procedural requirement for transfers of shares of the corporation. It doesn't really involve the corporation itself.

The CHAIRMAN. Right.

All right, sir, go ahead.

Mr. HAUSER. More than 65 percent of the present 3,929 shareholders of Overseas who own more than 65 percent of the 1,947,000 issued and outstanding shares of stock of Overseas, are U.S. persons who acquired their stock in Overseas without liability for interest equalization tax, as the result of a reorganization and various other transactions which were exempted from the imposition of the interest equalization tax. These transactions, which are too numerous and detailed to relate at this time, are set forth in a memorandum I have submitted with my statement.

As of Overseas last record date prior to January 1, 1971, more than 95 percent of its issued and outstanding shares of stock were held of record by U.S. persons. While it is quite clear that these U.S. persons, who own most of Overseas stock, can dispose of their stock to other U.S. persons without the purchasers being subject to interest equalization tax liability, nevertheless, under present section 4918 of the Internal Revenue Code of 1954 ("the Code"), the exemption from tax on the purchaser must be established through one of three quite burdensome procedures, the so-called validation certificate procedure, the "IET clean confirmation" procedure, or the final alternative of satisfying the Internal Revenue Service by other means that the exemption applies. These procedures tend to inhibit transactions in Overseas' stock.

Under section 4920(b) of the Code, a class of stock in a foreign corporation is treated, for interest equalization tax purposes, as stock in a domestic corporation, but under very limited circumstances—where more than 65 percent of the class was owned prior to July 19, 1963, by U.S. persons, or where more than 50 percent of the class was so owned and the class had as its principal market in 1962 one or more national security exchanges registered with the Securities and Exchange Commission.

While all of the stock of Overseas predecessor corporation, Western Sales, Ltd, a Bahamian corporation, was owned by U.S. persons in 1962, and well in excess of 65 percent of the value of Overseas stock and that of its predecessor has always been owned by U.S. persons, for a variety of technical reasons, set out in the attached memorandum, the section 4920(b) exemption is inapplicable to Overseas, and its shareholders must comply with the burdens of the section 4918 exemption procedure on an individual basis.

We respectfully urge that an amendment to section 4920(b) of the Code, which would free the Overseas shareholders from this inhibition on the transfer of their shares, would be in accord with the purpose of section 4920(b), which was to eliminate from the interest equalization tax transfers of stock of foreign corporations substantially owned by U.S. persons prior to the enactment of the tax.

This purpose could be accomplished in overseas situation by adding to section 4920(b) a provision which would treat a class of stock of a foreign issuer as a domestic issue if, as of the corporation's latest record date before January 1, 1971, more than 65 percent of such class of stock was held of record by U.S. persons who acquired such stock in a reorganization exchange, and more than 95 percent of such class of stock was held by U.S. persons. We have the exact language we would suggest at the end of our memorandum.

While it is not necessary for our purposes, the committee might wish to consider whether some amendment of even broader application might be desirable. More than 7 years have elapsed since the effective date of section 4920(b), and there must now be many foreign corporations which are substantially owned by U.S. persons whose shares are subject not to the interest equalization tax on transfers, but to the procedural morass of section 4918 to establish exemption. It would save them, as well as the Internal Revenue Service, a great deal of time and money to include these substantially U.S.-owned foreign corporations within the section 4920(b) exemption.

Further, it is not believed that eliminating the stock of foreign corporations now more than 95 percent held of record by U.S. persons from the application of the statute would frustrate the purposes of the Interest Equalization Tax Act. If a more than 65-percent involvement by U.S. persons in a foreign corporation prior to 1963 was considered sufficient to exempt all of the corporation's stock from the tax, no good reason appears why a more than 95-percent involvement today should not have the same result.

Thank you.

(A memorandum attached to Mr. Hauser's statement follows:)

MEMORANDUM ATTACHED TO STATEMENT OF CRANE C. HAUSER, WINSTON, STRAWN, SMITH & PATTERSON, CHICAGO, ILL., ON BEHALF OF OVERSEAS INDUSTRIES, S.A.,

The stockholders of Western Sales, Limited ("Western"), a Bahamian corporation, and more recently the stockholders of Overseas Industries, S. A. ("Overseas"), a Luxembourg corporation, which is the successor to Western by virtue of a reorganization, have been subject to various provisions of the interest equalization tax. In general, the interest equalization tax is an excise tax payable by a United States person on each acquisition made by him after July 18, 1963, of stock of a foreign issuer or of a long-term debt obligation of a foreign obligor. Section 4911(a) of the Internal Revenue Code of 1954 (the "Code"). Kindly note that all sections cited herein refer to sections of the Code unless otherwise stated.

It appears, however, that most of the stockholders of these two companies were not actually liable for an interest equalization tax on the stock acquisitions that they made. The reason for this is that the stock of Western was originally distributed as a dividend by a United States person, Transcontinental Bus System, Inc. ("Transcon"), a Delaware corporation, to its stockholders, almost all of whom were also United States persons as defined in section 4920(a)(4). As the result, by virtue of section 4918(a), concerning an exemption for prior American ownership, the Transcon stockholders, as well as those persons who subsequently acquired the Western stock from Transcon's United States stockholders who were

not ineligible from disposing of the stock as United States persons, were exempt from the tax. Section 4918(a) of the Code provides as follows:

"(a) General Rule.—The tax imposed by section 4911 shall not apply to any acquisition of stock of a foreign issuer or a debt obligation of a foreign obligator if it is established in the manner provided in this section that—

"(1) the person from whom such stock or debt obligation was acquired was a United States person throughout the period of his ownership or continuously since July 18, 1963, and was not ineligible, under the provisions of this chapter to dispose of such stock or debt obligation as a United States person; and

"(2) such person—

(A) had paid the tax imposed by section 4911 with respect to the acquisition of such stock or debt obligation by such person; or

(B) acquired such stock or debt obligation without liability for payment of such tax."

The problem, however, is that even though a stockholder comes within this exemption, he is still not entitled to the exemption unless he establishes in the manner provided in section 4918 and the regulations thereunder that the previous owner from whom such stock or debt obligation was acquired was a United States person throughout the period of his ownership or continuously since July 18, 1963, and was not ineligible, under some other provision of the interest equalization tax, to dispose of such stock or debt obligation as a United States person; and that such previous owner had either paid the tax with respect to his acquisition of such stock or debt obligation or had acquired such stock or debt obligation in a transaction which was not subject to such tax.

Proof of the exemption is established if the United States person (1) receives a "validation certificate" and files such "validation certificate" as required or (2) receives an "IET clean confirmation" from a "participating firm" acting as a broker in effecting the acquisition (or acting for its own account) at the time the United States person acquires the foreign stock or debt obligation. In addition, if the person making the acquisition is unable to establish the exemption by one of these two methods and shows reasonable cause for such inability, he may furnish other evidence to establish to the satisfaction of the Internal Revenue Service that such exemption is applicable to such acquisition. For purposes of this exemption, a validation certificate or an IET clean confirmation will be conclusive proof that such exemption applies if the person making the acquisition relies in good faith on the validity of such validation certificate or IET clean confirmation. Section 4918(b)(1). Nevertheless, the procedures surrounding the establishment of proof of exemption for prior American ownership and compliance as specified in the various subsections of section 4918 are both time consuming and burdonsome on the parties affected;[1] and, in the opinion of Overseas now and Western previously tend to discourage acquisitions of their stocks. Furthermore, since Western has been and Overseas is presently owned by more than 65 percent United States persons, Overseas submits that the Overseas stockholders should be exempt both from the tax and from the procedures establishing prior American ownership. This can be accomplished by amending section 4920(b), which treats foreign stocks as domestic stocks, so that Overseas will come within its exempting provisions.

In order to fully understand the reasons that section 4920(b) must be amended if it is to cover Overseas, it is first necessary to review the facts concerning Western's capital structure and the reorganization involving Western and Overseas. These facts are as follows:

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[1] For example, in probably the most common situation, a United States person who wishes to acquire Overseas stock will place an order for such stock with his broker. If the stock is acquired by the broker from a United States person and if the broker is a participating firm, the broker will deliver an IET clean confirmation, together with the stock certificate to the purchaser. However, should the purchaser subsequently decide to sell the Overseas stock, he must first file the IET clean confirmation, together with a completed Form 4322-A, Application for Validation Certificate of Prior American Ownership and Interest Equalization Tax Compliance, and evidence of his status as a United States person with his local District Director of Internal Revenue who will then issue to the said person a validation certificate. Subsequently, upon sale of the stock, the seller (who was the purchaser referred to above prior to this sale) will deliver to his broker both the stock certificate and the validation certificate. This procedure is further complicated if, after acquiring the validation certificate, the seller decides to sell less than the total amount of stock covered by the validation certificate. In that case, the seller may return the validation certificate to the District Director and obtain two or more new validation certificates which together cover the same total amount of stock.

1. On January 1, 1963, Western's capital totaled £1,020,000 and consisted of the following:

STOCK	OWNED BY
10,000 ordinary (voting) £1 shares (issued).	Commerce Insurance Co. ("Commerce" a Bermuda corporation unrelated to Transcon. Commerce was the beneficial owner while Jules Egli, a Swiss National, was the owner of record.
10,000 ordinary (voting) £1 shares (issued).	General Highway Services, Inc., a wholly owned subsidiary of Transcon.
10,000 non-voting £100 shares (not issued). At this time Deeds of Covenant were issued by Western to Services. By the Deeds of Covenant, Western obligated itself to issue the non-voting shares as soon as the amount capitalized had been ascertained.	General Highway Services, Inc. ("Services").

2. On December 12, 1963, the capital of Western was increased to £1,037,600 by the creation of 176 additional non-voting shares of £100 each.

3. On July 9, 1964, 10,176 non-voting shares of £100 each (the 10,000 shares referred to in 1 above and the 176 shares referred to in 2 above) were issued to Services. Western's issued and outstanding capital stock was then as follows:

	Services	Commerce
£1 ordinary (voting shares	10,000	10,000
£100 nonvoting shares	10,176	

4. On August 3, 1964, a recapitalization of Western took place as follows:

(a) The capital was increased to £1,070,850 by the creation of 33,250 new ordinary (voting) $1 shares.

(b) Profits were capitalized and 33,250 ordinary (voting) £1 shares were authorized to be issued to the existing shareholders.

At this point, the authorized and issued capital was:

53,250 ordinary (voting) £1 shares.

10,176 non-voting £100 shares.

(c) The 53,250 ordinary (voting) shares of £1 each were then divided into two classes and redesignated so that 60 percent thereof would be Class A ordinary £1 shares (except that five specific shares of the ordinary £1 shares would be designated Class B ordinary £1 shares) and 40 percent thereof would be Class B ordinary £1 shares.

(d) The 10,176 non-voting shares of £100 each were also divided into two classes and redesignated so that 6,106 shares thereof would be Class A ordinary £100 shares and 4,070 shares thereof would be Class B ordinary £100 shares.

(e) Thereafter, all of the Class A ordinary £1 and £100 shares were consolidated and converted into Class A stock; and all of the Class B ordinary £1 and £100 shares were consolidated and converted into Class B stock. It should be noted that both the Class A and Class B stock was voting stock and was identical in all respects except that the Class A stockholders were entitled to elect one more director to the Western Board of Directors than were the Class B stockholders.

(f) Services and Commerce then directed that the stock to which they were entitled be issued to Transcon.

5. On or about August 10, 1964, Transcon purchased the 10,000 ordinary (voting) £1 shares owned by Commerce.[2] Shortly thereafter, Services transferred

[2] Since Transcon purchased from Commerce 50 percent of Western's ordinary (voting) £1 shares, and since at the time of this purchase Transcon's 100 percent owned subsidiary, Services, already owned the remaining 50 percent of Western's ordinary (voting) £1 shares, said purchase came within the section 4915(a) (1) exclusion for direct investments. As the result, Transcon was not liable for an interest equalization tax on this acquisition. Section 4915(a)(1) provides, in part, as follows:

"(a) IN GENERAL.—

(1) Excluded Acquisitions. —* * * the tax imposed by section 4911 shall not apply to the acquisition by a United States person (A) of stock * * * of a foreign corporation * * * if immediately after the acquisition such person (or one or more includible corporations in an affiliated group, as defined in section 1504, of which such person is a member) owns (directly or indirectly) 10 percent or more of the total combined voting power of all classes of stock of such foreign corporation, * * *."

the Western stock it owned to Transcon as a dividend. The result was that at this point Transcon owned 100 percent of both the Class A and Class B stock of Western.

6. On August 24, 1964, Transcon delivered £546,307.6.0 of Class A stock (approximately 85 percent of the total Class A stock) to the First National Bank in Dallas ("Bank"), as Depositary. American Depositary Receipts ("ADR's"), representing units of said stock of 11 shillings per unit were then distributed by the Bank as a dividend from Transcon to Transcon's stockholders of record at the close of business on August 28, 1964. Western's stock was thus held as follows:

The First National Bank in Dallas as Depositary	£546,307.6.0 Class A
Transcontinental Bus System, Inc,	96,202.14.0 Class A
	428,340.0.0 Class B

7. On October 19, 1964, Western's capital was increased to £2,200,000 by the creation of 677,490 new class A £1 shares and 451,660 new Class B £1 shares. However, none of these newly created shares were ever issued.

8. On June 6, 1966, Transcon delivered £96,202.14.0 of Class A stock to the Bank as Depositary. ADR's representing units of said stock of 11 shillings per unit were then distributed by the Bank as a dividend from Transcon to Transcon's stockholders of record at the close of business on April 1, 1966.

9. On May 27, 1968, Transcon delivered £428,334.10.0 of Class B stock to the Bank as Depositary. ADR's representing units of said stock of 11 shillings per unit were then distributed by the Bank as a dividend from Transcon to Transcon's stockholders of record at the close of business on April 5, 1968.

10. On May 12, 1965, Westsales, S.A. ("Westsales"), a Luxembourg corporation was organized with an authorized capital of $2,310.00, represented by 1,500 shares of $1.54 par value stock.

11. By virtue of a tax free reorganization under section 368(a)(1)(D) of the Code, Westsales changed its name to Overseas and became the successor to Western which will be liquidated. On or about September 28, 1969, pursuant to the reorganization, Western began exchanging the ADR's held by its stockholders for $2.00 par value common stock of Overseas. The exchange was made on the basis of 1 share of Overseas common stock for each unit of Western Class A and/or Class B stock; and no gain or loss resulting from this exchange was recognized to the Western stockholders pursuant to section 354(a).

With regard to the reorganization referred to in 11 above, under section 4912(b)(4), pertaining to reorganization exchanges, any acquisition of stock or debt obligations of a foreign issuer or obligor in an exchange to which section 354 applies as here (or would apply, but for section 367) shall be deemed an acquisition from such foreign issuer or obligor in exchange for its stock or for its debt obligations. Under this rule, stock distributed in a reorganization is deemed to have been acquired from the foreign issuer (Overseas) even though actually received from another corporation (Western) which is a party to the reorganization. As a result, a United States person receiving stock or debt obligations of the foreign issuer in such an exchange for stock of another corporation will qualify for the section 4914(a)(4) exclusion. Such exclusion provides that the term "acquisition" does not include any distribution by a corporation of its stock or debt obligations to a shareholder with respect to or in exchange for its stock. Therefore, the stockholders of Western who exchanged their Class A and/or Class B stock of Western for $2.00 par value common stock of Overseas were not subject to the interest equalization tax upon receipt of said Overseas stock.

As mentioned above, the Overseas stockholders can be exempt both from the interest equalization tax and from the burdensome procedures for establishing prior American ownership if section 4920(b) is amended in certain respects. Section 4920(b)(1) as presently enacted provides as follows:

"(b) FOREIGN STOCK ISSUES TREATED AS DOMESTIC.—

(1) IN GENERAL.—For purposes of this chapter, a foreign corporation (other than a company registered under the Investment Company Act of 1940) shall not be considered a foreign issuer with respect to any class of its stock if—

(A) as of the corporation's latest record date before July 19, 1963, more than 65 percent of such class of stock was held of record by United States persons, or

(B) the class of stock had its principal market during the calendar year 1962 on one or more national securities exchanges registered with the Securities and Exchange Commission, and, as of the corporation's latest record date before July 19, 1963, more than 50 percent of such class of stock was held of record by United States persons."

It is important to note that record ownership of stock refers to the owner as shown on the regular stock record books of the corporation and does not refer to the beneficial owner. Furthermore, the latest record date before July 19, 1963, is the latest date as of which record ownership of the stock of the foreign corporation was determined by such corporation, whether for the declaration of dividends or for other corporate purposes. Temporary Regulations section 147.7–2(c)(4). Finally, the determination of whether a class of stock of a foreign corporation meets the requirements of the 65 percent and 50 percent American ownership tests must be made separately with respect to each class of stock of such corporation. Temporary Regulations section 147.7–2(b)(1).

In our situation, Overseas was not in existence prior to July 19, 1963. Therefore, unless section 4920(b)(2)(C)[3] applies to make the Overseas stock identical to the pre-July 19, 1963, Western stock, an indispensible part of section 4920(b)(1) is not met and thus the section 4920(b)(1) exemption does not cover Overseas. Moreover, even if the provision pertaining to class of stock is met, this exemption would still not apply because of the following: On the latest record date prior to July 19, 1963, 50 percent of Western's £1 ordinary (voting) shares were held of record by a United States person while the other 50 percent was held of record by a Swiss national. In addition, none of the £100 non-voting shares were held of record by anyone. As the result, these classes of stock do not meet the percentage requirements of section 4920(b)(1)(A) since less than 65 percent of such classes of stock were held of record by United States persons. Moreover, the provisions of section 4920(b)(1)(B) are not met since (a) Western was a closely held company and thus during the calendar year 1962 the classes of stock did not have their principal market on one or more national securities exchanges, and (b) *more* than 50 percent of such classes of stock was not held of record by United States persons.

* * * * * * *

"(C) issued after November 10, 1964, to a shareholder with respect to or in exchange solely for shares described in this paragraph; * * *"

It is doubtful that this section applies to reorganizations involving two or more corporations.

Therefore, in order that Overseas not be considered a foreign issuer with respect to its $2.00 par value common stock and thus that such stock not be considered stock of a foreign issuer, it is necessary that section 4920(b) of the 1954 Code be amended by adding the wording underscored:

"(b) FOREIGN STOCK ISSUES TREATED AS DOMESTIC.—

(1) IN GENERAL.—For purposes of this chapter, a foreign corporation (other than a company registered under the Investment Company Act of 1940) shall not be considered a foreign issuer with respect to any class of its stock if—

(A) as of the corporation's latest record date before July 19, 1963, more than 65 percent of such class of stock was held of record by United States persons, or

(B) the class of stock had its principal market during the calendar year 1962 on one or more national securities exchanges registered with the Securities and Exchange Commission, and, as of the corporation's latest record date before July 19, 1963, more than 50 percent of such class of stock was held of record by United States persons, *or*

(C) as of the corporation's latest record date before January 1, 1971, more than 65 percent of such class of stock was held of record by United States persons who acquired such stock in an exchange described in section 4912(b)(4), and more than 95 percent of such class of stock was held of record by United States persons.

(2) CLASS OF STOCK DEFINED.—For purposes of this subsection, the term "class of stock" means all shares of stock of a corporation issued and outstanding as of the corporation's latest record date before July 19, 1963, "*(or, in the case of a corporation described in subparagraph (C) of paragraph (1), before January 1, 1971)*" which are identical with respect to the rights and interest such shares represent in the control, profits, and assets of the corporation. Such term also includes additional shares possessing rights and interests identical with

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[3] Section 4920(b)(2) of the Code defines class of stock, in part, as follows:

"(2) CLASS OF STOCK DEFINED.—For purposes of this subsection, the term 'class of stock' means all shares of stock of a corporation issued and outstanding as of the corporation's latest record date before July 19, 1963, which are identical with respect to the rights and interests such shares represent in the control, profits, and assets of the corporation. Such term also includes additional shares possessing rights and interests identical with the rights and interests of shares described in the preceding sentence if such additional shares shall have been—

the rights and interests of shares described in the preceding sentence if such additional shares shall have been—* * *"

The CHAIRMAN. Thank you very much, sir.

Any questions.

Thank you very much, sir. We will certainly consider this when we go into executive session.

Mr. HAUSER. Thank you very much.

The CHAIRMAN. The next witness will be Mr. Page Chapman III, vice president of the Bankers Trust Co. of New York City.

STATEMENT OF PAGE CHAPMAN III, VICE PRESIDENT, BANKERS TRUST CO., NEW YORK, N.Y.

Mr. CHAPMAN. Thank you, Mr. Chairman. I am here with Mr. Sachs, our counsel.

I appeared before the House Ways and Means Committee at its public hearing preceding the introduction of House bill 5432, and recommended that section 4914(b)(2)(A) of the Internal Revenue Code be amended, to eliminate the requirement that the exclusion from interest equalization tax for acquisitions by a commercial bank at a foreign branch, should apply only to loans made in the ordinary course of the commercial banking business. My statement is contained at pages 19 through 22 of the printed hearings by the Committee on Ways and Means, held on February 22, 1971. A copy of my written statement before that committee is attached to my prepared text.

In essence our position is that the limitation of the section 4914(b)-(2)(A) exclusion to commercial loans restricts the competitive ability of foreign branches of U.S. banks, does not help, but probably hinders, the U.S. balance of payments. We maintain that foreign branches of U.S. banks are adequately controlled, from a balance-of-payments standpoint, by the guidelines of the Federal Reserve Board, and that such branches should be permitted to acquire any debt obligations consistent with local foreign banking practice.

As reported in the Ways and Means Committee report, No. 92-35, pages 24-25, the Treasury Department indicated to the committee that it believed the problem could be dealt with administratively. The solution suggested by the Treasury Department would permit foreign branches of U.S., commercial banks, to acquire so-called floating rate Eurodollar notes if the following conditions are met:

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

(*b*) The notes are not convertible.

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

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

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

We believe that the foregoing proposal does not solve the problem, particularly as a result of the condition described in point (c) that, subject to limited exceptions the notes must be acquired as a new issue.

I might point out incidentally, though it is not in my prepared text, that we understand that by the words "subject to limited exceptions" in condition (c), the Treasury Department intends that only those banks which acquired floating rate notes as an original issue, may thereafter acquire more notes from another bank and then only may acquire an amount not greater than the amount acquired as an original issue.

This restriction in (c) would in practice severely restrict, if not eliminate, the availability of these notes to a foreign branch of a U.S. bank, because it would mean that the branch could not feel confident that it could dispose of the notes to a foreign branch of another U.S. bank, in the event that banking liquidity requirements made it necessary to do so. In other words, a significant portion of the after market would be eliminated, which elimination does not appear to be essential in order to comply with the commercial loan standard, since the assignment of or "participation" of loans among banks is not uncommon in the United States, and is even more prevalent in Europe. Such assignments are made as part of the loan function for diversification or liquidity, and not as a dealer since banks are prohibited by Federal law (12 U.S.C. SS 378), from dealing in or distributing corporate securities. Moreover, it is not apparent why the condition in (c) is necessary at all to protect the U.S. balance-of-payments position.

If, contrary to our views, this condition is believed to be required because of the loan standard in section 4914(b)(a)(A), then it appears that an administrative solution, unfortunately is not a practical one, and that a legislative solution as suggested in my statement before the Ways and Means Committee is necessary. A legislative change would have the further advantage of removing the competitive barrier faced by foreign branches of U.S. banks with respect to other new forms of Euro-dollar debt obligations which may develop as well as the floating rate notes, which are the subject of the Treasury Department proposal. There is no reason to impose such a competitive barrier when the balance of payments considerations do not require it.

Thank you, Mr. Chairman.

(An attachment to Mr. Chapman's statement follows:)

WRITTEN STATEMENT OF PAGE CHAPMAN III, REPRESENTING BANKERS TRUST CO., NEW YORK

SUMMARY

A technical amendment to the Interest Equalization Tax (§ 4914(b)(2)(A)) is proposed to make clear that foreign branches of United States banks may acquire foreign debt obligations without the need to characterize them as "loans".

BACKGROUND

Present section 4914(b) of the Internal Revenue Code provides the following exclusion from the Interest Equalization Tax ("IET"):

"(b) Excluded Acquisitions.—The tax imposed by section 4911 shalll not apply to the acquisition—* * * .

"(2) Commercial Bank Loans.

"(A) Of debt obligations by a commercial bank in making loans in the ordinary course of its commercial banking business."

Pursuant to authority in section 4931(a), the President, by Executive Order 11328, has limited the section 4914(b)(2)(A) exclusion to "an acquisition of such debt obligation which is made by a commercial bank at any of its branches located

outside the United States." Thus, at present, the exclusion may be paraphrased to read:

"The tax imposed by section 4911 shall not apply to the acquisition of debt obligations by a commercial bank at any of its branches located outside the United States in making loans in the ordinary course of its commercial banking business."

I. *Elimination of "Loan" Requirement*

It is submitted that for the reasons outlined herein, this exclusion should be amended to provide that the IET should not apply to the acquisition of debt obligations by a commercial bank at any of its branches located outside the United States. In other words, for foreign branches of United States commercial banks, there should be no requirement that the debt obligations be acquired in making loans in the ordinary course of the commercial banking business.

Basically, as will be explained below, the reason for this proposal is that the present statute is an unnecessary restriction which inhibits the ability of foreign branches of United States banks effectively to compete with foreign banks, without furthering the purposes of the IET and probably hindering such purposes.

The Federal Reserve Board has issued guidelines applicable to banks which effectively prevents banks from transferring funds to their foreign branch Banks are required to make periodic reports to the Federal Reserve Board of their status with respect to these guidelines, and there has been a high degree of compliance in the interest of cooperating in the balance of payments program.

As a result of these guidelines, foreign branches of United States banks have effectively been insulated from their United States offices as a source of funds. Thus, they operate in the foreign sphere as essentially independent repositories and sources of foreign owned dollars, commonly called Eurodollars. In so doing, they perform a vital function in connection with the United States balance of payments program. They accumulate short-term Eurodollar deposits and make them available on a longer-term basis to United States (and foreign) borrowers who would otherwise have to seek their funds in the United States. They make it feasible in many cases for United States corporations to finance their foreign operations while complying with the OFDI restrictions on foreign investments and requirements for repatriation.

Moreover, to the extent that United States banks can effectively do this business in competition with foreign banks, they generate earnings which, in turn, are repatriated under the Federal Reserve guidelines.

Besides the restriction which the present IET imposes on competition by foreign branches, present law also serves to stifle innovation in foreign financing. Even though the legislative history of section 4914(b)(2)(A) states that the excludible debt should be defined in terms of whether "* * * the loans or investments would be considered to be in the ordinary course of commercial banking business either in the United States or in the foreign countries in which the U.S. bank has foreign branches," S. Rep. No 1267, 88th Cong., 2d Sess. 24 (1964), there is a degree of uncertainty as to the application of this standard which makes it impractical for foreign branches to make significant acquisitions, particularly of new forms of debt which are developing in Europe. This forces United States foreign branches to seek to include IET indemnity provisions in foreign debt obligations, which is an adverse competitive factor.

An example of a relatively new form of debt in which foreign banks have been taking very large positions, but which foreign branches have been inhibited from acquiring is the floating rate note. Also, foreign branches have been prevented from making temporary investments in foreign currency debt issued by foreign governments and foreign commercial paper of more than one year to maturity. Such investments are normal in the United States for a bank's funds not immediately needed for loan purposes.

An incidental benefit from removing the loan characterization requirement from the IET exclusion is that it will eliminate any possible confusion from the classification of loans in accordance with foreign law and practice. This would permit United States standards to be used in defining loans for accounting purposes and for income tax purposes, to the extent there may be any difference from foreign standards.

To be measured against the foregoing reasons for extending the section 4914(b)(2)(A) exclusion, there may be raised two possible objections:

a. That it would be inequitable with respect to United States persons which are not banks.

b. That it would reduce the incentive for foreign branches to make deposits or investments in the United States.

Neither of these objections is significant enough to offset the countervailing considerations set forth above.

The inequity argument has really been resolved already by the recognition in section 4914(b)(2)(A) that at least some exception is permissible for commercial banks. Presumably this is because such an exception is essential for banks' survival abroad, since their business consists of acquiring debt obligations, which is not true for most other businesses. A significant part of the business of commercial banks in the United States, in addition to making loans, consists of investments in debt obligations (issued by the United States, states and municipalities). This is certainly recognized in the financial community, so that an IET exception permitting foreign branches to make analogous types of investments in the foreign market should not be looked upon as preferential. Moreover, since banks are heavily regulated, both internally and by independent agencies, there is no likelihood of the type of abuse of such an exception which could easily develop if it were more broadly applicable. Thus, the possibility that the proposed provision may be used, in conjunction with the prior American ownership provision (section 4918), to permit others than banks to acquire foreign debt can be precluded by excluding debt obligations acquired under the foreign branch exclusion from qualification for the prior American ownership exemption.

The question about U.S. debt acquisitions by foreign branches assumes that there are limited funds available for such purposes. As a practical matter if desirable debt obligations are available to foreign branches both in the United States and abroad funds will be made available for both. Furthermore, the repatriation of foreign branch funds, if desirable, can be accomplished by more direct means (such as by reserve requirements), rather than by limiting the legitimate business functions of foreign branches.

The foregoing proposal may be effectuated simply by deleting from section 4914(b)(2)(A) the words "in making loans in the ordinary course of its commercial banking business."

II. Alternative means of expanding § 4914(b)(2)(A).

In the event that the elimination of the "loan" standard should be deemed unacceptable, there are a number of alternatives which may have a beneficial effect, though they are not as simple and direct. These fall into two basic categories:

a. Substituting a different standard in lieu of "loans".

b. Making it more easy procedurally to meet the "loan" standard.

One possible standard which could be used to qualify the foreign debt obligations which a foreign branch of a United States bank could acquire is to limit the exclusion to debt obligations acquired in accordance with the practice in the foreign country in which the branch is located. This would permit foreign branches to compete effectively with foreign banks in acquiring any kind of foreign debt obligation the foreign banks could acquire under the foreign banking law. As a practical matter this would give foreign branches of United States banks about the same latitude as under the principal proposal, since they would not normally seek to go beyond the local practice. However, there would be an undesirable procedural obstacle in that it would be necessary to show what is the foreign practice. Perhaps this could be simplified by the use of a presumption that the acquisition of a debt obligation is in accordance with foreign practice if not expressly prohibited by foreign law or practice.

If it should be desired to retain the "loan" standard, it would appear at a minimum that the statute should be amended to permit easier proof of compliance with that standard. For example, a loan could be defined for this purpose as any debt security carried as a loan and not prohibited from being so carried under the laws or practice of the foreign country in which the foreign branch is located.

For the reasons stated in point 1, at a minimum, one of the alternatives set forth in this point II should be adopted.

The CHAIRMAN. Thank you very much, sir.

The next witness, Mr. Henri Froy, who is the chairman of the foreign committee, has submitted his statement. I will ask that it be printed at this point in the record.

(Mr. Henri Froy's statement follows:)

Statement of Henri L. Froy, Chairman, Foreign Committee of the National Association of Securities Dealers, Inc.

I have taken the liberty of attaching to my statement before your Committee a copy of the statement I made before the Committee on Ways and Means of the House of Representatives. I think that by reviewing that statement you can understand the philosophy behind the amendment which I suggest should be made by your Committee. I think by proceeding in this manner I can avoid being redundant at this time.

My comments are directed toward the provisions of Section 4919(a)(1) of the Act as proposed by the bill. In summary, however, I feel that we need facilities to put us on a parallel basis with foreign broker/dealers. We do not have such presently and as a result we are competitively disadvantaged. Such facilities would permit us to make competitive markets which would benefit both United States and foreign investors. This could result in an "invisible support" and would produce an inflow of foreign exchange.

Mr. Chairman, the Association suggests that international arbitrage firms, the definition of which would be determined by the Secretary of the Treasury, should be allowed a period of 13 customer days within which to effect market making transactions, that is, to resell to foreigners foreign securities purchased, or to cover short sales. These transactions could be reflected on a special blotter on acquisition and we have no objection to such a procedure. Dealers should not, however, be required to name customers or prospective customers. A requirement such as that would seriously interfere with the flexibility of a market maker.

Thus, we believe the Committee's proposed bill is too restrictive in its present form. Reference to "customers" or "with a specific customer in mind" should be eliminated, as long as the international arbitragist does not acquire these shares for his investment account.

Mr. Chairman, with the exception of the above, we support for the first time since 1963 the extension for two years of this "temporary expedient" in the Interest Equalization Tax. I close with the sincere hope that we will not have to discuss these problems again two years from now.

Thank you very much for having given me this opportunity to present the views of the National Association of Securities Dealers.

Statement of Henri L. Froy, Before the Committee on Ways and Means of the House of Representatives

My name is Henri L. Froy. I am Chairman of the Foreign Committee of the National Association of Securities Dealers, Inc., and a general partner of Abraham & Co., a member of the Association, the New York Stock Exchange and other major exchanges.

The National Association of Securities Dealers, Inc., is a self-regulatory organization composed of approximately 90 to 95% of all of the securities dealers doing business in the United States. It was established in 1938 as a result of an Act of Congress, the Maloney Act, and since that time it has been actively engaged in enforcing just and equitable principles of trade for the protection of the public.

Perhaps I should state at this time that my testimony here today has the support of various other industry organizations and I believe it can safely be said that it represents a unanimity of thought in the securities industry on the subject presently before your committee. In this connection, I have with me letters from the New York Stock Exchange, the American Stock Exchange and the Association of Stock Exchange Firms indicating their concurrence with the statement I am making today and I would like at this time to submit for the record copies of those letters.

The Association, and I believe the securities industry as a whole, has been opposed to the Interest Equalization Tax Act from the time it was first proposed as a temporary expedient by the late President Kennedy in 1963. At that time, and each time the law has been re-enacted—1965, 1967 and 1969—I, representing the Association, and other representatives from the industry have testified before your Committee in opposition thereto.

On March 31, 1971, the Act will again expire unless prior to that time it is extended by Congress. Careful thought and consideration has been given by all of the securities industry's organizations to the proposed extension and in this connection we have reviewed the balance of payments situation of the United States and find the problems in respect thereto are acute. The year 1970 resulted

in a deficit situation of $3.5 billion on the liquidity basis. This is aggravated by the fact that the "official settlements" account reflects approximately an $8 billion deficit which changed from the 1969 situation of a $2.7 billion surplus.

In view of these factors, the Association and the other industry organizations mentioned above, notwithstanding that we philosophically disagree with the law at the present time for the same reasons we have opposed it in the past, have concluded that it is in the best interest of the United States at this juncture to support the Administration in its current request to extend the Act. We believe, or at least we are fearful, that any attempt to rescind the law at this point could conceivably precipitate unfavorable psychological reactions abroad, especially in view of the considerable adverse publicity which has already been given to our balance of payments position. We would have been much happier, however, if the request for extension were only for a one-year period but we shall not interpose any objection to the suggested two-year extension.

We believe, however, that this tax must be rescinded just as soon as such action is compatible with the national interest. In addition to our philosophical disagreement with the tax, I think it should be noted that the tax has other effects on our industry which are not readily recognizable but nevertheless are real and are with us. I am sure you have all read of the profitability and "paper crunch" problems which the securities industry has experienced during the past one to two years.

Hopefully, those situations have reversed themselves, but the imposition of this tax because of the complicated and expensive bookeepping procedures which must be followed by brokers in accounting therefor, has a distinct effect on profitability and contributes materially to the record keeping difficulties. The national interest must come first, however, and we are willing to assume this expense and inconvenience but I believe the industry would be remiss if it did not urge upon this Committee that it must not consider that this Act should automatically be extended every two years. Rather, it must be reviewed critically and carefully not solely from the standpoint of the balance of payments position but also from the standpoint of the image of the United States as an international marketplace and to maintain its status as the leading marketplace of the world.

In supporting the Administration at this time we would like to urge upon the Committee an amendment to Section 4919 of the present law by extending from the there-stated three (3) business days to fourteen (14) business days the period of time granted to broker/dealers for international arbitrage transactions. To broker/dealers doing a substantial business in foreign securities this would be a most important provision and should have a direct and meaningful effect upon the profitability of the firm, or at least its profitability from foreign transactions. Its effect would also be favorably reflected in our balance of payments.

I have been informed that it is possible that such a change could be accomplished by amending the law to permit the issuance of an executive order. I would like to bring to the attention of this Committee and the Administration the need for such a change since the present provisions have the effect of disriminating against domestic broker/dealers in favor of foreign broker/dealers in connection with arbitrage and block transactions. If changed as suggested, the United States broker/dealers would be placed in a nearly equal competitive position with their foreign counterparts in these kinds of situations.

Perhaps an illustration of how these transactions work is in order. Institutions abroad, just as they do here in the United States, like to give block orders which in effect are "all or none" orders. This means the broker/dealer must fill the entire purchase order at once or he must purchase the entire block in the case of a sell order. In the domestic market the dealer, being confident that he can accumulate sufficient stock over a period of time, would in the case of a purchase order by an institution, if he did not have the stock on hand, sell short to the institutional buyer and cover the short position at his leisure over a period of two weeks. If he were buying from the institution he would buy the block at a set price in the expectation of being able to liquidate it in the marketplace at a profit over a period of days.

With the three-day limitation presently in the law, however, many times it is impossible for a United States broker/dealer to engage in such block transactions with a foreign institution, that is, to accumulate or liquidate his position, without incurring the interest equalization tax which becomes applicable if the three-day period is exceeded and could easily result in a loss equivalent to the rate of the interest equalization tax.

Another illustration would be a situation where a broker/dealer sees or thinks he sees a demand arising for a foreign stock and in view of that he attempts to build a long position in it. If the domestic demand which he anticipates comes about he will then pay the interest equalization tax and sell the securities as United States-owned in the American marketplace. If, however, his judgment is erroneous and the anticipated demand does not materialize, he would then resell in the foreign marketplace before the tax is applicable. This kind of legitimate activity is severely restricted when he has only a three-day period within which to work. He cannot build an adequate position or, if he does, chances are that he cannot liquidate it within that time frame if such becomes necessary.

Knowing of these restrictions on the American broker/dealer the foreign dealer is obviously in a much better position because in accumulating or liquidating positions he doesn't have to work within the three-day period since the tax doesn't apply to him. He therefore has a better opportunity to properly service United States and foreign institutions.

In conclusion, therefore, I would like to again state the unanimous position of the securities industry, by separate vote of the Boards of Governors of each of the above-noted organizations, for the Administration's proposal to extend the Interest Equalization Tax Act with the observations discussed above. We also unanimously urge upon you the extension of the three-day limitation in connection with arbitrage transactions to fourteen days.

Thank you very much for having given me this opportunity to present the views of the industry and I sincerely hope I do not have to do so again two years from now.

The CHAIRMAN. That concludes the hearings. It is the intention of the Chair to call a meeting next Tuesday, March 23, at 10 a.m. to vote on the matter in executive session.

Thank you very much.

(Whereupon, at 12:25 p.m., the committee was adjourned, to reconvene at 10 a.m., Tuesday, March 23, 1971.)

APPENDIX A

Communications Received by the Committee Expressing an Interest in the Interest Equalization Tax

NATIONAL FOREIGN TRADE COUNCIL, INC.,
New York, N.Y., March 12, 1971,

Re Extension of Interest Equalization Tax.

TOM VAIL, Esq.
Chief Counsel, Senate Committee on Finance, New Senate Office Building, Washington, D.C.

DEAR MR. VAIL: In accordance with the announcement of Senator Long regarding the Finance Committee Hearings concerning the extension of the Interest Equalization Tax, we are attaching hereto a list of several problems encountered by our members which, we believe, warrant legislative modification in order to exempt from the Interest Equalization Tax the securities or debt obligations which arise in these situations.

Should you have any questions regarding the suggestions, we will be happy to discuss them with you or other members of the Staff in any required detail.

Yours very truly,

MALCOLM ANDRESEN,
Director, Tax-Legal Division.

SUGGESTED MODIFICATIONS IN H.R. 5432 EXTENDING THE INTEREST EQUALIZATION TAX

(PASSED BY HOUSE ON MARCH 10, 1971)

Foreign mineral facilities (section 3(c) of H.R. 5432):

Section 3(c) of H.R. 5432, passed by the House on March 10, 1971, amends Code section 4914(c)(5)(B) relating to foreign mineral facilities loans so as to eliminate the need for tracing the minerals supplied to the specific facility to which the loan relates where the U.S. person can establish that he meets the "substantial portion" test with respect to all the foreign mineral facilities of the foreign person which process the same types of ores or minerals. The House report notes that the need which gave rise to this amendment was the practical difficulty being encountered in tracing the ores and minerals supplied by the U.S. person to a specific mineral facility where such U.S. person, among others, was supplying ores and minerals to several plant facilities owned by the same foreign obligor. Notwithstanding the House amendment, a tracing problem still remains in respect of mineral facilities the total construction cost of which is obtained from funds loaned by several joint venturers. Inasmuch as the Congress recognized in its reports concerning the extension of the interest equilization tax in 1969 that such joint venture loan arrangements were not uncommon, it is equally appropriate, as well as equitable, to eliminate the need for the tracing of minerals and ores in the case of a facility constructed with funds obtained from several joint venturers provided that the United States person meets the "substantial portion" test required in respect of such joint venture loan by supplying minerals or ores for processing in any of the facilities of the foreign obligor in an amount equivalent to that constituting a "substantial portion" in respect of such loan and provided that such amount is in addition to the total amount of the minerals or ores furnished by such United States person to such foreign obligor immediately prior to the making of the joint venture loan. Accordingly, it is so recommended. One manner in which this suggested amendment could be accomplished is illustrated in Exhibit A attached hereto.

Acquisitions required under foreign law (page 24, H. Rept. No. 92–35) :

In House Report No. 92–35, accompanying House passed bill, H.R. 5432, several problems are noted which the Treasury Department indicated to the Ways and Means Committee could be dealt with administratively. One such problem set forth in the second paragraph on page 24 concerns acquisitions required by an administrative practice of a foreign country or an informal requirement imposed by a foreign country. By way of illustration an example is given concerning the need for reinvesting a portion of the earnings generated in a foreign country in a pollution control agency of such foreign country. Although we believe this is an excellent example which many United States persons may face, we believe it would be helpful to add another type of example illustrating a problem that does not necessarily relate to a reinvestment of earnings so as to avoid creating any inference that the problems which can be handled administratively are limited to those dealing with reinvestment of earnings. For instance, an example could be added similar to that set forth in Exhibit B attached hereto concerning the acquisition of the indebtedness of a foreign country issued to a United States person in payment for the purchase of an ownership interest in a plant facility located in such foreign country.

Industry insurance companies (page 23, H. Rept. No. 92–35) :

We believe it would be helpful in providing clarity if the text of the discussion at the top of page 24 of the Committee Report relating to the concept of companies within a specific industry mutually agreeing to provide insurance were modified so that the term "insurance company" appearing at the end of line five and at the beginning of line six were amended to read "insurance or other similar type company." This would avoid any suggestion that the company involved had to meet any specific type of definition of an insurance company.

DEBT OBLIGATIONS ACQUIRED IN THE ACTIVE CONDUCT OF TRADE OR BUSINESS BY U.S. PERSONS THROUGH BRANCHES LOCATED IN FOREIGN COUNTRIES

An additional problem area revolves around a situation where the United States Company is engaged, through foreign branches, in the active conduct of trade or business abroad. The foreign branch acquires foreign debt obligation through the credit sales of tangible goods in the ordinary course of its business. A good percentage of the tangible goods which are sold are "manufactured or assembled" by the United States company or one of its branches including the branch making the actual sales. However, a certain percentage of the goods sold are acquired by purchase. Some of such purchases are from unaffiliated foreign companies; also in a certain number of cases the goods which are acquired by purchase are not further "manufactured or assembled" by the United States company or its foreign branch.

It has been suggested that debt obligations resulting from the extension of credit on sales of products as described above should be excluded from payment of the Interest Equalization Tax even though the duration of such credit is more than one year. This result would appear to be accomplished through the amendment to existing Code section 4914(b) as set forth in Exhibit C attached hereto.

FOREIGN FINANCING AND LEASING ACTIVITIES OF BANK AFFILIATES

A technical question has arisen with respect to the possible application of the Interest Equalization Tax in connection with certain foreign finance and/or foreign leasing activities carried on by affiliates of U.S. banks, operating with the permission of the Federal Reserve Board.

The foreign finance companies generally make short term consumer loans abroad in local currencies. The foreign leasing companies enter into both finance leases which (since 1969) would be considered a substitute for a loan and therefore subject to IET and also non-finance leases not subject to tax. Both the finance and leasing companies borrow funds abroad principally in local currencies and, where possible, in maturities corresponding to the term of the loan. The U.S. commercial bank and its domestic and foreign affiliates are regulated by the Federal Reserve Board and must comply with its balance of payments program.

Problem

A 10% or more equity investment in foreign affiliates by U.S. banks or their domestic affiliates would be excluded from Interest Equalization Tax under sec-

tion 4915(a) (but not the Federal Reserve Board's balance of payments program). However, where the foreign affiliate is engaged in the finance or leasing business abroad, it might be contended under section 4915(c)(1) that such affiliate was "formed or availed of" to make otherwise taxable acquisitions. In such event, the exclusion provided under section 4915(a) would not apply and the acquisition of stock or debt obligations of the foreign affiliate by the U.S. affiliate would be subject to the Interest Equalization Tax under section 4911. This could occur even though:

(1) The activities of the locally incorporated finance or leasing affiliate are conducted outside the United States.

(2) The source of its funds (exclusive of minimal equity capital invested directly or indirectly by the U.S. bank or its domestic affiliate) are derived aboard.

(3) The borrowers aboard are not typically borrowers of funds in the U.S. market, and

(4) the U.S. bank and its affiliates operate with the permission of the Federal Reserve Board and remain subject to its balance of payments program.

It should be stressed that loans made in the foreign finance business and the foreign finance leases which are considered taxable loans could be made directly by a foreign branch of a U.S. commercial bank and the Interest Equalization Tax would not apply. Non-finance leasing of personal property to non-U.S. persons would not be subject to Interest Equalization Tax.

Advantages to the U.S.

Such leasing and finance activities will make a substanttial contribution to the U.S. balance of payments through profit remittances to the U.S. Having a leasing facility in place abroad doing a general foreign leasing business through an affiliate of a U.S. commercial bank will facilitate the financing of so-called "large ticket" items of U.S. manufacture such as aircraft and computers. (It would not be profitable for the leasing company to restrict its activities to the leasing of U.S. exports.) This should assist U.S. exports. Moreover, the foreign leasing facility will help increase the U.S. profit remittances of both foreign manufacturing affiliates of U.S. corporations as well as foreign affiliates of U.S. corporations who obtain more favorable financing through the leasing facility.

Locally incorporated finance affiliates of Edge Act corporations[1] provide U.S. commercial banks with great flexibility in their overseas operations to meet competition in local markets. Oftentimes, local law restrictions to U.S. commercial banks operating abroad do not apply to a locally incorporated finance company. The existence of a locally incorporated financing subsidiary provides a valuable marketing tool by complementing the financial services offered by a U.S. commercial bank abroad. Further, it is often possible to permit local participation through offering such participation in a locally incorporated finance company.

U.S. banks operating abroad are in the forefront in developing finance company and leasing businesses on a worldwide basis. As foreign controlled financial institutions, which are *not* subject to Interest Equalization Tax and generally not subject to the otherwise strict regulations applicable to U.S. financial institutions, have entered the field, intense competition has resulted. If subject to Interest Equalization Tax, the affiliates of U.S. commercial banks would be placed at a severe competitive disadvantage in local markets. Our present lead in this type of financing could be lost, perhaps for good.

Federal Reserve Programs

Under the balance of payments program of the Federal Reserve Board, the total of loans to foreign borrowers and investments abroad which can be made by a U.S. commercial bank and its affiliates is restricted to the amount of such loans outstanding and investments existing as of a base date. It should be stressed that this permissible investment ceiling is an ever reducing ceiling. Further, a new investment can only be made if there is room under the ceiling which could only have resulted from repayment of loans by foreign borrowers or liquidating foreign investments.

Accordingly, new foreign investments made by banks and their affiliates operating with the permission of the Federal Reserve Board have a neutral effect on the U.S. balance of payments. Therefore, the tracing requirement of section 3(e) of H.R. 5432, 92d Congress, first session, is unnecessary and would, as a

[1] A domestic corporation organized under section 25(a) of the Federal Reserve Act (commonly known as the Edge Act); all such investments must be approved by the Federal Reserve Board.

practical matter, be unworkable. (In another context, section 3(c) of H.R. 5432 amended section 4914(c)(5) to eliminate significant tracing problems. See H. Rept. No. 92-35, 92d Cong., first session.)

Discussion

It is at cross purposes with the balance of payments to restrict the foreign finance and leasing[2] businesses described herein, in view of the substantial contributions thereto resulting from the conduct of such businesses.

The favorable U.S. balance of payments impact of foreign financing and leasing business should be preserved. Thus, it could be established to the satisfaction of the Secretary of the Treasury that the funds obtained for the acquisition of the stock of or contribution to capital to a foreign finance or leasing affiliate of a U.S. commercial bank were obtained from the sale of debt obligations by affiliates described in section 48(c)(3)(C) to non-U.S. persons. Further protection could be obtained if it also was established to the satisfaction of the Secretary that the debt obligations acquired from unrelated non-U.S. persons by a foreign finance or leasing affiliate of a U.S. commercial bank were obtained with foreign funds from non-U.S. persons (other than the amounts paid for stock or made as a capital contribution).

Accordingly, since the funds used in the finance or leasing business were obtained abroad, there should be no balance of payments reasons not to permit the funds to be utilized abroad in such businesses. For the same reasons, there should be no problem with respect to acquiring stock of a foreign corporation from its shareholders. Moreover, in view of such protection, the acquisition of a minority interest in a foreign financing company should be permitted.

A requirement that payments for stock or as a contribution to caiptal of the foreign financing or leasing affiliates described herein remain in the U.S. could give rise to an investment in U.S. property under section 956 which would be immediately taxable to the U.S. parent. In addition, foreign governments may consider the capital funds required to be maintained in the U.S. under section 3(e) of H.R. 5432 to be the equivalent of a loan by the foreign affiliate to the U.S. parent and therefore may require the payment of interest by the parent to the affiliate. This condition might also create allocation problems under the regulations promulgated under section 482 of the Code.

Recommendations

Under these circumstances, the Council makes the following recommendations:

(1) Section 4915(c) should be amended along the lines set forth in Exhibit D attached hereto.

(2) It should be made clear by appropriate Committee Report language that a foreign corporation which is "primarily engaged in the lending or finance business outside the U.S." will include a corporation engaged in the foreign leasing business described herein.

EXHIBIT A

PROPOSED AMENDMENT TO CODE SECTION 4915(c)(5)(B) CONTAINED IN HOUSE PASSED H.R. 5432

Section 4915(c)(5)(B) is amended by adding at the end thereof the following sentence:

"The substantial portion requirement shall be deemed to be met where after completion of the facility to which the loan relates ores or minerals extracted outside the United States by the United States person are stored, handled, transported, processed or serviced in or through any of the facilities of the obligor used for such purposes in an amount equivalent to that constituting a substantial portion in respect of such loan provided such amount is in excess of the amount of the ores or minerals extracted outside the United States by such United States persons which were stored, handled, transported, processed or serviced in or through all of the facilities of the obligor immediately prior to the loan."

[2] In developed country markets where competition is intense, foreign leasing affiliates of U.S. banks are competing with foreign controlled companies on the basis of a spread of ⅛ of 1% of the rentals charged. Imposition of Interest Equilization Tax on the investment in such affiliate could make U.S. controlled companies non-competitive.

Exhibit B

Suggested Example to be Included in Paragraph 2, Appearing on Page 24 of the House Committee Report Relating to Acquisitions Required Under Foreign Law

"Similarly, a foreign country might indicate that its debt obligations should be accepted as the consideration for its purchase of an ownership interest in a plant facility located in such country if the person owning such facility is to be allowed to continue carrying on business in the country."

Exhibit C

Proposed Amendment to Code Section 4914(b)

Proposed Amendment to Code Section 4914(b) relating to the exemption from the Interest Equalization Tax for foreign debt obligations acquired in the active conduct of trade or business by a United States person through its branch located in a foreign country. Section 4914(b) is amended by the following subsection:

(16) Certain Loans in Foreign Currency.—Any acquisition of a debt obligation of a foreign obligor by a United States person through its branch located in a foreign country if the debt obligation is—

(A)(i) acquired with local currency funds which were not obtained from U.S. sources or

(ii) acquired in the active conduct of trade or business including the purchase and sale of inventory items, other than a securities business, as an incident of such trade or business, and

(B) repayable in the currency of such foreign country.

[Exhibit D]

Amend Section 4915 by adding at the end thereof the following new subsection:

"(f) SPECIAL RULE FOR INVESTMENTS BY FINANCIAL INSTITUTIONS IN FOREIGN CORPORATIONS

"(1) A foreign corporation which is primarily engaged in the lending or finance business outside the United States, shall be treated as a foreign corporation which is not formed or availed of for the principal purpose described in subsection (c)(1) with respect to an acquisition of stock of such corporation (whether or not as a result of a contribution to capital) by a corporation which is (or is affiliated with) a U.S. commercial bank but only upon compliance with paragraph (2).

"(2) Paragraph (1) shall apply only if it is established to the satisfaction of the Secretary or his delegate, pursuant to rules and regulations promulgated by the Secretary or his delegate, that

"(i) the proceeds of payment for stock, or a contribution to the capital, of the foreign corporation, were derived from the sale of debt obligations by one or more affiliated corporations (within the meaning of Section 48(c)(3)(C) to persons other than persons described in Section 4920(d)(3)(A) (i), (ii) and (iii) and such debt obligations (other than those arising from the conduct of a commercial banking business abroad by a branch of a domestic financial institution) if acquired by United States persons, would be subject to the tax imposed by Section 4911.

"(ii) debt obligations acquired by the foreign corporation are acquired from persons described in section 4920(d)(3)(A) in the manner described in section 4920(d)(3) except that clause (A)(iii) thereof does not include an affiliated foreign corporation engaged in the commercial banking business abroad and paragraph (B) of that section shall be applied in a manner consistent with clause (i) of this paragraph.

"(iii) the acquisition described in paragraph (1) is and remains consistent with balance of payments guidelines to which such financial institution is subject.

"(3) For purposes of this subsection, two corporations are 'affiliated' with each other if they are members (or would be members if they were both domestic corporations) of the same affiliated group (within the meaning of section 48(c)(3)(C)).

"(4) In any case where a foreign corporation has been treated as a foreign corporation which is not formed or availed of for the principal purpose described

in subsection (c)(1) with respect to an acquisition of stock by another corporation as provided in paragraph (1) of this subsection, but such acquiring corporation fails to comply with the rules and regulations promulgated under paragraph (2), then liability for the tax imposed by section 4911 shall be incurred by the acquiring corporation (with respect to such acquisition) at the time of such failure; and the amount of such tax shall be equal to the amount of tax for which the acquiring corporation would have been liable under such section upon its acquisition of the stock involved if such domestic or foreign corporation had not been so treated."

COMMENTS ON SECTION 3(a) OF H.R. 5432, THE INTEREST EQUALIZATION TAX EXTENSION ACT OF 1971 SUBMITTED BY HARVEY M. KRUEGER, CHAIRMAN, FOREIGN INVESTMENT COMMITTEE, INVESTMENT BANKERS ASSOCIATION OF AMERICA

The Foreign Investment Committee of the Investment Bankers Association of America wishes to comment on certain technical aspects of Section 3(a) of H.R. 5432 which provides for an election to treat debt obligations of a United States corporation as subject to the tax.

This election is intended, as stated in the report of the House Ways and Means Committee (pp. 14–15), to make it possible for United States corporations to have their foreign borrowings treated as subject to the tax if acquired by United States persons in certain circumstances where the tax does not presently apply. Such borrowings may be required in order to comply with the Foreign Direct Investment Regulations imposed by the Commerce Department as part of the President's Balance of Payments Program.

Under present law such borrowings may be made by a United States corporation only if the corporation is "formed or availed of" to obtain funds for foreign persons, the obligations of which would be subject to the tax if acquired directly by United States persons. Section 3(a) would add a new Section 4912 (b)(4) to the Internal Revenue Code of 1954 which would permit any domestic corporation to elect to treat any new issue of its debt obligations as subject to the tax. The election would be available "without regard to the type of investments the company makes with the borrowed funds" (House Ways and Means Committee Report, p. 15), *i.e.*, without regard to whether the obligations would be subject to the tax under the "formed or availed of" provisions.

This amendment would eliminate the necessity that exists under present law in some circumstances of using a foreign incorporated finance subsidiary in order to issue debt obligations which are subject to the interest equalization tax, and thereby to comply with the Foreign Direct Investment Regulations. (The issuance of obligations subject to the tax may also be required to comply with the Federal Reserve Balance of Payments Guidelines which apply to banks and other financial institutions and to be entitled to certain exemptions under rules and policies of the Securities and Exchange Commission which require that obligations be subject to the interest equalization tax.

The Foreign Investment Committee strongly supports the elimination of this bias in favor of using foreign incorporated finance subsidiaries, which is detrimental to the United States balance of payments and also results in a loss of tax revenue. However, Section 3(a) of H.R. 5432 does not fully accomplish this purpose where the borrowed funds are to be invested in the United States, even though this may be and often is necessary to comply with the Foreign Direct Investment Regulations and it in fact provides a net benefit to the United States balance of payments. This is because the obligations of a domestic corporation (whether or not a financing subsidiary) under such circumstances would still be subject to United States withholding and estate taxes while the obligations of a foreign incorporated financing subsidiary under present law generally are not subject to those taxes under the same circumstances.

These differences should be eliminated by providing that debt obligations which are deemed to be debt obligations of a foreign obligor pursuant to Section 4912(b) (4) will not be deemed to be property within the United States under Section 2104(c) of the Internal Revenue Code of 1954 and that interest on such obligations will not be interest from sources within the United States under Section 861(a). This would simply apply to such obligations the same treatment under those sections that applies under present law to obligations of a foreign finance subsidiary. It would not make the withholding and estate taxes inapplicable to any greater extent than is possible under present law if a foreign finance sub-

sidiary is used since it would apply only to obligations which are subject to the interest equalization tax by virtue of the election provided by Section 4912(b)(4).

We note the following specific comments on the provisions of Section 4912(b)(4) as passed by the House of Representatives.

1. In the case of debt obligations which are convertible into stock, Section 4912(b)(4) requires the election to be made in respect of the entire class of stock into which the obligations may be converted, which would include stock already outstanding and stock issued other than pursuant to conversions of the debt obligations. The election apparently could not be made in respect of the debt obligations alone. The election should be available in respect of the debt obligations alone in order to conform with the Foreign Direct Investment Regulations which, even in the case of a foreign finance subsidiary, treat convertible obligations as foreign borrowings before conversion if the obligations are subject to the tax even though the stock into which the obligations may be converted (typically common stock of the United States parent corporation) is not subject to the tax. One way to achieve this conformity would be to eliminate all references to stock from Section 4912(b)(4).

2. Section 4912(b)(4) applies only to debt obligations of United States corporations but the same problems may be encountered by other United States persons who are subject to the Foreign Direct Investment Regulations. Accordingly, it is suggested that the term "domestic corporation" in Section 4912(b)(4) be replaced either by the term "United States person" or at least by the term "domestic corporation or domestic partnership."

3. Since Section 4912(b)(4) would make it unnecessary to use a separate finance subsidiary, whether foreign or domestic, for new issues of debt obligations in many cases, it would be desirable to make the election applicable to already outstanding debt obligations of such subsidiaries upon the assumption of such obligations by the United States parent corporation or a domestic affiliate thereof. This would only continue the tax treatment applicable to such obligations prior to the assumption and could be accomplished by providing that the assumption of a subsidiary's obligations will be treated as an original or new issue by the assuming parent or other affiliated corporation for the purposes of Section 4912(b)(4).

Statement of Duncan C. Lee, Counsel, American International Reinsurance Co., Inc.

This statement is submitted on behalf of American International Reinsurance Company, Inc., (AIRCO), a Panama corporation, in support of an amendment to the Interest Equalization Tax Act, to permit certain foreign issuers to issue stock upon the exercise of a *qualified* employee stock option which would be exempt from the Interest Equalization Tax both in the hands of the optionee and in the hands of his transferees. We emphasize that (1) only a foreign corporation which as of July 19, 1963, was considered a domestic issuer by virtue of Section 4920(b) Internal Revenue Code will be benefited by the amendment, and (2) the option must be qualified under Sections 422 and 423 of the Internal Revenue Code. These two restrictive conditions should prevent any possibility that the proposed amendment would open the doors to abuse.

Attached to this statement is a suggested amendment to the Interest Equalization Tax Act, which would, we feel, accomplish this purpose. We are, of course, amenable to any language which the Committee may feel is preferable in attaining the objective.

In proposing this amendment AIRCO is seeking to remove a discrimination resulting from the wording of the present Act which so far as AIRCO knows affects very few other foreign corporations, if any, which may be in the same situation as AIRCO. AIRCO was incorporated in 1958 for the purpose of conducting directly and through subsidiaries the business of insurance and reinsurance abroad. It was incorporated in Panama because all of its business was to be conducted overseas.

AIRCO has always been predominantly U.S. owned, and its key managerial and technical personnel are U.S. persons. In order to attract and keep these key U.S. employees, AIRCO found it expedient, as do many U.S. business enterprises, to offer them qualified options in its common stock. In 1963 AIRCO's outstanding common stock, and common stock dividends subsequently distributed thereon, was exempt from IET by virtue of Section 4920(b). For a number of years, therefore, AIRCO was able to hold as treasury stock sufficient IET-exempt shares to satisfy the exercise of outstanding options. In January, 1971, however,

AIRCO's supply of tax-exempt shares in its treasury was exhausted, and it can now only satisfy the exercise of options by issuing new shares which, as the law now stands, are subject to IET.

In other words, an optionee who exercises after January, 1971, must pay 11½% more for his shares than the man who exercised earlier. Such an outcome has resulted in an inequity, the consequences of which is unjustified under the purpose of the Act. It has been suggested that should exempt and nonexempt stock both be issued pursuant to AIRCO's qualified stock option plan, two markets would exist for AIRCO stock; one at its prevailing fair market value, and the other at 11½% under that value by reason of the fact that the stock in the second market will be subject to the burden of IET. It is further suggested that the optionee holding such IET-taxable stock would recover his penalty for the reason that he could resell the stock at the prevailing fair market value and thereby recapture the penalty.

We believe these suggestions are based upon a basic misunderstanding of the situation. It is true that there would be two markets for exempt and nonexempt AIRCO stock issued to optionees, with the taxable stock selling at a discount. It is not true that the optionee receiving taxable stock would ever recoup the IET penalty of 11½% which he has had to pay.

The optionee who must pay IET could only recoup any part of the penalty if (1) he reecives an increase in the basis of the option stock in the amount of the IET paid, or (2) he gets a tax deduction in the amount of IET paid, or (3) he gets a better market for his stock by reason of the fact that IET had been paid.

As we understand the provisions of the Code, he gets none of these advantages. There is no increase in the basis of his stock in the amount of IET paid. There is no deduction from ordinary income by reason of the payment of IET.

Finally, and this is the important point, he would have no market advantage in acquiring IET-paid stock, but rather the reverse. In the case of AIRCO, almost all of the stock being traded, and which will hereafter be traded, is stock exempt by virtue of section 4920(b). That stock is perpetually exempt in the hands of any holder. It is indeed exempt upon sale to another U.S. person. But if the stock is issued to, or is later acquired by, a non-U.S. person, any U.S. person acquiring the stock from such a holder must pay the tax, even though it may have already been paid upon original issuance to the optionee. In other words, the fact that a U.S. optionee has paid IET does not render the stock exempt to another U.S. person and the result is that the market in the taxable stock is perpetually subject to a discounted price. Thus, the U.S. optionee not only pays IET in the first instance on the stock issued to him, but in addition can only dispose of that stock at a discounted price. That is why there is always a substantial discrimination against an optionee who must take stock subject to IET in comparison with an optionee fortunate enough to acquire stock exempt under Section 4920(b).

To require payment of IET on AIRCO's still outstanding stock options will not benefit the U.S. balance of payments position because the options will be exercised anyway, in spite of the IET penalty, due to the dramatic increase in the fair market value of AIRCO stock over the past few years and the expected increase in such value in the next few years.

As stated before, we believe the AIRCO situation is unique. Unlike the typical U.S. enterprises overseas, it is neither a branch nor a foreign subsidiary of a U.S. corporation. If it were, its key U.S. personnel would be rewarded in the stock of the U.S. corporation and, of course, would not have to pay IET on such stock. AIRCO's situation is further narrowed by the fact that in 1963 it qualified as a domestic issuer under Section 4920(b).

Since AIRCO presents a unique situation, it is pertinent to call attention to the substantial inflow of dollars into the United States which have resulted from the operations over nearly fifty years of AIRCO and its subsidiaries. A part of the record is attached as Exhibit A to this statement.

We hope the Committee will agree that the proposed amendment should be adopted so that AIRCO, a distinct plus factor in the U.S. balance of payments position, can offer qualified stock options to its indispensible key U.S. personnel on a nondiscriminatory basis. The amendment will cure an injustice in the present law. It will not have an adverse effect upon the U.S. balance of payments position. Rather, by giving incentives to a team proven effective in bringing dollars into the U.S., the effect will be beneficial to our balance of payments. The amendment will not open the door to abuse. We are proposing a very narrow amendment. We do not seek to extend the 1963 exemption for all purposes to newly issued AIRCO stock but only to equalize the position of all holders of AIRCO-qualified stock options.

[ATTACHMENT]

SUGGESTED AMENDMENT OF INTEREST EQUALIZATION TAX ACT TO ACCOMPLISH PURPOSE DISCUSSED IN THE FOREGOING STATEMENT

By amending Subparagraph (E) of § 4920(a)(2) IRC to read as follows: "(E) any interest in, or option or similar right to acquire, any stock described in this paragraph, *other than an option granted to an employee of an issuing corporation, which as of July 19, 1963, was not considered a foreign issuer by virtue of Section 4920(b), its parent, or subsidiary, of stock of such issuing corporation pursuant to an employee stock option plan or similar plan which meets the requirements of Sections 422 and 423, or stock issued upon the exercise of such an option.*" [Emphasis supplied to indicate proposed qualifying language.]

[EXHIBIT A]

AMERICAN INTERNATIONAL REINSURANCE CO., INC.

The following are approximate but reasonably accurate figures on the contribution that the American International Reinsurance Company (AIRCO) group has made in aid of the U.S. Balance of Payments position during the ten-year period 1960–1969, inclusive. Comparable figures are not available for the years before 1959, but we know that the contribution to dollar inflow was certainly substantial in those earlier years.

It is emphasized that the AIRCO group was started with a minimum of contributed U.S. capital going back to 1921. It is quite possible that no U.S. capital whatever was exported in this regard but certainly U.S. $10,000 would be an outside figure. Today the AIRCO group on a consolidated basis has assets in excess of U.S. $1 billion. Its growth and development has derived primarily out of foreign source insurance premium income.

Below are the partial specifics for the ten-year period in question:

1. Imported insurance reserves now invested in the United States	$16,500,000
These were brought in from the following territories:	
Southeast Asia	11,500,000
Venezuela	2,000,000
Sterling Satellite Countries	2,000,000
Miscellaneous	1,000,000
2. Paid to U.S. companies for management services in New York	4,000,000
3. Dividends paid to U.S. persons	3,600,000

[Note that the total of $24,100,000 represented by items 1 through 3 (which, incidentally, are almost certainly not a complete picture of the actual items of dollar inflow) is all the result of repatriated foreign source income.]

4. Today the AIRCO group with respect only to its foreign operations holds approximately $15,000,000 in U.S. bank accounts.

An example of the growth of one AIRCO insurance subsidiary during the period in question, American International Assurance Company, Ltd., of Hong Kong, is that its net worth increased by U.S. $8,500,000 even after paying $2,400,000 in dividends to AIRCO.

NEW YORK, N.Y., *March 15, 1971.*

Hon. RUSSELL B. LONG,
Chairman, Committee on Finance,
U.S. Senate.

DEAR SIR: In response to the invitation of the Committee on Finance for comments on H.R. 5432, the Interest Equalization Tax Extension Act of 1971, the undersigned respectfully submit for your consideration comments with respect to Section 3(a) of the Act, which would add a new Section 4912(b)(4) to the Internal Revenue Code. Both of the undersigned are members of the bar of the State of New York, and have, in the course of their practice, become familiar with the problems presented by financing transactions with foreign lenders, including those to which the proposed new Section 4912 (b)(4) is directed.

THE GENERAL PRINCIPLE

The general principle of the proposed new Section 4912(b)(4) is to enable domestic corporations to make debt instruments issued by them subject to

interest equalization tax at the highest rate. This provides a simple and desirable means of insuring with a high degree of certainty that debt instruments issued to foreign lenders in financing transactions undertaken to comply with balance of payments programs will not be resold into the United States.

For the reasons set out below, it is suggested that the proposed new Section 4912(b)(4) be amended in certain respects. Further, it is submitted that amendments should be made to those income and estate tax provisions which interlock with the interest equalization tax in financing transactions entered into to comply with the balance of payments programs. These latter amendments would encourage such financing transactions to be effected in simplified form by employing the principle of Section 4912(b)(4), to the benefit of both the companies involved and the revenues of the United States Treasury.

DETAILED COMMENTS

1. The proposed Section 4912(b)(4) should not apply to stock

In the form enacted by the House, the proposed Section 4912(b)(4) would apply interest equalization tax not only to a debt instrument with respect to which a notice was filed, but also to any stock of a domestic corporation into which it is converted. It is submitted that Section 4912(b)(4) should not apply to such stock.

To meet the problem posed by finance subsidiaries which issue debt instruments to foreign investors and desire to invest the proceeds in less developed countries, it is not necessary to go further than to deal with the debt itself. Even though the stock into which it may be converted were free of interest equalization tax, the election to be provided by the statute would be sufficient to give the debt instrument the desired status.

Many convertible debt instruments have been issued in transactions designed to comply with the Foreign Direct Investment Regulations of the Department of Commerce.[1] The original borrowing on a convertible debt instrument permits the borrowing corporation to make investments in foreign subsidiaries which would not, otherwise, be allowable. §§ 1000.306(e)(2) and 1000.313(e)(1), FDIR. On the other hand, any transaction which is treated as a payment of a debt to a foreign creditor usually has the effect of a cash investment in a foreign subsidiary which is subject to the restraints and limitations imposed by the Regulations. § 1000.312(a)(7), FDIR. The conversion of a convertible debt instrument is treated as if it were such a payment. §§ 1000.324(b)(2) and 1000.1002(a)(3), FDIR. Thus, the Regulations treat a borrowing on a convertible debt instrument as any other foreign borrowing and treat conversion of the debt instrument into domestic stock as if a cash repayment had occurred.

As the Regulations now stand, there is no reason for subjecting to interest equalization tax domestic stock issued upon the conversion of a debt instrument issued to foreign lenders in a financing undertaken to comply with the Regulations.[2] The fundamental premise for such a financing is that the issuance of stock upon conversion of the original debt instrument is the equivalent of a cash payment for balance of payments purposes because it is assumed this stock may be and will be resold in the United States. If stock issued upon the conversion of a debt instrument were itself to become subject to interest equalization tax simply because of an election to employ Section 4912(b)(4) with respect to the debt out of which it arose, the proposed new Code provision could almost certainly never be employed for a convertible debt, simply because such a debt would not be marketable on these terms.

The change in proposed Section 4912(b)(4) suggested here could be effected by striking from it the four parenthetical references to stock which occur in the bill as enacted by the House.

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[1] These regulations are contained in Title 15, Chapter X, Part 1000, Code of Federal Regulations. They are referred to here as "the FDIR".

[2] Considerable interest has been expressed in expanding the extent to which the proceeds of equity securities sold abroad can be applied to make investments in foreign subsidiaries in the same way as the proceeds of borrowing now can be. Though the interrelationship between such a proposal and the tax law should be explored, this does not seem an appropriate occasion for doing so, if only because of the limited time for consideration of what is admittedly a difficult problem which has both securities and tax law aspects. See Committee on Foreign Investments, Section of International and Comparative Law, American Bar Association, *A Proposal for The Use of Equities as a Means of Financing Investments in Foreign Affiliates by U.S. Companies*. The Business Lawyer (November, 1969) p. 53. Equity issues abroad can now be given limited effect for limited periods of time under the FDIR if the issuer has been granted specific authorization in a particular case.

2. The effect of the election to be permitted by proposed Section 4912(b)(4) is too broadly stated

The bill as enacted by the House would make a debt instrument subject to interest equalization tax upon the filing of notice "notwithstanding any other provision of this chapter other than section 4911(d)". Presumably, the purpose of these words is to insure that no doubt could arise under the "conduit" provisions of Section 4912(b)(3). Conceivably, it could be argued that, without such a provision, a domestic corporation's debt instrument deemed "foreign" by virtue of Section 4912(b)(4) could, in turn, be deemed the obligation of a "less developed country corporation" or an obligation entitled to the special exemption of Section 4917[2a] by the application of this conduit rule. The argument would be, in effect, that Section 4912(b)(4) was ineffective to accomplish one of the stated purposes for which it was drawn. Though it seems clearly desirable to guard against such an argument, the form of words employed creates difficulties which could render Section 4912(b)(4) useless in practice. For example:

(i) Debt obligations of a finance subsidiary which has borrowed abroad to comply with the FDIR are often subject to sinking fund provisions. It is often advantageous to the parent corporation to purchase some of the instruments in advance of sinking fund dates because market conditions have caused them to trade below par. Such repurchases are now exempt from tax under Section 4915. They should continue to be.

(ii) Debt instruments issued in a financing accomplished to comply with the FDIR are often sold to underwriters and dealers who resell them to foreign investors. Such sales and resales are exempt from tax under Section 4919 and should continue to be.

(iii) Any taxable debt instrument is subject to tax only once, when first acquired by a United States person. Thus, it can pass from one United States person to another free of tax under Section 4918. Since there is nothing unique about the debt instruments described in Section 4912(b)(4), this should continue to be the rule with respect to them.

(iv) There are a variety of ways in which otherwise taxable debt instruments can move into United States ownership without tax. For example, inheritances, gifts, transfer between fiduciaries, transfers to a creditor in bankruptcy or by way of dividend or upon certain reorganizations are all tax free under Section 4914(a) and it is not clear what impact the language of the bill would have on such transfers of debt instruments subject to Section 4912(b)(4).

There should, at least, be inserted after the phrase "notwithstanding any other provisions of this chapter other than section 4911(d)" the following additional material:

", section 4915, section 4918 and section 4919".

It would, however, be preferable if there were substituted for the entire phrase "notwithstanding any other provision of this chapter other than section 4911(d)" the following phrase:

"notwithstanding any provision of this chapter which would require such debt obligations to be treated as or deemed to be, either in whole or in part, obligations or stock described in section 4916(a) or section 4917(a)".

3. The election provided by proposed Section 4912(b)(4) should be implemented by amendments to Section 861 and Section 2104 so that it can be employed for debt instruments now issued by foreign finance subsidiaries of United States corporations

The Office of Foreign Direct Investments of the Department of Commerce estimates that, as of December 31, 1970, American companies had incurred $10.5 billion of debt in the Eurodollar money and capital markets. This total has been employed to offset foreign investment under the voluntary balance of payments restraint program in effect from 1965 through 1967, and under the FDIR imposed January 1, 1968 under Executive Order 11387. This total is now increasing at a rate utterly inconceivable a short time ago. Investment bankers estimate that, during the first two months of 1971, about 1.5 billion was added to this debt.

This enormous debt to foreigners has not been incurred in a free market. The continuation of the FDIR from one year to the next has imposed upon American companies doing business abroad a constantly increasing obligation to borrow

[2a] This provision has been employed to exempt new issues of Canadian securities.

in the Eurodollar market.[3] The increasing pressures imposed by the FDIR have required American companies to meet the requirements as to rate, maturity and terms imposed by the nonresident alien investors who are collectively referred to as "the Eurodollar market".

The universally experienced demand imposed on American companies borrowing in the Eurodollar market during the last six years is that interest on the debt instruments they issue must be free of withholding for United States federal income tax and that these debt instruments must not be subject to United States estate tax when held by a nonresident alien.

A variety of methods have been employed for issuing debt securities the payment of interest on which will be free of withholding tax. Short-term borrowings have been made through European banks or European branches of American banks, which, in turn, buy matching Eurodollar funds. Short and medium term debt instruments subject to restrictions on transfer have been sold to financial institutions in nations with which we have a treaty exempting interest payments from withholding. Finally, long-term freely transferrable debt instruments have been issued through so-called "international finance subsidiaries" (which are domestic corporations) and "offshore finance subsidiaries" (which are foreign corporations of the type recognized by §§ 1000.1401 through 1000.1405, FDIR).[4]

The Internal Revenue Code itself and treaties to which the United States is a party permit interest on short and medium term Eurodollar debt to be paid free of United States withholding. The Internal Revenue Service has issued many (certainly more than one hundred) rulings during the last six years which (together with existing treaties to which the United States is a party) have permitted interest on Eurodollar debt incurred through finance subsidiaries to be paid free of United States withholding tax.

All finance subsidiaries are complicated corporate structures, but the offshore finance subsidiaries are particularly so. Nevertheless, they have proliferated rapidly. As the FDIR continue applicable over an increasing number of years, their cumulative effect combined with the complex effects of foreign tax laws and the Internal Revenue Code itself have forced American companies to employ them as borrowing channels.[5]

Offshore finance subsidiaries incur income taxes in the jurisdictions in which they are organized. These taxes may be claimed as credits against United States Federal income tax of the parent American companies which finance through them. Sections 902 and 960 Internal Revenue Code. If interest on the debt instruments which offshore finance subsidiaries issue in the Eurodollar market could be issued by domestic corporations under rules permitting interest on these debts to be paid free of withholding tax, offshore finance subsidiaries would be employed only in the most unusual circumstances. Almost all the debt instruments they issue would be issued by American parent companies (which must guarantee their debt instruments in any event) or by domestic subsidiaries of American parent companies.

To the extent obligations of domestic corporations could be substituted for the debt obligations of offshore finance subsidiaries, American parent corporations would benefit in several ways. Because their borrowings must be backed up by capital equal to 20% of the principal,[6] American parent companies have very large amounts of liquid capital exposed in jurisdictions in which offshore finance subsidiaries are organized. This exposure could be eliminated. Administrative and legal expenses of borrowing in the Eurodollar market could be reduced. The principal beneficiary of the substitution of debt obligations of domestic corporations for debt obligations of offshore finance subsidiaries would be the Treasury by reason of the reduction in allowable foreign tax credits now generated by these corporations. Neither issuing corporation, nor their parents nor the non-

[3] The FDIR are "not designed to curb foreign investment. . . It is the source of financing . . . which is at issue." Statement of Charles E. Fiero, Director, OFDI Annual Conference of the Tax Foundation, Inc. December 2, 1968 CCH Balance of Payments Serv. Par. 9202. Sec. 306(e)(2) and 313(d)(1) FDIR.

[4] Though formal statistics are not available, a very substantial portion of the total borrowing done by American companies in the Eurodollar market has been effected through finance subsidiaries organized in Luxembourg, the Netherlands or the Netherlands Antilles.

[5] Again formal statistics are not available, but those familiar with foreign financings estimate that 75% of the $1.5 billion addition to the Eurodollar debt of American companies which has occurred in 1971 has been incurred through offshore finance subsidiaries organized in the Netherlands Antilles.

[6] This is a requirement universally imposed by the Revenue Service as a condition to a favorable ruling on any finance subsidiary.

resident alien lenders would, under the amendments proposed, receive any United States tax advantage which is not now available through the use of an offshore finance subsidiary.

Interest paid on a debt instrument subject to interest equalization tax by reason of proposed Section 4912(b)(4) could be made free of withholding tax by treating such interest as income from sources without the United States. This could be done by adding to Section 861(a)(1) a provision to the following effect:

> (G) interest on debt obligations which were, when issued, deemed to be obligations of a foreign obligor pursuant to section 4912(b)(4).

Correspondingly, such debt obligations could be exempted from United States estate tax by amending the last sentence of Section 2104(c) dealing with debt obligations which are property within the United States to refer to the above provision. As amended, this sentence of the statute would read:

> "This subsection shall not apply to a debt obligation to which section 2105(b) applies or to a debt obligation of a domestic corporation if any interest on such obligation, were such interest received by the decedent at the time of his death, would be treated by reason of section 861(a)(1)(B) *or section 861(a)(1)(G)* as income from sources without the United States." [7]

By adding these amendments to the income and estate tax provisions of the Code, debt instruments subjected to interest equalization tax by the proposed Section 4912(b)(4) would be treated in precisely the same manner as are debt obligations presently issued by offshore finance subsidiaries.

(4) Section 4912(b)(4) should be extended to permit outstanding debt instruments to be made subject to interest equalization tax when assumed by a domestic successor to an offshore finance subsidiary

Even though the amendments to Sections 861(a)(1) and 2104(c) proposed above were adopted, it would be impossible in many cases to refinance existing obligations issued through offshore finance subsidiaries by repaying them and issuing new obligations which could be subjected to interest equalization tax pursuant to the proposed Section 4912(b)(4). Among other things, the Eurodollar capital market has been so heavily strained that remarketing these debt issues might be extremely difficult in many cases.

It would, however, be possible, under the indentures to which they are subject, to dissolve many, and perhaps most, existing offshore finance subsidiaries and cause their debt obligations to be assumed by American parent companies (or their domestic affiliates) if the assumed debts of these companies could be made subject to interest equalization tax under the proposed new Section 4912(b)(4). This could be accomplished by adding to the proposed statutory provision the following sentence:

"For the purposes of this paragraph, if all the stock of a foreign corporation is owned by a single domestic corporation (or by two or more corporations, each of which was an includible corporation in a single affiliated group, as defined in a section 1504) and if such foreign corporation has been formed or availed of principally for the purpose of borrowing funds outside the United States, the date on which a debt obligation of such foreign corporation is assumed by any such domestic corporation or by any domestic corporation which is a member of such affiliated group shall be deemed to be the date on which such debt obligation is issued."

Since this would permit disposing of many, if not all, existing offshore finance subsidiaries, it would benefit both the Treasury and American corporations which have been forced into the Eurodollar market.

Respectfully submitted.

M. BERNARD AIDINOFF.
JOHN P. CARROLL, Jr.

AMERICAN BAR ASSOCIATION,
Washington, D.C., March 16, 1971.

CHIEF COUNSEL,
Senate Committee on Finance,
New Senate Office Building, Washington, D.C.

DEAR SIR: Enclosed herewith is a compilation of individual comments submitted with respect to the above, by the members of the Section of Taxation through its Committee on Foreign Tax Problems. The following members of that Committee submitted comments:

[7] The material to be added by the proposed amendment is italicized.

M. Bernard Aidinoff, Esq., 48 Wall Street, New York, N.Y. 10005
John P. Carroll, Jr., Esq., 1 Chase Manhattan Plaza, New York, N.Y. 10005
John A. Corry, Esq., 1 Chase Manhattan Plaza, New York, N.Y. 10005
Henry W. deKosmian, Esq., 1 Chase Manhattan Plaza, New York, N.Y. 10005
T. Paul Freeland, Esq., 1000–16th Street, N.W., Washington, D.C. 20036
Ralph O. Winger, Esq., 80 Pine Street, New York, N.Y. 10005

These comments represent only the individual views of the members who submitted comments and are in no way to be construed as representing the position of the American Bar Association or of its Section of Taxation.

Sincerely yours,

SHERWIN T. MCDOWELL,
Chairman.

(Enclosures.)

COMMENTS OF THE MEMBERS OF THE COMMITTEE ON FOREIGN TAX PROBLEMS SECTION OF TAXATION, AMERICAN BAR ASSOCIATION

Set forth below are the comments of members of the Committee on Foreign Tax Problems, Section of Taxation, American Bar Association, on certain provisions contained in H.R. 5432.

1. *Section 3(a) of the Bill.* Section 3(a) would add a new paragraph (4) to Code Section 4912(b). This would provide a special election whereby any class of the debt obligations of a domestic corporation would be treated for interest equalization tax purposes as debt obligations of a foreign corporation. The language of the proposed Code Section 4912(e)(4) makes it clear that if such an election is made in the case of convertible debt obligations, it must also apply to any class of stock into which such debt obligations may be converted. It is submitted that there is no reason to impose such a requirement. In the case of domestic corporations whose debt obligations are subject to interest equalization tax under Code Section 4912(b)(3), the Internal Revenue Service has never required as a condition to issuing a ruling that the underlying stock should also be made subject to interest equalization tax. We understand that the Service's position is the same in the case of debt obligations of foreign incorporated financing subsidiaries which are convertible into shares of stock of a domestic corporation. It is submitted that there is no reason why a different requirement should apply in the case of convertible debt obligations of a domestic corporation as to which an election is made under Section 4912(b)(4), and we have reason to believe that making such stock subject to interest equalization tax might be a substantial deterrent to selling such convertible debt obligations to foreign purchasers.

As presently drafted, the exemption for prior American ownership under Section 4918 and the exclusion for direct investments under Section 4915 may not be available with respect to obligations described in proposed Section 4912(b)(4). There also may be some ambiguity with respect to Section 4919, sales by underwriters and dealers to foreign persons. Since there is no reason why obligations described in Section 4912(b)(4) should be treated differently than obligations of foreign obligors generally, these statutory exclusions should be available. This can be done by changing line 21 on page 2 of the Bill to read "than Sections 4911(d), 4915, 4918 and 4919 . . ."

In addition, it should be emphasized that Section 4912(b)(4) will have only limited utility unless parallel provisions are inserted in the income and estate tax provisions of the Internal Revenue Code, which would exempt payments in respect of such debt obligations from United States withholding taxes and would exempt such obligations from United States estate taxes when held by nonresident aliens. At the present time, United States corporations have borrowed substantial amounts of funds from foreign sources through the use of foreign borrowing subsidiaries, mostly incorporated in the Netherlands Antilles, interest paid by which is not subject to United States withholding taxes. The use of such subsidiaries, however, does result in the incurrence of additional costs and other inconveniences which would not exist if these funds could be borrowed directly by United States corporations. Furthermore, the use of a foreign borrowing subsidiary results in such subsidiary incurring a foreign income tax liability, which in most cases is not an extra cost to the borrower but merely a tax which ultimately reduces United States income taxes by reason of the foreign tax credit provision. The loss of United States tax revenue could be avoided if United States corporations could effectively borrow overseas without the use of foreign financing subsidiaries.

Accordingly, it is suggested that a new Section 861(a)(1)(G) be added to the Internal Revenue Code, under which interest (including original issue discount as defined in Code Section 1232(b)) on debt obligations of a domestic corporation as to which an election is made under Section 4912(b)(4) would be excluded from the definition contained in Section 861(a)(1) of income from sources within the United States. At the same time, the last sentence of Section 2104(c) would be amended by inserting a reference to new Section 861(a)(1)(G) so that a debt obligation of a domestic corporation would not be treated for estate tax purposes as property within the United States if any interest thereon would be treated by reason of Section 861(a)(1)(G) as income from sources without the United States. It is submitted that such amendments would not result in any tax avoidance, since the same results can be reached today through the use of foreign incorporated financing subsidiaries. However, as we have noted above, the adoption of such amendments would eliminate certain difficulties and costs which presently exist for United States corporations which wish to borrow funds abroad for use in the United States, and hence, in our opinion, such amendments would advance the balance of payments program of the United States.

2. *Section 3(f) of the Bill.* Section 3(f) would amend Code Section 4919 to permit the President by Executive order to extend to a period not exceeding thirteen days the present three-day period within which a dealer must resell foreign stock to foreign persons if he is to obtain a credit or refund of the interest equalization tax imposed when he purchases such foreign stock. In order for such an extended period to be available, the Bill provides that the acquiring dealer must keep such records and must submit to the Secretary or his delegate an identifying procedure in advance of any acquisition of foreign stock which the dealer wishes to resell during such extended period. It is submitted that since the general provisions under which this credit or refund is available apply only to acquisitions by a dealer in the ordinary course of his business, there is no reason why there need be such an advance notification requirement. Furthermore, since a dealer acting in the ordinary course of business could not be making acquisitions for investment purposes, the limitation of the Executive Order to "acquisitions made for customers and not for investment purposes" seems unnecessary and might even raise the inference that under present rules acquisitions might be made for investment purposes by a dealer. Accordingly, it is suggested that the amendment to Code Section 4919(a) be revised to add a period immediately after the word "days" on line 23 of page 10 of the Bill and to delete the balance of that sentence. For the same reason, it is suggested that a period be added after "subsection (a)" on line 16 of page 11 of the Bill and that the balance of that sentence be deleted. Alternatively, since appropriate conditions may be included in the Executive Order, new Section 4919(b)(1)(C) could be deleted entirely.

3. *Section 3(i) of the Bill.* Section 3(i) amends Code Section 6651 so as to extend the penalties set forth therein to the failure to file interest equalization tax returns or the failure to comply with the reporting and withholding requirements imposed on participating firms under Code Section 4918(e). It is submitted that such an amendment is not necessary in the case of quarterly interest equalization tax returns, since Section 6651 presently applies to returns required under Section 6011, and since the filing of quarterly interest equalization tax returns is required under Section 6011(d)(1). For the same reason, it would appear that no such amendment is necessary in cases where there is a failure to pay the taxes shown or required to be shown as taxes on such returns. Thus, it would appear that any amendment of this sort should be limited to returns required under the authority of Section 4918(e). It also should be noted, however, that Section 6651(e) as set forth in H.R. 5432 specifically refers only to returns and not to taxes shown or required to be shown on such returns, even though the report of the House Ways and Means Committee at pages 21–22 indicates concern over this point as well. Accordingly, it is also submitted that in addition to deleting the reference to Section 6011(d)(1), there should be inserted before the word "in" on line 17 of page 13 of the Bill the words "and to the amounts shown or required to be shown as tax on such returns". For the same reason, it is suggested that there be inserted before the word "specified" on line 18 of page 13 of the Bill the words "or taxes".

STATEMENT OF THE CHAMBER OF COMMERCE OF THE UNITED STATES OF AMERICA ON INTEREST EQUALIZATION TAX EXTENSION ACT OF 1971

(By Robert R. Statham*)

The Chamber of Commerce of the United States appreciates the opportunity to express its views on the Administration's proposal to extend the Interest Equalization Tax Act to March 31, 1973, The National Chamber continues in opposition to an interest equalization tax, and opposes its further extension by H.R. 5432, the Interest Equalization Tax Extension Act of 1971.

SUMMARY OF THE POSITION OF THE CHAMBER OF COMMERCE

The Chamber is very much concerned with the proposal to extend again the interest equalization tax. Although originally adopted in 1964 as a temporary measure, and made retroactive to July 1963, this "temporary tax" is proposed to be extended for the fourth time since its enactment. After eight years, it is time for us to reappraise the necessity and long-range effect of this so-called temporary tax.

The National Chamber has consistently opposed the interest equalization tax since it was proposed in 1963. The tax contravenes established national policies and does not advance our long-term balance-of-payments goals. The tax restricts trade and investment and imposes artificial controls on the free international movement of capital.

While it is recognized that the United States balance-of-payments position needs strengthening, the extension of this temporary measure—which has proved difficult to administer and enforce—is no solution to the problem.

NOT A SOLUTION TO THE BALANCE-OF-PAYMENTS PROBLEM

The interest equalization tax was enacted as a corrective measure for the purpose of attempting to solve this country's balance-of-payments problem. This excise tax on the purchase by U.S. persons from foreign nationals of portfolio securities of foreign issuers was a departure from our traditional advocacy of a free capital market and the unrestricted movement of capital.

At the time of enactment, it was apparent that any attempt to solve the Nation's balance-of-payments problem had to be temporary in nature. While in the short run, investments in foreign securities may create a deficit in our balance of payments, the repayment of debt and the receipt of interest and dividends are substantial surplus factors. Therefore, reduction in portfolio investments in foreign securities might be desirable as a short-term remedial measure, but in the long run it acts against a surplus by reducing the income to be realized by persons in this country from foreign investments. It is time to terminate this tax which runs contrary to our long-run objective of equilibrium in our balance of payments. Continuation of this measure will only further postpone the achievement of equilibrium.

It would be preferable to attack our balance-of-payments deficit by reducing domestic inflation and Government outlays overseas. More competitive prices for exports, and more encouragement to business investment abroad, particularly in underdeveloped countries, constitute long-range approaches to solving our payments problem. For example, the recent changes in our depreciation provisions announced by the Treasury Department are expected to increase the competitiveness of American goods abroad, and thereby strengthen our balance of payments.

In an effort to seek new ways to improve the Nation's balance of payments, the Chamber has encouraged the study of the value-added tax. One recent study was made by The President's Task Force on Business Taxation. The National Chamber urges additional in-depth study and discussion of the value-added tax, or a similar tax as a means of correspondingly reducing the income tax and improving the Nation's international balance of payments.

We also urge the adoption of the proposed Domestic International Sales Corporation concept as another means of improving the Nation's trade position and helping to alleviate the balance-of-payments problem. DISC will put American exporters in a more competitive position in the search for world markets, will

* Taxation and Finance Manager, Chamber of Commerce of the United States.

encourage American manufacturers to locate their plants in this country, rather than overseas, and will help companies which are too small to operate foreign subsidiaries to enter the export field.

Another positive approach toward strengthening the U.S. export position in world markets would be improved export financing. The future of the U.S. trade balance depends largely on expanding sales of sophisticated, high technology capital goods, and it is precisely these exports where competitive export financing is becoming crucial to the sale. Our export credit facilities such as Eximbank, the Agency for International Development, and the new Overseas Private Investment Corporation should be given additional funding leeway to provide our exporters financing on a parity (rates and payment terms) with that which foreign counterpart institutions provide our competitors.

Such techniques as this are far better methods of improving our balance-of-payments picture than an interest equalization tax.

RESTRICTS TRADE AND INVESTMENT

The interest equalization tax restricts trade and investment. However, restriction on the free movement of private goods and capital is not the solution to our balance-of-payments problem. Remedial measures should be oriented to expansion rather than restriction of world trade and investment. Business should not be required to conduct its operations for any length of time in ways that do not permit it to be fully competitive with foreign business.

This type of economic barrier encourages retaliation by other nations since the interest equalization tax is correctly interpreted by foreign countries as a form of exchange control.

CONTROLS UNDESIRABLE

Controls in peacetime on the free international movement of capital are undesirable. Such controls disrupt normal business decisions. The provisions in the law which permit modification of the tax rates by executive order introduce an element of uncertainty, further disrupting normal business decisions and restraining business planning. Because of the recent decline in domestic interest rates, it can be expected that the tax rate again may be adjusted.

Artificial controls tend to bring about artificial results. For the investor, there is in effect a devaluation of his dollar, since the tax increases the cost of his investment. And the tax tends to reduce the quality of foreign investments marketed in this country, since foreign borrowers resort to marketing their securities in the United States only if they cannot be sold elsewhere.

IN CONCLUSION

It is time that short-run effects be given less emphasis, and that primary consideration be given to long-run objectives. The Interest Equalization Tax Act should be eliminated rather than extended.

MORRISON, FOERSTER, HOLLOWAY, CLINTON & CLARK,
San Francisco, Calif., March 12, 1971.

[AIRMAIL]
TOM VAIL, ESQ.,
Chief Counsel, Senate Committee on Finance,
New Senate Office Building, Washington, D.C.

DEAR TOM: I reached Dennis Bedell by telephone this morning regarding section 3(d) of H.R. 5432, which you and I briefly discussed on the telephone yesterday. Since you and I talked I have had section 3(d) of H.R. 5432 dictated to me from Washington and I have now had an opportunity to study the exact language of the House bill. Based upon my reading of section 3(d) and my conversations with Dennis Bedell, I am satisfied that the intention is to cover the case of stock issued within a two-year period preceding the effective date of the enactment of H.R. 5432. Indeed, unless the statute is so construed, you have the ridiculous situation which you and I reflected on during our telephone conversation, *e.g.*, stock issued more than two years prior to the date of enactment could qualify for waiver of the 15-day notice; stock issued after enactment could qualify for waiver, but stock issued within the two-year period immediately preceding enactment could not qualify for waiver! Surely, this result was not intended and I think that the statutory language should be construed accordingly.

Although I have not yet received a copy of the Ways and Means Committee Report on H.R. 5432, I understand that the general explanation contains an

example illustrating section 3(d)(2) of the bill, *e.g.*, the special 60-day rule for filing waivers with respect to stock issued more than two years in the past. In order to nail down once and for all the Committee's intention that there is no "gap" in the coverage of section 3(d), I believe that the following language in the Committee Report would be very helpful:

"[Pursuant to Section 3(d)] the Secretary or his delegate is authorized to waive the 15-day notice requirement with respect to shares issued before or after the date of enactment of the bill, provided an application is filed by the issuing corporation within two years after the shares are issued. Further, if more than two years have elapsed since the issuance of shares, the Secretary or his delegate may waive the notice provided the issuing corporation makes application for the waiver within 60 days after the date of enactment of the bill."

As I indicated above, this language has been drafted without the benefit of the Ways and Means Committee Report so I am not in a position to frame my suggestion in the specific context of the Ways and Means Committee's language. Obviously, the key to my suggestion is the "*before* or after the date of enactment" phrase in the first sentence of my draft.

As I indicated to you on the telephone, my firm does represent a corporate client who may be benefited by section 3(d) of H.R. 5432. If you have any further questions or desire any additional information, please let me know. Obviously, I stand ready to provide you with any additional information which you may require.

Sincerely,

THOMAS D. TERRY.