REVENUE ACT OF 1962

HEARINGS

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

EIGHTY-SEVENTH CONGRESS

SECOND SESSION

ON

H.R. 10650

AN ACT TO AMEND THE REVENUE ACT OF 1954 TO PROVIDE A CREDIT FOR INVESTMENT IN CERTAIN DEPRECIABLE PROPERTY, TO ELIMINATE CERTAIN DEFECTS AND INEQUITIES, AND FOR OTHER PURPOSES

JUNE 18, 19, JULY 2 AND 3, 1962

PART 11

Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE

82190 O WASHINGTON : 1962

For sale by the Superintendent of Documents, U.S. Government Printing Office
Washington 25, D.C. - Price $1.25

COMMITTEE ON FINANCE

HARRY FLOOD BYRD, Virginia, *Chairman*

ROBERT S. KERR, Oklahoma
RUSSELL B. LONG, Louisiana
GEORGE A. SMATHERS, Florida
CLINTON P. ANDERSON, New Mexico
PAUL H. DOUGLAS, Illinois
ALBERT GORE, Tennessee
HERMAN E. TALMADGE, Georgia
EUGENE J. McCARTHY, Minnesota
VANCE HARTKE, Indiana
J. W. FULBRIGHT, Arkansas

JOHN J. WILLIAMS, Delaware
FRANK CARLSON, Kansas
WALLACE F. BENNETT, Utah
JOHN MARSHALL BUTLER, Maryland
CARL T. CURTIS, Nebraska
THRUSTON B. MORTON, Kentucky

ELIZABETH B. SPRINGER, *Chief Clerk*

CONTENTS

WITNESSES

Page

Adams, Warren S., 2d, general counsel, Corn Products Co — 4535
Alvord, Ellsworth G., U.S. Council of the International Chamber of Commerce, presented by Fred W. Peel, member of the committee on taxation — 4799
Barker, John M., director of taxes and accounting, General Mills, Inc — 4467
Bowen, H. J., president, Industrial Models, Inc — 4542
Brady, Joseph B., vice president, National Foreign Trade Council, Inc — 4486
Carusi, Eugene C., in behalf of American Committee for Flags of Necessity — 4459
Collado, Emilio, vice president and director of Standard Oil Co. (New Jersey) — 4820
Connally, John L., on behalf of member State chambers of the Council of State Chambers of Commerce — 4454
Cooper, John J., corporate attorney, Varian Associates — 4531
Corcoran, Thomas G., American International Underwriters — 4472
Danielian, N. R., president, International Economic Policy Association; accompanied by Raphael Sherfy, attorney — 4522
Dechert, Daniel Orville, American Chamber of Commerce for Milan — 4670
Eppert, Ray R., on behalf of the Greater Detroit Board of Commerce — 4853
Faure, Emile, Importadora de Maquenaria, S.A. de C.V. and Automotrix del Golfo de California, S.A. de C.F., of Carretera Packard, Apartado Postal 452, Mexicali, Baja California, Mexico — 4517
Gillespie, Tyrone, assistant to the president, the Dow Chemical Co — 4845
Gleason, Donald H., chairman, Subcommittee on Taxation of Foreign Source Income of Taxation Committee, National Association of Manufacturers — 4581
Goldman, Max, accompanied by Raymond O'Neill — 4837
Haynes, Elliott, executive vice president, Business International — 4650
Horne, William M., Jr., chairman, Tax Policy Committee, Manufacturing Chemists' Association — 4558
Huggins, E. V., executive vice president, Westinghouse Electric Corp — 4555
Kelley, Augustus W., chairman, tax committee of the Proprietary Association; accompanied by William J. Stetter, vice chairman, tax committee of the Proprietary Association — 4547
Kornhauser, Albert E., treasurer of Controls Co. of America — 4737
Landolt, Robert J., Committee on Taxation, Financial Executives Institute; accompanied by William N. Kall — 4793
Levin, Donald C., general counsel, Cargill, Inc — 4555
Luter, Edward R., vice president for fiscal affairs, Abbott Laboratories — 4449
Mallon, H. Neil, chairman of executive committee, Drisser Industries, Inc — 4555
McCarthy, Clarence F., partner in charge of tax division, Arthur Anderson & Co — 4659
Naess, Erling D., Naess Shipping Co., New York, N.Y — 4461
Nusbaum, Simon J., the European Common Market Development Corp — 4680
Olds, Frank V., assistant comptroller, Chrysler Corp — 4668
Royall, Kenneth C., Pharmaceutical Manufacturers Association — 4772
Rustigan, Edward C., in behalf of Brunswick Corp — 4788
Ruttenberg, Stanley H., director of research, American Federation of Labor and Congress of Industrial Organizations — 4826
Seath, John, director of taxes, International Telephone & Telegraph Corp — 4641
Seghers, Paul D., president, Institute on U.S. Taxation of Foreign Income, Inc — 4506
Slowinski, Walter A., member of the Committee on Taxation of the Chamber of Commerce of the United States — 4816
Stewart, Charles W., president, Machinery and Allied Products Institute — 4609

Page
Stock, Leon O., Peat, Marwick, Mitchell & Co — 4784
Sumerwell, Robert F., manager, tax affairs, Clark Equipment Co — 4860
Watts, David, representing a group of New York lawyers; accompanied by Edwin Cohen — 4747
Weiss, A. H., tax manager, Harnaschfeger Corp — 4848
Wender, Ira T., member, Baker, McKenzie & Hightower — 4503
White, H. Lee, member of the law firm of Cadwalader, Wickersham & Taft, and chief executive officer of the Marine Transport Lines Group, Oswego Group, and Trinity Group — 4463

COMMUNICATIONS

Aerospace Industries Association of America, Inc., letter of George F. Hannaum, acting president, to chairman — 4693
Altman, Levenfeld & Kanter, Chicago, Ill., letter of Burton W. Kanter, to chairman — 4892
American & Foreign Power Co., Inc., New York, N.Y., letter and enclosure of Kenneth B. Sprague, vice president — 4712
American Book Publishers Council, Inc., Washington, D.C., letter of Robert W. Frase, to chairman — 4732
American Chamber of Commerce of the Philippines, statement of Finley J. Gibbs — 4722
American Institute of Certified Public Accountants, statement — 4879
American Life Convention, Chicago, Ill., letter of Glendon E. Johnson, general counsel, to chairman — 4727
American Paper & Pulp Association, New York, N.Y., statement of Robert E. O'Connor — 4710
American Textbook Publishers Institute, Washington, D.C., letter of Robert W. Frase, to chairman — 4732
Ampex International, letter of B. A. Oelerich to committee — 4729
Association of Casualty and Surety Companies, letter of Robert N. Gilmore, Jr., general counsel, to chairman — 4707
Association of the Bar of the City of New York, the, statement of D. Nelson Adams, chairman — 4702
Big Dutchman, Automatic Poultry Feeder Co., Zeeland, Mich., letter of Jack DeWitt, president, to chairman — 4689
Blaw-Knox Co., Pittsburgh, Pa., letter of J. J. Gibbons, assistant treasurer, to chairman — 4692
Bristol-Meyers Co., letter of A. W. Kelley, tax manager, to Hon. Robert S. Kerr — 4552
Busick, Charles J., income tax administrator, New York, N.Y., statement — 4706
Campbell Soup Co., Camden, N.J., letter and enclosure of E. M. Nuchols, Jr., vice president, administrative services — 4715
Caterpillar Tractor Co., statement of E. W. Kuhlman — 4731
Chicago Association of Commerce and Industry, statement of E. C. Logelin — 4700
Coca-Cola Export Corp., The, New York, N.Y., letter of Roy S. Jones, executive vice president, to chairman — 4580
Colon Free Zone Managers Association, Republic of Panama, letter of Herbert Toledano, president, to chairman — 4891
Commerce and Industry Association of New York, New York, N.Y., letter of Arnold Witte, general manager, to chairman — 4689
Cravath, Swaine & Moore, New York, N.Y., letter to chairman — 4877
Glidden Co., the, Cleveland, Ohio, letter of Dwight P. Joyce, chairman and president, to chairman — 4691
Goodman, Arthur H., New York, N.Y., to chairman — 4687
Grace, W. R. Co., statement of Kenneth A. Lawder, treasurer — 4720
Illinois Manufacturers Association, Chicago, Ill., letter of J. R. Barnes, director, tax department, to committee — 4699
International Trade Club of Chicago, statement of John A. Miguel, Jr — 4870
Kaiser Industries Corp., Washington, D.C., statement of Chad F. Calhoun, vice president — 4893
Libby, McNeill & Libby, Chicago, Ill., telegram of Robert L. Gibson, president — 4734
Life Insurance Association of America, New York, N.Y., letter of Eugene M. Thoré, vice president and general counsel — 4727
Lincoln National Life Insurance Co., statement of Henry F. Rood — 4903

	Page
Lybrand, Ross Bros. & Montgomery, Washington, D.C., letter and enclosure, to chairman	4724
Mallory, P. R., & Co., Inc., Indianapolis, Ind., letter of G. B. Mallory, to chairman	4901
Mañosa, Antonio, Cataño, P.R., letter to chairman	4694
McDermott, Will & Emery, Chicago, Ill., letter of C. E. Murphy, Jr., to chairman	4705
Minnesota Mining & Manufacturing Co., statement of Robert H. Tucker	4888
National Board of Fire Underwriters, New York, N.Y., letter and enclosure of J. Raymond Berry, general counsel, to chairman	4707
Overseas Management Services, Inc., statement of William D. Vaughn, president	4899
Owens-Illinois Glass Co., statement of Raymon H. Mulford, president	4699
Pfaudler Permutit, Inc., Rochester, N.Y., statement of William G. vonBerg	4874
Philadelphia International Investment Corp., statement of H. Peter Somers	4868
Philadelphia National Bank, statement of H. Peter Somers	4868
Puerto Rico Organics, Inc., Arecibo, P.R., letter of Teodoro Vega, president, to committee	4735
Rockwell Manufacturing Co., Pittsburgh, Pa., letter of Jerome A. Earley, manager, tax planning	4871
Ryan, Hon. William F., New York, N.Y., letter to chairman	4700
Signode Steel Strapping Co., Chicago, Ill., letter of John H. Leslie, chairman of the board, to chairman	4730
Smith, Dan Throop, professor of finance, Harvard Graduate School of Business Administration, statement	4718
Smith, Kline & French Overseas Co., Philadelphia, Pa., letter of K. A. Solmssen, vice president, to chairman	4689
Sprague International Ltd., statement of William M. Adams, president	4578
Stires, Hardwick, statement on behalf of registered foreign investment companies	4872
Sverdrup & Parcel & Associates, Inc., St. Louis, Mo., letter of L. J. Sverdrup to Hon. Stuart Symington	4888
Virginia State Chamber of Commerce, statement	4904
Whitman, Ransom & Coulson, New York, N.Y., letter of James K. Polk, and Gerald D. Groden, to chairman	4728
Worthington Corp. of New York, statement of Robert E. Marshall, vice president	4902
Zimmer, W. L. III, Richmond, Va., statement	4716

ADDITIONAL INFORMATION

Amendment submitted by Senator Gore	4589
Draft of statutory language, with accompanying explanation, of amendments proposed by the Secretary of the Treasury on May 10, 1962, to sections 13, 15, 16, and 20 of H.R. 10650 (language submitted by the Treasury Department as a working draft for the consideration of the Committee on Finance	4413

REVENUE ACT OF 1962

MONDAY, JUNE 18, 1962

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

The committee met, pursuant to recess, at 10:15 a.m., in room 2221, New Senate Office Building, Senator Harry F. Byrd (chairman) presiding.

Present: Senators Byrd, Kerr, Smathers, Anderson, Gore, Talmadge, McCarthy, Williams, Carlson, Butler, and Curtis.

Also present: Elizabeth B. Springer, chief clerk.

The CHAIRMAN. The committee will come to order. The hearing today is on the additional amendments to sections 13, 15, 16, and 20, of H.R. 10650, which were recommended by the Secretary of the Treasury on his second appearance before the committee on this bill on May 10, 1962.

I shall place in the record a Treasury draft of statutory language of the amendment with accompanying explanations.

(The draft and explanations referred to follow:)

87th Congress }
2d Session }

COMMITTEE PRINT

DRAFT OF STATUTORY LANGUAGE, WITH ACCOMPANYING EXPLANATION, OF AMENDMENTS PROPOSED BY THE SECRETARY OF THE TREASURY ON MAY 10, 1962, TO SECTIONS 13, 15, 16, AND 20 OF H.R. 10650

(LANGUAGE SUBMITTED BY THE TREASURY DEPARTMENT AS A WORKING DRAFT FOR THE CONSIDERATION OF THE COMMITTEE ON FINANCE)

COMMITTEE ON FINANCE
UNITED STATES SENATE

MAY 31, 1962

Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE
WASHINGTON . 1962

4413

COMMITTEE ON FINANCE

HARRY FLOOD BYRD, Virginia, *Chairman*

ROBERT S. KERR, Oklahoma
RUSSELL B. LONG, Louisiana
GEORGE A. SMATHERS, Florida
CLINTON P. ANDERSON, New Mexico
PAUL H. DOUGLAS, Illinois
ALBERT GORE, Tennessee
HERMAN E. TALMADGE, Georgia
EUGENE J. McCARTHY, Minnesota
VANCE HARTKE, Indiana
J. W. FULBRIGHT, Arkansas
JOHN J. WILLIAMS, Delaware
FRANK CARLSON, Kansas
WALLACE F. BENNETT, Utah
JOHN MARSHALL BUTLER, Maryland
CARL T. CURTIS, Nebraska
THRUSTON B. MORTON, Kentucky

ELIZABETH B. SPRINGER, *Chief Clerk*

LETTER OF TRANSMITTAL

THE SECRETARY OF THE TREASURY,
Washington.

HON. HARRY F. BYRD,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: In accordance with your request we submit drafts of statutory language. These drafts amend sections of H.R. 10650 as follows:

1. The draft of an amended section 13 (controlled foreign corporations) embodies an approach to impose tax on tax-haven income. The Treasury recommends in accordance with the President's message of April 20, 1961, and my statement of April 2, 1962, before your committee that deferral of taxation of income of controlled foreign corporations be eliminated. However, we are submitting the enclosed draft of an amended section 13 as an aid to the committee if it prefers the more limited tax-haven approach. The draft embodies those technical improvements in the application and mechanics of the House bill which I recommended in my statement before you on May 10, 1962, which were in response to suggestions of witnesses during your hearings.

2. The draft of section 15 (foreign investment companies) makes minor technical amendments in the House bill which the representatives of foreign investment companies suggested to you during the hearings.

3. The drafts of section 16 (gain from certain sales or exchanges of stock in certain foreign corporations) and section 20 (information with respect to certain foreign entities) make the changes which I recommended to you on the first day of the hearings and certain other improvements in response to the suggestions of witnesses who appeared before you.

Sincerely yours,

DOUGLAS DILLON.

CONTENTS

Letter of transmittal.
Part 1A. Explanation of amendments recommended by Treasury Department of section 13 of H.R. 10650.
Part 1B. Draft of statutory language incorporating amendments recommended by Treasury Department to section 13 of H.R. 10650.
Part 2. Explanation and draft of amendments recommended by Treasury Department of section 15 of H.R. 10650.
Part 3. Explanation and draft of amendments recommended by Treasury Department of section 16 of H.R. 10650.
Part 4. Explanation and draft of amendments recommended by Treasury Department to section 20 of H.R. 10650.

PART 1A

Explanation of Amendments Recommended by Treasury Department to Section 13 of H.R. 10650

General Description

1. *Certain income of controlled foreign corporations taxed to 10-percent U.S. shareholders.*—The draft legislation provides that certain undistributed income of controlled foreign companies is to be included in the income of U.S. shareholders in the year the income is earned by the foreign corporation, whether or not it is distributed. In these cases, the shareholders are permitted foreign tax credits to the same extent as if actual distributions had been made. Only U.S. shareholders having a 10-percent interest are taxed and counted in determining whether the corporation is to be classified as a "controlled foreign corporation." A foreign corporation is controlled for this purpose when more than 50 percent of the combined voting power of all classes of stock is owned directly or indirectly (with certain stock attribution rules) by U.S. persons on any date of the taxable year of the corporation. The basic pattern here is largely the same as in section 13 of H.R. 10650.

2. *Description of income taxed to U.S. shareholders.*—The income which would be taxed to U.S. shareholders is described as "subpart F income." This income consists of (1) income from insurance of U.S. risks on property or persons and (2) income of foreign base companies. In addition, any increase in earnings invested in certain U.S. property by a controlled foreign corporation, which constitutes an attempt to repatriate earnings to the United States without the payment of tax, would result in tax to the U.S. shareholders of the corporation.

A separate provision taxes the sale of a patent, copyright, or like property to a controlled foreign corporation at ordinary income rates in cases where only capital gains or no tax would be paid under present law. This provision, which imposes tax at the time of transfer of a patent, etc., abroad, is complementary to subpart F but is not part of that subpart. It replaces the provision in section 13 of H.R. 10650 for taxing on a current basis the annual income from U.S. patents, etc.

3. *Income derived from insurance of U.S. risks.*—The income derived from insurance of U.S. risks provision is the same as that which was included in section 13 of H.R. 10650, except for minor technical changes.

4. *Foreign base company income.*—Foreign base company income includes several elements:

(a) *Foreign personal holding company income.*—This category covers mainly dividends, interest, rents, and royalties when they constitute "passive" income or "tax haven" type income. Passive dividends, interest, rents, and royalties are those received from

unrelated persons not in connection with the active conduct of a trade or business. Tax-haven dividends, interest, rents, and royalties are those received from related persons in connection with income-producing activities located outside the country of incorporation of recipients.

Foreign base company income does not include dividends and interest received from less-developed country corporations which are reinvested in less-developed country corporations. Deferral with respect to this income derived from less-developed countries is, however, ended when investment of the earnings in less-developed countries is finally terminated.

(b) *Foreign base company sales income.*—This is income derived in connection with the purchase and sale of personal property where the property is purchased outside the country under the laws of which the controlled foreign corporation is created or organized and is sold for use, consumption, or disposition outside such foreign country. This rule is substantially the same as that which was contained in section 13 of H.R. 10650, with the addition of provisions to cover situations in which a controlled foreign corporation acts as an agent and in which a branch or similar establishment acts in the same manner as a controlled foreign corporation. These additions serve to clarify and to complete coverage with respect to tax haven sales income.

(c) *Foreign base company service income.*—Income derived in connection with the performance or furnishing of technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial, or like services is treated as foreign base company income if the services are performed or furnished for or on behalf of a related person in connection with business activities outside the country of incorporation of the controlled foreign corporation. Foreign base company service income is a significant form of tax haven income, and its omission from section 13 of H.R. 10650 presented a serious gap in the base company provisions of that bill.

The draft legislation also adds an overall exception to deal with situations where use of a controlled foreign corporation covered by the provisions of the bill has not resulted in substantial reduction of taxes. This provision adds flexibility to insure a fair application of the base company income provisions.

5. *Increase in earnings invested in certain U.S. property.*—The provision for taxing the increase in investment in certain U.S. property is, with technical changes, substantially the same as in section 13 of H.R. 10650. Now, however, this is the only type of investment which constitutes nonqualified property (within the terms of sec. 13 of H.R. 10650), the remaining provisions having been eliminated. Thus non-tax-haven profits, such as those of a manufacturing operation, would not be taxed under section 13 unless they were invested in certain U.S. property.

6. *Technique for taxing U.S. shareholders.*—The mechanical features of the draft for taxing income to U.S. shareholders are in large part the same as in section 13 of H.R. 10650 but have been improved in certain respects. Thus, losses of a taxable year are permitted to offset earnings of other taxable years. Losses of one controlled foreign corporation in a chain of controlled foreign corporations are permitted to

offset gains in the current year of other controlled foreign corporations. These provisions for losses make more equitable the taxing mechanism of section 13 of H.R. 10650. Further, the constructive ownership rules have been limited somewhat by providing that, in lieu of attributing to a shareholder all of the stock owned by a corporation in which he owns stock, attribution will only take place if he owns 10 percent of the stock. There are also various minor technical changes designed to make more clear and workable the mechanics of the draft.

MAJOR CHANGES FROM SECTION 13 OF H.R. 10650

There are listed below the major changes which the draft makes in section 13 of H.R. 10650.

1. *Elimination of provision for taxing income from U.S. patents, etc., to U.S. shareholders on current basis and substitution of provision for taxing the sale of U.S. patents, etc., to controlled foreign corporations.*—This change obviates the need under the House bill to determine the amount of income generated by the use of U.S. patents, etc. It eliminates abuse by insuring that patents will be transferred abroad in arm's-length transactions producing a full U.S. tax at the time of transfer or on an annual basis.

2. *Elimination of provision restricting the use of earnings by operating companies, except that such earnings cannot be invested in certain U.S. property.*—Operating companies will, under the draft, not be faced with the difficulty of determining whether or not earnings are invested in the same trade or business that gave rise to them. Also, other problems such as determining when a trade or business would be considered to have been conducted by substantially the same interests, will be eliminated.

3. *Dividends, interest, rents, and royalties derived in connection with active business operations with unrelated persons are removed from coverage as foreign base company income.*—This change would remove the objection that section 13 treats certain types of operating income as "passive" income in non-tax-haven situations. Thus, companies engaged in the active business with unrelated persons of banking, financing, shipping, insurance, and leasing of property, would not be covered by the foreign base company income provisions.

4. *Addition of a provision to eliminate coverage under foreign base company provisions where the controlled foreign corporation is not used to effect a substantial reduction in taxes.*—This provision permits flexibility to deal with situations where a controlled foreign corporation technically covered by the provisions of the bill does not differ from a non-tax-haven operation for which deferral of taxation is permitted. It insures a fair application of the foreign base company income provisions.

5. *Changes in the determination of when a foreign corporation is considered to be "controlled" so that (a) only 10-percent U.S. shareholders are counted in determining control and (b) there will be attribution of ownership of stock owned by a corporation to shareholders of that corporation only where such shareholders own a 10-percent interest.*—These changes remove objections that the coverage of foreign corporations was too broad, reaching situations where ownership was widely scattered and no U.S. group was in effective control.

6. *Greater recognition of losses under which (a) losses of one year may offset profits of future years and (b) losses of one controlled foreign corporation in a chain of controlled foreign corporations may in the current year offset gains of the other corporations.*—These provisions provide for an equitable application of the taxing mechanism in situations where losses are involved.

7. *Provision so that tax will not be payable in situations in which the presence of blocked income means that earnings of a controlled foreign corporation could not be distributed to U.S. shareholders.*—This change meets the objection that shareholders might be taxed on constructive distributions in situations in which there could not be actual distributions.

8. *Provision for the establishment of guidelines, under regulations, for the computation of earnings and profits in accordance with the rules which have been developed for domestic corporations.*—Among other matters, provision will be made so that elections similar to those which are available to domestic corporations will be available. These guidelines will facilitate compliance with the legislation from the standpoint of taxpayers and will meet certain criticism that great difficulty will be involved in determining tax liability under subpart F.

9. *Elimination of provision permitting a pour-over of profits from developed areas to less developed areas.*—This change, in large part, follows from the elimination of certain restrictions with respect to the earnings of operating companies and permits considerable simplification in the application of this part of the draft. The only reinvestment which qualifies to reduce foreign base company income involves dividends and interest derived from less developed country corporations. Less developed country corporations are, in general, corporations carrying on an active trade or business within a less developed country or countries and whose assets are located in such countries. The terms on which such reinvestment may take place have been liberalized so that minority stock (10 percent) and certain debt interests may qualify and, also, the time in which the investment may be made has been extended from 75 days after the close of the taxable year to 1 year or such longer period as may be designated by the Secretary or his delegate. Also, investments made at a time when a country is classified as a less developed country shall be treated as a qualified investment even if that country ceases to be a less developed country.

10. *Clarification of terms and minor technical improvements.*—In general, the provisions of the draft meet various technical points which were raised with respect to the meaning of terms and the mechanical features of section 13.

11. *Elimination of coverage of corporations in the Commonwealth of Puerto Rico and the Virgin Islands.*—The draft leaves these corporations subject to the rules of existing law with, however, provision to insure that such corporations will not be availed of for tax haven activities.

12. *Rounding out of coverage with respect to tax haven activities.*—Provision has been made to treat certain service income derived from related parties as foreign base company and to prevent avoidance of the foreign base company sales income provisions in certain situations which are like those which are covered by the House bill. These changes are in accordance with the purpose of the bill to effectively eliminate deferral of taxation for tax haven activities.

PART 1B

Draft of Statutory Language Incorporating Amendments Recommended by Treasury Department to Section 13 of H.R. 10650

On page 103, beginning with line 14, strike out all through line 18, on page 137 (sec. 13 of the bill) and in lieu thereof insert the following:

SEC. 13. CONTROLLED FOREIGN CORPORATIONS.

(a) IN GENERAL.—Part III of subchapter N of chapter 1 (relating to income from sources without the United States) is amended by adding at the end thereof the following new subpart:

"Subpart F—Controlled Foreign Corporations

"Sec. 951. Amounts included in gross income of United States shareholders.
"Sec. 952. Subpart F income defined.
"Sec. 953. Income from insurance of United States risks.
"Sec. 954. Foreign base company income.
"Sec. 955. Withdrawal of previously excluded subpart F income from qualified investment.
"Sec. 956. Investment of earnings in United States property.
"Sec. 957. Controlled foreign corporations.
"Sec. 958. Rules for determining stock ownership.
"Sec. 959. Exclusion from gross income of previously taxed earnings and profits.
"Sec. 960. Special rules for foreign tax credit.
"Sec. 961. Adjustments to basis of stock in controlled foreign corporations and of other property.
"Sec. 962. Miscellaneous provisions.

"SEC. 951. AMOUNTS INCLUDED IN GROSS INCOME OF UNITED STATES SHAREHOLDERS.

"(a) AMOUNTS INCLUDED.—

"(1) IN GENERAL.—If a foreign corporation is a controlled corporation on any day of a taxable year beginning after December 31, 1962, every person who is a United States shareholder (as defined in subsection (b)) of such corporation and who owns (within the meaning of section 958(a)) stock in such corporation on the last day, in such year, on which such corporation is a controlled foreign corporation shall include in his gross income, for his taxable year in which or with which such taxable year of the corporation ends—

"(A) the sum of—

"(i) his pro rata share (determined under paragraph (2)) of the corporation's subpart F income for such year, and

"(ii) his pro rata share (determined under section 955(a)(3)) of the corporation's previously excluded subpart F income withdrawn from investment in less developed country corporations for such year; and

82190 O - 62 - pt. 11 - 2

"(B) his pro rata share (determined under section 956(a)(2)) of the corporation's increase in earnings invested in United States property for such year (but only to the extent not excluded from gross income under section 959(a)(2)).

"(2) PRO RATA SHARE OF SUBPART F INCOME.—The pro rata share referred to in paragraph (1)(A)(i) in the case of any United States shareholder is the amount—

"(A) which would have been distributed with respect to the stock which such shareholder owns (within the meaning of section 958(a)) in such corporation if on the last day, in its taxable year, on which the corporation is a controlled foreign corporation it had distributed pro rata to its shareholders an amount (i) which bears the same ratio to its subpart F income for the taxable year, as (ii) the part of such year during which the corporation is a controlled foreign corporation bears to the entire year, reduced by

"(B) the amount of any distribution received by any other United States person during such year as a dividend with respect to such stock.

"(3) LIMITATION ON PRO RATA SHARE OF PREVIOUSLY EXCLUDED SUBPART F INCOME WITHDRAWN FROM INVESTMENT.—For purposes of paragraph (1)(A)(ii), the pro rata share of any United States shareholder of the previously excluded subpart F income of a controlled foreign corporation withdrawn from investment in less developed country corporations shall not exceed an amount (A) which bears the same ratio to his pro rata share of such income withdrawn (as determined under section 955(a)(3)) for the taxable year, as (B) the part of such year during which the corporation is a controlled foreign corporation bears to the entire year.

"(4) LIMITATION ON PRO RATA OF INVESTMENT IN UNITED STATES PROPERTY.—For pursposes of paragraph (1)(B), the pro rata share of any United States shareholder in the increase of the earnings of a controlled foreign corporation invested in United States property shall not exceed an amount (A) which bears the same ratio to his pro rata share of such increase (as determined under section 956(a)(2)) for the taxable year, as (B) the part of such year during which the corporation is a controlled foreign corporation bears to the entire year.

"(b) UNITED STATES SHAREHOLDER DEFINED.—For purposes of this subpart, the term 'United States shareholder' means, with respect to any foreign corporation, a United States person (as defined in section 7701(a)(30)) who owns (within the meaning of section 958 (a)), or is considered as owning by applying the rules of ownership of section 958(b), 10 percent or more of the total combined voting power of all classes of stock, or of the total value of shares of all classes of stock, of such foreign corporation.

"(c) COORDINATION WITH ELECTION OF A FOREIGN INVESTMENT COMPANY TO DISTRIBUTE INCOME.—A United States shareholder who, for his taxable year, is a qualified shareholder (within the meaning of section 1247(c)) of a foreign investment company with respect to which an election under section 1247 is in effect shall not be required to include in gross income, for such taxable year, any amount under subsection (a) with respect to such company.

"SEC. 952. SUBPART F INCOME DEFINED.

"(a) IN GENERAL.—For purposes of this subpart, the term 'subpart F income' means, in the case of any controlled foreign corporation, the sum of—

"(1) the income derived from the insurance of United States risks (as determined under section 953), and

"(2) the foreign base company income (as determined under section 954).

"(b) EXCLUSION OF UNITED STATES INCOME.—Subpart F income does not include any item includible in gross income under this chapter (other than this subpart) as income derived from sources within the United States of a foreign corporation engaged in trade or business in the United States.

"(c) LIMITATION.—For purposes of subsection (a), the subpart F income of any controlled foreign corporation for any taxable year shall not exceed the earnings and profits of such corporation for such year reduced by the amount (if any) by which—

"(1) the sum of the deficits in earnings and profits for prior taxable years beginning after December 31, 1962 exceeds

"(2) an amount equal to the earnings and profits described in section 959(c)(3) accumulated for taxable years beginning after December 31, 1962 (determined as of the close of the taxable year).

For purposes of the preceding sentence, any deficit in earnings and profits for any prior taxable year shall be taken into account under paragraph (1) for any taxable year only to the extent it has not been taken into account under such paragraph for any preceding taxable year to reduce earnings and profits of such preceding year.

"(d) SPECIAL RULE IN CASE OF INDIRECT OWNERSHIP.—For purposes of subsection (c), if—

"(1) a United States shareholder owns (within the meaning of section 958(a)) stock of a foreign corporation, and by reason of such ownership owns (within the meaning of such section) stock of any other foreign corporation, and

"(2) any of such foreign corporations has a deficit in earnings and profits for the taxable year,

then the earnings and profits for the taxable year of each such foreign corporation which is a controlled foreign corporation shall, with respect to such United States shareholder, be properly reduced to take into account any deficit described in paragraph (2) in such manner as the Secretary or his delegate shall prescribe by regulations.

"SEC. 953. INCOME FROM INSURANCE OF UNITED STATES RISKS.

"(a) GENERAL RULE.—For purposes of section 952(a)(1), the term 'income derived from the insurance of United States risks' means that income which—

"(1) is attributable to the reinsurance or the issuing of any insurance or annuity contract—

"(A) in connection with property or liability arising out of activity in, or in connection with the lives or health of residents of, the United States, or

"(B) in connection with risks not included in subparagraph (A) as the result of any arrangement whereby another corporation receives a substantially equal amount of premiums

or other consideration in respect of any reinsurance or the issuing of any insurance or annuity contract in connection with property or liability arising out of activity in, or in connection with the lives or health of residents of, the United States, and

"(2) would (subject to the modifications provided by paragraphs (1), (2), and (3) of subsection (b)) be taxed under subchapter L of this chapter if such income were the income of a domestic insurance corporation.

This section shall apply only in the case of a controlled foreign corporation which receives during any taxable year premiums or other consideration in respect of any reinsurance or the issuing of any insurance or annuity contract described in paragraph (1) in excess of 5 percent of the total of premiums and other consideration received by it during such taxable year in respect of all reinsurance and issuing of insurance and annuity contracts.

"(b) SPECIAL RULES.—For purposes of subsection (a)—

"(1) In the application of part I of subchapter L, life insurance company taxable income is the gain from operations as defined in section 809(b).

"(2) A corporation which would, if it were a domestic insurance corporation, be taxable under part II of subchapter L shall apply subsection (a) as if it were taxable under part III of subchapter L.

"(3) The following provisions of subchapter L shall not apply:

"(A) Section 809(d)(4) (operations loss deduction).

"(B) Section 809(d)(5) (certain nonparticipating contracts).

"(C) Section 809(d)(6) (group life, accident, and health insurance).

"(D) Section 809(d)(10) (small business deduction).

"(E) Section 817(b) (gain on property held on December 31, 1958, and certain substituted property acquired after 1958).

"(F) Section 832(b)(5) (certain capital losses).

"(4) The items referred to in—

"(A) section 809(c)(1) (relating to gross amount of premiums and other consideration).

"(B) section 809(c)(2) (relating to net decrease in reserves).

"(C) section 809(d)(2) (relating to net increase in reserves), and

"(D) section 832(b)(4) (relating to premiums earned on insurance contracts),

shall be taken into account only to the extent they are in respect of any reinsurance or the issuing of any insurance or annuity contract described in paragraph (1).

"(5) All items of income, expenses, losses, and deductions (other than those taken into account under paragraph (4)) shall be properly allocated or apportioned under regulations prescribed by the Secretary or his delegate.

"SEC. 954. FOREIGN BASE COMPANY INCOME.

"(a) FOREIGN BASE COMPANY INCOME.—For purposes of section 952(a)(2), the term 'foreign base company income' means for any taxable year the sum of—

"(1) the foreign personal holding company income for the taxable year (determined under subsection (c) and reduced as provided in subsection (b)(5)),

"(2) the foreign base company sales income for the taxable year (determined under subsection (d) and reduced as provided in subsection (b)(5)), and

"(3) the foreign base company services income for the taxable year (determined under subsection (e) and reduced as provided in subsection (b)(5)).

"(b) EXCLUSIONS AND SPECIAL RULES.—

"(1) CERTAIN DIVIDENDS AND INTEREST FROM LESS DEVELOPED COUNTRY CORPORATIONS EXCLUDED.—For purposes of subsection (a), foreign base company income does not include dividends and interest received during the taxable year by a controlled foreign corporation from qualified investments in less developed country corporations (as defined in section 955(b)), to the extent that such dividends and interest do not exceed the increase for the taxable year in qualified investments in less developed country corporations of the controlled foreign corporation (as determined under subsection (f)).

"(2) CERTAIN INSURANCE INCOME EXCLUDED.—For purposes of subsection (a), foreign base company income does not include any income derived from the insurance of United States risks (as defined in section 953(a)).

"(3) SPECIAL RULE WHERE FOREIGN BASE COMPANY INCOME IS LESS THAN 20 PERCENT OR MORE THAN 80 PERCENT OF GROSS INCOME.—For purposes of subsection (a)—

"(A) If the foreign base company income (determined without regard to paragraph (5)) is less than 20 percent of gross income, no part of the gross income of the taxable year shall be treated as foreign base company income.

"(B) If the foreign base company income (determined without regard to paragraph (5)) exceeds 80 percent of gross income, the entire gross income of the taxable year shall, subject to the provisions of paragraphs (1), (2), (4), and (5), be treated as foreign base company income.

"(4) EXCEPTION FOR FOREIGN CORPORATIONS NOT AVAILED OF TO REDUCE TAXES.—For purposes of subsection (a), foreign base company income does not include any item of income received by a controlled foreign corporation if it is established to the satisfaction of the Secretary or his delegate with respect to such item that the creation or organization of the controlled foreign corporation receiving such item under the laws of the foreign country in which it is incorporated does not have the effect of substantial reduction of income, war profits, excess profits or similar taxes.

"(5) DEDUCTIONS TO BE TAKEN INTO ACCOUNT.—For purposes of subsection (a), the foreign personal holding company income, the foreign base company sales income, the foreign base company services income, and gross income to which paragraph (3)(B) applies shall be reduced, under regulations prescribed by the Secretary or his delegate, so as to take into account deductions (including taxes) properly allocable to such income.

"(6) ITEMS OF INCOME TO BE INCLUDED ONLY ONCE.—If an item of income would, but for the provisions of this paragraph, be includible as an item of income under more than one paragraph of subsection (a), such item shall be included under the paragraph specified by regulations prescribed by the Secretary or his delegate.

"(c) FOREIGN PERSONAL HOLDING COMPANY INCOME.—

"(1) IN GENERAL.—For purposes of subsection (a) (1), the term 'foreign personal holding company income' means the foreign personal holding company income (as defined in section 553), modified and adjusted as provided in paragraph (2), (3), and (4).

"(2) RENTS INCLUDED WITHOUT REGARD TO 50 PERCENT LIMITATION.—For purposes of paragraph (1), all rents shall be included in foreign personal holding company income without regard to whether or not such rents constitute more than 50 percent of gross income.

"(3) CERTAIN INCOME DERIVED IN ACTIVE CONDUCT OF TRADE OR BUSINESS.—For purposes of paragraph (1), foreign personal holding company income does not include dividends, interest, rents, and royalties which—

"(A) are derived in the active conduct of a trade or business; and

"(B) are received from a person other than a related person (within the meaning of subsection (d) (3)).

"(4) CERTAIN INCOME RECEIVED FROM RELATED PERSONS.—For purposes of paragraph (1), foreign personal holding company income does not include—

"(A) dividends and interest received from a related person which (i) is organized under the laws of the same foreign country under the laws of which the controlled foreign corporation is created or organized, and (ii) has a substantial part of its assets used in its trade or business located in such same foreign country; or

"(B) rents, royalties, and similar amounts received from a related person for the use of, or the privilege of using, property within the country under the laws of which the controlled foreign corporation is created or organized.

"(d) FOREIGN BASE COMPANY SALES INCOME.—

"(1) IN GENERAL.—For purposes of subsection (a)(2), the term 'foreign base company sales income' means income (whether in the form of profits, commissions, fees, or otherwise) derived in connection with the purchase of personal property from a related person and its sale to any person, the sale of personal property to any person on behalf of a related person, the purchase of personal property from any person and its sale to a related person, or the purchase of personal property from any person on behalf of a related person where—

"(A) the property which is purchased (or in the case of property sold on behalf of a related person, the property which is sold) is manufactured, produced, grown, or extracted outside the country under the laws of which the controlled foreign corporation is created or organized, and

"(B) the property is sold for use, consumption, or disposition outside such foreign country, or, in the case of property

purchased on behalf of a related person, is purchased for use, consumption, or disposition outside such foreign country.

"(2) CERTAIN BRANCH INCOME.—For purposes of determining foreign base company sales income (within the terms of paragraph (1)), in situations in which the carrying on of activities by a controlled foreign corporation through a branch or similar establishment outside the country of incorporation of the controlled foreign corporation has substantially the same effect as if such branch or similar establishment were a wholly owned subsidiary corporation deriving such income, then, under regulations prescribed by the Secretary or his delegate, the income attributable to the carrying on of such activities of such branch or similar establishment shall be treated as income derived by a wholly owned subsidiary of the controlled foreign corporation and shall constitute foreign base company sales income of the controlled foreign corporation.

"(3) RELATED PERSON DEFINED.—For purposes of this section, a person is a related person with respect to a controlled foreign corporation, if—

"(A) such person is an individual, partnership, trust, or estate which controls the controlled foreign corporation;

"(B) such person is a corporation which controls, or is controlled by, the controlled foreign corporation; or

"(C) such person is a corporation which is controlled by the same person or persons which control the controlled foreign corporation.

For purposes of the preceding sentence, control means the ownership, directly or indirectly, of stock possessing more than 50 percent of the total combined voting power of all classes of stock entitled to vote. For purposes of this paragraph, the rules for determining ownership of stock prescribed by section 958 shall apply.

"(e) FOREIGN BASE COMPANY SERVICES INCOME.—For purposes of subsection (a)(3), the term 'foreign base company services income' means income (whether in the form of compensation, commissions, fees, or otherwise) derived in connection with the performance of furnishing of technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial, or like services which are—

"(1) performed or furnished for or on behalf of any related person (within the meaning of subsection (d)(3)), and

"(2) are performed or furnished for or in connection with business activities carried on by such related person outside the country under the laws of which the controlled foreign corporation is created or organized.

"(f) INCREASE IN QUALIFIED INVESTMENTS IN LESS DEVELOPED COUNTRY CORPORATIONS.—For purposes of subsection (b)(1), the increase for any taxable year in qualified investments in less developed country corporations of any controlled foreign corporation is the amount by which—

"(1) the qualified investments in less developed country corporations (as defined in section 955(b)) of the controlled foreign corporation at the close of the taxable year, exceeds

"(2) the qualified investments in less developed country corporations (as so defined) of the controlled foreign corporation at the close of the preceding taxable year.

"SEC. 955. WITHDRAWAL OF PREVIOUSLY EXCLUDED SUBPART F INCOME FROM QUALIFIED INVESTMENT.

"(a) GENERAL RULES.—

"(1) AMOUNT WITHDRAWN.—For purposes of this subpart, the amount of previously excluded subpart F income of any controlled corporation withdrawn from investment in less developed country corporations for any taxable year is an amount equal to the decrease in the amount of qualified investments in less developed country corporations of the controlled foreign corporation for such year, but only to the extent that the amount of such decrease does not exceed an amount equal to—

"(A) the sum of the amounts excluded under section 954(b)(1) from the foreign base company income of such corporation for all prior taxable years, reduced by

"(B) the sum of the amounts of previously excluded subpart F income withdrawn from investment in less developed country corporations of such corporation determined under this subsection for all prior taxable years.

"(2) DECREASE IN QUALIFIED INVESTMENTS.—For purposes of paragraph (1), the amount of the decrease in qualified investments in less developed country corporations of any controlled foreign corporation for any taxable year is the amount by which—

"(A) the amount of qualified investments in less developed country corporations of the controlled foreign corporation at the close of the preceding taxable year, exceeds

"(B) the amount of qualified investments in less developed country corporations of the controlled foreign corporation at the close of the taxable year,

to the extent the amount of such decrease does not exceed the sum of the earnings and profits for the taxable year and the earnings and profits accumulated for prior taxable years beginning after December 31, 1962. For purposes of this paragraph, if qualified investments in less developed country corporations are disposed of by the controlled foreign corporation during the taxable year, the amount of the decrease in qualified investments in less developed country corporations of such controlled foreign corporation for such year shall be reduced by an amount equal to the amount (if any) by which the losses on such dispositions during such year exceed the gains on such dispositions during such year.

"(3) PRO RATA SHARE OF AMOUNT WITHDRAWN.—In the case of any United States shareholder, the pro rata share of the amount of previously excluded subpart F income of any controlled foreign corporation withdrawn from investment in less developed country corporations for any taxable year is his pro rata share of the amount determined under paragraph (1).

"(b) QUALIFIED INVESTMENTS IN LESS DEVELOPED COUNTRY CORPORATIONS.—

"(1) IN GENERAL.—For purposes of this subpart, the term 'qualified investments in less developed country corporations' means property acquired after December 31, 1962, which is—

"(A) stock of a less developed country corporation held by the controlled foreign corporation, but only if the controlled foreign corporation owns 10 percent or more of the total combined voting power of all classes of stock, or of the total value of shares of all classes of stock, of such less developed country corporation; or

"(B) an obligation of a less developed country corporation held by the controlled foreign corporation, which, at the time of its acquisition by the controlled foreign corporation, has a maturity of 5 years or more, but only if the controlled foreign corporation owns 10 percent or more of the total combined voting power of all classes of stock, or of the total value of shares of all classes of stock, of such less developed country corporation.

"(2) COUNTRY CEASES TO BE LESS DEVELOPED COUNTRY.—For purposes of this subpart, property which would be a qualified investment in less developed country corporations, but for the fact that a foreign country has, after the acquisition of such property by the controlled foreign corporation, ceased to be a less developed country, shall be treated as a qualified investment in less developed country corporations.

"(3) INVESTMENTS AFTER CLOSE OF YEAR.—For purposes of this subpart, a controlled foreign corporation may, under regulations prescribed by the Secretary or his delegate, elect to treat property described in paragraph (1) or (2) which was acquired after the close of a taxable year and on or before the close of the following taxable year, or on or before such day after the close of the following taxable year as such regulations may prescribe, as having been acquired on the last day of such year.

"(4) AMOUNT ATTRIBUTABLE TO PROPERTY.—The amount taken into account under this subpart with respect to any property described in paragraph (1) or (2) shall be its adjusted basis, reduced by any liability to which such property is subject.

"(c) LESS DEVELOPED COUNTRY CORPORATIONS.—

"(1) IN GENERAL.—For purposes of this subpart, the term 'less developed country corporation' means a foreign corporation which during the taxable year is engaged in the active conduct of one or more trades or businesses and—

"(A) 80 percent or more of the gross income of which for the taxable year is derived from sources within less developed countries,

"(B) 80 percent or more in value of the assets of which on each day if the taxable year consists of—

"(i) property used in such trades or businesses and located in less developed countries,

"(ii) money, and deposits with persons carrying on the banking business, located in less developed countries,

"(iii) stock, and obligations which, at the time of their acquisition, have a maturity of 5 years of more, of any other less developed country corporation,

"(iv) obligations of the government of a less developed country,

"(v) an investment which is required because of restrictions imposed by a less developed country, and

"(vi) property described in section 956(b)(2); and

"(C) is created or organized under the laws of one of the less developed countries in which property described in subparagraph (B)(i) is located.

For purposes of subparagraph (A), the determination as to whether income is derived from sources within less developed countries shall be made under regulations prescribed by the Secretary or his delegate.

"(2) LESS DEVELOPED COUNTRY DEFINED.—For purposes of this subpart, the term 'less developed country' means (in respect of any foreign corporation) any foreign country (other than an area within the Sino-Soviet bloc) or any possession of the United States, with respect to which on the first day of the taxable year, there is in effect an Executive order by the President of the United States designating such country or possession as an economically less developed country for purposes of this subpart. For purposes of the preceding sentence, an overseas territory, department, province, or possession may be treated as a separate country. No designation shall be made under this paragraph with respect to—

Australia
Austria
Belgium
Canada
Denmark
France
Germany (Federal Republic)
Hong Kong
Italy
Japan
Liechtenstein
Luxembourg
Monaco
Netherlands
New Zealand
Norway
Union of South Africa
San Marino
Sweden
Switzerland
United Kingdom

"SEC. 956. INVESTMENT OF EARNINGS IN UNITED STATES PROPERTY.

"(a) GENERAL RULES.—For purposes of this subpart—

"(1) AMOUNT OF INVESTMENT.—The amount of earnings of a controlled foreign corporation invested in United States property at the close of any taxable year is the aggregate amount of such property held, directly or indirectly, by the controlled foreign corporation at the close of the taxable year, to the extent such amount would have constituted a dividend (determined after the application of section 955(a)) if it had been distributed.

"(2) PRO RATA SHARE OF INCREASE FOR YEAR.—In the case of any United States shareholder, the pro rata share of the increase for any taxable year in the earnings of a controlled foreign corporation invested in United States property is the amount determined by subtracting—

"(A) his pro rata share of the amount determined under paragraph (1) for the close of the preceding taxable year, reduced by amounts paid during the taxable year to which section 959(c)(1) applies, from

"(B) his pro rata share of the amount determined under paragraph (1) for the close of the taxable year.

"(3) AMOUNT ATTRIBUTABLE TO PROPERTY.—The amount taken into account under paragraph (1) or (2) with respect to any property shall be its adjusted basis, reduced by any liability to which the property is subject.

"(b) UNITED STATES PROPERTY DEFINED.—

"(1) IN GENERAL.—For purposes of subsection (a), the term 'United States property' means any property acquired after December 31, 1962, which is—

"(A) tangible property located in the United States;

"(B) stock of a domestic corporation; or

"(C) an obligation of a United States person.

"(2) EXCEPTIONS.—For purposes of subsection (a), the term 'United States property' does not include—

"(A) money, or deposits with persons carrying on the banking business, located in the United States;

"(B) property located in the United States which is purchased in the United States for export to, or use in, foreign countries;

"(C) any obligation of a United States person arising in connection with the sale of property if the amount of such obligation outstanding at no time during the taxable year exceeds the amount which would be ordinary and necessary to carry on the trade or business of both the other party to the sale transaction and the United States person had the sale been made between unrelated persons;

"(D) any aircraft, railroad rolling stock, vessel, motor vehicle, or container used in the transportation of persons or property in foreign commerce and used predominantly outside the United States; or

"(E) the amount of assets of an insurance company equivalent to the unearned premiums on outstanding business with respect to contracts which are not described in section 953(a)(1).

"(c) PLEDGES AND GUARANTEES.—For purposes of subsection (a), a controlled foreign corporation shall, under regulations prescribed by the Secretary or his delegate, be considered as holding an obligation of a United States person if it is a pledgor or guarantor of such obligation.

"SEC. 957. CONTROLLED FOREIGN CORPORATIONS.

"(a) GENERAL RULE.—For purposes of this subpart, the term 'controlled foreign corporation' means any foreign corporation of which more than 50 percent of the total combined voting power of all classes of stock entitled to vote is owned (within the meaning of section 958(a)), or is considered as owned by applying the rules of ownership of section 958(b), by United States shareholders on any day during the taxable year of such foreign corporation.

"(b) SPECIAL RULE FOR INSURANCE.—For purposes only of taking into account income described in section 953(a) (relating to income derived from insurance of United States risks), the term 'controlled foreign corporation' includes not only a foreign corporation as defined by subsection (a) but also one of which more than 25 percent of the total combined voting power of all classes of stock is owned (within the meaning of section 958(a)), or is considered as owned by applying

the rules of ownership of section 958(b), by United States shareholders on any day during the taxable year of such corporation, if the gross amount of premiums or other consideration in respect of the reinsurance or the issuing of insurance or annuity contracts described in section 953(a)(1) exceeds 75 percent of the gross amount of all premiums or other consideration in respect of all risks.

"(c) CORPORATIONS ORGANIZED IN UNITED STATES POSSESSIONS.—For purposes of this subpart, the term 'controlled foreign corporation' does not include any corporation created or organized in the Commonwealth of Puerto Rico or a possession of the United States or under the law of the Commonwealth of Puerto Rico or a possession of the United States if—

"(1) 80 percent or more of the gross income of such corporation (computed without regard to section 931) for the 3-year period immediately preceding the close of the taxable year (or for such part of such period immediately preceding the close of such taxable year as may be applicable) was derived from sources within the Commonwealth of Puerto Rico or a possession of the United States; and

"(2) 50 percent or more of the gross income of such corporation (computed without regard to section 931) for such period, or for such part thereof, was derived from the active conduct within the Commonwealth of Puerto Rico or a possession of the United States of any trades or businesses constituting the manufacture or processing of goods, wares, merchandise, or other tangible personal property; the processing of agricultural or horticultural products or commodities (including but not limited to livestock, poultry or fur-bearing animals); the catching or taking of any kind of fish or the mining or extraction of natural resources, or any manufacturing or processing of any products or commodities obtained from such activities; or the ownership or operation of hotels."

For purposes of paragraphs (1) and (2), the determination as to whether income was derived from sources within the Commonwealth of Puerto Rico or a possession of the United States and was derived from the active conduct of a described trade or business within the Commonwealth of Puerto Rico or a possession of the United States shall be made under regulations prescribed by the Secretary or his delegate.

"SEC. 958. RULES FOR DETERMINING STOCK OWNERSHIP.

"(a) DIRECT AND INDIRECT OWNERSHIP.—

"(1) GENERAL RULE.—For purposes of this subpart (other than sections 955(b)(1) (A) and (B)), stock owned means—

"(A) stock owned directly, and

"(B) stock owned with the application of paragraph (2).

"(2) STOCK OWNERSHIP THROUGH FOREIGN ENTITIES.—For purposes of subparagraph (B) of paragraph (1), stock owned, directly or indirectly, by or for a foreign corporation, foreign partnership, or foreign trust or foreign estate (within the meaning of section 7701(a)(31)) shall be considered as being owned proportionately by its shareholders, partners, or beneficiaries. Stock considered to be owned by a person by reason of the application of the preceding sentence shall, for purposes of applying such sentence, be treated as actually owned by such person.

"(3) SPECIAL RULE FOR MUTUAL INSURANCE COMPANIES.—For purposes of applying paragraph (1) in the case of a foreign mutual insurance company, the term 'stock' shall include any certificate entitling the holder to voting power in the corporation.

"(b) CONSTRUCTIVE OWNERSHIP.—For purposes of sections 951(b,) 954(d)(3), and 957, section 318(a) (relating to constructive ownership of stock) shall apply to the extent that the effect is to treat any United States person as a United States shareholder within the meaning of section 951(b), to treat a person as a related person within the meaning of section 954(d)(3), or to treat a foreign corporation as a controlled foreign corporation under section 957, except—

"(1) In applying paragraph (1)(A) of section 318(a), stock owned by a nonresident alien individual (other than a foreign trust or foreign estate) shall not be considered as owned by a citizen or by a resident alien individual.

"(2) In applying the first sentence of subparagraphs (A) and (B), and in applying clause (i) of subparagraph (C), of section 318 (a)(2)—

"(A) if a partnership, estate, trust, or corporation owns, directly or indirectly, more than 50 percent of the total combined voting power of all classes of stock entitled to vote of a corporation, it shall be considered as owning all the stock entitled to vote, and

"(B) if a partnership, estate, trust, or corporation owns, directly or indirectly, more than 50 percent of the total value of shares of all classes of stock of a corporation, it shall be considered as owning the total value of all of the outstanding stock of such corporation. The application of this subparagraph shall not have the effect of increasing voting power of a partner, beneficiary, or shareholder, for purposes of subparagraph (A).

"(3) Stock owned by a partnership, estate, trust, or corporation, by reason of the application of the second sentence of subparagraphs (A) and (B), and the application of clause (ii) of subparagraph (C), cf section 318(a)(2), shall not be considered as owned by such partnership, estate, trust, or corporation, for the purposes of applying the first sentence of subparagraphs (A) and (B), and in applying clause (i) of subparagraph (C), of section 318(a)(2).

"(4) In applying clause (i) of subparagraph (C) of section 318(a)(2), the phrase '10 percent' shall be substituted for the phrase '50 percent' used in subparagraph (C).

"SEC. 959. EXCLUSION FROM GROSS INCOME OF PREVIOUSLY TAXED EARNINGS AND PROFITS.

"(a) EXCLUSION FROM GROSS INCOME OF UNITED STATES PERSONS.—For purposes of this chapter, the earnings and profits for a taxable year of a foreign corporation attributable to amounts which are, or have been, included in the gross income of a United States shareholder under section 951(a) shall not, when—

"(1) such amounts are distributed to, or

"(2) such amounts would, but for this subsection, be included under section 951(a)(1)(B) in the gross income of,

such shareholder (or any other United States person who acquires from any person any portion of the interest of such United States

shareholder in such foreign corporation, but only to the extent of such portion, and subject to such proof of the identity of such interest as the Secretary or his delegate may by regulations prescribe) directly, or indirectly through a chain of ownership described under section 958(a), be again included in the gross income of such United States shareholder (or of such other United States person).

"(b) EXCLUSION FROM GROSS INCOME OF CERTAIN FOREIGN SUBSIDIARIES.—For purposes of section 951(a), the earnings and profits for a taxable year of a controlled foreign corporation attributable to amounts which are, or have been, included in the gross income of a United States shareholder under section 951(a), shall not, when distributed through a chain of ownership described under section 958(a), be also included in the gross income of another controlled foreign corporation in such chain for purposes of the application of section 951(a) to such other controlled foreign corporation with respect to such United States shareholder (or to any other United States shareholder who acquires from any person any portion of the interest of such United States shareholder in the controlled foreign corporation, but only to the extent of such portion, and subject to such proof of identity of such interest as the Secretary or his delegate may prescribe by regulations).

"(c) ALLOCATION OF DISTRIBUTIONS.—For purposes of subsections (a) and (b), section 316(a) shall be applied by applying paragraph (2) thereof, and then paragraph (1) thereof—

"(1) first to earnings and profits attributable to amounts included in gross income under section 951(a)(1)(B) (or which would have been included except for subsection (a)(2)),

"(2) then to earnings and profits attributable to amounts included in gross income under section 951(a)(1)(A) (but reduced by amounts not included under section 951(a)(1)(B) because of the exclusion in subsection (a)(2)), and

"(3) then to other earnings and profits.

"(d) DISTRIBUTIONS EXCLUDED FROM GROSS INCOME NOT TO BE TREATED AS DIVIDENDS.—Except as provided in section 960(a)(3), any distribution excluded from gross income under subsection (a) shall be treated, for purposes of this chapter, as a distribution which is not a dividend.

"SEC. 960. SPECIAL RULES FOR FOREIGN TAX CREDIT.

"(a) TAXES PAID BY A FOREIGN CORPORATION.—

"(1) GENERAL RULE.—For purposes of subpart A of this part, if there is included, under section 951(a), in the gross income of a domestic corporation any amount attributable to earnings and profits—

"(A) of a foreign corporation at least 10 percent of the voting stock of which is directly owned by such domestic corporation, or

"(B) of a foreign corporation at least 50 percent of the voting stock of which is directly owned by a foreign corporation at least 10 percent of the voting stock of which is in turn directly owned by such domestic corporation,

then, under regulations prescribed by the Secretary or his delegate, such domestic corporation shall be deemed to have paid the same proportion of the total income, war profits, and excess profits taxes paid (or deemed paid, if, paragraph (4) applies) by such

foreign corporation to a foreign country or possession of the United States for the taxable year which the amount of earnings and profits of such foreign corporation so included in gross income of the domestic corporation bears to the entire amount of the total earnings and profits of such foreign corporation for such taxable year.

"(2) TAXES PREVIOUSLY DEEMED PAID BY DOMESTIC CORPORATION.—If a domestic corporation receives a distribution from a foreign corporation, any portion of which is excluded from gross income under section 959, the income, war profits, and excess profits taxes paid or deemed paid by such foreign corporation to any foreign country or to any possession of the United States in connection with the earnings and profits of such foreign corporation from which such distribution is made shall not be taken into account for purposes of section 902, to the extent such taxes were deemed paid by such domestic corporation under paragraph (1) for any prior taxable year.

"(3) TAXES PAID BY FOREIGN CORPORATION AND NOT PREVIOUSLY DEEMED PAID BY DOMESTIC CORPORATION.—Any portion of a distribution from a foreign corporation received by a domestic corporation which is excluded from gross income under section 959(a) shall be treated by the domestic corporation as a dividend, solely for purposes of taking into account under section 902 any income, war profits, or excess profits taxes paid to any foreign country or to any possession of the United States, on or with respect to the accumulated profits of such foreign corporation from which such distribution is made, which were not deemed paid by the domestic corporation under paragraph (1) for any prior taxable year.

"(4) TAXES PAID BY A FOREIGN SUBSIDIARY.—If subparagraph (A) of paragraph (1) applies with respect to an amount included in gross income under section 951(a) for a taxable year, then such amount shall be considered a dividend for purpose of the application of section 902(b).

"(5) INCLUSION IN GROSS INCOME.—

"For inclusion in gross income of amount equal to taxes deemed paid under paragraph (1), see section 78.

"(b) SPECIAL RULES FOR FOREIGN TAX CREDIT IN YEAR OF RECEIPT OF PREVIOUSLY TAXED EARNINGS AND PROFITS.—

"(1) INCREASE IN SECTION 904 LIMITATION.—In the case of any taxpayer who—

"(A) either (i) chose to have the benefits of subpart A of this part for a taxable year in which he was required under section 951(a) to include in his gross income an amount in respect of a controlled foreign corporation, or (ii) did not pay or accrue for such taxable year any income, war profits, or excess profits taxes to any foreign country or to any possession of the United States, and

"(B) chooses to have the benefits of subpart A of this part for the taxable year in which he receives a distribution or amount which is excluded from gross income under section 959(a) and which is attributable to earnings and profits of the controlled foreign corporation which was included in his

gross income for the taxable year referred to in subparagraph (A), and

"(C) for the taxable year in which such distribution or amount is received, pays, or is deemed to have paid, or accrues income, war profits, or excess profits taxes to a foreign country or to any possession of the United States with respect to such distribution or amount,

the applicable limitation under section 904 for the taxable year in which such distribution or amount is received shall be increased as provided in paragraph (2), but such increase shall not exceed the amount of such taxes paid, or deemed paid, or accrued with respect to such distribution or amount.

"(2) AMOUNT OF INCREASE.—The amount of increase of the applicable limitation under section 904(a) for the taxable year in which the distribution or amount referred to in paragraph (1)(B) is received shall be an amount equal to—

"(A) the amount by which the applicable limitation under section 904(a) for the taxable year referred to in paragraph (1)(A) was increased by reason of the inclusion in gross income under section 951(a) of the amount in respect of the controlled foreign corporation, reduced by

"(B) the amount of any income, war profits, and excess profits taxes paid, or deemed paid, or accrued to any foreign country or possession of the United States which were allowable as a credit under section 901 for the taxable year referred to in paragraph (1)(A) and which would not have been allowable but for the inclusion in gross income of the amount described in subparagraph (A).

"(3) CASES IN WHICH TAXES NOT TO BE ALLOWED AS DEDUCTION.—In the case of any taxpayer who—

"(A) chose to have the benefits of subpart A of this part for a taxable year in which he was required under section 951(a) to include in his gross income an amount in respect of a controlled foreign corporation, and

"(B) does not choose to have the benefits of subpart A of this part for the taxable year in which he receives a distribution or amount which is excluded from gross income under section 959(a) and which is attributable to earnings and profits of the controlled foreign corporation which was included in his gross income for the taxable year referred to in subparagraph (A),

no deduction shall be allowed under section 164 for the taxable year in which such distribution or amount is received for any income, war profits, or excess profits taxes paid or accrued to any foreign country or to any possession of the United States on or with respect to such distribution or amount.

"(4) INSUFFICIENT TAXABLE INCOME.—If an increase in the limitation under this subsection exceeds the tax imposed by this chapter for such year, the amount of such excess shall be deemed an overpayment of tax for such year.

"SEC. 961. ADJUSTMENTS TO BASIS OF STOCK IN CONTROLLED FOREIGN CORPORATION AND OF OTHER PROPERTY.

"(a) INCREASE IN BASIS.—Under regulations prescribed by the Secretary or his delegate, the basis of a United States shareholder's

stock in a controlled foreign corporation, and the basis of property of a United States shareholder by reason of which he is considered under section 958(a)(2) as owning stock of a controlled foreign corporation, shall be increased by the amount required to be included in his gross income under section 951(a) with respect to such stock or with respect to such property, as the case may be, but only to the extent to which such amount was included in the gross income of such United States shareholder.

"(b) REDUCTION IN BASIS.—

"(1) IN GENERAL.—Under regulations prescribed by the Secretary or his delegate, the adjusted basis of stock or other property with respect to which a United States shareholder or a United States person receives an amount which is excluded from gross income under section 959(a) shall be reduced by the amount so excluded.

"(2) AMOUNT IN EXCESS OF BASIS.—To the extent that an amount excluded from gross income under section 959(a) exceeds the adjusted basis of the stock or other property with respect to which it is received, the amount shall be treated as gain from the sale or exchange of property.

"SEC. 962. MISCALLENOUS PROVISIONS.

"(a) EARNINGS AND PROFITS.—For purposes of this subpart, the earnings and profits of any foreign corporation, and the deficit in earnings and profits of any foreign corporation, for any taxable year shall be determined according to rules substantially similar to those applicable to domestic corporations, under regulations prescribed by the Secretary or his delegate.

"(b) BLOCKED FOREIGN INCOME.—Under regulations prescribed by the Secretary or his delegate, no part of the earnings and profits of a controlled foreign corporation for any taxable year shall be included in earnings and profits for purposes of sections 952, 955, and 956, if it is established to the satisfaction of the Secretary or his delegate that such part could not have been distributed by the controlled foreign corporation to United States shareholders who own (within the meaning of section 958(a)) stock of such controlled foreign corporation because of currency or other restrictions or limitations imposed under the laws of any foreign country.

"(c) RECORDS AND ACCOUNTS OF UNITED STATES SHAREHOLDERS.—The Secretary or his delegate may by regulations require each person who is, or has been, a United States shareholder of a controlled foreign corporation to maintain such records and accounts as may be prescribed by such regulations as necessary to carry out the provisions of this subpart."

(b) TECHNICAL AND CLERICAL AMENDMENTS—.

(1) Section 551(b) (relating to foreign personal holding company income included in gross income of United States shareholders) is amended by adding at the end thereof the following new sentence: "The amount included in the gross income of any United States shareholder for any taxable year under the preceding sentence shall be reduced by such shareholder's proportionate share of the undistributed personal holding company income which is included in his gross income under section 951(a)(1)(A)(i) (relating to amounts included in gross income of United States

82190 O - 62 - pt. 11 - 3

shareholders) for such taxable year as his pro rata share of the subpart F income of the company."

(2) Section 901 (relating to foreign tax credit) is amended by striking out "section 902" and inserting in lieu thereof "sections 902 and 960".

(3) Section 902(e) is amended to read as follows:

"(e) CROSS REFERENCES.—

"(1) For application of subsections (a) and (b) with respect to taxes deemed paid in a prior taxable year by a United States shareholder with respect to a controlled foreign corporation, see section 960.

"(2) For reduction of credit with respect to dividends paid out of accumulated profits for years for which certain information is not furnished, see section 6038."

(4) Section 904(f) is amended to read as follows:

"(f) CROSS REFERENCES.—

"(1) For increase of applicable limitation under subsection (a) for taxes paid with respect to amounts received which were included in the gross income of the taxpayer for a prior taxable year as a United States shareholder with respect to a controlled foreign corporation, see section 960(b).

"(2) For special rule relating to the application of the credit provided by section 901 in the case of affiliated groups which include Western Hemisphere trade corporations for years in which the limitation provided by subsection (a)(2) applies, see section 1503(d)."

(5) The table of subparts for part III of subchapter N of chapter 1 is amended by adding at the end thereof the following:

"Subpart F. Controlled Foreign Corporations."

(6) Section 1016(a) (relating to adjustments to basis) is amended—

(A) by striking out the period at the end of paragraph (18) and inserting in lieu thereof a semicolon; and

(B) by adding after paragraph (18) the following new paragraph:

"(19) to the extent provided in section 961 in the case of stock in controlled foreign corporations (or foreign corporations which were controlled foreign corporations) and of property by reason of which a person is considered as owning such stock."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to taxable years of foreign corporations beginning after December 31, 1962, and to taxable years of United States shareholders within which or with which such taxable years of such foreign corporations end.

Page 164, after line 18, insert the following new section:

SEC. . SALES AND EXCHANGES OF PATENTS, ETC., TO CERTAIN FOREIGN CORPORATIONS.

(a) TREATMENT OF GAIN AS ORDINARY INCOME.—Part IV of subchapter P of chapter 1 (relating to special rules for determining capital gains and losses) is amended by adding after section 1248 (as added by section 16 of this Act) the following new section:

"SEC. 1249. GAIN FROM CERTAIN SALES OR EXCHANGES OF PATENTS, ETC., TO FOREIGN CORPORATIONS.

"(a) GENERAL RULE.—Gain from the sale or exchange after December 31, 1962, of a patent, an invention, model, or design

(whether or not patented), a copyright, a secret formula or process, or any other similar property right to any foreign corporation by any United States person (as defined in section 7701(a)(30)) which controls such foreign corporation shall, if such gain would (but for the provisions of this subsection) be gain from the sale or exchange of a capital asset or of property described in section 1231, be considered as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231.

"(b) CONTROL.—For purposes of subsection (a), control means, with respect to any foreign corporation, the ownership, directly or indirectly, of stock possessing more than 50 percent of the total combined voting power of all classes of stock entitled to vote. For purposes of this subsection, the rules for determining ownership of stock prescribed by section 958 shall apply.

"(c) OTHER TRANSFERS OF PATENT RIGHTS, ETC., TO FOREIGN CORPORATIONS.—

"For allocation, etc., of income by the Secretary or his delegate in case of corporations owned or controlled directly or indirectly by the same interests, see section 482(a)."

(b) CLERICAL AMENDMENT.—The table of sections for such part IV is amended by adding at the end thereof the following:

"Sec. 1249. Gain from certain sales or exchanges of patents, etc., to foreign corporations."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 1962.

PART 2

Explanation and Draft of Amendments Recommended by Treasury Department to Section 15 of H.R. 10650

SECTION 15. FOREIGN INVESTMENT COMPANIES

NOTE REGARDING THE REDRAFT OF SECTION 15

Amendment No. 1 provides that this section applies only to foreign investment companies for taxable years after December 31, 1962.

Amendment No. 2 limits the definition of a foreign investment company in a manner similar to the Investment Companies Act of 1940, by adopting all of the appropriate exceptions provided therein.

Amendments Nos. 3 and 4 limit the earnings and profits taxable on the sale by a successor in interest to a deceased shareholder to those accumulated after December 31, 1962.

Amendment No. 4 extends the time for mailing the written notice by the foreign investment company to its shareholders of their portion of long-term capital gain from 30 to 45 days.

Amendments Nos. 6, 7, 8, 9, and 11 make clerical changes.

Amendment No. 10 makes several changes.

New subsections (d) and (e) of section 1247 are technical changes clarifying the rules respecting shareholder taxation.

New subsections (f) and (g) provide that a foreign investment company may elect to pass through the credit for taxes paid to foreign countries and possessions of United States to its shareholders.

New subsection (i) makes a clerical change.

Amendment No. 1—On page 149, line 25, insert "which, for any taxable year beginning after December 31, 1962, is" after the word "corporation".

Amendment No. 2—On page 150, line 8, insert ", as limited by paragraphs (2) through (10) (except paragraph (6)(C)) and paragraphs (12) through (15) of section 3(c) thereof" after the word "Act".

Amendment No. 3—On page 151, beginning on line 24 and continuing to page 152, line 1, strike the word "accumulated".

Amendment No. 4—On page 152, line 1, insert "accumulated after December 31, 1962" after the word "company".

Amendment No. 5—On page 153, line 17, insert "45" in lieu of "30".

Amendment No. 6—On page 153, line 20, strike the word "gains" and insert in lieu thereof the word "gain".

Amendment No. 7—On page 153, line 21, strike "losses;" and insert in lieu thereof "loss of the taxable year,".

Amendment No. 8—On page 154, line 9, strike the words "capital gains over losses" and insert in lieu thereof "net long-term capital gain over net short-term capital loss".

Amendment No. 9—On page 155, line 3, strike "capital gains over losses" and insert in lieu thereof "net long-term capital gain over net short-term capital loss".

Amendment No. 10—Commencing on page 156, line 18, redesignate subsection (d) as subsection (e), redesignate present subsection (e) as subsection (i), insert the following new subsection (d), change the now subsection (e), and insert the following new subsections (f), (g), and (h):

"(d) TREATMENT OF DISTRIBUTED AND UNDISTRIBUTED CAPITAL GAINS BY SHAREHOLDERS.—

"(1) Every shareholder of a foreign investment company for any taxable year of such company with respect to which an election pursuant to subsection (a) is in effect shall include, in computing his long-term capital gains for his taxable year in which received or accrued, his pro rata share of the distributed portion of the excess of the net long-term capital gain over the net short-term capital loss for such taxable year of the company.

"(2) To the extent that a shareholder of a foreign investment company at the close of any taxable year of such company with respect to which an election pursuant to subsection (a) is in effect includes in his return, for his taxable year in which the last day of the company's taxable year falls, his pro rata share of the undistributed portion of the excess of the net long-term capital gain over the net short-term capital loss for such taxable year of the company, such share shall be included in his gross income as a long-term capital gain.

"(e) ADJUSTMENTS.—Under regulations prescribed by the Secretary or his delegate, proper adjustment shall be made—

"(1) in the earnings and profits of the electing foreign investment company and a shareholder's ratable share thereof, and

"(2) in the adjusted basis of stock of such company held by such shareholder (whether or not qualified)

to reflect such shareholder's inclusion in gross income of undistributed capital gains."

"(f) ELECTION BY FOREIGN INVESTMENT COMPANY WITH RESPECT TO FOREIGN TAX CREDIT.—A foreign investment company with respect to which an election pursuant to subsection (a) is in effect and more than 50 percent of the value (as defined in section 851(c)(4)) of whose total assets at the close of the taxable year consists of stock or securities in foreign corporations may, for such taxable year, elect the application of this subsection with respect to income, war profits, and excess profits taxes described in section 901(b)(1) which are paid by the foreign investment company during such taxable year to foreign countries and possessions of the United States. If such election is made—

"(1) the foreign investment company—

"(A) shall compute its taxable income, for purposes of subsection (a) (1) (A), without any deductions for taxes paid to foreign countries or possessions of the United States,

"(B) shall treat the amount of such taxes, for purposes of applying subpart A of part III of subchapter N and subsection (g) (1), as having been paid to the country in which the foreign investment company is incorporated, and

"(C) shall treat the amount of such taxes, for purposes of subsection (a) (1) (A), as distributed to its shareholders;

"(2) each qualified shareholder of such foreign investment company—

"(A) shall include in gross income and treat as paid by him his proportionate share of taxes, and

"(B) shall treat as gross income from sources within the country in which the foreign investment company is incorporated, for purposes of applying subpart A of part III of subchapter N, the sum of his proportionate share of such taxes and the portion of any dividend paid by such foreign investment company which represents income from sources without the United States.

"(g) NOTICE TO SHAREHOLDERS.—The amounts to be treated by a qualified shareholder, for purposes of subsection (f)(2), as his proportionate share of—

"(1) taxes paid to the country in which the foreign investment company is incorporated, and

"(2) gross income derived from sources without the United States,

shall not exceed the amounts so designated by the foreign investment company in a written notice mailed to its shareholders not later than 45 days after the close of its taxable year.

"(h) MANNER OF MAKING ELECTION AND NOTIFYING SHAREHOLDERS.—The election provided in subsection (f) and the notice to shareholders required by subsection (g) shall be made in such manner as the Secretary or his delegate may prescribe by regulations."

Amendment No. 11—On page 158, line 14, strike "paragraphs (1) and (2)" and insert in lieu thereof "paragraph (1)".

PART 3

Explanation and Draft of Amendments Recommended by Treasury Department to Section 16 of H.R. 10650

SEC. 16. GAIN FROM CERTAIN SALES OR EXCHANGES OF STOCK IN CERTAIN FOREIGN CORPORATIONS

EXPLANATION OF CHANGES

1. *Restriction of coverage to future earnings only.*—The application of section 16 is limited to earnings and profits of controlled foreign corporations accumulated after December 31, 1962. Under H.R. 10650, section 16 applies to earnings accumulated after 1913.

2. *Coordination of treatment of liquidations, redemptions, sales and exchanges.*—The rules applicable to (*a*) liquidations and redemptions, and (*b*) sales and exchanges are coordinated. Thus, corporate shareholders selling stock in a transaction would be allowed a foreign tax credit with respect to the portion of gain made taxable as a dividend. Under H.R. 10650, the credit is only available in the case of liquidations or redemptions. Likewise, the amount of earnings to be taxed as a dividend is limited to the shareholder's pro rata portion of the corporation's earnings during the time the stock was held. Under H.R. 10650, this limitation does not apply in the case of liquidations and redemptions.

3. *Limitations on tax of individual shareholders.*—Provision is made so that the amount of tax on individual shareholders on gain made taxable as a dividend is listed to the lesser of (*a*) an amount equal to U.S. tax that would have been payable by a domestic corporation and the individual shareholder had the individual been a shareholder of a domestic corporation, or (*b*) a tax equal to an amount that would have been payable by the individual had the foreign corporation distributed its earnings and profits in the years in which earned. Under H.R. 10650, no such limitations were provided and an individual shareholder would be taxable on the gain covered by section 16 at the progressive income tax rates.

4. *Allowance of capital gain treatment for gains realized within the 12 months preceding liquidation.*—Amended section 16 would exempt from the application of this section earnings and profits of a foreign corporation attributable to the sale of assets within a 12-month period ending on the date of the liquidation of the foreign corporation. No such relief is granted under H.R. 10650.

5. *Elimination of coverage of corporations in the Commonwealth of Puerto Rico and the Virgin Islands.*—Amended section 16 would not be applicable to corporations incorporated under the laws of the Commonwealth of Puerto Rico and possessions of the United States, such as the Virgin Islands.

6. *Exemption of gain with respect to the stock of less developed country corporations that has been held for a continuous period of 10 years.*—This

change would make section 16 inapplicable to the gain with respect to certain long-term investments in less developed countries.

SEC. 16. GAIN FROM CERTAIN SALES OR EXCHANGES OF STOCK IN CERTAIN FOREIGN CORPORATIONS.

(a) TREATMENT OF GAIN FROM THE REDEMPTION, CANCELLATION, OR SALE OF STOCK IN CERTAIN FOREIGN CORPORATIONS.—Part IV of subchapter P of chapter 1 (relating to special rules for determining capital gains and losses) is amended by adding after section 1247 (as added by section 15 of this Act) the following new section:

"SEC. 1248. GAIN FROM CERTAIN SALES OR EXCHANGES OF STOCK IN CERTAIN FOREIGN CORPORATIONS.

"(a) IN GENERAL.—If—

"(1) a United States person sells or exchanges stock in a foreign corporation, or if a United States person receives a distribution from a foreign corporation which, under section 302 or 331, is treated as an exchange of stock, and

"(2) such person can be considered, by applying the rules of constructive ownership of section 955 (b), as being the owner of 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation at any time during the 5-year period ending on the date of sale or exchange when such foreign corporation was a controlled foreign corporation (as defined in section 954),

then the gain recognized on the sale or exchange of such stock shall, to the extent the earnings and profits of the foreign corporation attributable (under regulations prescribed by the Secretary or his delegate) to the stock sold or exchanged were accumulated in taxable years of the foreign corporation beginning after December 31, 1962 and during the period the stock sold or exchanged was held by such person, be taxed in the manner prescribed in subsection (b).

"(b) TREATMENT OF GAIN.—The amount described in subsection (a) shall be included in gross income as a dividend. However, tax attributable to the inclusion of such amount in gross income of an individual or estate or trust shall not be greater than a tax determined under subsection (c).

"(c) LIMITATION OF TAX APPLICABLE TO INDIVIDUALS, ETC.—If the amount described in subsection (a) is included in gross income of an individual, or of an estate or trust, the tax attributable to such amount shall not be greater than—

"(1) if the stock sold or exchanged is a capital asset (within the meaning of section 1221) and has been held for more than 6 months, a tax equal to—

"(A) 52 percent of the sum of—

"(i) the amount described in subsection (a), plus

"(ii) an amount equal to the same proportion of any income, war profits, or excess profits taxes paid by the foreign corporation to any foreign country on or with respect to earnings and profits of the foreign corporation for the period the stock sold or exchanged was held by the United States person in taxable years beginning after December 31, 1962, which the amount determined under subsection (a) bears to total earnings and profits of the foreign corporation for the period the stock sold or exchanged was held by the United States person in

taxable years of the foreign corporation beginning after December 31, 1962, reduced by

"(B) the amounts described in (ii) of subparagraph (A), increased by

"(C) an amount equal to a tax that would result by including in gross income 48 percent of the amounts described in (i) and (ii) of subparagraph (A) as gain from the sale or exchange of a capital asset held for more than 6 months; or

"(2) the aggregate of the taxes which would have been attributable to the amount described in subsection (a) had it been included in the gross income of the individual as a dividend in the year or years in which earned by the foreign corporation, adjusted for losses and distributions in a manner prescribed by the Secretary or his delegate.

"(d) SPECIAL RULES.—

"(1) ELIMINATION FROM EARNINGS AND PROFITS OF AMOUNTS INCLUDED IN GROSS INCOME UNDER SECTION 951.—In determining the amount of earnings and profits under subsection (a), there shall be excluded from the earnings and profits attributable to the stock sold or exchanged as determined under subsection (a) any amount previously included in the gross income of such person under section 951, with respect to the stock sold or exchanged, but only to the extent such amount did not result in an exclusion from gross income under section 956.

"(2) ELIMINATION FROM EARNINGS AND PROFITS OF GAIN REALIZED FROM THE SALE OR EXCHANGE OF PROPERTY IN PURSUANCE OF A PLAN OF COMPLETE LIQUIDATION.—If a foreign corporation adopts a plan of complete liquidation in a taxable year of a foreign corporation beginning after December 31, 1962, and, within the 12-month period beginning on the date of the adoption of such plan, all of the assets of the corporation are distributed in complete liquidation, less assets retained to meet claims, then the amount described in subsection (a) shall not include earnings and profits attributable (under regulations prescribed by the Secretary or his delegate) to any net gain from the sale or exchange of property (as defined in section 337(b)) by the foreign corporation within such 12-month period.

"(3) GENERAL EXEMPTIONS.—This section shall not apply to—

"(A) distributions to which section 303 (relating to distributions in redemption of stock to pay death taxes) applies,

"(B) gain realized on exchanges to which section 356 (relating to receipt of additional consideration in certain reorganizations) applies, or

"(C) any amount to the extent that such amount is, under any other provision of this title, treated as—

"(i) a dividend,

"(ii) gain from the sale of an asset which is not a capital asset, or

"(iii) gain from the sale of an asset held for more than 6 months.

"(D) gain described in subsection (a) of any United States person with respect to the stock of a foreign corporation which

has qualified as a less developed country corporation (as defined in section 955(c)) for a continuous period of at least ten years ending with the date on which such gain is recognized. This subparagraph shall apply only to a United States person (if an individual, including his successors by bequest or intestate succession) who has owned such stock during the whole of such continuous period, and, if such United States person is a corporation, only if at no time during the whole of such continuous period has any individual owning 10 percent or more of the value of the outstanding stock of such United States person transferred any of his stock in such United States person other than by bequest or intestate succession. In determining the ownership of stock of a United States person, section 318(a)(1)(C)(i) shall apply but without regard to the 50 percent limitation.

"(e) TAXPAYER TO ESTABLISH EARNINGS AND PROFITS.—Unless the taxpayer establishes the amount of the earnings and profits of the foreign corporation to be taken into account under subsection (a), all gain from the sale or exchange shall be considered a dividend under subsection (a), and unless the taxpayer establishes the amount of foreign taxes to be taken into account under subsection (c)(1)(A), the limitation of such subparagraph shall not apply.

(b) CLERICAL AMENDMENT.—The table of sections for such part IV is amended by adding at the end thereof the following:

"Sec. 1248. Gain from certain sales or exchanges of stock in certain foreign corporations."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to sales or exchanges occurring after December 31, 1962.

PART 4

Explanation and Draft of Amendments Recommended by Treasury Department to Section 20 of H.R. 10650

SECTION 20. INFORMATION WITH RESPECT TO CERTAIN FOREIGN ENTITIES

Amendment No. 1—[This amendment would restrict the application of the constructive ownership rules under section 6038 for purposes of determining whether 50-percent U.S. control exists. It would provide that (1) stock owned by corporations will not be attributed to the corporation's shareholders unless such shareholders are at least 10-percent owners, and (2) corporations will not be considered as owning stock owned by the shareholders of such corporations.]

In line 9 on page 235, strike the material after the semicolon and strike lines 10 and 11 and insert the following language:

except—

(A) in applying clause (i) of subparagraph (C) of section 318(a)(2), the phrase "10 percent" shall be substituted for the phrase "50 percent" used in subparagraph (C), and

(B) clause (ii) of subparagraph (C) of section 318(a)(2) shall not apply.

Amendment No. 2—[This amendment would liberalize the reporting requirements under section 6046 with respect to U.S. officers and directors. It would provide that such persons need not file any return unless the foreign corporation has a 5-percent U.S. shareholder and, further, when a return is required, U.S. officers and directors need only disclose the names and addresses of 5-percent U.S. shareholders.]

Page 236, line 9—Substitute the following for paragraph (1) of subsection (a) of section 6046:

(1) each United States citizen or resident who is at any time on or after January 1, 1963, an officer or director of a foreign corporation, 5 percent or more in value of the stock of which is owned at such time by a United States person,

At the end of line 8 on page 237, strike the period and insert a comma and the following clause:

except that in the case of persons described only in subsection (a)(1), the information required shall be limited to the names and addresses of persons described in subsection (a)(2).

Amendment No. 3—[This amendment would provide a limitation on the information required under section 6046 to the effect that such information must be required under regulations in effect prior to the date a person becomes liable to file a return.]

On page 237, line 22, redesignate subsection (e) as subsection (f) and insert the following new subsection (e):

(e) LIMITATION.—No information shall be required to be furnished under this section with respect to any foreign corporation unless such information was required to be furnished under regulations in effect prior to the date on which the United States citizen, resident, or person becomes liable to file a return required under subsection (a).

Senator CARLSON. Mr. Chairman, I think it is generally agreed that the House is going to pass a sugar bill probably today. This is an act that must be extended or approved before June 30.

I would like to suggest that the chairman give some thought to either postponing these hearings in order that we may get in at least 2 or 3 days of hearings on the sugar bill this week, if it would meet his views on it.

I am just making a suggestion that he give some thought to that because I do think we ought to have some hearings on the sugar bill.

As the chairman well knows, we have been accused as a committee from time to time coming to a conference without holding hearings and it's not a very good position to be in. So all I am suggesting, Mr. Chairman, is you give some thought to it before we take any action.

The CHAIRMAN. Thank you, Senator Carlson.

The first witness is Mr. Edward R. Luter of the Abbott Laboratories. Take a seat, sir, and proceed.

Mr. LUTER. Thank you, Mr. Chairman.

STATEMENT OF EDWARD R. LUTER, VICE PRESIDENT FOR FISCAL AFFAIRS, ABBOTT LABORATORIES

Mr. LUTER. Mr. Chairman and members of the committee, my name is Edward R. Luter.

I am vice president for fiscal affairs of Abbott Laboratories, one of the largest of the Nation's pharmaceutical companies. We employ 8,500 people, manufacture in three States including Illinois, Kansas, and Tennessee. We distribute in all 50 States.

Last year we had worldwide sales of $129,850,000.

From our previous statement you know that our company believes that section 13 of H.R. 10650 as it passed the House, would reduce total employment in the United States, curtail the manufacture of goods in the United States for export abroad, sharply decrease what is presently the largest favorable factor in the U.S. balance of payments, and put American business at a grave disadvantage in competition with aggressive and less encumbered producers of other counties for world markets.

The Treasury Department is still advocating the discouragement of oversea investment through complete elimination of the so-called deferral principle.

Secretary Dillon has reiterated this on many occasions.

It is our conviction that the new draft language of these foreign income provisions of H.R. 10650 represent no significant improvement over the bill as passed by the House.

Here are some of the pitfalls we see in the legislation as revised.

First, in no fewer than 17 instances in section 13 alone, the draft delegates legislative power to the Treasury Department "by regulations prescribed by the Secretary or his delegate" to establish rules for determining such important facts as:

(*a*) What constitutes earnings and profits;

(*b*) The source of income—whether income is earned in an underdeveloped country, in Puerto Rico, or elsewhere.

Second, the proposed section 13 gives the Internal Revenue Service the right to treat a branch of a foreign manufacturing subsidiary as a subsidiary for the purpose of determining whether its income is foreign base company sales income which should be subject to current U.S. tax.

Thus, if we have a manufacturing subsidiary in the Netherlands and we wish to sell the products in France through a sales branch, we may find that the sales income will be taxed to the parent company at 52 percent.

It appears the only way we could be sure of our status is to establish a manufacturing plant in each country in which we wish to do business. Obviously there is error in the Treasury Department's claim that the new draft does not affect foreign manufacturing subsidiaries.

Third, the Treasury Department heralds as another concession the elimination of the tax on imputed royalties. In its place, however, is a new tax on the initial transfer, not only of patents, copyrights, and exclusive processes—as under H.R. 10650—but also on inventions, models, designs, or "other similar property rights" (apparently now including trademarks).

Not only has the language been deliberately broadened, but now we would be faced with paying a tax on these transfers at ordinary income tax rates (52 percent) whereas, under present law, the tax could be postponed (in an exchange for stock) or at most the transfers would be taxed at capital gains rates.

If Abbott developed a new patented product which it wished to manufacture and market in 22 countries (where we now manufacture), it would have to determine 22 different fair market values so as to compute 22 different amounts of U.S. tax, each of which would be reviewed during a lengthened period of limitation, according to the recommendation of the Secretary of the Treasury.

If we wished to transfer the patent to get product protection in the name of a subsidiary in a certain country before we had built a plant to exploit the patent, how would the Internal Revenue agent value the patent?

Suppose next that our plans were changed or delayed, would we receive a refund of the tax we had paid? The provisions are so vague and complex it would almost appear that the Treasury Department does not want American companies to use American technology to build their foreign trade.

Let me give you another example: Suppose that after the patent has been transferred to a foreign subsidiary and a 52-percent tax paid on the transfer, the subsidiary licenses another company to use the patent. The license fee will be considered foreign base company income and taxed to the U.S. parent at 52 percent over and above the 52-percent tax paid on the initial transfer described above.

Fourth, the new draft language broadens the definition of foreign base company income taxable in the United States to include all types of service income. This is a complete departure from the longstanding rule of U.S. tax law that service income arises where the services are rendered. But what does this mean to our company—Abbott Laboratories?

Having long ago learned that you cannot establish and expand markets abroad by writing letters from Chicago, Abbott has a Swiss

company which not only purchases and sells, but also services orders, renders technical advice, finances, makes market surveys, and handles credit and collections.

Under present law, if the Swiss company charges our English subsidiary for services rendered, the charge is deductible by the English company at a rate of 51 percent.

The charge is taxable in Switzerland at about 10 percent. The 41 percent differential is available for expansion of Abbott's business—for broadening the base for future earnings.

If the 41 percent is remitted to the parent immediately or later, the U.S. Treasury gets its share. Would the Treasury, under section 13, have us stop charging this service fee? If so, the profits could be left in the English company.

Then, when remitted to the U.S. parent, there would be no U.S. tax collected because of the high tax rate in England for which we would get an offsetting credit.

Secretary Dillon has testified he wants to stop "tax avoidance" by U.S. companies. Both as good citizens and as responsible businessmen who pay every tax dollar that law prescribes, we support him in that aim.

But from the examples we have given, we think it is fair to ask, is this tax avoidance? Whose taxes are we avoiding? Not U.S. taxes, certainly. If the purpose of H.R. 10650 is not to collect revenues for the United States, then what is its purpose? To regulate commerce? To regulate and direct the investment of private funds?

The Treasury Secretary says the new draft language hits only at "tax havens." Again, as responsible businessmen we applaud his goal. Neither we at Abbott Laboratories nor the members of the committee for export expansion through subsidiaries abroad, of which I am president, defend sham or paper corporations set up abroad to avoid taxes. These loopholes, which can be readily closed by enforcing existing law, increase the proportionate share of the cost of Government which must be paid by legitimate operators and should be closed.

But when the Secretary of the Treasury testified before this committee on May 11, he gave a definition of "tax haven" which was a far cry from that which we have all understood the term to imply for many years.

When asked for the Treasury Department's definition of a tax haven company, he said:

> What we have done is not to define a tax haven company specifically, but to define in effect a tax haven transaction. For example, a tax haven transaction is one where a company incorporated in country A purchases from country B and resells in country C.

With this departmental definition from the Treasury Secretary, matched against the examples we have given of these principles of the proposed revisions applied to our business, you can see why we at Abbott Laboratories find no more comfort in the present language than in that previously under consideration.

The Secretary of the Treasury himself has admitted that the data upon which these proposals are based are incompleted.[1]

---

[1] See p. 186 of exhibit III to Secretary Dillon's testimony of Apr. 2, 1962.

Much of the language was admittedly hurriedly drafted. To pass legislation having such far-reaching implications under these conditions would place the Nation's long-range economic strength in the most serious jeopardy.

We recommend that all sections of H.R. 10650 having to do with foreign course income be stricken from the bill and that the matter be referred to the Joint Committee on Internal Revenue Taxation for further study.

Also, on Monday, June 4, before the Financial Writers Association in New York, the following exchange took place:

The question: Industry has done a number of studies that indicate that taxing of earnings of foreign subsidiaries of U.S. companies would actually damage our balance-of-payments position. Yet the Treasury advocates such a tax as benefiting our balance of payments. Will you comment on this?

Secretary Dillon's answer: Industry has done some studies on this subject, but our information is really incomplete. I understand that the National Industrial Conference Board is undertaking a study right now. We welcome such a study because we need all of the light on this that we can get. As you know, however, we advocate this tax proposal because we are much concerned about eliminating tax havens.

Thank you, Mr. Chairman.

If any of the members of the committee have any questions they would like to ask we will attempt to answer them.

The CHAIRMAN. Any questions?

Senator CURTIS. Mr. Chairman, could I ask a question?

You say you have 22 plants abroad; is that in 22 different countries?

Mr. LUTER. Twenty-two different countries.

Senator CURTIS. Are they all subsidiaries?

Mr. LUTER. They are all subsidiaries.

Senator CARLSON. Over what period of time have they been established?

Mr. LUTER. We started about 1934, Senator.

Senator CARLSON. Have your oversea operations of your subsidiaries increased or decreased your employment in this country?

Mr. LUTER. They have increased our employment in this country, Senator, because during the past 6 years, during which we have had the greatest growth in our oversea operations, we have also had the greatest increase in our exports.

Senator CARLSON. What exports are promoted by having these plants overseas?

Mr. LUTER. We actually realize three types of exports when we build a plant abroad. In the first place we equip it with U.S. machinery and equipment.

In the second place, as soon as the plant starts operating we start shipping to it bulk products and raw materials which it uses in its manufacture.

And thirdly, we have found that once we establish a real subsidiary abroad and start manufacturing locally and staff it with technical experts and salespeople we build good will and acceptance of Abbott products in those countries, then we find we are able to import into those countries products manufactured in the United States which we wouldn't be able to sell if this—if we didn't have a company abroad.

Senator CARLSON. Is the objective of building a plant in a foreign country abroad to get into a market you couldn't from the United States?

Mr. LUTER. That is correct.

Senator CARLSON. Or to ship goods of low-cost producing countries into the United States?

Mr. LUTER. We do not ship such goods into the United States, Senator.

Senator CARLSON. Do you have any figures to show the effect Abbott Laboratories has had on the balance-of-payments problem?

Mr. LUTER. Yes, sir, Senator; I will try to recall them. They were contained in the statement filed with this committee by our president, Mr. George Cain, for the period 1956 through 1960, a 5-year period.

Our exports exceeded our imports by $50 million. During the same period we brought into the United States $9,200,000 in dividends, and during that same period, interestingly enough, the 5-year period during which we experienced the greatest growth in Abbott's history, our capital exports were only $2,200,000.

This comes to a favorable balance for a country, I think, of around $57 million.

Senator CARLSON. That is all, Mr. Chairman.

The CHAIRMAN. Any further questions?

Senator MCCARTHY. I have a question, Mr. Chairman.

Do you have any substantial competition between your oversea operations and American laboratories that are producing primarily in the United States and are not exporting into countries in which you have established subsidiaries?

Mr. LUTER. I think very generally, Senator, when it is necessary for Abbott to open a plant in a country in order to sell there, it is also necessary for other American pharmaceutical companies to do the same and I think generally throughout the world where we are competing abroad with American companies, we are competing with the same type local manufacturing operation.

Senator MCCARTHY. What then is the economic advantage in establishing a subsidiary rather than producing here and shipping overseas.

Mr. LUTER. In the pharmaceutical industry particularly, Senator, it is almost impossible, after awhile in most countries, to export your goods from the United States because of local health regulations, local drug laws, and so forth.

For example, in Australia, if a product similar to yours is manufactured locally, no one else can import that product into the country, so if you want to compete in Australia you produce it there or you don't sell.

Senator MCCARTHY. This is then a political question; not an economic one primarily?

Mr. LUTER. Right.

Senator MCCARTHY. Do you consider the standards unreasonable?

Mr. LUTER. Well, I don't think I can judge whether they are reasonable or not, Senator. I think they are based a lot on nationalistic feeling, also probably for some very good health reasons.

Senator MCCARTHY. In some cases?

Mr. LUTER. Yes.

Senator MCCARTHY. So there is no significant economic advantage, we will say to establishing a laboratory, an Abbott laboratory in most of the countries in which you have established them.

82190 O—62—pt. 11——4

Mr. LUTER. I don't think there is, Senator. I think if it weren't for the regulations, we probably would not open the plant just for the sake of going abroad and producing.

Senator McCARTHY. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Any other questions?

Thank you very much, Mr. Luter.

Mr. LUTER. Thank you, Mr. Chairman.

The CHAIRMAN. The next witness is Mr. John L. Connolly of the Council of State Chambers of Commerce.

Take a seat, Mr. Connolly, and proceed.

STATEMENT OF JOHN L. CONNOLLY, ON BEHALF OF MEMBER STATE CHAMBERS OF THE COUNCIL OF STATE CHAMBERS OF COMMERCE

Mr. CONNOLLY. Mr. Chairman, my name is John L. Connolly; I have with me Mr. Gene Rinta, executive director of the council. I reside in St. Paul, Minn., and I am general counsel of the Minnesota Mining & Manufacturing Co.

I am chairman of the Federal Finance Committee of the Council of State Chambers of Commerce, and I appear before you on behalf of 27 State and regional chambers of commerce which are listed at the end of my statement.

We appeared before your committee on April 26, 1962, and among other things, stated that we were opposed to section 13 of H.R. 10650. This section sets apart certain kinds of income received by controlled foreign corporations and taxes such income annually to U.S. shareholders, whether distributed or not.

On May 10 the Treasury Department suggested that certain amendments be made in section 13. The amendments and a brief explanation thereof were made public on May 31. We have studied these amendments and find that they in no way modify our basic reasons for opposing section 13 even though it should be finally enacted according to the draft language submitted by the Treasury.

Briefly, our reasons for opposing the proposed section 13, as well as the House-approved section 13, are that taxation of U.S. shareholders on current undistributed income of a bona fide controlled foreign corporation would be uneconomical, has never been attempted, and, in our opinion, would be unconstitutional.

We, in the Council of State Chambers of Commerce, have long had a policy that no taxpayer should be permitted to avoid his legal obligation to pay taxes to the U.S. Government. On the other hand, we are opposed to placing all taxpayers operating in foreign countries in a straitjacket because of tax evasion by some.

To the extent that some American taxpayers may be shifting income to controlled foreign corporations, we believe that the practice can be halted by adequate enforcement of the present section 482 of the Internal Revenue Code. If the transactions between the domestic corporation and the controlled foreign corporation are arm's-length transactions, there is no evasion of U.S. tax. Also, there are no evasions of U.S. tax on income derived from transactions between controlled foreign corporations organized and doing business in different foreign countries. Taxation of such income to U.S. shareholders

would be an unwarranted interference by the Treasury in the economies of other countries:

COMMENTS ON CHANGES PROPOSED BY THE TREASURY

In response to invitation from this committee we submit our views as follows with respect to the changes proposed in section13. These changes are set out in the committee's print of May 31.

The first one would eliminate provision for taxing income from U.S. patents, et cetera, to U.S. shareholders on current basis and substitution of provision for taxing the sale of U.S. patents, et cetera, to controlled foreign corporations.

Comment. The provision in H.R. 10650 would have been practically impossible to administer and should be eliminated as proposed.

Moreover, it was unnecessary since abuses in the allocation of income from patents, et cetera, can be taken care of under the existing section 482.

We do not however, concur with the proposal to tax as ordinary income the proceeds from sale of patents to controlled foreign corporations. It is hardly tax equity or tax neutrality to discriminate thus against such sales to controlled foreign corporations.

The second amendment would eliminate provisions which would restrict the investment earnings of certain foreign corporations, except that such earnings cannot be invested in certain U.S. property.

Comment. This change is a material improvement over section 13 in the House bill. It would eliminate some most difficult administrative problems as well as remove this portion of foreign income from the unwise and, in our opinion, unconstitutional taxing provisions of section 13.

Three: Dividends, interest, rents, and royalties derived in connection with active business operations with unrelated persons are removed from coverage as foreign base company income.

Comment. This provision is an improvement over section 13, but the exclusion from coverage as foreign base company income should not be limited to unrelated persons. The provision should apply to related persons as well as unrelated persons so long as bona fide operations are involved. This could be accomplished by eliminating subsection (c)(3)(B) from under section 954.

Four: Addition of a provision to eliminate coverage under foreign base company provisions where the controlled foreign corporation is not used to effect a substantial reduction in taxes.

Comment. This change would be effected by subsection (b)(4) of section 954 except for one ambiguity. The draft language states that foreign corporations not used to effect substantial tax reductions would be excluded under foreign base company provisions if it is established—

> that the creation or organization of the controlled foreign corporation receiving (income) under the laws of the foreign country in which it is incorporated does not have the effect of substantial reduction of income, war profits, excess profits, or similar taxes.

This provision should be amended by inserting the words "United States" between the words "of" and "income" in the last line of subsection (b)(4) as set out on page 9 of the committee print. This would clarify the fact that the Treasury should be concerned with

reduction of U.S. taxes and not the taxes of foreign countries. It would also be in harmony with the language of the present section 367 of the code. We do not believe it is the responsibility of the Treasury Department to police the taxes of other countries all over the world.

Five: Changes in the determination of when a foreign corporation is considered to be "controlled" so that (*a*) only 10 percent U.S. shareholders are counted in determining control, and (*b*) there will be attribution of ownership of stock owned by a corporation to shareholders of that corporation only where such shareholders own a 10-percent interest.

Comment. This 10-percent minimum ownership provision is some improvement over section 13 but in many instances it would still leave minority stockholders in a position of not knowing whether they came under the provisions of the section with respect to their stockownership in foreign corporations. This would be a particularly serious problem for corporations having a large but not controlling interest, such as 41 to 50 percent.

Six: Greater recognition of losses under which (*a*) losses of 1 year may offset profits of future years, and (*b*) losses of one controlled foreign corporation in a chain of controlled foreign corporations may in the current year offset gains of the other corporations.

Comment. Recognition is given in this change to the need for taking into account losses as well as income. The proposed language in section 952(c) is, however, quite ambiguous. Accordingly, if section 13 should be enacted in whatever form, section 952(c) should be carefully studied and clarified to assure that it actually would permit offset of losses against future profits. The right also should be given to carry back, as well as forward, any losses just as in the case of losses under section 172 of the Internal Revenue Code.

Seven: Provision so that tax will not be payable in situations in which the presence of blocked income means that earnings of a controlled foreign corporation could not be distributed to U.S. shareholders.

Comment. Provision for exclusion of blocked income from current taxation to U.S. shareholders is certainly necessary if any types of undistributed income are to be taxed currently. Similarly, provision should be made for exclusion of situations where income cannot be remitted in dividends to U.S. shareholders because of limitations growing out of legitimate business transactions. The language on these exclusions should not be left to the discretion of the Treasury through regulations as provided in section 962(b) of the draft on page 21 of the committee print.

Eight: This gives the authority to the Treasury Department to issue regulations, 1 of the 17 places where such authority is provided in this section.

Comment: It gives the authority to the Treasury to determine the earnings and profits of a foreign corporation on the same basis as they are determined under our laws for domestic corporations.

Where you control the corporation 100 percent, you can tell your people abroad how you want the books and records kept, although you will have to keep separate books under the foreign laws. But where you do not have control, but are still required to report the income, you are going to have a difficult problem complying with the regulations.

Nine: Elimination of provisions permitting the pourover of profits from developed areas to less developed areas.

Comment. This change is contrary to the pronounced policy of the present administration which calls for encouragement of investment in less developed countries. It is a step backward from the House provision.

Ten: Deals with clarification of terms and minor technical improvements. We have no comment.

Eleven: Eliminated from coverage under certain conditions operating corporations in the Commonwealth of Puerto Rico and the Virgin Islands.

Comment: Exclusion of Puerto Rico and the Virgin Islands and the provision of covering tax-haven activities in these possessions is evidence that the Treasury believes that the tax-haven problem can be handled through apportionment under section 482 of the present Internal Revenue Code.

Twelve brings in a new provision. It has to do with service companies.

Communist. The treatment of foreign base company services income under section 954(e) is an addition to previous drafts of section 13. We oppose the provision as unnecessary and improper. To the extent that services are performed by the domestic corporation for or on behalf of the controlled foreign corporation, section 482 would be applicable in determining apportionment of income.

In other words, if it is not an arm's-length transaction and the parent company is diverting income to a foreign country and escaping tax on it, it can be handled at home today. On the other hand, where services are performed by the controlled foreign corporation for a related person in another foreign country, the United States has no tax jurisdiction in our opinion.

In conclusion, we say that while the amendments proposed by the Treasury to section 13 are improvements in some respects, as well as being more onerous in others, we oppose section 13, as amended, because of its detrimental effect on our foreign trade and, in our view, its unconstitutionality.

Our discussion on these matters is fully set out in our statement of April 26, 1962, and appears in part 7 of the Finance Committee hearings on H.R. 10650, beginning at page 2895.

Thank you.

The following organizations have subscribed to this statement:

Alabama State Chamber of Commerce.
Arkansas State Chamber of Commerce.
Colorado State Chamber of Commerce.
Connecticut State Chamber of Commerce.
Delaware State Chamber of Commerce.
Florida State Chamber of Commerce.
Georgia State Chamber of Commerce.
Idaho State Chamber of Commerce.
Indiana State Chamber of Commerce.
Kansas State Chamber of Commerce.
Kentucky Chamber of Commerce.
Maine State Chamber of Commerce.
Michigan State Chamber of Commerce.
Missouri State Chamber of Commerce.
Montana Chamber of Commerce.
New Jersey State Chamber of Commerce.
Empire State Chamber of Commerce (New York)
Ohio Chamber of Commerce.
Oklahoma State Chamber of Commerce.
Pennsylvania State Chamber of Commerce.
Greater South Dakota Association.
East Texas Chamber of Commerce.
South Texas Chamber of Commerce.
West Texas Chamber of Commerce.
Lower Rio Grande Valley Chamber of Commerce (Texas).
West Virginia Chamber of Commerce.
Wisconsin State Chamber of Commerce.

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

Any questions?

Senator CURTIS. I have one question.

Would the enactment of this revised version in the long run increase revenue for the U.S. Treasury?

Mr. CONNOLLY. No; it would have the opposite effect, Senator.

Senator CURTIS. Would its enactment increase employment in the United States?

Mr. CONNOLLY. No; I do not think so. I think it would put us at a disadvantage in manufacturing here, and shipping abroad.

Senator CURTIS. Would its enactment increase exports?

Mr. CONNOLLY. I do not think so, Senator.

Senator CURTIS. That is all, Mr. Chairman.

The CHAIRMAN. Thank you.

Senator TALMADGE. Mr. Connolly, do you have any idea what percentage of the foreign subsidiaries are remitted annually to the parent corporations for tax purposes?

Mr. CONNOLLY. Of all foreign subsidiaries?

Senator TALMADGE. Yes.

Mr. CONNOLLY. No; I do not. I had the percentage in mind when I appeared before the House Ways and Means Committee in 1961 but I do not have it in mind today.

Senator TALMADGE. Does the average domestic corporation pay out approximately 50 percent of its earnings in dividends?

Mr. CONNOLLY. I think that is substantially correct.

Senator TALMADGE. Would you think that some formula requiring foreign subsidiaries to pay out approximately what domestic corporations pay out would be fair.

Mr. CONNOLLY. No. I would be afraid of such a formula. I would be afraid, Senator, that the corporation might get itself into a straitjacket. I, too, vividly recall section 102 which provides a tax on the unreasonable accumulation of earnings of corporations to prevent the imposition of the surtax on its shareholders, where the Treasury Department adopted a 70 percent payout rule which caused all kinds of trouble.

It will not work for all corporations. I know it would not work for our foreign corporations because it has been impossible to pay out any such percentage. To have the tax apply when a corporation fails to pay a certain percentage of income would be very unfair.

Senator TALMADGE. Thank you, Mr. Connolly.

The CHAIRMAN. Thank you, Mr. Connolly.

The next witness is Mr. Eugene C. Carusi, appearing in behalf of the American Committee for Flags of Necessity. Mr. Carusi, take a seat, sir, and proceed.

STATEMENT OF EUGENE C. CARUSI, IN BEHALF OF AMERICAN COMMITTEE FOR FLAGS OF NECESSITY

Mr. CARUSI. The American Committee for Flags of Necessity (hereinafter ACFN), a group whose members include most of the major American owners of foreign-flag shipowning corporations, filed with your committee on April 30, 1962, a statement which registered strenuous opposition to certain provisions of H.R. 10650 on the ground that those provisions threatened the existence of an industry which is vital to American commerce and defense.

On May 10 and 11, 1962, Secretary Dillon in both his statement and testimony before your committee recognized certain problems created by language of H.R. 10650 affecting American-controlled foreign-flag shipping. Thereafter, the Treasury Department, in a draft dated May 31, 1962, submitted to your committee language suggesting amendments to some of the foreign income provisions of H.R. 10650 having an unwarranted impact on such shipping. This language would cure some of the serious defects in H.R. 10650 but fails to deal with others.

This statement briefly outlines some of the more serious problems which would be encountered by foreign shipping companies under the new Treasury draft, and which (together with certain technical problems) should be met if this industry is to continue as a vigorous segment of American enterprise.

SECTION 13

The basic problems posed by the foreign base company rental and services income provisions of section 13 of H.R. 10650 relate to (i) the active trade or business test in the section and (ii) its provisions concerning rents and services income received from "related persons."

Under section 954(c)(3) of the above-mentioned Treasury draft dated May 31, 1962, "rentals" (which term would include certain types of shipping income) are excluded from foreign base company income and thus from the major impact of section 13, provided two conditions are met; namely, that the rentals (*a*) are derived in an active trade or business, and (*b*) are not received from a related person.

Where rentals are received from a related person, on the other hand, exclusion under section 954(c)(4)(B) is provided only if the rentals are derived from property used in the country where the recipient owner is incorporated. Similarly, under section 954(e), income derived from shipping services performed for a related person outside the country where the company performing the services is incorporated conceivably could be held to be "foreign base company services income."

These provisions set forth in the two preceding paragraphs are aimed at passive or portfolio types of income on the one hand and so-called tax-haven operations on the other. However, in the case of vessels engaged in international shipping, the language is so broad as to encompass income from this active and intensely competitive industry. For valid business reasons, foreign shipowning corporations may (*a*) have certain of their active operational functions performed by other companies and/or (*b*) furnish transportation to related companies, as in large integrated operations. As to related persons, it is patently impossible to incorporate shipowning companies in countries where the property is located because the vessels are vehicles of transportation which continually ply the ocean trade routes of the world.

SECTION 16

On May 11, 1962, Secretary Dillon, in testimony before your committee concerning the increase in tax rates up to 64 percent (for liquidations, etc.), suggested that foreign-flying operations of individual shipowners would not be substantially affected by this provision.

Since May 11, inquiries have been made of a number of individual shipowners in an attempt to ascertain whether their operations would be materially affected.

The only significant expression developed by these inquiries has been that such a change in the existing tax treatment—because of risks inherent in international shipping, the effects of marked tax advantages of foreign competitors, and the availability of more attractive investment opportunities in areas outside of shipping—would threaten to reduce American participation in foreign-flag shipping.

Perhaps the most surprising feature of this provision is that it encourages individual Americans to abandon control of foreign shipowning corporations to ready and willing foreign buyers. Simply by disposing of 51 percent control, the American shareholders can retain existing capital gains treatment as to the stock that they keep. Any such encouragement to abandon control with the consequent reduction in American investment in this defense-related industry clearly would not be in the national interest.

Because of these and other considerations, including the adverse tax effects which would result from the abandonment of established tax principles, ACFN emphatically opposes any change in the exist-

ing system for taxing capital gains in the hands of a U.S. shareholder upon the sale or other disposition of stock in a foreign shipping corporation.

The CHAIRMAN. Thank you very much for your statement, Mr. Carusi.

Our next witness is Mr. Erling D. Naess, Naess Shipping Co., of New York City. You may proceed, Mr. Naess.

STATEMENT OF ERLING D. NAESS, NAESS SHIPPING CO., NEW YORK, N.Y., COMMENTING ON DRAFT OF STATUTORY LANGUAGE PROPOSED BY THE SECRETARY OF THE TREASURY AMENDING H.R. 10650

Mr. NAESS. On April 2, 1962, the House of Representatives passed the revenue bill of 1962 (H.R. 10650). On April 30, 1962, I submitted a statement to this committee, outlining the grave problems which the foreign-flag shipping industry faced under the bill.

The Treasury Department has submitted to this committee a draft of proposed amendments to H.R. 10650, dated May 31, 1962. This draft presents a completely revised section 13 and a substantially amended section 16. Whereas, under this draft, many of the problems which existed under H.R. 10650 have been resolved, nonetheless, substantial technical problems remain.

SECTION 13

The Treasury draft defines foreign base company income as foreign personal holding company income (with certain modifications) except that rentals are included without reference to whether they constitute 50 percent of gross income. However, rentals are excluded from foreign base company income under section 954(c)(3) if they are (A) derived in the active conduct of a trade or business, and (B) received from a person other than a related person.

The problems still faced by the foreign-flag shipping industry under the draft may perhaps be better understood in light of the corporate structures through which shipping companies in general, and mine specifically, operate. For valid business reasons, separate corporations are established to own each vessel, or small group of two or three vessels. Liability for maritime risks is limited to the assets owned by the corporation which owns the vessel. Also, financing institutions prefer not to lend money for construction of new vessels to corporations which own other vessels financed by other lenders. As a result, there are usually several vessel-owning companies within a foreign shipping group, and this is the case with my group.

As it would be inefficient for each vessel-owning corporation to have its own managerial and administrative personnel, it is normal industry practice to have managerial and administrative functions performed on behalf of these corporations by an operating agent. Often, the operating agent is a related corporation in the sense that the stockholders of the agent are also stockholders, directly or indirectly, in the foreign shipowning companies. There is a possibility that some individual companies within a foregn shipping group might not, under a stringent technical interpretation of section 954

(c)(3), be able to meet the tests of that section even though the group as a whole were clearly engaged in the active conduct of a trade or business with unrelated persons.

In certain cases, a vessel-owning company within a shipping group will bareboat charter to another corporation within the group, which in turn will time charter the vessel to the ultimate charterer (this is not, however, the case with any of the corporations in my group). This may be done to resolve particular problems under local law or to meet financing problems. However, the bareboat chartering company would probably be receiving rents from a related party and thereby violate proposed section 954(c)(3)(B). Thus, nontax considerations may force a shipping group into a situation which is colorable, from a tax point of view, under the Treasury draft.

Rentals are excluded from foreign base company income under section 954(c)(4), whether or not derived from active business with unrelated persons, if the property with respect to which the rental is paid is used in the country within which the owning company is incorporated. For obvious reasons, a shipping company cannot come within this exception.

SECTION 16

The Treasury has proposed extensive revisions to section 16. Under these revisions, the increased rate of tax would apply only to earnings and profits accumulated after December 31, 1962, and the effective rate of tax would be limited to a maximum of 64 percent.

Prospective application of section: It is the intent of the Treasury to tax only earnings and profits accumulated after December 31, 1962, at the increased effective rate of tax. However, if, after December 31, 1962, a foreign corporation is liquidated into its parent or two foreign corporations are merged or otherwise reorganized, under certain conditions, the resulting gain will increase post-1962 earnings and profits of the resulting corporation. Such gain may be attributable to pre-1963 accumulations. It ought to be made clear that, when the resulting corporation is liquidated, the gain attributable to such pre-1963 accumulations will not be taxed at the higher rate.

Increased effective rate of tax: Under the Treasury draft, the rate of tax applicable to the gain realized by an American shareholder on the liquidation of a foreign corporation or the sale or redemption of his stock is taxed at ordinary income rates, limited to a maximum effective rate of 64 percent. This higher rate of tax will have the effect of reducing the inducement to Americans to invest in foreign-flag shipping. This industry, which is vital to the defense posture of the United States, depends for its continued vitality on new capital.

Furthermore, under the draft, whereas the increased rate of tax applies to an American-controlled foreign corporation, no such increase applies to foreign corporations that are not controlled by American interests. Thus, the bill will have the effect of encouraging American shipowners to sell control of their companies to foreign interests. This does not appear to be in keeping with the national interests. Therefore, I urge that the existing capital gain treatment be permitted to continue for Americans who invest in foreign corporations whose earnings are derived from the ownership or operation of ships in foreign commerce.

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

Our next witness is Mr. H. Lee White, appearing as chief executive officer of the Marine Transport Lines Group, Oswego Group, and Trinity Group. Please have a seat, Mr. White, and proceed with your statement.

STATEMENT OF H. LEE WHITE, MEMBER OF THE LAW FIRM OF CADWALADER, WICKERSHAM & TAFT, AND CHIEF EXECUTIVE OFFICER OF THE MARINE TRANSPORT LINES GROUP, OSWEGO GROUP, AND TRINITY GROUP

Mr. WHITE. I appeared before the Senate Finance Committee on April 30, 1962, in my capacity as a substantial stockholder of a group of Liberian corporations which own and operate a number of Liberian-flag vessels. In addition to my oral testimony I submitted a prepared, written statement. In that statement I outlined in considerable detail the inequitable, and apparently unintentional, impact of H.R. 10650 as originally enacted by the House of Representatives upon the individual American stockholders of foreign corporations owning foreign-flag vessels. I registered opposition to certain of the provisions of H.R. 10650 on the grounds that—

(1) The American controlled foreign corporations which own or operate PanLibHon vessels (vessels registered under the flags of Panama, Liberia, or Honduras) were not, in fact, either tax haven corporations or corporations receiving passive income. These fleets were created with the encouragement of the U.S. Government to meet the intense competition on the high seas of non-American-owned foreign-flag vessels.

(2) Such provisions would threaten the existence of the effective control fleet of the United States and result in: (*a*) the loss of many ships which are vital to the defense and commerce of the United States, (*b*) a substantial adverse effect on the balance-of-payments position of the United States, and (*c*) an expenditure by the U.S. Government of funds in the near future far in excess of any tax revenue expected to be derived from these provisions.

When the Secretary of the Treasury appeared before the Senate Finance Committee on May 10, 1962, his statement indicated an intent to permit American independent owners of foreign shipping companies to retain their stockholdings and continue their operations as before. The U.S. effective control fleet was thereby to be preserved and American participation in this phase of world trade assured. Since then the Treasury Department, in a draft dated May 31, 1962, has submitted to the Senate Finance Committee language which completely revises section 13 and substantially amends section 16. This language does cure some of the defects in H.R. 10650 with respect to American-controlled foreign-flag shipping but fails to deal with others having a serious impact on such shipping.

The balance of this statement briefly outlines some of these problems.

A. SECTION 13

It is my understanding that the Treasury Department intended in this new draft to exclude foreign corporations engaged in the

shipping business and their American stockholders from the coverage of section 13 (see testimony of the Honorable Douglas Dillon, Secretary of the U.S. Treasury, at page 4336, part 10 of the "Hearings before the Committee on Finance, U.S. Senate, on May 10 and 11, 1962").

However, the new draft fails technically to accomplish this purpose. Under section 954(c)(3), rents, dividends, and interest are excluded from foreign base company income only if they are: (*a*) derived in the active conduct of a trade or business, and (*b*) received from a person other than a related person. Alternatively, under section 954(c)(4), these categories of income are, generally, excluded from foreign base company income if they are received from a related party and stem from assets located in the country in which one or both companies are incorporated.

The problems faced by the shipping industry with these sections are created by two principal factors:

(1) The corporate structure and mode of operation of independent shipping companies in general: Since title to individual ships must, under the normal requirements of financing institutions, be placed in separate corporations, the structure of a particular shipping operation often takes the form of a number of Liberian subsidiary corporations owned by a common Liberian parent corporation. As a result, there are usually a number of vessel-owning corporations. For example, in our group we have 9 corporations owning a total of 15 Liberian-flag vessels.

The shoreside management and technical personnel of a shipping group are distributed the world over. Since it would be inefficient and uneconomical for each vessel-owning corporation to have its own management and operating personnel, these functions are performed on behalf of the Liberian owning corporations by another corporation owned by the same group which acts as operating agent for all the vessels. For financing or other reasons, sometimes one subsidiary of the group may own a vessel and bareboat charter it to another subsidiary or to the parent, which, in turn, time charters or voyage charters the vessel to a major oil, steel, chemical, or aluminum company.

There is no question that the shipping group in its entirety is actually engaged in an active trade or business and that its income is actually received from an unrelated person, but a technical interpretation of section 954(c)(3) applied to each corporation of the group might bring a contrary result.

(2) The nature of the property owned by the foreign shipping corporation: The principal property assets of a shipping corporation is its vessel. A vessel, by its nature, can only be located on the high seas and, therefore, cannot be physically located within the land boundaries of any foreign country. Accordingly, a technical interpretation of section 954(c)(4) would not cover the American-controlled foreign shipping industry since the vessel cannot be said to be located within the physical boundaries of the country under whose flag it operates.

B. SECTION 16

The Treasury has proposed extensive revisions to section 16. Under these amendments, the increased rate of tax would apply only to gain with reference to earnings and profits accumulated after December 31, 1962, and the effective rate of tax would be 64 percent rather than the 25 percent under present law.

I have shown in my earlier statement that the foreign-flag shipping industry is a high risk venture and today, in the face of fierce competition and low charter rates, produces a relatively low return on capital investment at capital gains rates of 25 percent. The examples cited in my earlier statement show a return to investors of 4½ percent after paying capital gains taxes at the 25-percent rate. If the tax is to be at the 64-percent rate, this return would be only 2½ percent. It can hardly be said that any reasonable businessman would make substantial investments for such a small return in view of the risks inherent in a shipping transaction and the fact that he usually cannot, under customary financing arrangements, get any of his original investment back or any of the modest profit for long periods of time, i.e., 15 to 20 years.

PanLibHon vessels under American ownership numbered 456 ships of an aggregate of approximately 11 million deadweight tons as of January 1, 1961. The largest part of this fleet is controlled by individual businessmen. Under section 16, as amended, this control (51-percent ownership) which makes it possible to commit these vessels to the United States in the event of war or national emergency becomes the very agent for increasing the tax on any gains which might be realized from their operation. The 25-percent capital gains tax will still be available under this legislation to Americans who, as a group, own less than 51 percent of the foreign shipping corporations and, therefore, do not have the ability to commit their vessels to "effective control." It would, accordingly, appear that much of the present "effective control" fleet would be sold to non-Americans.

In the future American businessmen will be able, under revised section 16, to participate profitably in new commitments to foreign-flag vessels on only a minority basis. Therefore, the only effect of the proposed legislation will be to remove the element of control from American hands. The overall PanLibHon fleet will continue to grow. Only that portion available to the United States for defense purposes will diminish. This I do not believe can be the intention of Congress.

C. LESS-DEVELOPED COUNTRY CORPORATIONS

The new draft of the Treasury Department contains provisions with respect to "less-developed country corporations." It seems to be the design of the Treasury Department to encourage investment in less-developed countries by controlled foreign corporations and to permit the reinvestment by them of the earnings and profits of such investments in new corporate ventures in the same or similar countries without immediate tax consequences to U.S. shareholders. Further, it appears to be intended to exclude such businesses from the provisions of section 16, provided the stock of such corporations has been held for a period of 10 years. Unintentionally, I am sure, for-

eign corporations (organized under the laws of less-developed countries) owning or operating vessels registered in the country of incorporation and the American stockholders of such corporations have not technically been embraced within the provisions pertaining to "less-developed country corporations."

The Trinity and Oswego group of shipping corporations, of which I am a stockholder, are foreign corporations incorporated in Liberia, a less-developed country. As an integrated group, they are engaged in an "active trade or business"; i.e., international shipping. The vessels (property) owned by these corporations are documented under the laws of Liberia, and each of these vessels operates under the flag of Liberia. Very significant revenue results to the Liberian Government from these corporations in the form of initial registration fees for the vessels and annual tonnage taxes on the vessels.

Our difficulty in complying technically with the requirements of section 955(c) is due to the fact that by its inherent nature a vessel cannot be physically located within the land boundaries of any country. While, as a practical matter, it is impossible to locate the physical assets and the active trade or business of a shipping corporation anywhere but on the international waterways, traditional situs concepts would tend to support their attribution to the country under whose flag they exist and under whose laws they are governed. If our vessels cannot technically be said to be within the land boundaries of Liberia, they also cannot technically be said to be within the land boundaries of any other country.

The policy considerations which led to the establishment of the concept of "less developed country corporations" apply with equal force for including less developed country corporations engaged in the shipping business within the technical definition of section 955(c). Especially is this true when one considers the vital importance of the vessel-owning "less developed country corporations" to the defense and commerce of the United States.

Aside from shipping, it should be noted generally, however, that if the less developed country corporation concept was introduced to permit reinvestment by stockholders in other underdeveloped nations by providing for deferment of tax on ultimate U.S. shareholders under section 13, this purpose will probably be defeated by other aspects of H.R. 10650. Under current law, for example, profits from a less developed country corporation could be withdrawn in the form of dividends and reinvested in another such corporation as long as such dividends (foreign personal holding company income) constituted less than 50 percent of the recipient's gross income from this and operating sources. With the reduction to 20 percent of the foreign personal holding company classification test in section 7 of H.R. 10650, however, significant reinvestment becomes impossible despite the amendment of section 13.

Since the American-owned foreign-flag fleet (*a*) was created with the encouragement of the U.S. Government, (*b*) is vital to the defense of the United States, and (*c*) is not a typical "tax haven" situation as described by the Secretary of the Treasury, it is respectfully requested that this industry be exempt from H.R. 10650.

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

Our next witness is Mr. John M. Barker, General Mills. Mr. Barker, take a seat, sir, and proceed.

STATEMENT OF JOHN M. BARKER, DIRECTOR OF TAXES AND ACCOUNTING, GENERAL MILLS, INC.

Mr. BARKER. Mr. Chairman, and members of the committee, my name is John M. Barker, I am director of taxes and accounting for General Mills at Minneapolis.

Because of your time limitations I request that the detailed statement I have prepared on the proposals for amendment of H.R. 10560 as made by the Secretary of the Treasury on May 10 be included in the record.

The CHAIRMAN. Without objection, your supplemental statement will be printed in the record following your testimony.

Mr. BARKER. I offer these added comments for your consideration.

Your committee has heard some 75 witnesses on the foreign provisions of this revenue act. There has been unanimous opposition to the proposals by all but two of them.

The proposed amendments correct some of the injustices brought out in the mass of material included in the record of the prior hearings on the bill. The amendments do not, however, change the basic policy which proposes to tax U.S. shareholders on income before it is received as a dividend. The business community is certain to continue to oppose adoption of such a policy in total or in part.

I believe there are factors inherent in this proposed policy which will have adverse effects upon our economy. Unfortunately these have not yet been thought of and thus they have not been considered and studied to determine their possible effects. I believe the point I will shortly make has not been previously brought out in the record. I hasten to confess I have not read all the testimony or the entire record.

At no place in this bill, as passed by the House or as it is now proposed to be amended, is the U.S. taxpayer permitted any adjustment in taxes, or is he permitted a deduction for loss of U.S. dollar value of the taxed income due to declines in the values of foreign currencies.

Proponents of the policy to tax foreign income to shareholders as earned, suggest that controlled foreign subsidiaries need not necessarily be at a competitive disadvantage to other businesses operating in the same local market because the U.S. parent is not required to withdraw the earnings from the subsidiary to pay the U.S. tax.

They contend the tax can be paid by the U.S. parent as an advance, as an addition to the capital, or by some other device. If this suggested remedy is followed, the U.S. parent loses working capital and it then is less competitive in its own markets. It is my belief, aside from any other considerations, that it would be difficult and perhaps impossible for a controlled foreign subsidiary, or for that matter any corporation, to remit all of its earnings to its shareholders currently as they are earned.

To illustrate the point the following example sets out the problem of loss of value of a currency when earnings are not remitted and U.S. shareholders are taxed on profits as they are earned rather than when declared as dividends.

1963 earnings of a foreign subsidiary before income tax of the foreign country..........units of foreign currency..	100
Foreign income tax (30 percent)..........do....	30
Income after foreign income tax..........do....	70
Value of foreign currency, at time U.S. tax is paid by parent cents per unit of foreign currency..	20
Tentative U.S. tax on foreign income (52 percent of 100 foreign units times 20 cents)..........	$10.40
Credit for foreign tax paid (30 foreign units times 20 cents)..........	6.00
Net U.S. tax paid..........	4.40
At this time the U.S. dollar equivalent of the after tax earnings are....	$9.60
Assume the foreign subsidiary is able to remit these earnings at a future date when the value of the foreign currency is 15 cents per unit; the 70 units remitted are then worth..........	$10.50
(For simplicity it is assumed the foreign country does not withhold tax on the dividend remittance, but if it is alert and if the United States adopts this proposed policy, the withholding tax on grossed-up dividends will likely be 22 foreign units.)	
After deducting the U.S. tax of $4.40 which was previously paid, the after-tax income to the U.S. shareholder is..........	$6.10
Under present law and under identical conditions the U.S. taxpayer would pay a U.S. tax of $2.31 on the $10.50 dividend, and the after-tax income to the U.S. shareholder would be..........	$8.19

To change our tax policy on taxing shareholders for earnings of controlled foreign corporations will not change the present rules which have been established by our courts. These rules permit deductions for losses only as actually incurred on completed transactions which involve foreign exchange. The courts will have considerable difficulty in determining the incidence of a loss in foreign currency when the tax has been applied on a nonexisting transaction at a previous time.

It would appear very unlikely that the taxpayer would have any success in establishing a right to a deduction in the courts.

This type of situation has the following adverse economic effects:

(1) It places a foreign subsidiary at a distinct disadvantage compared to a foreign branch. Proponents claim equality between these two types of operation is an objective of the proposed policy.

(2) The parent corporation receives negative interest and no return on its advance of the U.S. tax. Proponents claim our present policy permits interest-free loans for the U.S. tax.

(3) The parent becomes an involuntary speculator in foreign exchange to the extent of the U.S. tax. Present policy automatically adjusts U.S. tax to the exchange rate at time the dividend is declared.

(4) The parent company is paying total tax on actual earnings at not less than 59.3 percent. (NOTE.—In the example cited at the time the tax is paid the dollar value of the total taxes is $10.40. The tax at 52 percent on the actual $15 value of before-tax earnings at the time of remittance is $7.80. The total effective tax rate on the dollar equivalent of the total tax on the dollar value of the remitted earnings is 69.3 percent. The $2.60 differential is 52 percent of the $5 exchange loss in before-tax earnings. The exchange loss applicable to the U.S. portion of the tax is $1.10. If only this factor is considered the effective tax rate on the $15 before-tax earnings is 59.3 percent. This is a strong argument against the proposed gross-up provision included as sec. 11 of the bill.)

(5) The parent company will have less total capital to invest either in the United States or elsewhere in the world.

(6) The parent company pays a tax on phantom income.

(7) The U.S. parent has less earnings available to it for payment of dividends to its shareholders.

I believe this is a strong and convincing reason against enactment of section 13 either as originally passed by the House or as it is proposed to be amended.

I strongly urge, as a minimum, that this committee continue our present policy and tax foreign income only as it is available from dividends.

I would suggest consideration of my previous proposal made to you on April 26, 1962, that U.S. corporations be permitted to receive dividends from foreign corporations free from U.S. tax and that the foreign tax credit system be continued for individuals with foreign income.

Thank you for allowing me this time.

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

Any questions?

Senator CARLSON. Mr. Chairman, just one.

The CHAIRMAN. Senator Carlson.

Senator CARLSON. You mentioned, and I think in the very interesting discussion you have brought before the committee, taxation of foreign subsidiaries particularly with reference to decline in the value of foreign currencies.

Would that situation not prevail at the present time with our relationship with Canada.

Mr. BARKER. That is correct.

Senator CARLSON. That is one country——

Mr. BARKER. The currency is down to around 92, I believe right now.

Senator CARLSON. Right.

And the situation you have discussed that would be an example of what could happen.

Mr. BARKER. I didn't look up the statistics but my general impression is that the value of foreign currency in relation to U.S. money over the past years had declined more than it has advanced.

Senator CARLSON. That is all, Mr. Chairman.

The CHAIRMAN. Thank you, Mr. Barker.

(The statement of amendments previously referred to follows:)

STATEMENT ON AMENDMENTS PROPOSED BY THE SECRETARY OF THE TREASURY ON MAY 10, 1962, TO SECTION 13 OF H.R. 10650 SUBMITTED FOR THE RECORD BY JOHN M. BARKER OF GENERAL MILLS, INC., MINNEAPOLIS, MINN.

The proposed amendments continue substantially the policies of the section before amendment. The objections to these policies have been amply presented to the committee in prior testimony. They are no more acceptable now than before. It is doubtful that the proposals as amended are capable of equitable administration or enforcement. The U.S. businessman will never understand the complications of the section and its enactment will be a further deterrent for participation in international trade. The businessman will be properly concerned that he will be caught in a financial trap he cannot anticipate and over which he will have little or no control.

Business has submitted ample evidence that sales to foreign buyers are not possible exclusively from U.S. establishments. In General Mills, Inc., foreign sales are being cut off because of prohibitions against imports by the buying countries. In order to continue in these markets and to sell agricultural prod-

ucts, particularly wheat, we have participated in ownership of corporations in these countries.

An overall criticism of proposed section 13, as amended, is that generally each foreign corporation is considered individually, and as a result, a group of corporations may have little or no income in total, but by particular individual corporations the income to be taxed to shareholders may be substantial. Losses in activities subject to tax when profitable are not permitted as deductions in computing the U.S. tax in the year of the loss. If the loss is ever recognized it must be offset from future profits. Deficits accumulated to date of the act are not recognized for the future.

Section 951(a)(2)

Subparagraphs (A) and (B) provide that a U.S. shareholder in a foreign-controlled corporation will include in his income the pro rata share of the corporation subpart F income reduced by the amount of any distribution received by any other U.S. person during such year as a dividend with respect to such stock.

This means that if additional shares in a corporation, which is a controlled corporation, throughout a taxable year are purchased by a U.S. shareholder from a foreigner after a dividend is declared and paid from income, that the U.S. shareholder, if he owns 10 percent or more of the stock, will pay a U.S. tax on income he can never receive.

Section 952(c)

This subsection limits subpart F income subject to tax, to the earnings and profits for the current year reduced by the excess of the sum of the deficits in earnings and profits for prior years beginning after December 31, 1962, over the earnings and profits accumulated after December 31, 1962, which have not been taxed to U.S. shareholders.

This limitation does not recognize deficits in earnings and profits prior to December 31, 1962, but the proposal is to tax all earnings after that date. It would seem that if a deficit existed before December 1962, the taxpayer should be relieved from U.S. tax until the deficit was recouped. Proposed section 961 adds to the basis of stock the income subject to U.S. taxes under 951(a). Liquidation of a foreign-controlled corporation at a loss which is not recognized under present section 332 means that losses attributable to deficits before December 31, 1962, not only will not be recognized but earnings taxed to the U.S. shareholder and added to basis cannot be deducted.

Section 952(d)

This subsection permits deficits in other controlled corporations to be taken into account (it is presumed but it is not certain this is to be on a consolidated basis) for purposes of determining the limitation on subpart F income. Deficits prior to December 31, 1962, are not recognized and the same criticism as on 952(c) above applies. This section is subject to rules to be promulgated by the Secretary. It is difficult to see why this provision is necessary unless the use of any such deficit is to be limited under the rules.

Section 954(b)(1)

This subparagraph provides for exclusion of dividends and interest received by controlled foreign corporations from qualified investments in less developed country corporations. To qualify for exclusion the dividend and interest received cannot exceed the increase in qualified investment in less developed country corporations.

This is inconsistent with the exclusion of dividends from the definition of personal holding company income (954(c)(3)). If the business is a legitimate active trade or business, and a dividend is received from other than a related person (one with 50 percent or less control), the dividend under 954(c)(3) is exempt. It would appear there is discrimination against dividend income from less developed countries.

There is no provision for consolidation of qualified investments in less developed countries by a group of corporations. One controlled corporation could be making investments while anther received dividends but only the investment by the corporation receiving dividends appears to qualify.

It is doubtful that under this provision U.S. investments will be made in less developed countries. Many of these countries offer tax incentives for new investment but little or no U.S. capital will be attracted if the tax which is exempt as an incentive is to be remitted immediately to he U.S. Treasury unless the investment is continually increased by amounts equal to possible dividends.

Section 954(b)(5)

This subparagraph provides that the Commissioner, by regulation, will prescribe deductions to be taken into account which are properly applicable to the different types of income. No provision is made for allowance of deductions in those countries where the laws are different from in the United States. Certain countries require creation of surplus reserves which cannot be distributed as dividends but which U.S. tax law would not permit as deductions.

Section 954(d)

This subparagraph defines foreign base company sales income. The country of incorporation determines if income is taxed to the shareholder regardless of whether the corporation operates as a branch in several countries, is qualified to do business in the various countries, conducts operations including manufacturing in the various countries, and pays local taxes in the various countries. This type of rule requires separate corporations in each country in which operations are carried on so sales can be made in the country of incorporation. A rule which determines taxation simply from the happenstance of the country of incorporation is completely arbitrary. Under this rule the income of a Canadian corporation which is a U.S. subsidiary would be taxed to the U.S. parent if it purchased raw materials outside Canada and manufactures in Canada for sale to a related person in another country. This would be true even if the purchasing company paid the Canadian company a price determined by customs officers of the importing country to be a legitimate arm's-length price.

Section 954(e)

This subparagraph defines foreign base company service income. If a U.S. parent corporation has several corporations in several different countries, selling and/or manufacturing products, and if, as a matter of efficient operation, a single service corporation is set up to service products in the hands of the general public and sold or produced by all of these selling and/or manufacturing corporations, the income of the service corporation must be included in the U.S. parent income. If, however, a separate service corporation was operative in each country, the income of the service corporations would not be taxed to the U.S. shareholders. Taxation is arbitrarily determined by place of incorporation and even though the service corporation deals entirely with the general public.

Section 955(a) (1) and (2)

These paragraphs define the amount withdrawn from qualified investment in less developed countries and it appears the computation is limited to investments made by a single foreign corporation and to its own investments. There is no provision for decreases in investments by one foreign corporation to be offset by increases in investments by another foreign corporation. In computing the decrease in qualified investments excess of losses over gains or disposals are considered, but no provision is made to eliminate intercorporate profits and losses within the controlled group. If a U.S. parent corporation or a U.S. domestic subsidiary corporation increases investments in foreign corporations, this does not reduce the subpart F income of the foreign corporations in the consolidated group.

No account is taken of existing contracts or foreign government action requiring disposal of investments in less developed countries. Under such conditions the U.S. taxpayer pays a tax on previously excluded subpart F income even if there is a net total loss after the sale.

Section 955(b)(3)

This subparagraph permits controlled foreign corporations to elect to include investments made in less developed country corporations after the close of a taxable year, as part of the investments on the last day of the year. The time limitation of 1 year is not realistic. Experience has been that anywhere from 1 to 5 years are the rule rather than the exception in arranging for and finally consummating foreign investments.

Section 960

This section establishes special rules for foreign tax credit. It is not certain that a foreign tax, arising on intercorporate distributions among foreign corporations, of income already taxed under section 951(a) and excluded from income under section 959(b) for inclusion again under section 951(a), is eligible for foreign tax credit to the U.S. shareholder. If it is eligible it would appear to be eligible under section 960(b) but this subsection refers to a taxpayer and neither the subsidiary nor its controlled subsidiary is the taxpayer.

Section 961. Provides for adjustment to basis of stock and property

It is not clear under paragraph (a) which provides for increase in basis, whether stock of a controlled corporation owned by the U.S. shareholder is to be increased in basis for income taxable to the U.S. shareholder under section 951(a) or if the stock owned by a controlled foreign corporation in another foreign corporation, controlled by it, is to be increased in basis. It would appear that the basis of the stock in the hands of both the parent and the subsidiary should be increased for income included under section 951(a) which was earned by the subsidiary of the subsidiary.

The amount of the reduction in basis under paragraph (b) is not certain. If a distribution is received, exempt under section 959(a), there is no indication if the distribution so received is to be grossed up for applicable foreign tax or not.

The receipt of a distribution under section 959(a) is valued at conversion rates of foreign currency to U.S. currency on the date of the distribution. If the conversion is at a lesser price than at the time income was taxed under section 951(a) basis will not be reduced as much as it was increased. Conversely, if the currency value is higher the basis is decreased more than it was originally increased.

The provision taxing amounts excluded from gross income under section 959(a) to the extent they exceed basis appears to be a taxation of capital. Under present law the tax here contemplated can only apply on complete or partial liquidation of a corporation.

Although basis of stock of a U.S. shareholder is evidently adjusted under section 961 and he is taxed on income under section 951(a), in the case where a U.S. shareholder is a domestic corporation there is no rule regarding accumulated earnings and profits of the U.S. corporation. The status of a distribution from a U.S. corporation to its shareholders is doubtful if earnings and profits at the time of the distribution are nil except for section 951(a) income taxed to the corporation.

Section 1249

Proposes to tax as ordinary income gain from sale or exchange by U.S. persons of patents, inventions, models, designs, copyrights, secret formulas, or processes or any similar property right to a controlled foreign corporation. Development and discovery of the types of property included here are not exactly and easily identifiable as to the source of the idea. Foreign nationals working in the controlled foreign corporation contribute substantially to discoveries and developments. This type of policy will encourage original ownership of these types of properties in foreign corporations.

There does not appear to be any reason to pick this type of property for penalty tax treatment. The result by sale of a patent, for instance, in the United States is to tax the seller at capital gain rates and permit the buyer to amortize the cost as a deduction against ordinary income with no tax on the buyer for income equivalent to the purchase price. To the extent U.S. shareholders sell patent rights to controlled foreign corporations, the U.S. Treasury gains the tax on the capital gain. Exploitation of a proven patent in new geographical locations will generally return a higher profit than within the territory where it is developed and the Treasury gains from taxation of higher dividends from the foreign corporation to the U.S. shareholder.

Adoption of this proposal would be a shortsighted policy and could well deny to the United States access to technical developments in other countries.

The CHAIRMAN. The next witness is Mr. Thomas G. Corcoran of the American International Underwriters.

Take a seat, sir.

STATEMENT OF THOMAS G. CORCORAN, AMERICAN INTERNATIONAL UNDERWRITERS

Mr. CORCORAN. Mr. Chairman, and members of the Finance Committee, my name is Thomas Corcoran, I am a lawyer with offices in Washington, D.C. I appear on behalf of the American International group of insurance and agency insurance companies.

I am grateful to the committee for this opportunity to supplement my earlier testimony and statement of May 3 objecting on behalf of American insurers doing business abroad to the original language of section 13 and related sections of H.R. 10650.

I am happy to say that since May 3 I have had conferences with the representatives of the Treasury whom I have found openminded, fair, and cooperative in finding solutions of these problems and the Treasury's amended draft of May 31 in principle substantially gives legitimate U.S. insurance operations abroad the freedom we asked to meet foreign competition without lessening the effectiveness of the Treasury's capacity to deal with situations of tax abuse.

We appreciate this very much. Details by which we still hope the revised Treasury draft can be refined from the point of view of such insurance companies are set forth in a supplementary statement submitted to this committee by the National Board of Fire Underwriters and the Association of Casualty Insurance Companies.

We are still concerned, however, and are here trying to offer constructive suggestions, on the last point of our earlier statement; i.e., on the interrelation of section 13 and section 12 which curtails that tax examption from personal income earned abroad about which have been constructed for two generations compensation arrangements for managers of U.S. capital abroad.

In my May 3 testimony I suggested that the amount of profit earned by U.S. capital abroad subject to section 13 and available for either immediate or deferred taxation and the value for other national purposes of that capital could not be separated from the effectiveness of U.S. managerial personnel affected by section 12—managers who may control the productivity and profit-earning power of 100 to 10,000 times their number in foreign personnel.

We could lose the international competition both for profits taxable under section 13 and economic and political power beyond these taxable profits if we cannot keep U.S. owner capital abroad managed by U.S. citizen-managers technically as competent as their opposite number European managers who would still enjoy personal tax exemption after we would enact section 12.

I had a realistic experience in government and business for 8 years with Mr. Jesse Jones and more and more I learn the deep wisdom of his remark "I will lend $5,000, $50,000, $500,000, $5 million, or $100 million provided you first find me the men to go with the money."

This statement concerns the men who go with U.S. money overseas.

If we are going to have a section 12 and section 13, it asks you to help wth a fundamental management problem of effecting the difficult transition from a lifelong exemption from tax to a heavily taxable status for these managers, without tolerating the notorious abuse situations of oversea tax exemption which the Treasury is rightly trying to reach.

Attached hereto as appendix A is a rough suggestion of a possible further amendment to section 12 of H.R. 10650. We have not had an opportunity to discuss this with Treasury representatives.

This is intended to reach two types of men: one the kind who already has the option of retiring, the experienced man whom we desperately need to hold as long as possible while we are going through a very difficult period; the other kind is a young man approaching

40, who for reasons I will later detail, needs encouragement to stay in this oversea business.

This amendment is intended to benefit only the particular kind of managers of U.S.-owned capital investment abroad most important both to taxable profits and to U.S. power abroad; for example, factories, plantations, mines, merchandise distribution, insurance, and banking. It will not help, beyond the present exemptions in proposed section 12 of H.R. 10650, movie actors, or those who either by being self-employed or by controlling the corporations who employ them can arrange their residence and location of earning power to take advantage of the foreign earned income exemption with no comparable benefit to the national profit or power.

These managers of these limited kinds, neither self-employed nor controlling their employment, whose skill and concentration of attention on their work—and not on their suddenly heavy tax troubles—could make the difference in the profit of U.S. oversea capital are included in the Treasury table 13 in the classification from $50,000 to $100,000.

Note that with the limitations to the kind of business they represent above suggested, there are only 204 of them from all over the world: with the limitations suggested possible there would be no more than 100 even including men up to $150,000. I suggest it is to the national advantage, taxwise and otherwise, to permit these men to "phase out" their tax transition over a period of 5 years to ease adjustment from many years of tax exemption to a period in which they will be paying possibly 50 percent of the income which may be attributed to them by the Treasury including fringe benefits and prorated perquisities.

The proposed amendment cuts off initial phaseout exemption benefits at the $100,000 figure including perquisites and benefits, even though there may be indispensable managers above this figure, because below this figure will be included the bulk of the experienced indispensable managers who can retire early if they find they are not compensated—after taxes—according to their hitherto ex taxes standards and with whom their employers will have to renegotiate to keep them working.

It is important because of the perquisites and benefits problem that I start from $100,000 because an unpredictable proration of perquisites and all benefits will presumptively be included in the newly taxable income base of these men unless your legislation specifically provides that perquisites and fringe benefits shall not be included in the income base.

The compensation pattern of U.S. foreign managers (like all foreign managers) has grown up like Topsy, finely adjusted to each particular foreign location and custom. The benefit of any differential from U.S. taxes is normally taken into consideration in fixing base salaries.

These managers, therefore, have not been escaping taxes—any tax differential advantage has always been calculated out of their base compensation. Company-paid benefits particular to each location have been added to this exemption-deducted base pay.

Except in a handful of European nations with an approximate U.S. level civilization (where the tax differential does not exist anyway) it would be my guess that there is hardly a single employee in this

vital top management group who does not have, in addition to his base salary, allowances or perquisites of some kind which a Treasury inquisitor may rule in some unpredictable amount as income of the taxpayer subject to tax in addition to salary.

Perquisites and benefits are required in oversea operations much more than in domestic business. A perquisite is often the rent-free manager's house with servants and automobiles in which, for reasons of prestige and face calculated to be profitable for the company and not through his own choice, the U.S. manager has always lived comparably to his English, Canadian, German, or Italian opposite number.

It may be entertainment facilities company-owned and paid for, but more intimately connected with the family living of the manager than in the United States. Where the custom of the country requires it, a benefit may be a necessarily unvouchered expense allowance; where school facilities are notoriously bad, it may be an educational allowance to send U.S. children home to U.S. schools; where climate is bad or medical care inadequate, it may be a travel allowance for an off-post vacation or a trip home to the United States; where living costs are disproportionate, it may be a cost of living allowance in addition to the manager's grade salary.

For income tax purposes these perquisites and benefits could add up to more than salary. It is not inconceivable that an oversea manager today projecting his first tax on his earned income next year under section 12, is sweating out whether with all his perquisites and benefits counted as income, he may need more cash than the amount of his cash salary to pay that tax.

If section 12 in its present terms becomes law the U.S. employing corporation has to choose between evils. It can—

(*a*) substantially raise its competitive cost to keep the American manager by raising his take-home pay to cover his new tax, partly or completely, or

(*b*) keep down its competitive cost by letting the American manager retire, replacing him by a non-United States citizen of the same business-capacity and pay the new foreign manager nothing more than the American's old compensation. Either course is bad.

Attached as appendix B is an amateur computation—not taking into account the variable of a deduction for foreign tax—of how much additional gross compensation to offset the effect of section 12 a U.S. employer would have to pay a U.S. foreign manager, married, with $75,000 salary and $25,000 Treasury valuation in perquisites and benefits, after giving effect to the $35,000 top exemption provided in H.R. 10650.

The manager's tax will be $29,500. To cover this $29,500 net the employer would have to give the manager an additional $132,000 gross salary on top of the $75,000 salary he was already getting. If the employee were unmarried like a large proportion of oversea men the figure would be much higher.

Look at the other alternative open to the employer, $75,000 take-home-pay value in human competence is the same whether it is American or foreign. If the U.S. employer cannot afford to pay $132,000 more to hold an American who wants $75,000 take-home pay, there is a foreigner of equal competence not subject to section 12 who can

take the U.S. citizen's place without costing the employer more than the American's old pay.

Business organizations are like baseball teams—other things being equal, you get in personnel what you pay for and higher paid players win—and until other countries adopt a section 12 $75,000 paid to a British citizen managing U.S. capital will buy a better manager than $75,000 paid a U.S. citizen manager who pays a $29,500 tax. We cannot unilaterally beat arithmetic.

We, therefore have to face the fact that just as before the recent Treasury amendments section 13 risked transferring the ownership and directorship of U.S. capital abroad to foreigners who had no section 13 to contend with, section 12 unless carefully administered can possibly transfer an uncomfortable amount of the upper managerial direction of U.S. capital abroad into managers of other nationalities.

I know there is a domestic advantage in days of high taxes to have domestic residents feel they are not paying higher taxes than foreign residents. But does this goal have to produce the disadvantage to general U.S. national policy of having U.S. citizen managers of U.S. oversea capital replaced by non-U.S. citizens especially in the highest paid and therefore highest managerial positions?

Therefore, we suggest that if on balance the committee wants section 12 it should consider phasing out section 12 over a period of years along the lines of the proposed amendment to see if U.S. employers and the most valuable U.S. managers can in the meantime find ways to make the mutual adjustments required to keep U.S. oversea capital in the management of U.S. nationals.

Certainly such adjustments—together with the correlative adjustments between compensation for domestic and foreign employees of the same corporations—are too big and too complicated to be worked out by January 1, 1963. It is proposed, therefore, in appendix A that we take 5 years to phase out the adjustment, reducing by 20 percent in each year the special exemption proposed for this particular class of indispensable managers.

The suggestion made above has been to try to hold the older U.S. managers. To try to hold the younger ones it is suggested that any exemption in H.R. 10650 be permitted to include prospective tax-free benefits from employers' contributions to pension funds to the degree that the employee does not otherwise use up the entire exemption—that is, if an employee more than 3 years out has only $25,000 salary and perquisites, leaving leeway in an exemption, that leeway could be applied to allow that amount of employer's contribution even in the future to be tax-free pension. Since I have not felt technically competent to prepare a technical amendment even in a rough manner on this subject, I have not submitted a draft.

Because of many factors, including 2 years of agitation about the consequences of section 13 on U.S. oversea business, there is a special uneasiness in the U.S. oversea managerial community among men under 40.

They know that after 40, on the statistical basis of the pension plans of U.S. corporations, it will be difficult for them to come home and get a domestic job with later life security.

Since the effect of section 12 will be to cut off the hope of accumulating capital by going into oversea service, it will dry up recruit-

ment for oversea service. It seems particularly important, therefore, to keep in oversea business for the next 20 years as many as possible of these younger men reaching a 40-year-old point of decision. To such men, unsure of any future job security in the United States, pension rights seem valuable out of proportion to other compensation.

To let them use up any margin between their salaries and an exemption in this way might cost the Treasury little but save for the future management of U.S. capital abroad many young U.S. managers now in place.

The old principle that individuals should be taxed only by the country of residence had the practical advantage that while universally accepted it avoided all problems of competitive adjustment.

When such a workable principle is abandoned for whatever good reasons we should be practical facing up to a sea of troubles of particular adjustments as we try to live by one set of rules while the rest of the world is living by different rules.

But if we have time to work out the individual adjustments required we may be able to have the best of both worlds—to keep our oversea capital competitive and under our own management and at the same time have the objectives of sections 12 and 13. The proposed amendments only ask for patience and time to accomplish just that.

(Appendixes A and B referred to follow:)

APPENDIX A TO STATEMENT OF THOMAS G. CORCORAN

Recommended amendment to section 911 IRC as proposed to be amended by section 12 of H.R. 10650:

Amend paragraph (1)(B) of subsection (c) by substituting ", or" for "." at the end of the sixth line thereof and by adding thereafter the following:

"(C) $50,000 in the case of an individual who qualifies under subsection (a)(1) and who is engaged in trade or commerce in manufacturing, transportation, construction, extractive, agricultural, merchandise distribution, insurance and banking enterprises, as defined more particularly in regulations to be issued by the Secretary of the Treasury, and who is in the employ of a corporation incorporated in the United States or of a foreign corporation not less than 51 percent of the value of whose outstanding stock is owned by U.S. nationals, provided however that such individual does not own control in excess of 10 percent of the value of the outstanding stock of any such employing corporation.

"(D) in the case of an individual who qualifies under subparagraph (C) the following amounts of earned income additional to that exempt under subparagraph (C) above received during the calendar years ending on the following dates respectively: $50,000 for year ending December 31, 1963; $40,000 for year ending December 31, 1964; $30,000 for year ending December 31, 1965; $20,000 for year ending December 31, 1966; $10,000 for year ending December 31, 1967;"

APPENDIX B TO STATEMENT OF THOMAS G. CORCORAN

Salary	$75,000
Perquisites	25,000
Total	100,000
Exemption	35,000
Total	65,000
Tax	29,500

Makeup pay

Rate	Gross	Net	Rate	Gross	Net
65	$11,000	$3,850	81	$20,000	$3,800
69	12,000	3,720	84	20,000	3,200
72	12,000	3,360	87	17,000	2,170
75	20,000	5,000			
78	20,000	4,400	Total	132,000	29,500

The CHAIRMAN. Thank you, Mr. Corcoran.

Any questions?

Senator SMATHERS. I am curious to know, Mr. Chairman, how much do these taxes bring in or how much would they bring in under section 12 as submitted by the House on these 204 managers that you have mentioned?

Mr. CORCORAN. I don't know, sir.

I blew up table 13 because my old eyes can't read it intelligently in the printed report, and I think I have submitted a blownup copy here. If you look at the "All-Continents" leading where I have marked the "$50,000 to under $100,000" men you will find there are 204 of them and the entire amount of excluded income is about $12 million.

The fellows from $20,000 to $50,000 account for $100 million.

Of course, the guts of oversea business management is in the $20,000 to $100,000 men and I am particularly worried about the retirement of the fellows who are already entitled to retire, who have an option to retire at any time within say 5 years and who are already entitled to retire. These are certainly within the $50,000 to $100,000 group. But you will see the entire income of the $50,000 to $100,000 group is $13 million.

Now, how much the taxes payable would be under section 12 would depend on many things. It would depend on how much they were taxed on the so-called perquisites and benefits on which you can't apply the employer's rule of convenience in the oversea business as you can domestically and which make up an unpredictable amount of tax basis because you don't know what the Treasury valuation prorating those benefits is going to be.

A fellow in a comparatively high bracket with the perquisites and benefits that go with a top manager cannot possibly know his tax now because after section 12 is the first time an evaluation will be attempted on what he is going to be taxed, for the manager's "casa grande," for the big house and for all of his travel allowances, I can't tell you how much revenue will come in but I suspect, Senator, it will be far less revenue than the Treasury expects.

I think that the Treasury is more concerned than it is with the amount of revenue which will be obtained with an understandable ability to say to the American domestic taxpayer, "We are not taxing you heavily and not taxing a fellow abroad at all."

But I think there is a balance here.

The right way obviously to have amended section 12 was something that was technically impossible for me, but which I would have liked to have done; that is, an amendment which excluded out of section 12 exemption in the people who were abusing section 12, and there are many people abusing section 12.

Since I can't, nor does anybody else seem to be able to, draft an amendment which will exclude the bad ones out of the exemption, I am trying to suggest the other tack; that is, that we draft an amendment which specially includes some good ones in.

But answering your first question, I don't think anyone knows what revenue you are going to get out of this tax under section 12. I think the purposes of section 12 are more social and egalitarian ends in taxation—and I understand that motivation—than they are in terms of revenue.

Senator SMATHERS. Your argument is that we are going to lose a great deal of know-how and managerial skill overseas in these competitive marks and get very little return for the Treasury.

Mr. CORCORAN. Certainly little return for the Treasury. What other social benefits you get is something else, but little returns for the Treasury. What concerns me, if I might talk like Mr. Churchill about liquidating His Majesty's Empire, is that I don't think we should lose what it means to this country to have the power and the prestige and the value of our American investments abroad which is already some $30 billion, and I am telling you if because of tax differentials you have to put that investment in the hands of Englishmen and Canadians and Germans and Italians or whoever it is you will lose 50 percent of the value to you of that empire, and I hope we are not going to preside in this session of Congress over the liquidation of "His Majesty's Empire."

Senator SMATHERS. Do you know of any other country in the world that is thinking about taking the steps that we envision here in section 12?

Mr. CORCORAN. No, I don't.

If they were all going to take the same step then we would be all right.

But this, Senator, is the same as the situation we find ourselves in when we apply the antitrust law abroad to American corporations which have to compete abroad with foreign corporations whose home law does not apply the antitrust law to them.

I mean it is like our problem where we have to pay the right wages to our people for labor purposes but we can't get enough labor unions in other countries to get other countries labor costs up to our own. I think what our efforts should be is to see if we can get everybody else to go along with these things first before we begin to handicap ourselves.

But answering your question specifically, there is no other country in the world that is presently contemplating a section 12; that is, so far as I know and I may be wrong.

Senator SMATHERS. All right, thank you.

The CHAIRMAN. Any further questions?

Senator GORE. Mr. Corcoran, what are your views with respect to the danger that Miami will lose its multimillionaire colony to Nassau?

Mr. CORCORAN. Well, under the statute as I attempted roughly to draft it, it would lose it.

Nassau would lose it back to Miami because I have carefully provided in here that self-employed people who can control their own place of employment and their own compensation will not get the benefits of this exemption.

Senator SMATHERS. He was asking you for my benefit. And I appreciate the question.

One thing I like about the Senator from Tennessee—he takes care of other people's business for them and does it very well. [Laughter.]

Mr. CORCORAN. Senator, I am sure that under my proposed amendment we would get them back from Nassau to Miami.

Senator GORE. I was asking you with respect to the present law in the unfortunate event that the Congress does not change it, your views on the possibility that Miami may continue to lose its multimillionaire colony to Nassau.

Mr. CORCORAN. Well, Senator, I am not unaware of what modern transportation in jet planes will do. I would myself try very hard if I were myself the Congress of the United States or Treasury of the United States, to stop that abuse of people who are avoiding U.S. taxes and are not contributing abroad anything to the state of the American economic empire.

I too would try to stop the Nassau business, and I have tried desperately to draft an amendment, as I have been informed by Treasury representatives that they have tried to draft an amendment, which would stop this going off to Nassau of people who don't engage in any really important use of American capital abroad for fundamental economic purposes. But we don't seem to be able to draft that kind of an amendment.

So, I am trying to draft another kind of amendment.

If I can't exclude them out, I am trying to include in the important people.

Senator GORE. So, were you in Congress where you could make a significant contribution you would join me in an attempt to solve the problems of getting out of Florida.

Mr. CORCORAN. Yes, but I would also ask you to help me solve my problems.

Senator SMATHERS. Is it not a fact that most of the people who go to Nassau as the Senator from Tennessee states who is usually very generous hearted and concerned about his coleagues, he wants to help me, I appreciate it, and I will have a chance to help later——

Senator GORE. Thank you.

Senator SMATHERS. On some of the other matters, but in any event——

Senator KERR. Would the Senator yield?

Did I come in on a situation where peace is being made or war is being declared? [Laughter.]

Senator SMATHERS. Peace is being made.

Mr. CORCORAN. Senator Kerr, I am trying to give each of them the best of his own world.

Senator SMATHERS. Peace is being made. But the fact of the matter is that most of the people who are going to Nassau which we are actually concerned about do not make any contribution.

Mr. CORCORAN. That is what I am saying.

Senator SMATHERS. Once they get to Nassau, they retire there and in point of fact they live there, drawing certain money from certain sham corporations and things of that kind and those are the people we ought to get as so far as the tax laws are concerned.

But what, I understand that you are talking about are people who are managers and have know-how and are competing in foreign markets for the United States and their companies vis-a-vis the Swiss, the British, and Italians, et cetera, that is what you are talking about.

Mr. CORCORAN. And who are assuring us ultimately control of certain oversea sources of supply which we are going to need more and more as time goes on, the fellows who contribute to the political strength of the economic power of the United States as represented by this investment.

Senator SMATHERS. Wouldn't you agree if we were subscribing to the great theories of Cordell Hull we should have a lot of trade, and the Senator from Tennessee was raised at the very knee of Cordell Hull and recognizes the need of foreign trade, wouldn't you agree we would need to have some kind of competent people overseas to make it possible for us to get the markets opened up to our businessmen, to make it available to them, that they can participate in the stream of traffic that goes from the oversea country to around the world?

Mr. CORCORAN. Yes, Senator. But I still think you can do this and give the Senator from Tennessee what he wants, too, and I think this back-door amendment of mine will do it.

And I don't think——

Senator SMATHERS. It is very clear that if we want to tax the movie stars who avoid it——

Senator GORE. Since my illustrious former neighbor and fellow townsman was brought into this, I would like to recall that his yardstick of taxation was taxation in accord with ability to pay, and I doubt if this amendment which you suggest could quite be measured by that yardstick.

Mr. CORCORAN. Except for one thing, Senator.

Senator GORE. That is it; it is an exception.

Mr. CORCORAN. It is fundamental to the position of these people to understand that their tax differential was taken out of their pay by the employer when their compensation was fixed.

A man abroad does not receive in a country where he has a tax preferential, as a matter of habit among American corporations, he does not get the equivalent salary of a fellow in the United States. There is an allowance, a deduction made in his pay for what he might gain by being abroad under a tax differential. This is the fundamental fact that people don't take into account. The problem here is a corporation problem.

Senator GORE. What you are saying is that the Treasury then, is paying part of the compensation of your high corporate officials abroad?

Senator SMATHERS. No, I think he is saying just the opposite. There is a deduction or a compensation made on the basis of the difficulty which each person encounters in that oversea company.

Senator GORE. He just said tax exemption is figured as a part of that compensation, which means that the Treasury of the United States is helping to pay the compensation.

Mr. CORCORAN. The Treasury of the United States is in exactly the same position as the treasury of every competing country in the world. This has been in the law, Senator, for two generations.

Senator GORE. You were speaking of, a moment ago, take-home pay of $75,000.

How much income, in the case of a domestic taxpayer, would permit a man with a wife to have $75,000 a year take-home pay?

Mr. CORCORAN. I gave that figure in appendix B. It would be substantially $200,000. I am only talking about the 100 or so fellows who really run this oversea empire. I am very careful where I am cutting this exemption off and I am only talking about this exemption for a phaseout period of 5 years until we can see what we can do about this as a matter of negotiation between the company and the employee. I am hoping in the meantime one or two things will happen. Either you will convince other countries to apply the same principle you propose in section 12 or you will get tired of section 12 yourself.

Senator GORE. What you are suggesting is, then, that we assess tax liability to these people but give them 5 years in which to get used to it?

Mr. CORCORAN. Well, you can put it that way, if you want to be mean about it. But I put it another way. [Laughter.]

I put it another way.

Senator GORE. I am not trying to be mean about it. That is what you mean.

Mr. CORCORAN. But when you are dealing with amounts of taxes of this size and when you have men who are eligible to retire, and when by other provisions of this section 12 you have already told these men that the employers' contributions to their pension shall no longer be tax free prospectively, what have the fellows to sit overseas about?

Would you like, Senator, to be sitting as an oversea manager on the top of a keg of worms that is the foreign competitive situation in Brazil right now?

Senator GORE. I don't like worms.

Mr. CORCORAN. I don't think, if there were nothing in pay in it for you, that you would stay in Brazil right now, with the responsibilities of the top men, assuming you are going to be taxed for the first time with 50 percent one whack next year and your retirement allowances, in substance, stopped.

I don't think I would do it, Senator. This is a practical problem, it is a practical problem of the liquidation of His Majesty's Empire, and all I am saying is let's phase it out until there is time to see how many of these men we can hold on a lower take-home base.

What I am cost afraid of is that, as I have said, you still can get a $75,000 Englishman for $75,000, and you can't get a $75,000 American for $75,000 any more. Just give us a little management time to turn around because right now——

Senator GORE. You don't think it would take you 5 years to turn around, do you?

Mr. CORCORAN. Yes, I think it will take you 5 years to figure this all out. You may think it can be done in a shorter time but certainly, Senator, it can't be done by January 1, 1963.

Senator GORE. Suppose we give the building and loan associations a 5-year phasing period.

Mr. CORCORAN. I don't know enough about the building and loans——

Senator GORE. Why not apply this rule to all new taxes levied by the Congress? This is a remarkable scheme, and it will be of great benefit.

Mr. CORCORAN. No, you don't have a competitive oversea problem in these other cases. I know, Senator, it is like the Indians and the elephant. It depends upon what part of the elephant you feel what you think the elephant is like, and you look at it from the standpoint, understandably, of domestic taxes; I am trying to see an oversea situation that will work.

Senator GORE. I thought that was the blind men and an elephant.

Mr. CORCORAN. No, they were Indians who blindfolded themselves. You are on the front end of the elephant where the tusks are. I am at the rear end of the elephant and I am feeling the elephant's tail. [Laughter.]

The CHAIRMAN. Any further questions?

Thank you, Mr. Corcoran, very much.

(Table 13 referred to follows:)

TABLE 13.—*Income excluded under sec. 911 of the code on returns filed in 1960 as disclosed on form 2555, by size of excluded income and continent*

Continent and size of excluded income	Residence				Physical presence				Total			
	Number	Percent	Amount	Percent	Number	Percent	Amount	Percent	Number	Percent	Amount	Percent
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
ALL CONTINENTS												
Total	39,482	100.0	418,906,940	100.0	11,232	100.0	92,175,510	100.0	50,714	100.0	511,082,450	100.0
Not stated	1,458	3.7			373	3.3			1,831	3.6		
Under $5,000	11,785	29.8	32,750,427	7.8	2,451	21.8	6,402,207	6.9	14,236	28.1	39,152,634	7.7
$5,000 under $10,000	9,076	23.0	62,650,725	15.0	4,376	39.0	32,014,862	34.7	13,452	26.5	94,665,587	18.5
$10,000 under $20,000	13,149	33.3	186,718,941	44.6	3,896	34.7	50,538,567	54.8	17,045	33.6	237,257,508	46.4
$20,000 under $50,000	3,768	9.5	100,000,678	23.9	130	1.2	2,794,622	3.0	3,898	7.7	102,795,300	20.1
$50,000 under $100,000	204	.5	12,991,339	3.1	5		302,945	.3	209	.4	13,294,284	2.6
$100,000 under $500,000	35	.1	5,835,576	1.4	1		122,307	.1	36	.1	5,957,883	1.2
$500,000 and over	7		17,959,254	4.3					7		17,959,254	3.5
NORTH AMERICA												
Total	11,199	100.0	109,420,551	100.0	1,166	100.0	8,398,037	100.0	12,365	100.0	117,818,588	100.0
Not stated	510	4.6			92	7.9			602	4.9		
Under $5,000	3,299	29.5	10,894,623	10.0	289	24.8	828,079	9.9	3,588	29.0	11,722,702	9.9
$5,000 under $10,000	3,068	27.4	21,447,700	19.6	464	39.8	3,171,618	37.8	3,532	28.6	24,619,318	20.9
$10,000 under $20,000	3,309	29.5	45,767,243	41.8	306	26.2	3,997,446	47.6	3,615	29.2	49,764,689	42.2
$20,000 under $50,000	935	8.3	25,368,822	23.2	13	1.1	275,266	3.3	948	7.7	25,644,088	21.8
$50,000 under $100,000	73	.7	4,603,566	4.2	2	.2	125,628	1.5	75	.6	4,729,194	4.0
$100,000 under $500,000	4		755,510	.7					4		755,510	.6
$500,000 and over	1		583,087	.5					1		583,087	.5
SOUTH AMERICA												
Total	9,238	100.0	121,937,893	100.0	1,398	100.0	13,382,853	100.0	10,636	100.0	135,320,746	100.0
Not stated	226	2.4			37	2.6			263	2.5		
Under $5,000	1,761	19.1	4,786,298	3.9	230	16.5	692,055	5.2	1,991	18.7	5,478,353	4.0
$5,000 under $10,000	1,660	18.0	12,697,092	10.4	502	35.9	3,914,723	29.3	2,162	20.3	16,611,815	12.3
$10,000 under $20,000	4,004	43.3	58,406,618	47.9	604	43.2	8,044,366	60.1	4,608	43.3	66,450,984	49.1
$20,000 under $50,000	1,522	16.5	39,804,562	32.6	23	1.6	536,805	4.0	1,545	14.5	40,341,367	29.8
$50,000 under $100,000	51	.6	3,238,838	2.7	1	.1	72,597	.5	52	.5	3,311,435	2.4
$100,000 under $500,000	13	.1	2,204,485	1.8	1	.1	122,307	.9	14	.1	2,326,792	1.7
$500,000 and over	1		800,000	.7					1		800,000	.6

WESTERN EUROPE

Total	5,249	100.0	61,484,793	100.0	3,216	100.0	25,622,333	100.0	8,465	100.0	87,107,126	100.0
Not stated	263	5.0	----	----	117	3.6	----	----	380	4.5	----	----
Under $5,000	1,429	27.2	3,645,129	5.9	843	26.2	2,067,621	8.1	2,272	26.8	5,712,750	6.6
$5,000 under $10,000	1,195	22.8	8,971,965	14.6	1,125	35.0	8,643,243	33.7	2,320	27.4	17,615,208	20.2
$10,000 under $20,000	1,746	33.3	24,132,851	39.3	1,099	34.2	14,228,547	55.5	2,845	33.6	38,361,398	44.0
$20,000 under $50,000	559	10.6	15,406,084	25.1	32	1.0	682,922	2.7	591	7.0	16,089,006	18.5
$50,000 under $100,000	46	.9	3,022,909	4.9	----	----	----	----	46	.5	3,022,909	3.5
$100,000 under $500,000	9	.2	1,375,655	2.2	----	----	----	----	9	.1	1,375,655	1.6
$500,000 and over	2	----	4,930,200	8.0	----	----	----	----	2	----	4,930,200	5.7

The CHAIRMAN. The next witness is Joseph B. Brady, of the National Foreign Trade Council.

Mr. Brady, come forward.

STATEMENT OF JOSEPH B. BRADY, VICE PRESIDENT, NATIONAL FOREIGN TRADE COUNCIL, INC.

Mr. BRADY. Mr. Chairman and members of the Committee on Finance, my name is Joseph B. Brady. I am vice president of the National Foreign Trade Council and secretary of its tax committee.

The National Foreign Trade Council, which was founded in 1914, is composed of U.S. corporations engaged in all aspects of foreign trade and business. Its basic function is the protection and promotion of American foreign trade and business.

The National Foreign Trade Council has considered the amendments to sections 13, 16, and 20 of H.R. 10650 proposed by the Secretary of the Treasury, May 10, 1962, and the draft of statutory language implementing these amendments as set forth in the committee print of May 31, 1962, released by the Committee on Finance of the U.S. Senate.

Some amendments suggested by the Secretary, as implemented by the draft language, make the pertinent sections of the bill less onerous that those contained in H.R. 10650 as passed by the House of Representatives. However, other proposed amendments would make the bill more complicated and less equitable.

The National Foreign Trade Council urges that the sections of H.R. 10650 affecting foreign trade and business not be enacted into law, either in the form as passed by the House of Representatives or in the amended form suggested by the Secretary of the Treasury.

They constitute in both forms a drastic and undesirable departure from tax principles which have been consistently followed in U.S. income tax law; and adverse effects to legitimate foreign business operations would result from the provisions which would far outweigh any advantages in curtailing the "tax haven" problem.

The National Foreign Trade Council has prepared a written statement which it is respectfully requested be inserted in the record.

The CHAIRMAN. It will be placed in the record at the end of your testimony.

Mr. BRADY. The accompanying explanation of amendments proposed by the Secretary of the Treasury on May 10, as set forth in the May 31 committee print, lists 12 "major changes from section 13 of H.R. 10650."

In the interest of brevity, we will summarize our position concerning each of these changes.

PATENTS

The substitute amendment concerning patents proposed by the Secretary would tax at ordinary income rates gains from the transfer of patents, et certera, to "controlled foreign corporations" rather than at capital gains rates at which rates such gains are presently taxed.

Further, the explanation of this section may imply that the proposed amendment would preclude the issuance of rulings under section 367, Internal Revenue Code.

Apparently the amendment proposed by the Secretary of the Treasury stems from his contention that the transfer of patents et cetera, constitutes a "tax haven" abuse.

As developed in our written memorandum, there are many cases where tax avoidance, or "tax haven" abuses play no part in the transfer of patents, et cetera, to "controlled foreign corporations."

Further, the proposal would distinguish, in our opinion improperly, such transfers from transfers of patents, et cetera, (*a*) domestic corporations; (*b*) to foreign corporations which are "not controlled"; and also would distinguish such transfers of patents, et cetera, from the transfers of other property.

The second major change listed on page 3 of the May 31 committee print refers to elimination of provisions restricting the use of earnings by operating companies, and to certain limitations concerning investment in U.S. property.

NFTC emphasizes that the proposed amendment does not cover all types of operation of income, e.g., certain sales income and certain service income.

Further, with reference to these two classes of operating income, there would be an added restriction in that such income may not be excluded from foreign base company income by reinvesting such income in less developed countries. This is permitted under section 13 as passed by the House.

The fact that some operating income is not immediately subject to U.S. taxation does not eliminate a number of undesirable effects which the section, both in its present form and in the amended form suggested by the Secretary, would have on controlled foreign corporations which earn such excluded "operating" income.

New and complicated recordkeeping would be required. There would have to be adherence to U.S. legal and accounting concepts which, until the present time, have not been pertinent to operations conducted entirely outside the United States by foreign corporations. Selling operations might have to be handled in a less efficient manner than at present.

Parenthetically, the same observations apply to income excluded because it is earned in less developed countries.

The meaning of many of the provisions in this section of the bill as in other sections of the bill is unclear. Attention is invited in particular to provisions concerning pledges and guarantors.

The third major change concerns dividends, interest, rents, and royalties. One effect of the complicated implementation of the proposed change seems to be that dividends and interest which are derived in connection with the active conduct of a trade or business in a developed country (other than the country of incorporation) of the receiving corporation are taxes solely because they come from a related person.

The section would result in unjustly penalizing and, in many cases, rendering noncompetitive legitimate foreign operating subsidiaries which, for sound business reasons, and in accordance with local laws and customs, have in turn established operating subsidiaries in other foreign countries.

The fourth change concerns an exception for foreign corporations not availed of to reduce taxes. The proposal which would implement

this fourth major change seems to be one of uncertain application which would place a severe burden of proof on the taxpayer without statutory standard.

The proper standard for exception from treatment as "tax haven" income should be whether or not the controlled foreign corporation was organized for reasons other than the avoidance of U.S. taxes.

In certain countries there is a higher reliance on indirect taxes as compared with direct taxes. Comparison of only the type of taxes enumerated in section 954(b)(4) accordingly might be unrealistic.

The fifth major change indicates that only shareholders having a 10-percent interest or more are considered in connection with subpart F. When this section is combined with the attribution rules there will be many situations where the affected taxpayer will have no actual control.

The sixth major change refers to losses. The proposed statutory language, particularly when considered in connection with the explanation, might indicate that certain types of losses of controlled foreign subsidiaries may not be covered by the proposed provisions.

Furthermore, the present draft as compared with the Treasury draft released on January 31, 1962, does not contain a provision for carryback of losses.

The seventh major change refers to blocked income. The concept of income varies from country to country, that is, requirement for legal reserves. In many countries there are practical as distinguished from legal restictions on the remittance of funds resulting from policies at various levels of the economy, or from unwritten decisions of an administrative agency.

The eighth major change concerns earnings and profits. This concept is extremely difficult to determine even for purposes of U.S. taxation of domestic source income and is probably unknown in foreign accounting and tax practice.

In general, the proposed provision would delegate broad authority to the Secretary without adequate statutory standards.

The ninth major change refers to the exclusion from foreign base income of certain dividends and interest from less-developed country corporations. In general, under the provisions, income from developed countries which would be otherwise taxable under section 13 may not be excluded from the scope of section 13 by being invested in less developed countries. This would be allowed to some extent by the provisions of section 13 as passed by the House.

No types of income other than dividends and interest from a less developed country corporation even though its source was a less developed country would not be eligible for reinvestment; for example, rents and royalties.

In addition the draft proposal would limit the types of investment which could be made. Apparently a corporation which received such dividends and interest could not invest directly in physical property in a less developed country even though such property were connected with the active conduct of its trade or business. It would be limited to investment in the stocks or obligations of so-called less developed country corporations.

The 10th major change refers to minor technical improvements. This may include the section which would require each person who

is or has been a shareholder of a controlled foreign corporation to maintain such records as may be prescribed. This confers broad authority to the Secretary. Requirements for such recordkeeping do not apply to shareholders generally under the present provisions of the code.

The 11th major change refers to corporations organized in U.S. possessions. The implementing provision does not include in the concept of trade or business, which are excluded from the adverse effects of section 13, certain types of activities which apparently would form a useful part in the economy of the Commonwealth of Puerto Rico and the Virgin Islands, for example, farming, transportation, and buying and selling of goods.

The 12th major change in the accompanying explanation refers to certain service income.

Some of the terms used are extremely broad, and of uncertain application, for example, "skilled," "industrial," "commercial" or "like" services "in connection with business activities."

Many sound business reasons not connected with U.S. taxation may require the establishment of a foreign corporation in a centrally located foreign country and staffed by experts to service a particular geographical area which includes a number of countries.

The major changes do not refer to taxation of sales income which is characterized as foreign base company income. Many business reasons may exist for decisions to carry out marketing operations for several countries through a single foreign subsidiary which subsidiary in turn may or may not have branches or subsidiaries. The advantages of efficiency in management, accounting, and finance frequently indicate such a procedure.

The proposed changes referring to branch operations are extremely unclear, and suffer from the same defect as noted above in that they may have been established for sound business reasons not connected with U.S. tax considerations. The same observation refers to situations where the foreign corporation acts as an agent.

Mr. Chairman, in our written memorandum we comment on each of the 12 major changes; some changes not so designated; on the overall legal and business reasons for rejecting section 13; on the proposed amendment of the Secretary to sections 16 and 20; and on the comments of the Secretary on May 10 concerning the meaning of his April 12 proposal for a separate limitation on foreign tax credit with respect to investment income.

Thank you, Mr. Chairman.

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

(The statement referred to follows:)

REVENUE ACT OF 1962 (H.R. 10650)—AMENDMENTS PROPOSED BY THE SECRETARY OF THE TREASURY ON MAY 10, 1962, TO SECTIONS 13, 16, AND 20

Statement on behalf of National Foreign Trade Council, Inc., before the Committee on Finance, U.S. Senate, 87th Congress, June 18, 1962

CONTENTS

Introduction.
Section 13—Controlled foreign corporations.
Amendments to section 13:
- Patents, etc.
- Operating companies, investments of earnings in U.S. properties.
- Dividends, interests, rents, and royalties.
- Exception for foreign corporations not availed of to reduce taxes.
- U.S. shareholder defined.
- Losses.
- Blocked foreign income.
- Earnings and profits.
- Certain dividends and interest from less developed country corporations excluded.
- Records and accounts of U.S. shareholders.
- Corporations organized in U.S. possessions.
- Foreign base company service income.
- Purchase and sale of property, foreign base company sales income.
- General comments concerning section 13, as amended.
- Legal reasons for rejecting proposal.
- Adverse effects of section 13 on U.S. foreign trade and business.
- Recommendations of NFTC concerning "tax havens."

Section 16. Gain from certain sales or exchanges of stock in certain foreign corporations.
Section 20. Information with respect to certain foreign entities.
Separate limitation on foreign tax credit with respect to investment income.
Appendix A. Excerpts from part 1A, Committee on Finance, committee print of May 31, 1962, explanation of amendments recommended by Treasury Department of section 13 of H.R. 10650.

INTRODUCTION

The National Foreign Trade Council, which was founded in 1914, is composed of U.S. corporations engaged in all aspects of foreign trade and business. Its basic function is the protection and promotion of American foreign trade and business. NFTC is most concerned that all segments of U.S. business operate at the highest level possible. However, it is urged that the overall economy will not be benefited by consciously depressing foreign trade and business which represent an extremely important sector of our total economy. If any action should be taken in the fiscal area in respect to foreign trade and business, it is that burdens should be made less onerous.

The National Foreign Trade Council has considered the amendments to sections 13, 16, and 20 of H.R. 10650 and the draft of statutory language implementing these amendments as set forth in the committee print of May 31, 1962, released by the Committee on Finance of the U.S. Senate.

Some amendments suggested by the Secretary, as implemented by draft language prepared by the Treasury, make the pertinent sections of the bill less onerous than those contained in H.R. 10650 as passed by the House of Representatives. However, other amendments make the amended bill more complicated and less equitable.

The National Foreign Trade Council urges that the sections of H.R. 10650 affecting foreign trade and business not be enacted into law, either in the form as passed by the House of Representatives, or in the amended form suggested by the Secrtary of the Treasury.[1] They constitute in both forms a drastic and undesirable departure from tax principles which have been consistently followed in U.S. income tax law, and a number of adverse business effects to legitimate foreign operations would result from the section which would far outweigh any advantages in curtailing the "tax haven" problem.

SECTION 13. CONTROLLED FOREIGN CORPORATIONS

The amendments to section 13 suggested by the Secretary are considered in the order enumerated on pages 3 and 4 of the explanation of the amendments recommended by the Treasury Department to section 13 of H.R. 10650 as set

[1] In addition to secs. 13, 16, and 20, several other provisions of H.R. 10650 are discussed in the National Foreign Trade Council testimony before the Committee on Finance, Apr. 25, 1962, pt. 6 hearings, pp. 2659 through 2767.

forth in the committee print of the Committee on Finance, U.S. Senate, of May 31, 1962. These changes are characterized as "major changes of section 13 of H.R. 10650." For convenience the pertinent sections of pages 3 and 4 of the May 31 print are attached as appendix A.

In our discussion reference is made to both the explanations as set forth in the committee print, and to the proposed statutory language which, it is our understanding, is to implement the proposed amendments. Further, in a number of instances the proposed amendments have not been considered separately, but rather in the context of the particular section amended. As indicated in the explanation a new section 13 is proposed (May 31 committee print, p. 5 et seq.).

AMENDMENTS TO SECTION 13

Patents, etc.

The first "major change" [2] refers to patents. It would—

(1) eliminate from section 13 the provisions for taxing to U.S. shareholders imputed income from U.S. patents, etc., the title to which had been transferred to certain controlled foreign corporations,

(2) add a new section to the Internal Revenue Code (pp. 22 and 23 of May 31 committee print) which would tax at ordinary income rates gain from the sale of a patent, etc., to any foreign corporation controlled by the transferor; such gains under present law are taxed at capital gains rates.

The National Foreign Trade Council strongly opposed the provision in section 13 as passed by the House which would have taxed to U.S. shareholders imputed income from U.S. patents, etc. Moreover, the NFTC opposes the new amendment (sec. 1249, pp. 22 and 23 of committee print) proposed by the Secretary which constitutes a drastic change in the tax law which applies to the transfer of patents, etc., to all foreign corporations controlled by the transferor.

The new provision would tax at ordinary income rates gain from all transactions effecting the transfer of patents, etc., to a controlled foreign corporation. It would distinguish gain arising from the transfer of patents from gains arising from the transfer of other types of property even though such gains are ordinarily taxed at capital gains rates. Attention is invited in particular to section 1235, Internal Revenue Code, which provides that "a transfer of [patents] shall be considered the sale or exchange of a capital asset held for more than 6 months * * *." It would discriminate against the sale or transfer of a patent, etc., to a controlled foreign corporation as compared with the transfer of a patent to a foreign corporation which is not a "controlled foreign corporation" and the transfer of a patent to a domestic corporation.

Apparently, the May 10 proposal of the Secretary to tax such gains at ordinary rates stems from his contention that the transfer of patents, etc., constitutes a "tax haven abuse."

While it may be true that in some cases lower taxes have been a factor in the transfer of patents or processes to foreign corporations, it is equally true that such is not so in the vast majority of cases. For example, one of the most common cases is where a U.S. company, having developed a patent or process, wishes to embark on a broad-scale licensing program. This takes a lot of time, effort, and money—not only to sell the licenses, but to police the patent against possible infringers and to render technical assistance to licensees. For sound legal and business reasons, this may be best done by a foreign company. Thus, in France, where a suit for infringement must be brought by the patent owner, there are obviously many good reasons why the patent should be transferred to a local subsidiary.

Another very common example is the case where a license to use is granted without a cash consideration, but in lieu thereof, the licensee is expected to carry out further research and development on the process and it agrees to grant back to the licensor a royalty-free license under any patents or inventions it may develop. Or there may be an outright exchange of patent licenses.

Still another common situation in which tax avoidance is patently not a factor is found where a patent or process is transferred to a controlled foreign corporation for stock pursuant to rulings under sections 367 and 351 of the Internal Revenue Code, which rulings hold that the transfer is not for the purpose of avoiding U.S. tax and that the transfer shall be free of tax. However, the explanation of the Secretary, as set forth on pages 1–3 of the committee print and page 1 of the Secretary's statement on May 10, may imply that the proposed

[2] P. 3, May 31 committee print.

amendment would preclude the issuance of rulings under section 367 in the event that patents, etc., are transferred from the parent to a controlled foreign subsidiary even though such transfer would otherwise come within the provisions of sections 351 and 367.

Furthermore, it should be pointed out that the overwhelming majority of controlled foreign corporations acquiring patents or processes which are developed in the United States are located in such highly developed countries as Canada, United Kingdom, Germany, France, Netherlands, Norway, Sweden, Finland, and Japan. Yet the taxes borne by these companies are substantial and in most cases as great or greater than those borne by U.S. taxpayers. Surely it cannot be said that tax avoidance is a motivating factor in these cases.

It should be clear from the above that there are a great many cases where tax avoidance plays no part in the transfer to or acquisition by a controlled foreign corporation of patents or processes and does not justify the measure proposed. The tax under proposed section 1249 cannot be justified as a measure designed to prevent so-called tax avoidance. Tax avoidance can be adequately prevented under present sections of the law. Section 1249 only imposes ordinary income rates on income which now is taxed at capital gain rates.

Operating companies—Investments of earnings in U.S. properties

The second "major change" listed on page 3 of the May 31 draft refers to elimination of provisions restricting the use of earnings by operating companies and to certain limitations concerning investment in U.S. property.

Although the proposal of the Secretary made on May 10 refers to "operating income," the proposed amendment does not cover all types of operating income. The provision does not extend to sales income which would be classified under the amended proposals as "foreign base company sales income" nor does it extend to service income which would be classified as "foreign base company service income." Both of these classes of income obviously are "operating" income. Further with reference to those two classes of income there would be an added restriction in the new bill in that such income according to the proposed section 13 may not be excluded from foreign base company income by reinvesting such income in less developed countries which is permitted under section 13 as passed by the House of Representatives.

The mere fact that certain operating income is not immediately subject to taxation does not mean that corporations earning such income are not adversely affected by the new proposals.

Such operations now must be the subject of new and complicated recordkeeping and management must be aware of the imposition of U.S. accounting and legal concepts which until the present time have not been pertinent. Frequently, selling operations have been separated from the manufacturing operations of a related company. The limitations in the present bill place a restriction on the use of corporate complexes centered around manufacturing operations, in that such selling operations may now be considered as foreign base sales income. As indicated in our discussion of purchase and sale of personal property, many selling operations have been separated from the manufacturing operations for sound business reasons.

Apparently, proposed section 956 [3] of the May 10 draft, as set forth in the May 31 print, would implement the Secretary's comments concerning investment in the United States.

Attention is invited to the fact that the comparable section in H.R. 10650, as passed by the House of Representatives, provides as an exception from the concept U.S. property "obligations of the United States" (953(b)(2)(B)(i), p. 112, line 14). It is not apparent why this item cannot be retained as an exception to U.S. property.

Proposed section 956(c) set forth on page 15 of the May 31 draft is extremely ambiguous. For example, it might be interpreted to include situations where a U.S. person is a guarantor of the obligations of a controlled foreign corporation which obligation might be made in the usual course of business. If this meaning is intended, the National Foreign Trade Council urges that that section should be changed to indicate clearly that such is not covered. A mere pledge or guarantee of itself does not create income. Further pledges and guarantees are a normal method of doing business in connection with commercial transactions, including exports from the United States, and their existence in any

[3] P. 14, May 31 committee print.

particular transaction certainly is no indication that such transaction is necessarily a "tax haven" operation. The National Foreign Trade Council believes the provision is too broad and would hurt legitimate business.

Dividends, interest, rents, and royalties

The third "major change" in the explanation of the amendments proposed by the Secretary of the Treasury, as set forth in the May 31 committee print, refers to dividends, interest, rents, and royalties. This proposal seems to be implemented in part by section 954(a)(1)[4] and section 954(c).[5] These sections as set forth in the committee print provide in effect for the immediate taxation to U.S. shareholders of income of controlled foreign corporations which is designated as foreign personal holding company income. Certain changes proposed by the Secretary on May 10 are reflected in the proposed draft.

The explanation of the Treasury amendment of foreign personal holding company income seems to be that this type of income is taxed to the U.S. shareholders because it is "tax haven type of income" (even though by definition it it is not passive income). The complete explanation is set forth on pages 1 and 2 of the May 31 committee print as follows:

"*Foreign base company income.*—Foreign base company income includes several elements:

"(*a*) *Foreign personal holding company income.*—This category covers mainly dividends, interest, rents, and royalties when they constitute "passive" income or "tax haven" type income. Passive dividends, interest, rents, and royalties are those received from unrelated persons not in connection with the active conduct of a trade or business. Tax-haven dividends, interest, rents, and royalties are those received from related persons in connection with income-producing activities located outside the country of incorporation of recipients.

"Foreign base company income does not include dividends and interest received from less developed country corporations which are reinvested in less developed country corporation. Deferral with respect to this income derived from less developed countries is, however, ended when investment of the earnings in less developed countries is finally terminated."

Since the concept "income producing activities" includes income "in connection with the active conduct of a trade or business" it seems clear that the two factors distinguishing tax-haven income from passive income are that it must be received from a related as distinguished from an unrelated person and the activities must be located outside the country of incorporation of the recipients.

One effect of the provisions referred to above seems to be that dividends and interest which are derived in connection with the active conduct of a trade or business in a developed country other than the country of incorporation of the receiving corporation are taxed solely because they come from a related person.

The report of the Ways and Means Committee accompanying H.R. 10650 (H. Rept. No. 1447) in discussing the inclusion in section 13 of foreign personal holding company type income indicated that it was doing so because it considered such income portfolio type of income or investment income. The committee said: "Your committee while recognizing the need to maintain active American business operations abroad on an equal competitive footing with other operating businesses in the same foreign countries, nevertheless sees no need to maintain deferral of U.S. tax where the investments are portfolio types of investments or where the company is merely passively receiving investment income. In such cases there is no competitive problem justifying postponement of the tax until the income is repatriated."

The National Foreign Trade Council approves of those proposals of May 10 which exclude from tax: (*a*) Those dividends, etc., received in the active conduct of a trade or business, and (*b*) those dividends received from a related corporation incorporated in the same country as the controlled foreign corporation. However, it is urged that taxing dividends merely because they are received from a related person is improper.

The classification of dividends and interest, etc., received from the active conduct of a trade or business in a developed country as "tax haven" income could seriously affect U.S. companies which have foreign subsidiaries which in turn have subsidiaries. In many cases, subsidiaries of foreign subsidiaries have been in existence many years and were established for sound and valid business reasons not connected with U.S. tax laws. Frequently there is substantial

---

[4] Pp. 8 and 9, May 31 committee print.
[5] P. 10, May 31 committee print.

ownership participation by local nationals in the various levels of foreign subsidiaries and the form of organization has reflected the decision of the foreign owners. Frequently, products manufactured abroad by U.S. subsidiaries are marketed by foreign incorporated subsidiaries of the manufacturing company.

In a number of cases foreign subsidiaries may have been established in order to comply with local law. The laws of some countries provide that only locally incorporated companies with local citizens on the board of the local company may engage in certain activities, or in certain geographic areas, e.g., companies operating ships, companies engaged in activities within a certain number of miles from the border.

This provision would result in unjustly penalizing and, in many cases, rendering noncompetitive legitimate foreign operating subsidiaries which, for sound business reasons, and in accordance with local laws and customs, have in turn established operating subsidiaries in either the same or other foreign countries. Dividend receipts by the parent foreign subsidiary could be greater than 20 percent of its gross income with the result that the U.S. parent would then be taxed on income which it had not received.

The foreign personal holding company provisions now existing under the Internal Revenue Code constitute a narrow exception to the principle that the corporation and its shareholders are, for tax purposes, separate and distinct. However, it is clear that such provisions were enacted with a specific background of glaring tax avoidance and were expressly designed to preclude the frequent use of incorporate pocketbooks. Even in such cases, the constitutionality of these provisions has never been considered by the Supreme Court.

Under the existing personal holding company provisions, the corporate entity is ignored only if 60 percent of income is passive income. Under section 13 this test would be reduced to an unrealistic 20 percent. It is submitted that it is unjustifiable to ignore the corporate entity when such a low percentage of income is involved.

The attribution of undistributed income to one entity upon being being earned by a bona fide operating foreign corporation, having no semblance of tax avoidance or evasion, could be considered as a prelude to application of the same concept to the domestic area.

It appears that section 13 as amended could result in taxing shipping income if it were received by a controlled foreign subsidiary from affiliates of a foreign subsidiary whose activities are an integral part of the company's business and constitute the active conduct of a trade or business. This totally ignores the fact that subsidiaries of American industrial or commercial companies have been incorporated in, and their vessels registered under the flags of, foreign countries for important legal and commercial reasons.

Our Government has officially encouraged the buildup of the "effective control" fleet of ships registered under the laws of countries which permit agreements by the owners pledging their vessels to the United States in the event of war or national emergency, the defense posture of our country would be weakened. It would be unfortunate if this encouragement were now to be negatived by H.R. 10650.

Exception for foreign corporations not availed of to reduce taxes

The fourth major change mentioned in the accompanying explanation of the Secretary's proposals as set forth in the May 31 committee print, seems to be implemented by proposed section 954(b)(4).[6] The provision set forth in section 954(b)(4) is a provision of uncertain application. The proper standard for exception should be whether or not the foreign-controlled corporation was created or organized for reasons other than the avoidance of U.S. tax.

The language of the present proposal refers to "substantial reduction of * * * taxes." It is obvious that the term "substantial reduction" is one which would give the Secretary broad administrative discretion. In addition, the provisions would place a severe burden of proof on the taxpayer without setting forth proper statutory standards.

In certain countries there is a higher reliance on indirect taxes as compared with direct taxes. Comparison of only the type of taxes enumerated in section 954(b)(4) accordingly might be unrealistic.

This provision might be interpreted as legislative approval of the concept that all income from foreign sources should be subject to taxes at least equivalent to the U.S. tax on such income.

[6] P. 9, May 31 committee print.

U.S. shareholder defined

The fifth major change in the accompanying explanation of amendments proposed by the Secretary in the May 31 print refers to a change in the determination of when a corporation is to be considered controlled. This change seems to be implemented by proposed section 951(b),[7] which indicates that only shareholders having a 10 percent interest or more are taxed and included in determining whether a corporation is classified as a controlled corporation.

Although this is a desirable limitation it is clear that when this section is combined with the attribution rules set forth in section 13 and incorporated by reference into section 13, that there will be many situations where, as a practical matter, taxpayers with only 10 percent interest will have no actual control and where conceivably such taxpayers may not be aware of the fact that their holdings together with that of other taxpayers constitute more than 50 percent ownership of the foreign corporation by American shareholders.

Losses

The sixth major change referred to in the explanations accompanying the proposed draft by the Secretary as set forth in the committee print of May 31, 1962, refers to losses. Apparently this recommendation is implemented in part by section 952 (c) and (d).[8]

The proposed statutory language, particularly when considered in connection with the explanation, might indicate that the following situation would not be covered: (*a*) assume a U.S. parent owns directly two foreign subsidiaries, both of which would be "controlled foreign corporations within the meaning of section 13"; (*b*) subsidiary A earns a profit in a particular year; (*c*) subsidiary B suffers a loss. It is not clear that the loss of subsidiary B may be used to offset the profit of subsidiary A. Such offsets should be allowed.

The present draft does not provide for a carryback of losses. The Treasury draft released January 31, 1962, provided that losses could be carried back 3 years. A companion provision was to the effect that U.S. shareholders previously taxed would be granted a refund.

Blocked foreign income

The seventh major change in the accompanying explanation of amendments proposed by the Secretary of the Treasury refers to blocked income. Apparently, this change would be implemented by section 962(b) [9] which provides in part that, "under regulations prescribed by the Secretary * * * no part of the earnings and profits of a controlled foreign corporation for any taxable year shall be included in earnings and profits for purposes of sections 952, 955, and 956, if it is established to the satisfaction of the Secretary * * * that such part could not have been distributed by the controlled foreign corporation to United States shareholders * * * because of currency or other restrictions or limitations imposed under the laws of any foreign country".

As pointed out in the prepared statement, submitted by the National Foreign Trade Council, April 25, to the Committee on Finance, concepts of income vary from country to country. For example, there is considerable variance in foreign laws concerning the establishment of legal reserves. In addition, there are many cases where practical restrictions limit the distribution of profits, due to (*a*) company policy, (*b*) industry policy, or (*c*) national policy. All of these situations should be covered by section 962(b).

In many cases, it is almost impossible to prove that blocking is in accordance with the laws of the foreign country; the blocking often results from unwritten decisions of a central bank or other administrative agency of the foreign country.

Earnings and profits

The eighth "major change" to which reference is made in the accompanying explanations of the amendments proposed by the Secretary of the Treasury in the committee print of May 31, concerns "earnings and profits." Apparently this change is implemented by proposed section 962(a)[10] which provides that * * * "earnings and profits of any foreign corporation * * * shall be determined according to rules substantially similar to those applicable to domestic corporations, under regulations prescribed by the Secretary * * *."

---

[7] P. 6, May 31 committee print.
[8] P. 7, May 31 committee print.
[9] P. 21, May 31 committee print.
[10] P. 21, May 31 committee print.

As pointed out in our memoranda of April 25, 1962, to the Committee on Finance (vol. 6, hearings, pp. 2659, 2725) earnings and profits is a concept probably unknown to foreign accounting practice. This concept is one which has not been set forth in statutory language and has been difficult to determine for purposes of U.S. taxation of domestic source income.

The explanation in the May 31 committee print refers to the fact that provision will be made for the establishment of "guidelines." "* * * Provision will be made so that elections similar to those which are available to domestic corporations will be available." The proposed statutory language does not indicate what these elections would be. In general, the proposed provision would delegate broad authority to the Secretary without statutory standards.

"Certain dividends and interest from less developed country corporations excluded"

Major recommendation 9 of the accompanying explanation of amendments proposed by the Secretary of the Treasury, as set forth in the May 31 committee print, refers in part to the fact that "certain dividends and interest from less developed country corporations [are excluded]." This proposed change apparently is accomplished in part by proposed section 954(b)(1)[11] and (f)[12] and section 955.[13] These sections contain related provisions concerned with the exclusion from foreign base company income of certain dividends and interest received from qualified investments in less developed country corporations and invested in such qualified less developed country corporations.

In general, no income from developed countries within the scope of section 13 is eligible for reinvestment in foreign countries, even though the income may arise from the conduct of an active trade or business. Consider, for example, the following types of income:

(1) Income from the sale of goods if it comes within the definition of foreign base company sales income.

(2) Income from the furnishing of services if it comes within the definition of foreign base company services income.

(3) Foreign personal holding company income which is derived from the active conduct of a trade or business which is taxable to the shareholder because it is received from a related person located in a country outside the country of the receiver.

All of the above types of income are from the active conduct of a trade or business. All of the above types would be eligible for reinvestment under H.R. 10650 as passed by the House of Representatives (sec. 952(f), pp. 115 and 116, and 953(b)(2)(B), pp. 118 and 119).

In addition, certain income from less developed countries is not eligible for reinvestment even though derived entirely from less developed countries, i.e., all income from less developed countries which is not dividends or interests from "less developed country corporations", e.g., rents, royalties, and other types of income even though the payor company meets all of the qualifications of section 955(c). Apparently because of the interplay of section 954(b)(1) and section 955(b)(1) even dividends and interest from a less developed country corporation within the meaning of section 955(c) is not excludable income if received from investments made before December 31, 1962.

Further, because of the definition of section 955(b) investments must be made in stocks and obligations and cannot be made in other property. For example, assume that a controlled foreign corporation (P) which is located in either a developed or less developed country received a dividend from a subsidiary (S) which qualifies as a less developed country corporation. Assume that P wishes to purchase a warehouse in a less developed country for the conduct of its trade and business. Apparently P could not make the investment directly. Apparently it would have to make the investment by purchasing the stock or obligations of a less developed country corporation. It is our understanding that the investment could be made directly in the warehouse under the provisions of the bill as passed by the House of Representatives. In addition to investments in stocks and obligations, investment should be allowed to be made in other types of property. All foreign base company income without restriction as to the type or source of income should be excluded from immediate taxation to the U.S. stockholders at least to the extent such income is invested in less developed countries by the controlled foreign corporation.

---

[11] P. 9, May 31 committee print.
[12] P. 11, May 31 committee print.
[13] Pp. 12 to 14, May 31 committee print.

In particular, all types of income from underdeveloped countries should be eligible for reinvestment, particularly income arising from the active conduct of a trade or business and dividends and interests from pre-1962 investments.

Under section 955(b)(1)(B)[14] qualified investments in less developed countries include obligations of less developed country corporations having a term of 5 years or more. There seems to be no reason for the 5-year requirement because, if an investment in such an obligation is repaid sooner, the amount repaid will be taxed under section 951(a)(1)(A)(ii)[15] unless reinvested in qualified investments in less developed countries. There are many reasons, such as exchange control requirements, which make it undesirable to make loans for a fixed period in less developed countries.

It is the basic position of the National Foreign Trade Council that the same treatment should be given to operations in developed countries. Section 13 would tend to impose tax burdens on subsidiaries incorporated in developed countries and carrying on activities in both developed and underdeveloped countries. In a number of instances, businesses do operate across a number of geographical boundaries. To draw distinctions between developed and underdeveloped countries, leads to undesirable restraints on the companies which, in the long run, may hamper what otherwise would be normal business developments.

Records and accounts of U.S. shareholders

"Major change" No. 10 set forth in the accompanying explanation of amendments proposed by the Secretary in the committee print of May 31, refers in part to "minor technical improvements." It is not clear what sections implement these changes. However, section 962(c)[16] provides in part that "the Secretary * * * may by regulations require each person who is, or has been, a U.S. shareholder of a controlled foreign corporation to maintain such records and accounts as may be prescribed * * *."

This delegates extremely broad authority to the Secretary and may impose upon minority shareholders or ex-shareholders a responsibiilty for maintaining records and accounts which they may not be able to maintain. This provision is not generally required for shareholders and is discriminatory from this point of view.

Corporations organized in U.S. possessions

The 11th "major change" in the accompanying explanation of amendments proposed by the Secretary of the Treasury in the committee print of May 31 refers in part to corporations in the Commonwealth of Puerto Rico and the Virgin Islands. This change apparently is implemented by proposed section 957(c)[17] which indicates that the term "controlled foreign corporation" does not include any corporations created or organized in the Commonwealth of Puerto Rico or a possession of the United States if it meets certain requirements.

Certain types of activities are omitted from the term "trade or businesses" enumerated in section 957(c)(2), e.g., purchase and sale of real property, erection of housing, income from cultivation of soil, the raising of any agricultural or horticultural crops, transportation, and selling or the sale of goods. It is difficult to determine the rationale for limiting the exemption to the enumerated types of income and omitting certain types which form a desirable and useful part of the economy of Puerto Rico and the Virgin Islands.

Foreign base company service income

The 12th "major change" in the accompnaying explanation of amendments proposed by the Secretary of the Treasury contained in the May 31, 1962, committee print refers, in part, to certain service income. This change apparently is implemented by the provisions of section 954(a)(3)[18] and section 954(e)[19] of the May 31 committee print. This section would tax as foreign base income certain income "derived in connection with the performance of furnishing of technical, managerial, engineering, architectual, scientific, skilled, industrial, commercial, or like services." This income would be taxed to the U.S. shareholder even though it was not distributed to the shareholder in the form of a dividend.

[14] P. 13, May 31 committee print.
[15] P. 5, May 31 committee print.
[16] P. 21, May 31 committee print.
[17] P. 16, May 31 committee print.
[18] P. 9, May 31 committee print.
[19] P. 11, May 31 committee print.

Initially, it may be observed that some of the terms in the proposed section are extremely broad, e.g., *skilled, industrial, commercial,* or *like* services performed in connection with *business activities.* [Italic added.] For example, is the term "business activities" to be equated to the "active conduct of a trade or business," or is to be given the connotation frequently given to "business" as contained in section 62(1) I.R.C., i.e., "attributable to a * * * business"?

There are at least two general types of services from a business or economic viewpoint, e.g., (A) a type of service subservient to the main activity of a corporation, for example, the servicing of goods exported from the United States or produced and marketed abroad or (B) the furnishing of services "per se," such as those furnished by companies engaged in engineering or management activities. Apparently, there is no distinction between the two types of services for the purpose of proposed section 954(e).

Many sound business reasons not connected with U.S. taxation may require the establishment of a foreign corporation in a centrally located foreign country and staffed by experts to service a particular geographic area which includes a number of foreign countries. Among the factors that may be present are communications, transportation facilities, general living conditions, local residence requirements, and most importantly the availability of well-trained local research people. Oftentimes one centrally located subsidiary will adequately and more economically furnish services to a large area. This normal and more efficient method of furnishing services of this type could be curtailed by the provisions in the Treasury draft.

It seems quite apparent that U.S. companies which have to service goods exported from the United States to various European countries might select a country for reasons not connected with U.S. taxation. Therefore, any criterion based on the place of incorporation is improper.

Purchase and sale of property—Foreign base company sales income

The "major changes" in the accompanying explanation of the amendments proposed by the Secretary of the Treasury as set forth in the May 31 committee print does not refer to sales. However, section 954(a)(2)[20] and section 954(d)[21] provide in effect that foreign base company sales income is income derived in connection with the purchase and sale of personal property where the property is purchased outside the country under the laws of which the controlled foreign corporation is created and organized, and is sold for use, consumption or disposition outside of such foreign country. This type of income is immediately taxable to the U.S. shareholder even though not distributed to him in the form of a dividend.

The explanation on page 2 of the May 31 committee print indicates that the provision is substantially the same as is contained in section 13 of H.R. 10650 as passed by the House of Representatives. However, the explanation notes that there are provisions referring to situations in which a controlled foreign corporation acts as an agent and in which a branch or similar establishment acts in the same manner as a controlled foreign corporation.

In addition to the changes mentioned in the explanation, the new provision does not seem to include the exception contained in section 13 as passed by the House of Representatives to the effect that foreign base company sales income is includible if "such income is equal to at least 20 percent of the gross income (not including for this purpose other foreign base company income under this subsection)" (H.R. 10650, p. 112, lines 16 to 19 inclusive). Further, the May 10 proposals do not provide for the exclusion of such income if it is invested in qualified property in less developed countries. A provision to this effect was included in section 13 as passed by the House of Representatives. This last change is discussed above under the hearing "Certain Dividends and Interest From Less Developed Country Corporations Excluded."

Many varied business reasons may exist for decisions to carry out marketing operations for several countries through a single foreign subsidiary which subsidiary in turn may or may not have branches or subsidiaries. The advantages of efficiency in management, accounting, and finance frequently indicate such a procedure.

Marketing in a general geographic area, such as the Central American or the European Common Market areas, might be best handled by one foreign sub-

[20] P. 9, May 31 committee print.
[21] P. 10, May 31 committee print.

sidiary. Marketing operations designed to take advantage of certain tariff considerations has been another reason for the establishment of foreign subsidiaries. Classical examples of this consideration were reflected in the formation in Canada and the United Kingdom of subsidiaries of American companies because of the imperial preference plan (now generally referred to as Commonwealth preference). These two factors, namely, the close proximity of several countries, and the reduction of tariff barriers have been combined in a number of instances, e.g., the European Common Market. Undoubtedly, a number of marketing operations established or set up in Europe during recent years have reflected the actual and anticipated results flowing from the development of the Common Market.

In a number of cases foreign corporations purchase goods in one foreign country and sell them in another. No economic contact with tne United States arises in situations such as this. To impose U.S. tax on income arising from such activities hardly can be regarded as preventing "diversion of U.S. income."

Proposed section 954(d)(1)(B)[22] refers in part to "* * * property * * * sold for use, consumption or disposition outside such foreign country." This provision is one of the tests for determining whether or not certain income from sales is to be treated as "foreign base company income." Frequently at the time of sale it is not possible to determine whether or not property may be used, etc., outside a particular foreign country, and yet it would seem that the enactment into law of this provision would introduce an additional test which would have to be considered in connection with the sale of goods abroad. It should be stressed that here again the taxpayer, even if certain sales income is excluded because of this provision, must keep records and otherwise take additional time-consuming and expensive steps to be certain he is complying with the particular exemption.

Proposed changes

The provision referring to "situations * * * in which a branch or similar establishment acts in the same manner as a controlled foreign corporation" is extremely unclear and suffers from the same defects indicated above; namely, that such branches "and similar establishments" may have been established for sound business reasons not connected with U.S. tax considerations.

Apparently, the statement in the explanation concerning the change in situations which would tax as foreign base company sales income, income arising where the foreign corporation acts as an agent refers to the provisions in the draft language "sold on behalf of a related person" or the "purchase * * * on behalf of a related person." The provision does not distinguish between situations which are established for sound business reasons and those which are established solely for tax considerations. Here as well as in the branch situation many such operations have been established for sound business reasons not connected with U.S. tax considerations.

General comments concerning section 13, as amended

The specific changes incorporated in the draft section 13 are commented upon above under specific headings. However, attention is invited to the comments of the National Foreign Trade Council concerning the overall section to which views we again subscribe (hearings before the Committee on Finance, U.S. Senate, on H.R. 10650, Apr. 24 and 25, 1962, pt. 6, pp. 2659 to 2767, inclusive).

The National Foreign Trade Council believes that section 13, as amended, in accordance with the suggestions of the Secretary made May 10 and set forth in draft statutory language in the committee print of May 31 should be rejected. It should not be enacted into law because it constitutes a drastic and undesirable departure from tax principles which have been consistently followed in U.S. income tax law, and also because a number of adverse business effects to legitimate foreign operations would result from the section which would far outweight any advantages in curtailing the "tax haven" problem.

Legal reasons for rejecting proposal

Some of the tax concepts reflected in Federal income tax law from which there would be a departure if section 13 were enacted into law are the following:

(1) The corporation is an entity separate from its shareholders, and the shareholder has not been taxable on the undistributed income of the corporation.

---

[22] Pp. 10, 11, May 31 committee print.

(2) Taxpayers are only subject to tax on realized income.

(3) The treatment of a foreign corporation as an entity distinct from its shareholders is recognized as a fundamental principle in 21 tax treaties, affecting some 44 foreign jurisdictions, to which the United States is a party.

(4) Even in the absence of tax treaties the United States has recognized foreign corporations as separate entities and has never claimed tax jurisdiction over them simply because they were owned in whole or in part by U.S. shareholders.

(5) The practical effect of this proposal is essentially the same as an attempt to tax the foreign corporation directly. This proposed policy of taxing by indirection is questionable from the standpoint not only of domestic policy, but also of international comity.

(6) The constitutionality of taxing American shareholders of foreign corporations on their shares of the income of those corporations before the income is distributed, has been seriously questioned.

(7) U.S. shareholders are not taxable on the undistributed income of U.S. corporations from domestic sources; similarly, U.S. shareholders should not be taxable on the income of foreign corporations from sources outside the United States before it is distributed.

In addition, no other economically advanced country ignores the corporate entity.

Adverse effects of section 13 on U.S. foreign trade and business

The proposal to tax to the U.S. shareholder certain undistributed profits of "controlled foreign corporations" will have unfavorable effects on U.S. foreign trade and business as a whole. Although it is our understanding that the Treasury officials intended to penalize "tax haven" operations, apparently there has not been adequate consideration of the adverse effects of the proposals on the overall economy and on legitimate foreign business. These adverse consequences would be substantial both to the affected shareholder and also to the economy as a whole.

The U.S. shareholder of many foreign controlled corporations would be adversely affected in cases where such profits are earned in foreign countries whose income taxes are lower than comparable U.S. income taxes on such profits, especially in underdeveloped areas. In many foreign countries the concept of income varies from that in the United States, e.g., requirements for legal reserves, depreciation and revalued assets, etc., and, also many foreign countries rely more heavily for revenues on taxes other than income taxes.

In addition to suffering a tax disadvantage, all U.S. foreign subsidiaries would have to take into consideration novel and artificial factors in determining their course of action. For example, any foreign subsidiary which bought goods from outside the country in which it was incorporated, processed them, and then sold such goods outside the country, would have to be mindful that the purchased goods have to be "substantially transformed" in order that the sale of the goods outside the country would not be regarded as giving rise to "foreign base company income." There would be uncertainty as to what constitutes processing or manufacturing. In implementing this and other novel concepts, time-consuming and expensive analysis and recordkeeping would have to be instituted and maintained.

The indirect effects of section 13 of the bill on shareholders might be several. It is likely that foreign nationals would hesitate to participate with U.S. nationals in the ownership of foreign operations because the income from such operations might be regarded as "subpart F income" for purposes of U.S. law and thereby adversely affect the reinvestment policy of the enterprise. In addition, U.S. shareholders who might have reached the conclusion that the most efficient method of operation in several countries was through a single foreign subsidiary might decide because of the provision of this section that they must operate in the more inefficient method through a number of corporations.

The provisions of this section are so broad that they would characterize as "tax haven transactions" many operations which were established for sound business reasons not related to U.S. tax considerations. Frequently the operations which would be adversely affected have been carried on for many years in the normal course of business. In many cases they existed prior to the time the present U.S. parent acquired its interest in the foreign company.

Decisions as to whether or not an operation should be undertaken, and the form in which it should be undertaken are made in response to a broad and complex range of considerations covering every related aspect of a firm's opera-

tions. H.R. 10650 would tax many operations which have been established for sound business reasons not related to U.S. tax considerations.

Recommendations of NFTC concerning "tax havens"

The basic position of the National Foreign Trade Council concerning possible legislation with reference to "tax havens" may be summarized as follows:

1. Present statutory provisions, if properly enforced, should prevent "tax haven" abuses.
2. If new legislation is deemed to be essential, it should not penalize legitimate foreign business.
3. If legislation is adopted, it should not provide for the taxing to U.S. shareholders of profits of foreign corporations which have not been distributed to the shareholders.
4. Complex and extensive legislation should not be enacted to correct a problem that to a considerable degree at least has been attributed to administrative difficulties.

SECTION 16. GAIN FROM CERTAIN SALES OR EXCHANGES OF STOCK IN CERTAIN FOREIGN CORPORATIONS

The National Foreign Trade Council urges that the proposed section 16, as amended, not be enacted into law. Our basic reasons for objecting to this section are set forth in our memorandum presented to the Committee on Finance on April 25 (see p. 6 hearings, pp. 2659, 2730, and 2731).

SECTION 20. INFORMATION WITH RESPECT TO CERTAIN FOREIGN ENTITIES

Part 4 of the May 10 recommendations set forth in the May 31 committee print,[23] includes certain changes in connection with information with respect to certain foreign entities.

Under section 6046 of the present law, U.S. citizens or residents who are officers or directors of a foreign corporation within 60 days after its creation, organization or reorganization, and U.S. persons who, within the same 60-day period, own 5 percent or more of the stock of the foreign corporation, must supply information. It is possible to avoid giving this information where these U.S. relationships to the foreign corporation are deferred until after the 60-day period expires.

It is believed that the requirement that a return be filed within the 90-day period is unnecessary, and that a single annual return should be adequate. A single annual return has been found adequate with respect to the gift tax, even where there are numerous gifts at various times during the year, and there seems to be no reason why it should not be adequate in the case of the information required by section 6046. It is therefore proposed that a single annual return be permitted.

Under present law, and under the bill, a return must be filed by each U.S. shareholder, officer, or director. It is believed that there is no need for a requirement for separate returns by each of them, with the same information being given in each return. The Internal Revenue Service has provided in its instructions on the return form used under the present law (no regulations having been issued) that a single return will be adequate, provided it is signed by all persons required to make the return. It is believed that no real purpose is served by requiring the signature of all persons on one or more returns, and that it should be possible for a single return to satisfy the legitimate needs of the Treasury. It is therefore proposed that the bill be amended so as to provide that, if a return is filed by any one of the persons obligated to file the returns. the others need not file.

It would seem as though the provisions of section 20, even as amended, might act as a barrier to the appointment of U.S. citizens or residents as officers or directors of foreign corporations, and in which U.S. citizens do not own substantially all the stock.

---

[23] P. 33, May 31 committee print.

82190—62—pt. 11——7

SEPARATE LIMITATION ON FOREIGN TAX CREDIT WITH RESPECT TO INVESTMENT INCOME

Although the changes proposed by the Secretary on May 10 do not contain any reference to the "investment income" proposal made by him at his April 2 appearance,[24] the Secretary did discuss this subject in his oral testimony[25] on May 10 in response to questions.

The National Foreign Trade Council reiterates its comments on the investment income proposal as set forth in our statement of April 25 to the Committee on Finance.[26] In particular we wish to stress that in our opinion the proposed amendment is not appropriate since it extends to all interest-type income, whether from a temporary or long-term investment and whether or not induced by tax-saving motives.

Further, we call attention to the statements made by the Secretary on May 10 concerning the intent of the Treasury in application of this provision. These are set forth on page 4260 of the hearings. If this section is enacted into law, as a minimum, appropriate statutory language should be included which would clearly implement the intent of the Treasury as outlined by the Secretary in his oral testimony of May 10.

APPENDIX A. MAJOR CHANGES FROM SECTION 13 OF H.R. 10650

Excerpt from part 1A, Committee on Finance, committee print of May 31, 1962, explanation of amendments recommended by Treasury Department of section 13 of H.R. 10650

There are listed below the major changes which the draft makes in section 13 of H.R. 10650.

1. *Elimination of provision for taxing income from U.S. patents, etc., to U.S. shareholders on current basis and substitution of provision for taxing the sale of U.S. patents, etc., to controlled foreign corporations.*—This change obviates the need under the House bill to determine the amount of income generated by the use of U.S. patents, etc. It eliminates abuse by insuring that patents will be transferred abroad in arm's-length transactions producing a full U.S. tax at the time of transfer or on an annual basis.

2. *Elimination of provision restricting the use of earnings by operating companies, except that such earnings cannot be invested in certain U.S. property.*—Operating companies will, under the draft, not be faced with the difficulty of determining whether or not earnings are invested in the same trade or business that gave rise to them. Also, other problems such as determining when a trade or business would be considered to have been conducted by substantially the same interests, will be eliminated.

3. *Dividends, interest, rents, and royalties derived in connection with active business operations with unrelated persons are removed from coverage as foreign base company income.*—This change would remove the objection that section 13 treats certain types of operating income as "passive" income in non-tax-haven situations. Thus, companies engaged in the active business with unrelated persons of banking, financing, shipping, insurance, and leasing of property, would not be covered by the foreign base company income provisions.

4. *Addition of a provision to eliminate coverage under foreign base company provisions where the controlled foreign corporation is not used to effect a substantial reduction in taxes.*—This provision permits flexibility to deal with situations where a controlled foreign corporation technically covered by the provisions of the bill does not differ from a non-tax-haven operation for which deferral of taxation is permitted. It insures a fair application of the foreign base company income provisions.

5. *Changes in the determination of when a foreign corporation is considered to be "controlled" so that (a) only 10-percent U.S. shareholders are counted in determining control and (b) there will be attribution of ownership of stock owned by a corporation to shareholders of that corporation only where such shareholders own a 10-percent interest.*—These changes remove objections that the coverage of foreign corporations was too broad, reaching situations where ownership was widely scattered and no U.S. group was in effective control.

[24] Pt. 1, Senate Finance hearings, "Revenue Act of 1962," p. 243 et seq.
[25] Pt. 10, hearings, Senate Finance Committee, pp. 4259 and 4260.
[26] Vol. 6, hearings, pp. 2659, 2763, and 2764.

6. *Greater recognition of losses under which (a) losses of one year may offset profits of future years and (b) losses of one controlled foreign corporation in a chain of controlled foreign corporations may in the current year offset gains of the other corporations.*—These provisions provide for an equitable application of the taxing mechanism in situations where losses are involved.

7. *Provision so that tax will not be payable in situations in which the presence of blocked income means that earnings of a controlled foreign corporation could not be distributed to U.S. shareholders.*—This change meets the objection that shareholders might be taxed on constructive distributions in situations in which there could not be actual distributions.

8. *Provision for the establishment of guidelines, under regulations, for the computation of earnings and profits in accordance with the rules which have been developed for domestic corporations.*—Among other matters, provision will be made so that elections similar to those which are available to domestic corporations will be available. These guidelines will facilitate compliance with the legislation from the standpoint of taxpayers and will meet certain criticism that great difficulty will be involved in determining tax liability under subpart F.

9. *Elimination of provision permitting a pour-over of profits from developed areas to less developed areas.*—This change, in large part, follows from the elimination of certain restrictions with respect to the earnings of operating companies and permits considerable simplification in the application of this part of the draft. The only reinvestment which qualifies to reduce foreign base company income involves dividends and interest derived from less developed country corporations. Less developed country corporations are, in general, corporations carrying on an active trade or business within a less developed country or countries and whose assets are located in such countries. The terms on which such reinvestment may take place have been liberalized so that minority stock (10 percent) and certain debt interests may qualify and, also, the time in which the investment may be made has been extended from 75 days after the close of the taxable year to 1 year or such longer period as may be designated by the Secretary or his delegate. Also, investments made at a time when a country is classified as a "less developed" country shall be treated as a qualified investment even if that country ceases to be a less developed country.

10. *Clarification of terms and minor technical improvements.*—In general, the provisions of the draft meet various technical points which were raised with respect to the meaning of terms and the mechanical features of section 13.

11. *Elimination of coverage of corporations in the Commonwealth of Puerto Rico and the Virgin Islands.*—The draft leaves these corporations subject to the rules of existing law with, however, provision to insure that such corporations will not be availed of for tax haven activities.

12. *Rounding out of coverage with respect to tax haven activities.*—Provision has been made to treat certain service income derived from related parties as foreign base company and to prevent avoidance of the foreign base company sales income provisions in certain situations which are like those which are covered by the House bill. These changes are in accordance with the purpose of the bill to effectively eliminate deferral of taxation for tax haven activities.

The CHAIRMAN. The next witness is Mr. Ira T. Wender, of Baker, McKenzie & Hightower.

Take a seat, sir, and proceed.

STATEMENT OF IRA T. WENDER, MEMBER, BAKER, McKENZIE & HIGHTOWER

Mr. WENDER. My name is Ira T. Wender. I am a member of the law firm of Baker, McKenzie & Hightower.

The redraft of section 13 presented to this committee by the Treasury Department suffers from the same confusions of policy and technical inequities and imperfections as the measure which passed the House.

The policies which have motivated the provisions are: First, the prevention of the abuses of so-called tax havens or base companies; second, tax neutrality; and, third, the need for a cessation of our outflow of gold.

What are the abuses of these tax haven companies? There is, I believe, general agreement that the abuses consist in diverting income which should normally bear U.S. tax to a foreign corporation which pays little or no tax on the income. The typical examples are subsidiary foreign corporations which earn large sums from the sale of their U.S. parent corporation's products abroad either without in fact engaging in substantial sales activities abroad, or without paying the parent a fair price for the goods and from licensing to outsiders patents, know-how, and similar intangible property of the parent corporation without paying a fair license fee to the parent or by returning the profits to the parent on a capital gains basis.

These problems of diversion of income out of U.S. tax jurisdiction, to the extent they would not be solved by effective administration of present law, are eliminated by section 6 of H.R. 10650 and by the proposed new IRC section 1249 of the redraft.

Under section 6, the Commissioner has power to treat substantially all income reported by a foreign subsidiary from exporting and licensing as earned by the parent U.S. corporation and, hence, subject to U.S. tax. Sales of intangible property to a controlled foreign subsidiary on a capital gains basis are eliminated under the proposed new section 1249 of the Code.

Section 13, as originally proposed and as redrafted, adds little or nothing to the solution of the problems of diversion of income.

What, then, is the function of section 13 of H.R. 10650?

For an answer, it is necessary to analyze its effects and the policies advocated by the Treasury on tax neutrality and gold outflow. If a foreign corporation controlled by U.S. shareholders receives—

(1) Interest from a foreign person;
(2) Royalties from a foreign person;
(3) Technical service fees from a releated foreign person; or
(4) Sales profits or commissions from a related foreign person;

the income so received will be deemed to be distributed to the U.S. shareholders of that foreign corporation.

It is vital to note that none of this income covered by section 13 is income which has been diverted from normal U.S. taxes.

Instead, it is income which may pay lower taxes in the country of incorporation of the foreign corporate recipient than in the country of the payor. To illustrate, the principal thrust of section 13 is to subject the U.S. tax income in the following type of situations: A Swiss corporation, controlled by U.S. persons, charges a Dutch corporation, controlled by it, interest on loans, a fee for management services actually rendered, and a sales commission on sales actually made by the Swiss company's personnel outside Holland.

If no charges were made, the Dutch tax on the income then retained by the Dutch corporation would be 47 percent. If the income is earned by the Swiss corporation an income tax of as low as 15 percent may be paid.

While the effect of this arrangement is to reduce taxes, it is a reduction of Dutch tax and is totally unrelated to the United States. No diversion of income normally subject to U.S. tax has occurred. Ironically it is the Dutch tax authorities whom one would expect to complain, not the U.S. Treasury.

The policy justification for such an unusual and, in fact, completely unique assertion of tax jurisdiction by the United States is neutrality and gold.

Neutrality is said to exist because U.S. taxpayers investing abroad would pay the same tax as taxpayers investing in the United States.

Neutrality has, however, many aspects. Individual shareholders in foreign enterprises may pay up to 91 percent tax on income not actually distributed to them as the section is written.

In a U.S. investment, a corporate vehicle limits tax to 52 percent for individuals until dividends are paid.

Is it neutral in a competitive world to forbid U.S. companies from legitimately reducing foreign taxes, when their English, German, French, Italian, Dutch, Japanese, and Canadian competitors may and do use devices, such as would bear U.S. tax under section 13, for the reduction of foreign taxes? Is it in the best interests of the United States to place its companies at a competitive disadvantage with their foreign competitors?

The second justification offered is that these devices reduce foreign tax rates and thereby induce investment abroad. The increase in foreign investment then is said to affect adversely our balance of payments. It is naive to assume the rapid expansion of private foreign investment is based upon the more favorable tax climate abroad.

The decision to invest abroad and particularly in the developed countries of Western Europe is based on the fact of large and growing markets. The main effect of the favorable tax arrangements has been to reduce the need for initial capital investment from the United States.

New investments in Europe because of lower effective taxes now can and do carry very heavy debt structures. If taxes are raised by this bill, the amount of debt will be reduced and the initial dollar investment will correspondingly increase. Thus, a further strain will be placed upon our balance of payments. The flow of investment to the developed countries will not in any event abate.

There are a number of technical objections to the redraft which I would request permission of this committee to submit for the record as an addendum to my statement.

Senator SMATHERS (presiding). Without objection.

(The document referred to had not been received on July 5, 1962, the date this hearing went to press. When received it will be made a part of the committee files.)

Mr. WENDER. In addition, two incongruous aspects of the redraft should be mentioned.

1. The foreign personal holding company provisions were enacted to prevent gross tax avoidance which bordered on evasion. Section 13 as redrafted concedes that the penalties imposed by it are more extreme than those of the foreign personal holding company provisions by providing in section 962(d) that amounts included in a shareholder's income under section 951(a) shall reduce the undistributed foreign personal holding company income to be included in shareholder's income and I might note it is substantially broader in its effect in this bill than in the foreign personal holding company provisions.

2. In more than a dozen places in the redraft, severe technical problems are left unresolved.

Instead, the Treasury asks Congress to cede legislative power to the Secretary or his delegate to resolve problems through regulation.

The problems to be resolved are, in fact, policy matters that the Treasury in its haste has not had an opportunity to analyze and upon which the Treasury is not even in a position to offer counsel to this committee.

In conclusion, I would urge the committee to defer action on the hastily conceived provisions of section 13 as redrafted until 1963 when a general revision of the income tax laws is to be presented to Congress.

Thank you.

Senator SMATHERS. Any questions?

No questions. Thank you, sir.

Our next witness is Mr. Paul D. Seghers, Institute on U.S. Taxation of Foreign Income.

STATEMENT OF PAUL D. SEGHERS, PRESIDENT, INSTITUTE ON U.S. TAXATION OF FOREIGN INCOME, INC.

Mr. SEGHERS. Mr. Chairman, my name is Paul D. Seghers and my appearance today is as president of the Institute on U.S. Taxation of Foreign Income.

A tax in the form of an income tax on what is not income of the taxpayer is unconstitutional.

We are still convinced that the radically new and untried theories embodied in the Treasury's latest, that is, fifth, set of proposals for collecting tax in advance from U.S. individuals and corporations on amounts which they did not earn; which do not belong to them; and they may never receive, cannot be imposed in the guise of an income tax without violating the Constitution of the United States.

In addition to being illegal, and hence leading to uncertainty, litigation, and at least delay in collection of the tax, this measure would establish a very dangerous precedent, by imposing a tax on an assumed increment in value of capital and taxing in advance what is not and may never be income of the taxpayer.

The Treasury continues to state that it wishes to—

> eliminate deferral of taxation of income of controlled foreign corporations.

However, it never has proposed such a tax—that is, a tax on the income earned by a foreign corporation outside the United States. Why? We leave the answer to the Treasury.

What it does propose is to tax U.S. citizens and corporations in advance on income not earned, received, or belonging to the taxpayer, which the provisions of its latest proposed section 13 assume will be received and become income of the taxpayer in some future year.

Is this the correction of a defect in the law in effect since 1913, or is it an unjust burden on U.S.-owned business activity abroad, discriminating in favor of foreign ownership?

Is the tax under section 13 to be levied for revenue purposes? That seems unlikely, as it would bring in relatively little additional tax revenue, although these provisions would result in collecting some tax not yet due on some amounts not yet earned, received, or owned

by the taxpayers. If the tax under section 13 is not levied for revenue purposes, should it be levied in the guise of an income tax?

A peculiar theory exemplified in the Treasury's latest proposals is that the Congress should enact provisions to protect the income tax revenues of other countries and to penalize U.S. owners of foreign corporations which operate in such a way as to reduce their foreign income tax burden.

This is sought by the Treasury even though it does not, and cannot, deny that such savings in foreign income tax result in increasing the amount of U.S. taxes thereafter collected by the U.S. Government on the same amount of income.

This peculiar theory looms so large in the Treasury's view that it proposes it as the test for granting overall exemption, which is to be allowed only where the Treasury is satisfied that there is no substantial reduction in foreign income taxes (sec. 954(a) (4)).

A further, and more serious, illustration of this peculiar Treasury theory is to be found in its latest recommendations regarding taxation of income earned by it from selling goods abroad.

This would be most damaging in the case of products manufactured in the United States by a U.S. parent company and sold abroad by foreign subsidiaries.

However, the Treasury's provisions in this regard would apply even to selling profits earned abroad from the sale of goods produced abroad by a related corporation, and to commissions and fees earned abroad in effecting purchases and sales for a related company.

We believe that income earned abroad by a foreign corporation in selling goods to foreign buyers should not be taxed until such income is received by a person subject to U.S. taxes. The Treasury now is willing to accept this principle, unless the sales are made in a country other than that in which the foreign corporation is incorporated. I read that slowly because it would seem to be a misprint, that the Treasury would penalize the shareholders of a foreign corporation selling goods abroad merely because it is incorporated in another foreign country. This it would do by taxing the U.S. shareholder in advance on such undistributed income of the foreign corporation. The Treasury has not given any explanation which seems adequate to us as to why this discrimination against the U.S. owners of a foreign corporation should depend on whether the corporation is incorporated in the country where it makes its sales (or the goods are to be used, consumed, or resold) or in some other foreign country.

We have found nothing in the record to indicate that a penalty based on such a distinction would be of benefit to the economy of the United States.

Senator SMATHERS. Whereabouts are you reading? I keep losing you. Are you reading your statement?

Mr. SEGHERS. Senator Smathers, I am skipping portions in order to stay within my 10-minute limit. I have changed very little in what I have read, but I am seeking to stay within the limit.

Senator SMATHERS. What is the last page you have read?

Mr. SEGHERS. I am right now reading from page 5, near the top.

Senator SMATHERS. Thank you.

Mr. SEGHERS. All that is there, I would like very much for every Senator to hear and not merely the few who are here, but I want to have the benefit of reading it as well as putting it in the record.

Another defect necessarily inherent in the Treasury's proposals for taxing what is not income to U.S. citizens who have not earned, do not own, and have not received the amounts to be taxed to them, is the extreme complexity of these provisions.

This complexity even extends to the point of proposing to tax U.S. taxpayers on mythical income of mythical nonexistent foreign corporations, theoretically owned by and theoretically paying income to the actual foreign corporations which actually earn the income. This is provided in the new proposed section 954(d)(2), the real meaning and effect of which provisions cannot be known until the Treasury issues regulations thereunder.

Since what is not income is to be taxed to U.S. corporations and individuals as if it were income, it is necessary to make provisions for allowing foreign tax credits with respect to such hypothetical income and to make adjustments to the cost of shares of stock of the foreign corporation on account of the nonreceipt of what is not income and subsequently to make adjustments of such costs if and when the owner eventually receives such income.

It likewise is necessary, of course, to make provisions not to tax again the same amount when actually received as income after having once been taxed in advance when only an expectation and not a fact.

The Treasury's memorandum accompanying its proposals, explaining major changes in its latest proposed section 13, states (in section 8) that guidelines will be established (in regulations to be issued) which—

> * * * will facilitate compliance with the legislation from the standpoint of taxpayers and will meet certain criticisms that great difficulty will be involved in determining tax liability under subpart F.

We do not believe that taxpayer compliance with the extremely complicated provisions of the Treasury's latest version of subpart F can be relieved by regulations. Where a great mass of detailed accounting analyses (derived from books kept in one or more foreign currencies and in accordance with foreign customs) must be assembled in order to determine the amounts of U.S. taxes payable on amounts not earned, received, or owned by the taxpayer, no regulations can lighten the burden of compliance with such requirement.

CAN THE TREASURY DRAFT A TAX RETURN FORM?

If the Senate Finance Committee desires tangible evidence of the complexity of the Treasury's latest set of recommendations, which will assuredly plague both taxpayers and the Treasury, the Treasury should be asked to submit at least a draft of a proposed tax return to be used by U.S. taxpayers to report income which has not been earned, has not been received, and might never be received, and to report the related foreign tax credit.

Such tax-return forms would have to set forth a tremendous volume of detail, not only regarding the nature and amount of income and expenses of a foreign corporation or corporations not subject to the jurisdiction of and not reporting directly to the United States, but

also details regarding its assets (under the Treasury's latest proposal some of these details would have to be given on a day-to-day basis for the entire year), facts regarding ownership of stock (likewise required to be determined on a day-to-day basis in some instances, and extremely complicated reconciliations between the amount of income and expenses of the foreign corporation and the portion of such income and expenses to be reflected in the U.S. taxpayer's tax return, all presented with a wealth of detail far beyond that presented in any normal financial statement or tax return.

If the Treasury cannot present even a tentative draft of such an income-tax return and foreign tax credit schedule, your committee will be in a position to draw its own conclusion as to the feasibility of its proposals in this regard.

LEGISLATION BY TREASURY DECISION

Another basic objection to the Treasury's latest version of section 13 is the extent to which it would leave to the discretion of Treasury officials the decision as to the immediate taxation, or exemption from immediate taxation, of amounts which are not income of the taxpayer.

To a very great extent the proposed section 13 does not lay down fixed rules under which a taxpayer could determine in advance its liability for tax, but depends upon subjective tests to be applied by Treasury officials in their largely unguided discretion.

In some instances the proposed section 13 does not even provide that rules shall be promulgated by the Treasury in the form of regulations, but leaves the decision up to individual action by the officials.

Even where the bill would require promulgation of regulations, it is to be remembered that the Treasury Department has not yet finished issuing regulations under the Internal Revenue Code as enacted in 1954, and that a large portion of the present regulations under that act were issued only during the past year.

One of the many instances in which the Treasury would, under its latest proposal, be given authority to legislate by regulation and, at least in this instance, change existing law is to be found in section 955(c)(1) and section 957(c), which would authorize the Secretary to issue regulations to determine the source of income; that is, the place where income is considered to be earned.

For a great many years the income tax law has included statutory provisions for this purpose; the regulations on this subject are very comprehensive; and there are numerous decisions interpreting these provisions of law and regulations.

Why does the Treasury wish to get new authority to issue new regulations solely for the purpose of determining the source of income under provisions of subpart F? Is it in order to change existing law on this subject?

We recommend that these provisions be stricken out of sections 955(c)(1) and 957(c). The Secretary of the Treasury has not complained of presently existing law and regulations with respect to the determination of the source of income.

To give the Treasury authority to change these rules might overthrow long-established principles and practices in this field and should not be done without adequate consideration of the facts and the reasons for such a change.

The Treasury's latest proposals are supposed to have removed some of the discrimination and added tax burdens which its original proposals would have imposed on business operations of U.S.-owned corporations in Latin America and other less developed countries.

However, it is clear that the Treasury is still determined to discourage foreign investment and still seeks to impose added burdens of taxation and reporting upon income earned abroad by U.S.-owned foreign corporations.

As a consequence, even its latest proposals, whether intentionally or not, would, in many instances, impose such additional burdens on operations in Latin America and other least developed countries and hence would discourage U.S. business activity in those countries.

Section 11 of H.R. 10650—the "gross up" proposal to tax as dividends amounts which have not been and never can be income of the taxpayer.

In connection with the foregoing it is essential to point out that the "gross up" provisions in section 11 of the bill would tax as dividend income, in addition to the amount of a dividend actually received from a foreign subsidiary, an additional amount equal to the foreign income tax paid by the subsidiary on the sum of the dividend plus the tax. It is clear that such amount is not income, and cannot be made into income by calling it "income."

This provision would increase the amount of U.S. taxes payable by a U.S. parent company on a dividend received from a foreign subsidiary where the effective foreign income tax rate is less than 52 percent. The percentage of such increase in U.S. tax will be greatest where such foreign rate is close to 26 percent and decrease as such foreign tax rate approaches 52 percent or zero. What is more serious, the propossed gross-up method would bear very lightly on dividends received from subsidiaries operating in countries—such as in Western Europe—having high income tax rates like ours, and bear most heavily on dividends from operations in developing countries with relatively low income tax rates.

"TAX EQUALITY"

The Treasury and others supporting the administration's viewpoint regarding taxing in advance unreceived income have written and said a great deal about "tax equality".

However, the Treasury's latest proposal is a far cry from affording tax equality, even of the kind that the Treasury insists would be equitable, i.e., the same rate of tax on the same amount of income, whether earned in the United States or abroad.

One striking example of inequality is the proposal that the investment credit be denied to the U.S. owner of a foreign corporation, even though the income of such corporation is taxed currently to such U.S. shareholder.

This certainly would not be equality, and it is but one of the great many ways in which a U.S.-owned foreign corporation is treated less favorably than a U.S. corporation.

The point is that there are many inevitable differences between the taxation of the income of a foreign corporation and the taxation of the income of a U.S. corporation subject to the jurisdictin of the United States.

Since any U.S. citizen or corporation is free to choose whether to operate, at home or abroad, in the form of a U.S. corporation or a foreign corporation, there is no discrimination in such differences in U.S. tax treatment of these two classes of corporations.

It seems that there is indeed need for more equality in the U.S. taxation of foreign income, earned outside the United States by foreign corporations, not subject to the jurisdiction of the United States, beyond the protection of our flag and not enjoying the numberless benefits for which we here at home are taxed.

Such income should be taxed at a lower rate than domestic income. Eventually—Why not now?—when we need to encourage rather than discourage exports and oversea business.

REPUDIATION OF U.S. TAX TREATIES

One of the recommendations most conspicuous by its absence from from the Treasury's latest proposals is the elimination of the provision in the original H.R. 10650 which would repudiate all U.S. tax treaties with other countries to the extent that any of the provisions of H.R. 10650 are in conflict with such treaties.

This is such an unwise provision that the Secretary of the Treasury himself on at least one occasion stated that it should be eliminated, and was endorsed by the Secretary of State. (See report of Senate Finace Committee hearings on H.R. 10650, p. 4248.)

It is noticeable, however, that in his latest set of recommendations the Secretary of the Treasury has failed to call for elimination of this repudiation of U.S. tax treaties. It is to be hoped that this is an oversight which will be corrected.

CORRECTION OF MONSTRUOUS INJUSTICES UNDER SECTION 16

Section 16, as originally proposed, would have resulted in unintended hardships, inequities and monstruous injustices. This is evidenced by the numerous exemptions, exceptions, complicated limitations on the resulting tax under this section and other changes in these new provisions now proposed by the Treasury.

Yet if Congress had relied upon the Treasury's earlier position, it would have enacted this measure as originally proposed.

The significant fact here is that had there not been such an outcry from taxpayers, principally U.S. citizens who have devoted their lives to building up small businesses in Latin America and other less developed countries, the Treasury would not have receded from its position.

Without these changes, section 16 would have amounted, in many cases, to virtual confiscation, not by foreign governments but by the U.S. Government, of the fruit of lifelong efforts of U.S. citizens who had worked abroad but retained their citizenship and remained liable for U.S. taxes.

Even as modified by the Treasury's latest proposals, section 16 still would have a more severe retroactive effect than the Treasury has yet realized.

You will soon hear from another witness who will tell you how he built up from a small beginning business which has generated exports of $19 million U.S. dollars of U.S. manufactured products and how he would be affected by this section 16.

DENIAL OF CAPITAL GAIN TREATMENT OF PATENT SALES

The Treasury now very properly proposes to eliminate the provisions of its original section 952(c) for taxing hypothetical income from what it originally inaccurately described as "U.S. patents" and other property.

However, it now has substituted a new and different provision regarding such property which likewise can properly be criticized as basically unsound and economically undesireable. This would tax "as a dividend" gain on transfers of patents and similar property rights from a U.S. taxpayer to a foreign corporation.

This provision is such that a saving of more than 50 percent of the U.S. tax otherwise payable on a transfer of such property to a foreign corporation would result if the transferee were controlled by foreigners rather than by a U.S. corporation or individuals.

This illustrates the Treasury's failure to recognize the economic consequences of the proposals being hastily formulated, as occasion arises, to combat well-merited criticisms of previous proposals.

It might be mentioned in passing that although, under the Treasury's latest proposal, gain on a transfer of patents or other such property from a U.S. parent company to a U.S. foreign subsidiary in exchange for stock of the latter would be taxed to the U.S. corporation as ordinary income, such a transfer to a U.S. corporation subsidiary would continue to be "tax free."

Are these the final recommendations of the Treasury or will it make still other proposals after the bill is reported out by your committee?

Certainly it has not offered sufficient evidence to overcome the weight of the evidence presented on behalf of U.S. businesses engaged in foreign commerce.

At this point I would like to ask the chairman the statement we filed today be a part of the record because it contains much that I have omitted for the sake of saving time.

Senator KERR. It will be inserted at the end of your testimony.

Mr. SEGHERS. In conclusion, I thank the chairman and the committee members for their attention and hope that any who have questions regarding the accuracy of the statements I have made, will give me an opportunity to satisfy them that my statements are soundly based.

Senator KERR. All right, Mr. Seghers.

Thank you, sir.

Senator CARLSON. Mr. Chairman, I just want to state that regrettably, the Senator from Illinois, Mr. Douglas, who was not here today, he is unavoidably absent on account of a death in the family, but I remember the intense and spirited discussion last time you appeared here.

Mr. SEGHERS. I have made some intentionally provocative statements here but I am prepared to back them up and I regret there are not more Senators here who are complaining but I can imagine they get hungry at lunchtime.

Senator KERR. That is all, Mr. Chairman.

Senator SMATHERS. I don't have any questions, thank you, Mr. Seghers.

Senator KERR. I have no questions. I can't tell whether you are looking for a contest or retiring slowly.

Mr. SEGHERS. I am trying to clarify the record, and to correct many misapprehensions that would be obtained from reading the Treasury's explanation of its own proposed legislation.

Senator KERR. Had you finished?

Mr. SEGHERS. Yes, sir.

Senator KERR. I just couldn't tell whether you were through or not and if you were through I was just trying to make it easy for you to act on that basis, and if you weren't I was trying to make it easy for you to say more.

Mr. SEGHERS. Thank you for your courtesy, Senator.

(Mr. Seghers' prepared statement follows:)

STATEMENT BY PAUL D. SEGHERS, PRESIDENT, INSTITUTE ON U.S. TAXATION OF FOREIGN INCOME, INC., NEW YORK, N.Y., ON THE TREASURY'S LATEST PROPOSALS FOR CHANGES IN H.R. 10650

Especially the proposal to tax in advance amounts not earned, owned, or received by the taxpayer, representing merely an assumed increment in value of shares attributable to undistributed income earned abroad by a foreign corporation

A tax in the form of an income tax on what is not income of the taxpayer is unconstitutional

Mr. Chairman, my name is Paul D. Seghers and my appearance today is as president of the Institute on U.S. Taxation of Foreign Income, Inc.

Mr. Chairman, we ask that the statement we have today filed with the committee be made a part of the record, with permission to file a further supplemental statement for the record if time permits.

We are still convinced that the radically new and untried theories embodied in the Treasury's latest (fifth) set of proposals for collecting tax in advance from U.S. individuals and corporations on amounts which they did not earn; which do not belong to them; and they may never receive, cannot be imposed in the guise of an income tax without violating the Constitution of the United States. In addition to being illegal, and hence leading to uncertainty, litigation, and at least delay in collection of the tax, this measure would establish a very dangerous precedent, by imposing a tax on an assumed increment in value of capital and taxing in advance what is not and may never be income of the taxpayer.

The Treasury still proposes to tax in advance income expected to be received by the taxpayer in a subsequent year

The Treasury continues to state that it wishes to "eliminate deferral of taxation of income of controlled foreign corporations." However, it never has proposed such a tax—that is, a tax on the income earned by a foreign corporation outside the United States. Why? We leave the answer to the Treasury. What it does propose is to tax U.S. citizens and corporations in advance on income not earned, received or belonging to the taxpayer, that the provisions of its latest proposed section 13 assume will be received by and become income of the taxpayer in some future year. (See the latest proposed sec. 959.)

Is this the correction of a defect in the law in effect since 1913, or an unjust burden on U.S.-owned business activity abroad, discriminating in favor of foreign ownership?

What is the purpose of the tax proposed to be levied under section 13?

Is the tax under section 13 to be levied for revenue purposes? That seems unlikely, as it would bring in relatively little additional tax revenue, although these provisions would result in collecting some tax not yet due on some amounts not yet earned, received, or owned by the taxpayers. If the tax under section 13 is not levied for revenue purposes, should it be levied in the guise of an income tax?

Why penalize U.S. taxpayers for reducing foreign income taxes?

A peculiar theory exemplified in the Treasury's latest proposals is that the Congress should enact provisions to protect the income tax revenues of other countries and to penalize U.S. owners of foreign corporations which operate in such a way as to reduce their foreign income tax burden. This is sought by the Treasury even though it does not, and cannot, deny that such savings result in increasing the amount of U.S. taxes thereafter collected by the U.S. Government on the same amount of income.

This peculiar theory looms so large in the Treasury's view that it proposes it as the test for granting overall exemption, which is to be allowed only where the Treasury is satisfied that there is a substantial reduction in foreign income taxes (sec. 954(a)(4)).

A further, and more serious illustration of this peculiar Treasury theory is to be found in its latest recommendations regarding taxation of income from selling goods abroad. This would be most damaging in the case of products manufactured in the United States by a U.S. parent company and sold abroad by foreign subsidiaries. However, the Treasury's provisions in this regard would apply even to selling profits earned abroad from the sale of goods produced abroad by a related corporation, and to commissions and fees earned abroad in effecting purchases and sales for a related company.

We believe that income earned abroad by a foreign corporation in selling goods to foreign buyers should not be taxed until such income is received by a person subject to U.S. taxes. The Treasury now is willing to accept this principle, unless the sales are made in a country other than that in which the foreign corporation is incorporated. Then it would tax the U.S. shareholder on such undistributed income of the foreign corporation. The Treasury has not given any explanation which seems adequate to us as to why this discrimination against the U.S. owners of a foreign corporation should depend on whether the corporation is incorporated in the country where it makes its sales (or the goods are to be used, consumed, or resold). We have found nothing in the record to indicate that a penalty based on such a distinction would be of benefit to the economy of the United States.

Effects of complexity of the Treasury's proposed section 13

Another defect necessarily inherent in the Treasury's proposals for taxing what is not income to U.S. citizens who have not earned, do not own, and have not received the amounts to be taxed to them, is the extreme complexity of these provisions. This complexity even extends to the point of proposing to tax U.S. taxpayers on mythical income of mythical nonexistent foreign corporations, theoretically owned by and theoretically paying income to the actual foreign corporations which actually earn the income. This is provided in the new proposed section 954(d)(2), the real meaning and effect of which provisions cannot be known until the Treasury issues regulations thereunder.

Since what is not income is to be taxed to U.S. corporations and individuals as if it were income, it is necessary to make provisions for allowing foreign tax credits with respect to such hypothetical income and to make adjustments to the cost of shares of stock of the foreign corporation on account of the nonreceipt of what is not income and subsequently to make adjustments of such costs if and when the owner eventually receives such income. It likewise is necessary, of course, to make provisions not to tax again the same amount when actually received as income after having once been taxed in advance when only an expectation and not a fact.

The Treasury's memorandum accompanying its proposals, explaining major changes in its latest proposed section 13, states (in par. 8) that guidelines will be established (in regulations to be issued) which "* * * will facilitate compliance with the legislation from the standpoint of taxpayers and will meet certain criticisms that great difficulty will be involved in determining tax liability under subpart F."

We do not believe that taxpayer compliance with the extremely complicated provisions of the Treasury's latest version of subpart F can be relieved by regulations. Where a great mass of detailed accounting analyses (derived from books kept in one or more foreign currencies and in accordance with foreign customs) must be assembled in order to determine the amounts of U.S. taxes payable on amounts not earned, received, or owned by the taxpayer, no regulations can lighten the burden of compliance with such requirement.

Can the Treasury devise an income tax return to report amounts under section 13?

If the Senate Finance Committee desires tangible evidence of the complexity of the Treasury's latest set of recommendations, which will plague both taxpayers and the Treasury, the Treasury should be asked to submit at least a draft of a proposed tax return to be used by U.S. taxpayers to report income which has not been earned, has not been received, and might never be received, and to report the related foreign tax credit. Such tax return forms would have to set forth a tremendous volume of detail, not only regarding the nature and amount of income and expenses of a foreign corporation or corporations not subject to the jurisdiction of and not reporting directly to the United States, but also details regarding its assets (under the Treasury's latest proposal some of these details would have to be given on a day-to-day basis for the entire year); facts regarding ownership of stock (likewise required to be determined on a day-to-day basis in some instances); and extremely complicated reconciliations between the amount of income and expenses of the foreign corporation and the portion of such income and expenses to be reflected in the U.S. taxpayer's tax return, all presented with a wealth of detail far beyond that presented in any normal financial statement or tax return. If the Treasury cannot present even a tentative draft of such an income tax return and foreign tax credit schedule, your committee will be in a position to draw its own conclusion as to the feasibility of its proposals in this regard.

Legislation by Treasury decision

Another basic objection to the Treasury's latest version of section 13 is the extent to which it would leave to the discretion of Treasury officials the decision as to the immediate taxation, or exemption from immediate taxation, of amounts which are not income of the taxpayer. To a very great extent the proposed section 13 does not lay down fixed rules under which a taxpayer could determine in advance its liability for tax, but depends upon subjective tests to be applied by Treasury officials in their largely unguided discretion. In many instances the proposed section 13 does not even provide that rules shall be promulgated by the Treasury in the form of regulations, but leaves the decision up to individual action by the officials. Even where the bill would require promulgation of regulations, it is to be remembered that the Treasury Department has not yet finished issuing regulations under the Internal Revenue Code as enacted in 1954, and that a large portion of the present regulations under that act were issued only during the past year.

One of the many instances in which the Treasury would, under its latest proposal, be given authority to legislate by regulation and, at least in this instance, change existing law is to be found in section 955(c)(1) and section 957(c) which would authorize the Secretary to issue regulations to determine the source of income; that is, the place where income is considered to be earned. For a great many years the income tax law has included statutory provisions for this purpose; the regulations on this subject are very comprehensive; and there are numerous decisions interpreting these provisions of law and regulations. Why does the Treasury wish to get new authority to issue new regulations solely for the purpose of determining the source of income under provisions of subpart F? Is it in order to change existing law on this subject?

We recommend that these provisions be stricken out of sections 955(c)(1) and section 957(c). The Secretary of the Treasury has not complained of presently existing law and regulations with respect to the determination of the source of income. To give the Treasury authority to change these rules might overthrow long-established principles and practices in this field and should not be done without adequate consideration of the facts and the reasons for such a change.

Effect on Latin America and the Alliance for Progress

The Treasury's latest proposals are supposed to have removed some of the discrimination and added tax burdens which its original proposals would have imposed on business operations of U.S.-owned corporations in Latin America and other less developed countries. However, it is clear that the Treasury is still determined to discourage foreign investment and still seeks to impose added burdens of taxation and reporting upon income earned abroad by U.S.-owned foreign corporations.

As a consequence, even its latest proposals, whether intentionally or not, would, in many instances, impose such additional burdens on operations in

Latin America and other less developed countries and hence would discourage U.S. business activity in those countries.

Section 11 of H.R. 10650—the "gross up" proposal to tax as dividends, amounts which have not been and never can be income of the taxpayer

In connection with the foregoing it is essential to point out that the "gross up" provisions in section 11 of the bill would tax as dividend income, in addition to the amount of a dividend actually received from a foreign subsidiary, an additional amount equal to the foreign income tax paid by the subsidiary on the sum of the dividend plus the tax. It is clear that such amount is not income, and cannot be made into income by calling it "income."

This provision would increase the amount of U.S. taxes payable by a U.S. parent company on a dividend received from a foreign subsidiary where the effective foreign income tax rate is less than 52 percent. The percentage of such increase in U.S. tax will be greatest where such foreign rate is close to 26 percent and decrease as such foreign tax rate approaches 52 percent or zero. Hence, the proposed "gross up" method would bear very lightly on dividends received from subsidiaries operating in countries—such as in Western Europe—having high income tax rates like ours, and bear most heavily on dividends from operations in developing countries with relatively low income tax rates.

"Tax equality"

The Treasury and others supporting the administration's viewpoint regarding taxing in advance unreceived income have written and said a great deal about "tax equality." However, the Treasury's latest proposal is a far cry from affording tax equality, even of the kind that the Treasury insists would be equitable, i.e., the same rate of tax on the same amount of income, whether earned in the United States or abroad. One striking example of inequality is the proposal that the investment credit be denied to the U.S. owner of a foreign corporation, even though the income of such corporation is taxed currently to such U.S. shareholder. This certainly would not be equality, and it is but one of the great many ways in which a U.S.-owned foreign corporation is treated less favorably than a U.S. corporation. The point is that there are many inevitable differences between the taxation of the income of a foreign corporation and the taxation of the income of a U.S. corporation subject to the jurisdiction of the United States. Since any U.S. citizen or corporation is free to choose whether to operate, at home or abroad, in the form of a U.S. corporation or a foreign corporation, there is no discrimination in such differences in U.S. tax treatment of these two classes of corporations.

It seems that there is indeed need for more equality in the U.S. taxation of foreign income, earned outside the United States by foreign corporations, not subject to the jurisdiction of the United States, beyond the protection of our flag and not enjoying the numberless benefits for which we here at home are taxed. Such income should be taxed at a lower rate than domestic income. Eventually—why not now—when we need to encourage rather than discourage exports and oversea business?

Repudiation of tax treaties

One of the recommendations most conspicuous by its absence from the Treasury's latest proposals is the elimination of the provision in the original H.R. 10650 which would repudiate all U.S. tax treaties with other countries to the extent that any of the provisions of H.R. 10650 are in conflict with such treaties. This is such an unwise provision that the Secretary of the Treasury himself on at least one occasion stated that it should be eliminated, and was endorsed by the Secretary of State. (See report of Senate Finance Committee hearings on H.R. 10650, p. 4248.) It is noticeable, however, that in his latest set of recommendations the Secretary of the Treasury has failed to call for elimination of this repudiation of U.S. tax treaties. It is to be hoped that this is an oversight which will be corrected.

Correction of monstrous injustices under section 16

Section 16, as originally proposed, would have resulted in unintended hardships, inequities, and monstrous injustices. This is evidenced by the numerous exemptions, exceptions, complicated limitations on the resulting tax under this section, and other changes in these new provisions now proposed by the Treasury.

Yet if Congress had relied upon the Treasury's earlier position, it would have enacted this measure as originally proposed. The significant fact here is that had there not been such an outcry from taxpayers, principally U.S. citizens who

have devoted their lives to building up small businesses in Latin America and other less developed countries, the Treasury would not have receded from its position. Without these changes, section 16 would have amounted, in many cases, to virtual confiscation, not by foreign governments but by the U.S. Government, of the fruit of lifelong efforts of U.S. citizens who had worked abroad but retained their citizenship and remained liable for U.S. taxes.

Even as modified by the Treasury's latest proposals, section 16 still would have a more severe retroactive effect than the Treasury has yet realized. This will be pointed out by a man who has come here from California solely to testify before your committee today on this subject. The committee undoubtedly will be impressed by the facts he will present regarding the business he has built up from a very small beginning, that has generated exports of $19 million of U.S.-manufactured products.

The Treasury's new idea about taxing the disposition of patents

The Treasury now very properly proposes to eliminate the provisions of its original section 852(c) for taxing hypothetical income from what it inaccurately described as "U.S. patents" and other property. However, it now has substituted a new and different provision regarding such property which likewise can properly be criticized as basically unsound and economically undesirable. This would tax "as a dividend" gain on transfers of patents and similar property rights from a U.S. taxpayer to a foreign corporation.

This provision is such that a saving of more than 50 percent of the U.S. tax otherwise payable on a transfer of such property to a foreign corporation would result if the transferee were controlled by foreigners rather than by a U.S. corporation or individuals. This illustrates the Treasury's failure to recognize the economic consequences of the proposals being hastily formulated, as occasion arises, to combat well-merited criticisms of previous proposals.

It might be mentioned in passing that although, under the Treasury's latest proposal, gain on a transfer of patents or other such property from a U.S. parent company to a foreign subsidiary in exchange for stock of the latter would be taxed to the U.S. corporation as ordinary income, such a transfer to a U.S. corporation subsidary would continue to be "tax free."

Will the Treasury recommend further changes?

Are these the final recommendations of the Treasury, or will it make still other proposals after the bill is reported out by your committee? Certainly it has not offered sufficient evidence to overcome the weight of the evidence presented on behalf of U.S. businesses engaged in foreign commerce.

In conclusion, I thank the chairman and the committee members for their attention and hope that any who have questions regarding the accuracy of the statements I have made, will give me an opportunity to satisfy them that my statements are soundly based.

Senator KERR. Our next witness is Mr. Faure, of El Centro, Calif.

STATEMENT OF EMILE FAURE, IMPORTADORA DE MAQUINARIA, S.A. DE C.V., AND AUTOMOTRIX DEL GOLFO DE CALIFORNIA, S.A. DE C.F., OF CARRETERA PACKARD, MEXICALA, BAJA CALIFORNIA, MEXICO

Mr. FAURE. Mr. Chairman, my name is Emile Faure, a U.S. citizen by birth, and I am appearing for myself in regard to two Mexican companies that I control. I appreciate, and I am grateful to the committee for, the opportunity to testify as to how section 16 of the Treasury's latest proposed amendments of H.R. 10650 would affect adversely a small businessman, if I understand correctly the effect of these provisions.

I have been continuously operating a small business for the last 17 years in Mexican corporate form in the northwestern part of Mexico. Mexican law, then as well as now, makes it mandatory to operate there as an official chartered Mexican corporation. I manage and own two

Mexican corporations. Directly and indirectly, I own 89 percent of their stock.

Senator KERR. I don't want to interrupt you, and I don't as a general thing, but is it possible for an American to own 89 percent of a Mexican corporation?

Mr. FAURE. In some business.

Senator KERR. In some businesses?

Mr. FAURE. Commercial business. There are some restricted businesses that they are not allowed to own 51 percent.

Senator KERR. All right.

Mr. FAURE. My business there is selling and servicing tractors, farm machinery, trucks, and small miscellaneous tools to Mexican users. The sum and total of everything we sell is of U.S. manufacture.

Our total retail sales volume is approximately $1,500,000 yearly. We employ 57 people. My original investment of $13,367.24 has sold approximately $19 million of U.S.-manufactured goods at retail to Mexican users in 17 years.

Under favorable circumstances, and if not penalized by U.S. taxes, this small business can be expected to continue the orderly marketing of American manufactured goods. In this process, our manufacturers have profited, their stockholders, their employees, their suppliers and employees, freight carriers, and the U.S. Treasury has derived revenue from each U.S. corporation, stockholder, employee, and individual that had a part in these transactions.

For the past 3 years, operations of the two companies have resulted in sales profits before taxes equal of 6.26 percent of sales, Mexican taxes of 2.33 percent, and net after taxes of 3.93 percent.

Taking as our American counterpart a like business in California handling pretty much the same lines, doing approximately the same volume, I find their percent of profit to sales to be 7.30 percent; State and Federal taxes, 3.52 percent; and profit after taxes, 3.78 percent for the like 3-year period.

In other words, for the preceding 3 years the net profit of these Mexican companies, after Mexican taxes, was only 0.15 percent more than its nearest U.S. counterpart after its corporate State and U.S. income taxes.

These figures reflect actual operations of two small businesses, one Mexican and one American, handling pretty much the same equipment of U.S. manufacture, doing about the same sales volume, currently employing approximately the same number of people, that have almost identical percentages of sales profit, income tax, and net profit after taxes.

If I understand the provisions of section 16, this is where the similarity ends. The stockholders of the American corporation could either sell or liquidate their business and pay a capital gain tax of 25 percent on the difference between the original investment and the ultimate gain, provided their interest was held for more than 6 months.

The American citizen similarly engaged in a business such as mine in Mexico would pay a much higher U.S. tax on the same amount of gain—up to 64 percent instead of 25 percent.

To say the least, I am disturbed and confused about the complexities of the proposed bill and its amendments as it relates to me as an individual operating a small business in a foreign country.

I understand the purpose of this Treasury bill under consideration is to raise revenue. I think it will reduce the Treasury's tax revenue.

I would like to use my own case as an example.

A good portion of my productive years has been devoted to working in Mexico with the hope that someday I would have accumulated sufficient assets in that country to enable me to accumulate enough capital so that, after paying capital gains tax to the United States, I would be able to take the balance and invest in the United States to derive enough yield after income taxes to live modestly in my retirement years.

I also had hoped that by the time of my death I would leave enough property so that, after inheritance taxes had been paid, my wife would have enough to live on. What might be left after that, our children would inherit, and they also would pay a tax on the yield that might be left.

If any national other than a U.S. citizen such as myself had developed this business in Mexico, the revenue to our Treasury would be zero. In my case, however, the Treasury will gain revenue and will benefit from my efforts as long as I continue this business.

I have read and I am otherwise informed that our factories are not producing to capacity. They need and would like to get more business. I read we have an unemployment problem. I understand the U.S. economy needs growth. I understand that our exports should be stimulated.

If these are the facts, then why deter or discourage U.S. citizens having businesses in these Latin American countries, who actually sell and service these goods of American manufacture? They compete day in and day out with competent nationals of other countries, selling their own countries' good products, often priced below comparable machines of U.S. manufacture.

I firmly believe the continued security of our foreign outlets for American manufactured goods rests to a large degree with these thousands of U.S. citizens in Latin American countries.

Such a U.S. citizen is confronted by many daily complications, in operating and conducting a small business in a foreign country. He has import quotas to contend with, application for import permits, the sometimes complicated execution of the permit itself wherein the monetary value of the permit is tied or balanced to exports of a certain commodity like coffee or cotton. He has to contend with labor laws which constantly become more complicated and severe and are different from our own. He has voluminous reports and statistics to compile, register, and return. There are many commercial risks involved in the operation of a small business. There is the problem of devaluation and the risks entailed and losses encountered. There are individual foreign barter exchanges to contend with.

The U.S. citizen operating a small business selling goods of U.S. maufacture, I can assure this honorable committee, needs reassurance, consideration, encouragement, and above all, I belive, tax equality, or he will finally lose the hope of monetary gain that motivated him in the first place and thereby cut off a future source of Treasury revenue.

I have asked tax attorneys to explain to me what sections of the bill and amendments would be applicable to me, and I have received

different opinions and interpretations that leave me, I regret to say, confused, disturbed, and discouraged, not only regarding myself, but also as to the small businessman who might eventually take my place, if he be a U.S. citizen.

I believe a U.S. citizen would be dissuaded from now entering foreign commerce for his own account, because of the insecurity and lack of confidence in the monetary gain he might expect to realize from his productive years.

Because of misunderstandings, complexities, and general lack of confidence generated by some of the aspects of this bill, even as the Treasury would now change it, small U.S. businessmen operating in Latin America today could well panic, liquidate their corporations in haste, to their disadvantage, in order to pay capital gains tax at a more favorable rate than otherwise would be possible after January 1, 1963.

This would result in leaving behind them a disrupted and chaotic market, instead of an orderly market that the U.S. manufacturers have used and depended upon for creating a large portion of their exports during the many years that such manufacturers and U.S. citizens selling their goods abroad have harmoniously and beneficially worked together.

I have been informed by an attorney who practices in Bermuda and the Bahamas that for the first time the newspapers contain lists of Americans who desire to obtain citizenship in those countries after having renounced their American citizenship.

I know as a mater of fact from conversations with Americans in Latin America that some have considered or thought of the same action.

Even as now proposed by the Treasury, section 16 would hurt me two ways: In the first place, any gain on sale or liquidation of my stock in my Mexican corporations would be taxable to me at a maximum rate of 64 percent to the extent of all earnings and profits accumulated after January 1, 1963, whereas gain on a similar sale or liquidation of a U.S. corporation would be taxed at only 25 percent.

In the second place, the fact of such a tax, at a maximum of 64 percent on all gain accruing after January 1, 1963, would make a U.S. investor reluctant to buy my stock. This would place me at the mercy of foreign investors who, having no competition from U.S. buyers, would offer very little for the business.

It is my feeling that this section 16, even as now proposed to be changed by the Treasury, would do the United States more harm than good and should be dropped.

However, if such a provision is retained, I feel that, in the case of an individual realizing a gain from a business which he has built up in Latin America, the tax on that gain should be no greater than the tax he would pay if he were liquidating or selling the stock of a U.S. corporation. Liquidation would impose a terrific problem on owners of small businesses in less-developed countries, even though it might not impose any particular problem to big business.

In the event of incapacity, retirement, or death of owners of a small business, the section will have a troublesome effect on the owners of small businesses, whereas it would be no problem with big business, who could transfer the operation of the business to others without too much disruption to their overall operation.

Now, small business by reason of its smallness cannot afford or justify a recruiting program and the training of their future personnel and future principles as does big business. The capriciousness of nature, the acts of God or man, or the incapacity or death of a principal in a small business are calamities and disasters that often overwhelm them.

A small business usually would have to be liquidated or sold despite the 10-year test. Big business usually can go on and on. So actually the 10-year test may have no particular disadvantages to big corporations but many harmful applications and painful consequences to small business.

In our particular area of Mexico, small business is run by U.S. citizens and outnumber big business nine to one. We only cover an area of about 45 miles wide by about 70 miles long, about 450,000 to 500,000 acres of irrigated land producing about 400,000 to 450,000 bales of cotton.

I believe small business should receive some consideration and relief from the 10-year test. I am not against big business just because it is big business. It has its proper place and value and function in our economy, but I sincerely believe that if further study were made of this bill U.S. business operating small foreign businesses in Latin America should be consulted for presentation of their thoughts and ideas and facts and realities; it would be beneficial to Congress, the Treasury Department, the State Department, the Department of Commerce, and the Department of Labor as well as to big business.

I believe that all these departments of our Government would be affected as well as many segments of our economy if the proposed bill were adopted as now proposed. Through more study of realities and assimilation of facts something good should result benefiting our domestic economy, our exports, and all its related people.

If there be tax abuses, then if present laws do not reach them, new ones should be adopted.

However, all the thousands of legitimate foreign businesses operated by U.S. citizens in less-developed countries should not be harmfully affected by the alleged abuses of a few.

Senator KERR. Thank you very much, Mr. Faure.

Are there questions?

That is fine.

Mr. FAURE. No questions?

Senator KERR. The committee will recess until 2:30.

(Whereupon, at 12:20 p.m., the committee stood in recess until 2:30 p.m. the same day.)

AFTERNOON SESSION

Senator ANDERSON (presiding). The committee will be in order.

The first witness this afternoon is Dr. Danielian, International Economic Policy Association.

STATEMENT OF N. R. DANIELIAN, PRESIDENT, INTERNATIONAL ECONOMIC POLICY ASSOCIATION; ACCOMPANIED BY RAPHAEL SHERFY, ATTORNEY

Mr. DANIELIAN. Mr. Chairman, my name is N. R. Danielian. I am appearing here today as president of the International Economic Policy Association. I have with me Mr. Raphael Sherfy of the law firm of Turney, Major, Markham & Sherfy.

The association reaffirms its position as expressed in the briefs submitted to this committee on April 30, 1962, as opposed to the principle of taxing U.S. shareholders on their portion of unremitted earnings of foreign corporations. At the same time, we favor such measures as are necessary to eliminate abuses which spring from unjustifiable use of foreign corporations where the jurisdiction of the United States is unquestionable. It is in this spirit that we wish to comment upon the May 31 draft of section 13 and section 16 as submitted by the Treasury Department.

The association wishes to express its appreciation to the Treasury Department for recognizing in the May 31 draft of section 13 the desirability of continuing a policy under which the United States does not, in general, tax unremitted earnings of U.S. manufacturing companies abroad. We hope that this will become the established policy of the Treasury Department, following the overwhelming proof presented to the committee that U.S. companies undertake manufacturing abroad in order to meet local competitive market conditions; that this penetration of foreign local markets would not be available to U.S. firms except through such subsidiary operations; and that this activity by U.S. business helps the balance-of-payments situation by increasing earnings abroad which will, sooner or later, be repatriated, and by creating export outlets for parts, finished and semifinished products, and raw materials shipped from the United States, thus benefiting U.S. domestic enterprise and creating jobs here.

We hope that this position in the May 31 draft, with respect to manufacturing income abroad, is a firm proposal to the Finance Committee by the Treausry Department, and that they will support it, not only before your committee, but also before the Senate of the United States and in conference between the two Houses if the bill should pass.

Insofar as base company operations are concerned, the new proposals do not yet adequately distinguish between legitimate business operations, on the one hand, and pocketbook, nameplate, or so-called suitcase companies, on the other, whose primary purpose is avoidance of remission of income to the United States and the payment of taxes thereon. Existing differences of tax rates between different foreign countries, in our view, do not justify extension of taxing jurisdiction of the United States to foreign countries where the income is wholly generated in or between foreign countries, any more than different tax rates, for example between New York and Florida, would justify the extension of taxing jurisdiction from New York to Florida enterprises just because a 10-percent stockholder resides in New York. Furthermore, the imposition of a capital tax on stockownership in a foreign corporation to achieve a purpose that is otherwise in violation of existing tax treaties seems to us of doubtful legal validity, and a dangerous precedent.

The problem that confronts this committee is to find a formula to distinguish between perfectly legitimate enterprises, primarily designed for efficient and profitable operation in competition with the enterprises of other countries, and those schemes whose primary purpose is to keep earnings abroad merely to escape payment of U.S. taxes. The May 31 draft of the Treasury is deficient in that it fails to make this very vital distinction.

I am confident that the able members of this committee and the Ways and Means Committee of the House, who have the exclusive jurisdiction to write into legislation the tax laws of this country, with the assistance of the respected and dedicated technical staffs of the joint committee, will be able to make this necessary distinction between the use of foreign corporations in legitimate business operations, and obvious tax avoidance schemes through "pocketbook" corporations.

Although our organization believes that flagrant abuses of the U.S. taxing jurisdiction should be curbed, it does not believe enactment of section 13 is necessary to achieve that result, since the provisions of existing law, in section 482, already provide the Commissioner with the authority to do so, and he could achieve more success in his efforts if armed with the information he will be able to get under section 6038 and section 6046 of existing law.

However, if the committee should decide to report out a bill covering the subject of foreign source income, we respectfully suggest, in addition to the points made above, the following specific changes in the May 31 draft:

(1) The provisions which exclude from current U.S. taxation certain dividends and interest reinvested in less developed countries should be expanded so that all income from all sources is excluded, including income from developed countries as well, which is reinvested in specified investments in less developed countries.

(2) Under the May 31 draft, qualified investments in a less developed country include, in addition to certain stocks, only those debt obligations of certain corporations which mature in 5 years or more after the date of their acquisition. The 5-year requirement is unnecessary and should be eliminated.

(3) Under the May 31 draft of section 16 of the bill, gain on the sale, exchange, or liquidation of stock of a controlled foreign corporation would be taxed as ordinary income, rather than capital gain, to the extent the earnings and profits of such corporation attributable to such stock were accumulated after December 31, 1962, and during the period the stock was held by the U.S. shareholder. In view of this treatment of such gains, the IEPA recommends that losses on a sale, exchange, or liquidation should be treated as ordinary losses, rather than capital losses, to the extent of the deficit, if any, in earnings and profits in the same period. Otherwise, the provisions would operate only as a one-way street.

No doubt there will be many constructive suggestions made by other witnesses, particularly with reference to discretionary powers granted to the Treasury, which deserve careful scrutiny by this committee.

While the IEPA offers the above modifications to the May 31 draft, it nevertheless wants to reiterate its objections in principle to U.S. taxation of the undistributed earnings of a controlled foreign corporation to its U.S. shareholders, except in cases of proved abuse of U.S. taxing jurisdiction, on the grounds stated in our April 30 brief.

Senator ANDERSON. Do you have any questions, Senator Carlson?

Senator CARLSON. Mr. Chairman, thank you.

Doctor, I notice you have a statement about the fact that the present proposals do not adequately distinguish between what you call legitimate business operations and then, I believe, you made some statement about "pocketbook" or "nameplate" or "suitcase" corporations.

Have you got some suggestions on that or as to what we can do about that?

Mr. DANIELIAN. Senator Carlson, I have thought right from the beginning that there has been a confusion in motivation in the presentation of the case for taxing foreign source income.

Everyone has admitted that there are situations where advantage is taken by various parties in creating sham corporations for tax avoidance purposes. I have heard no one defend these activities, and if attention is given, serious attention, to defining and developing indicators to help the Treasury to spot these situations and to tax those or eliminate them by appropriate application of either section 482 or a new provision strengthening 482 and, perhaps, others that will reach abused tax haven companies, companies that are used for purposes of tax avoidance, then I think progress can be made.

Unfortunately, the issue has been confused by the injection into the discussion of a great many other matters that, I think, factually have been disproved, such as the balance-of-payments effect and export of jobs, and so on.

In direct answer to your question, I must say that it is possible to have, for instance, payroll or relationship of expense to gross revenue or measurements as in the case of the February 1 draft that was tentatively approved by the House Committee on Ways and Means with respect to a reasonable accumulation of earnings in a tax haven company per se, and these are possible measurements. That is why I suggested, perhaps, the very able staff of this committee could apply its very highly respected technical ability to define this issue.

I think a great deal of controversy may be eliminated if this is done.

Senator CARLSON. Doctor, if you were present this morning and heard some of the testimony, I gathered from other witnesses that it is not an easy matter to write into language that will not, of course, injure legitimate corporations and, at the same time, write legislation that would somehow, in some way, secure taxes on these individuals, what we call people who are trying to avoid these taxes.

I think we are all agreed that we ought to do it. But if you have got any definite language I am sure that it would be gratefully received by this committee.

Mr. DANIELIAN. I shall try to persuade my very brilliant legal friends to help me out in that and, perhaps, we could come up with some suggestions on it.

Senator CARLSON. I can assure you that one member of this committee would be very happy if you did.

I notice in the last statement in your discussion of this you mentioned the words about the balance of payments. For many years, I think everyone knows you have been actively engaged in the promotion of our international trade and the expansion of it. Do you

think this pending legislation could or would have an effect on our balance of payments?

Mr. DANIELIAN. Senator, you are very kind to refer to my interest in this field. I think it goes back to 1958–59 when I started talking about the seriousness of the balance-of-payments deficit situation, and ever since then we have been making a number of suggestions to the administration and to congressional committees in order to correct that situation.

During that period many of the suggestions that we made were not always enthusiastically received by either the State Department or the Treasury Department, but I am glad to say some of them have now become national policy.

An analysis of the balance-of-payments deficit indicates that its primary causes are the military expenditures and the foreign aid program.

Military expenditures abroad are over $3 billion, and as of last year, the foreign aid program was still causing an outflow of dollars of $1.4 billion, by the testimony of the Secretary of the Treasury.

Now, these are both Government expenditures. It would seem to me that if as much concerted effort were put into correcting these situations as is put by many very brilliant members of the administration in trying to sell these programs to congressional committees, perhaps a solution can be found within the framework of the Government's own programs without violating the fundamental legal and economic interests of the United States, as this proposition does.

For instance, in the case of the foreign aid program, which is so universally supported, and I support it, as you know, and I have appeared before your Foreign Relations Committee in support of it, it is possible to control the outflow of dollars and yet still make aid available.

For instance, our Public Law 480 is that kind of a program. It is an aid program in kind.

Now, we could give aid programs in kind in the foreign aid area which would prevent the outflow of dollars.

Another approach to it, of course, would be sharing of the foreign aid expenditures with our allies in Europe who have balance-of-payments surpluses.

Now, if our top administration officials put as much effort into persuading our allies to share in this burden as they do in spending lengthy hours before committees such as this, perhaps we could save a few hundred million dollars or more by negotiation abroad instead of doing a selling job here on a proposition which every thoughtful person who has studied it says will not achieve the results that they predict for it.

In the case of military expenditures, similarly, I think sharing of military expenditures would save us hundreds of millions of dollars, and if those two things can be gotten under control, we would not have to worry about the impact of private investments on the balance-of-payments situation.

On the contrary, I think historically, you know, that investment abroad is one of the primary ways of earning money for a country. The European governments had known this throughout history over the past 200 years, and encouragement of foreign investment has been one of the primary governmental policies of the British, the Germans,

the French, and we are now reaching that stage where our external obligations are of such magnitude that we, too, must put great emphasis on the expansion of private investments abroad as a primary means of earning money abroad to be able to meet some of these governmental obligations.

There are, after all, three ways of earning money abroad: one is exports; the other is the selling of services; and the third is income on investments.

Now, the proposition of curtailing this third important source of income to me makes simply no sense whatsoever.

I also think that it is important for us to encourage exports through incentives, including tax incentives, and here I find there is an inconsistency between, say, the Department of Commerce policy which is trying to encourage exports, and a tax policy which is trying to put the export business in a state of uncertainty through proposed revisions in section 6.

There should be some coordination, and if we want to increase exports we should not exclude consideration of tax incentives to encourage exports, and in the field of investments, instead of trying to curtail investments we should try to expand investments, and these investments must be expanded not merely in undeveloped countries where investments are risky and many companies can only take the risk through Government guarantees, which is a contingent liability of the U.S. Government, but these must be encouraged in hard currency countries like Western Europe, so that we can earn a return in hard currency countries, that is convertible currencies, in order to meet the obligations for the payment of our troops and foreign aid obligations, and so on.

Senator CARLSON. I believe the press dispatches this morning state that the Secretary of Commerce, Governor Hodges, is urging a 10-percent increase in our exports.

Doesn't it seem reasonable, or does it seem unreasonable, which ever way you want to put it, that the proposal we have before us from the Treasury would, in my opinion, reduce income from foreign exports. It seems to me these two programs are contrary, just like the trade program that the administration is proposing, and one that I think we must adopt largely, are working in opposite directions. I mean, they are operating against each other.

Here is a tax proposal which is not in keeping with the proposed trade program.

Do you have any comment on it?

Mr. DANIELIAN. I think we have some very able people in the administration. I have very great respect for the Secretary of the Treasury, and I admire and have great affection for the Secretary of Commerce, and I do think that something would be gained if the Secretary of the Treasury and the Secretary of Commerce and the Secretary of State got together and put some of these programs together to see whether they really fit into each other.

Certainly, this tax proposal is not consistent with the attempt to expand exports. Certainly it must put the export trade and all these companies that are in operation abroad in a state of uncertainty, to say the least, as to what commitments they should make for the future, when they do not know what the future tax status is going to be.

Again I think there is some inconsistency between the trade program and this program. The trade program says that we are going to have, by and large, a fairly free market between Western Europe and the United States, and some of the other countries, through the application of this tariff reduction proposal, and the most-favored-nation clause application to other countries. If that is true, then we are going to have a growing volume of trade. Now, the question is, Are we going to penalize American companies from participating in that trade and give a free hunting license to foreign-owned enterprises to roam all over the world and garner the markets to themselves?

How is that going to help our balance of payments or our revenues for the Treasury if the European-owned companies will have a favored position in this competitive race? How can we afford, under these circumstances, to adopt the trade program if the end result is going to be to give a practical monopoly to foreign-owned enterprises to enter our markets and also to compete with us in world markets?

And the reverse of that is, How are we going to promote our exports in this market unless we do have the instrumentalities through export corporations and trading corporations, and so on, with adequate personnel to promote sales at home?

So, it seems to me there is something to be gained in the top level of policymakers getting together and putting these items together and coming up with a consistent foreign economic policy.

Senator CARLSON. Thank you, Mr. Chairman.

Senator ANDERSON. You say in your statement:

> We favor such measures as are necessary to eliminate abuses which spring from unjustifiable use of foreign corporations where the jurisdiction of the United States is unquestionable.

As Senator Carlson says, Do you have any language to eliminate abuses?

Mr. DANIELIAN. Just at the moment I do not, but I will be glad to work on it, Senator.

Senator ANDERSON. Well, then, again you say:

> The May 31 draft of the Treasury is deficient in that it fails to make this very vital distinction.

Can you take the May 31 draft of the Treasury and eliminate the deficiencies?

Mr. DANIELIAN. If these deficiencies we have talked about, including the definition of—a clear definition of—abuse in the use of tax haven companies, yes, that would be done satisfactorily.

Senator ANDERSON. I mean, can you do it?

Mr. DANIELIAN. I want to use my words very carefully. We do have a fundamental legal objection to taxing income that is generated abroad. But if the definition of the abusive use of these devices is clear cut, I think there may be a chance of escaping the legal limitations on the taxation of foreign source income.

Senator ANDERSON. You say you want to use your language very carefully. I am just using your own language now. You say:

> The problem that confronts this committee is to find a formula to distinguish between perfectly legitimate enterprises, primarily designed for efficient and profitable operation in competition with the enterprises of other countries, and those schemes whose primary purpose is to keep earnings abroad merely to escape payment of U.S. taxes.

Then you say that the May 31 draft is deficient. If that is as simple as it seems, why can't you give us language to catch them?

Mr. DANIELIAN. As I said, we will be glad to work on that if you direct us to supply language.

Senator ANDERSON. I cannot direct you. I can merely ask you to try to do it because the Treasury says it is difficult. You say it is very simple. If we had your language and we put it up to the Treasury——

Mr. DANIELIAN. Mr. Sherfy has a statement.

Senator ANDERSON. You have been saying this is easy. If you were a Senator and a member of this committee and you had before you the language of the Treasury, how would you modify it to make it the way you would like to have it?

Mr. SHERFY. Senator Anderson, I have to agree with you, and I am sure with your staff, that anything that is drafted in this area is going to be difficult.

If I were going to draft the type of abuses which should be eliminated, I would try to eliminate from the present subpart F income legitimate business, business which is actively carried on, business which is constituted of sales income, technical services income, where the assets, the personnel, the deductions can all be related in terms of a ratio to prove that this is an actual substantive business.

I would eliminate from the subpart F income those items of sales income which are received by a corporation from related parties, and which is taxed merely because of the fact that the Treasury thinks when you reduce foreign income taxes you are doing something wrong.

I would, if I were drafting this thing, draft along the general lines of the personal holding company provision which eliminated from those provisions royalties when the deductions had a certain percentage relationship to the royalties, on the assumption that if the relationship is a certain percentage there is substance to the operation.

I would approach the problem along the lines of the hobby loss provision which, in cases where there are allowable deductions in excess of $50,000 for each of 5 years, those deductions in excess of that amount are eliminated.

I would approach the draft along the lines of developing a concept such as subchapter S where a certain type of corporation is described which you want to cover; and, let me say this, that I sure do not think it will be a simple problem.

Senator ANDERSON. I only want to say to you that I went down to the Republic of Mexico one time and made a speech and was quite enthusiastic about a certain official of a foreign government, and he got up and replied to me in Spanish very quickly and said, "What is said can as well be written." He wanted me to put in writing what the American Government thought about him.

What you said can as well be written, and I would appreciate it as a draft. I have had man after man come into my office and say what is wrong with this section, and when I said, "Can you put it down in black and white?" they said that it would take 40 or 50 pages.

We had to have a new hearing because the Treasury Department came in with a somewhat modified suggestion. So I would like to see your 40 or 50 pages, that is all.

Let me just remind you that in your statement you say that—

> Although the IEPA believes that flagrant abuses of the U.S. taxing jurisdiction should be curbed, it does not believe enactment of section 13 is necessary to achieve that result.

You want to curb them, but you do not have to pass a law to do it. You say all you have to do is to make use of section 6038 and section 6046 of existing law.

You just got through saying that you thought that there were very able people in the Government. They cannot be very able if the law is right there to let them do it and they cannot do it. They have not been able to for a long, long time.

Mr. DANIELIAN. I think it is because of the confusion in motives that I referred to. If they apply themselves to this task——

Senator ANDERSON. If the Government official is confused he is not a very able administrator, is he?

Mr. DANIELIAN. Well, I think that the House Ways and Means Committee did have on February 1 a draft that came close to accomplishing this purpose. But then some very sudden changes took place, and I do not believe they were necessarily the considered views of the policymakers. There were certain forces at work that brought it about.

Senator ANDERSON. But you say the Commissioner could achieve more success in his efforts if armed with the information he will be able to get under section 6038 and section 6046 of existing law.

Now, if it is existing law, he can get them now, can he not?

Mr. DANIELIAN. Senator, if I may take just a moment——

Senator ANDERSON. Could you answer that one "Yes" or "No"—

Mr. DANIELIAN. I beg your pardon?

Senator ANDERSON. Could you answer that "Yes" or "No" and then go on to explain it.

Mr. DANIELIAN. Could you repeat it?

Senator ANDERSON. Well, you say in your own text here, your manuscript:

> * * * it does not believe enactment of section 13 is necessary to achieve that result, since the provisions of existing law, in section 482, already provide the Commissioner with the authority to do so, and he could achieve more success in his efforts if armed with the information he will be able to get under section 6038 and section 6046 of existing law.

Now, if existing law lets him get the job done and do better than section 13, who has been at fault? Can't they do it now under existing law?

Mr. DANIELIAN. I think they have complained about administrative difficulties in administering section 482.

Senator ANDERSON. Administrative difficulties are bound to be considered. You say he can do it now. Administrative difficulties enter into it. He can——

Mr. DANIELIAN. I think the amendments that were passed 2 years ago will give, under section 6038 and section 6046, which are new, the information he needs. They were passed in 1960, and the first reports under those provisions are due about this time, and when the Treasury

Department has had time to analyze these reports they will be in better position to know what is going on in the foreign, so-called, tax haven situations.

Senator ANDERSON. Then it is your testimony that we do not need them, as you say in your statement: "We favor such measures as are necessary."

We have already done it.

Mr. DANIELIAN. There are two parts to this problem, and let me explain it.

Four hundred eighty-two will be able to reach those situations where one part of the transaction originates or terminates in the United States.

There is beyond that a feeling that devices which are used in the foreign field to accumulate earnings between different countries not related to the United States, when used for the purpose of accumulation of earnings, like "pocketbook" companies, should also be taxed.

Now, these are the two different phases of the problem. The base company approach that is being considered is designed to go a step beyond 482. It is designed to get to those situations abroad where, like personal holding companies make money without paying taxes to the United States, without a legitimate business use for the funds.

Now, this is a different situation, and if they decide to reach those situations, then I think some clear definition of that kind of a situation is desirable.

Senator ANDERSON. You say if they decide to reach those situations: that is precisely what the hearings we have been having have been talking about for months, it is not? They do decide to reach those situations. Albert Gore has been talking about Liechtenstein corporations and so forth.

Have you got language that will catch these corporations that Albert Gore has been talking about?

Mr. DANIELIAN. We have not prepared it. We have not presumed to write legislation. But if the chairman would determine it desirable, we will be glad to apply ourselves to it.

Senator ANDERSON. I will not speak for the chairman of the committee, but the person who is here today sitting as chairman would like to see some of it because the last batch I got had a bigger loophole in it than all the rest of the law together. It was presented in behalf of that particular client that this person represented. It suited him well, but raised hob with everybody else. I would be glad for you to do something about it.

Mr. DANIELIAN. I will be glad to do that.

Senator ANDERSON. Because the committee is going to have to come down some day to writing this bill and reporting it out. The sooner the better. That is not the universal sentiment about it. There are those who may want to delay it a day or two, but I would like to see some language, and if we come up to final voting, and there is only the language of the bill before us, what would you do if you were a Senator? Would you throw it away because you could not help it, or would you try to help it?

Mr. DANIELIAN. I would try to get the best advice I could on the subject and I think, perhaps——

Senator ANDERSON. We have your advice on it. Now if we can see the actual language that carries it into fruition, I think we would be very happy, or I would, at least.

Mr. DANIELIAN. All right, sir, I will be glad to supply it.

(The material requested had not been received on July 5, 1962, the date this hearing went to press. If received it will be made a part of the committee files.)

Senator ANDERSON. Thank you.

Now, Mr. Cooper.

STATEMENT OF JOHN J. COOPER, CORPORATE ATTORNEY, VARIAN ASSOCIATES

Mr. COOPER. My name is John J. Cooper. I am an attorney, and I am here on behalf of Varian Associates.

On May 10, 1962, Secretary Dillon appeared before this committee to propose various amendments to H.R. 10650. One of these amendments would add section 1249 to provide that where such property as patents or inventions are sold to a foreign subsidiary by a U.S. corporation, the gain from the sale or exchange of this property may not receive long-term capital gains treatment.

Varian Associates previously has furnished each of you with its views on the provisions of the bill relating to controlled foreign corporations. Our position that in general this is undesirable legislation remains unchanged. These remarks, however, will be limited to the transfer of patents to a foreign subsidiary, and in this respect it is important to bear in mind that this bill will affect only foreign patents. The bill now deals with this subject by classifying income derived by a foreign subsidiary from patents developed in the United States and transferred to the foreign subsidiary as "subpart F income."

Following earlier hearings before this committee that position has been abandoned by the Treasury. It is submitted that the new proposal is equally, if not more, unsatisfactory.

There are a number of reasons why the Treasury's proposal should be rejected.

First, American enterprise should be encouraged to develop dominant patent positions abroad. Over the years Varian has acquired many foreign patents covering electronic and scientific instruments in Canada, France, Great Britain, Germany, Holland, Italy, Japan, Sweden, and Switzerland. As a result Varian was able to join with Thomson-Houston, one of the major electronic companies in France, in establishing a microwave tube manufacturing company there.

Had Varian not established its dominant patent position in this field it would not have become a part owner of a company which will be one of the leading microwave tube manufacturers in Europe. Thus this opportunity, and with it the European microwave tube market and the tax revenue, would have been lost to the United States.

Varian's experience suggests that it would be desirable to encourage American business to develop strong foreign patent positions. This bill will discourage it. Substantial costs, such as filing fees, attorney fees, and renewal fees or taxes, must be incurred to secure and maintain this patent position before any revenue can be derived from it. Obtaining and maintaining that position is dependent upon the after-tax income to be derived from the patents in the future.

This bill will do much more than reduce that income. As will be demonstrated shortly, it will impose a very substantial cost to initiate an activity to derive that income.

Second, section 1249 would encourage research activities abroad as it applies only to sales to foreign subsidiaries. Patents developed by a foreign subsidiary would not be within the ambit of this proposal. Moreover, a facility for the development and licensing of patents would be a trade or business. Thus under other provisions of the proposed bill and existing law, earnings and profits of the foreign facility could be retained abroad for expansion of these activities. It is in the interest of the United States to maintain these facilities here. This bill would not promote that interest.

Third, the Treasury's proposal will encourage the sale of patents to noncontrolled foreign corporations and thus place them beyond the control of the United States. While there may be other considerations requiring that patents be sold to the controlled foreign subsidiary, certainly there will be substantial tax pressures for the sale of the patents to a foreign corporation beyond the control of the U.S. corporation.

Fourth, it clearly is unfair to change the ground rules with respect to the tax treatment of foreign patents previously acquired. During the years when Varian and others were acquiring patent positions in these foreign countries, patents were capital assets or section 1231 property, so that their disposition could qualify for long-term capital gains treatment. Now it is proposed that we have a change of rules.

Finally, it is to be observed that the patents may be sold to a domestic subsidiary and the impact of the proposed legislation circumvented. Proposed section 1249 does not apply to sales to a domestic subsidiary; thus the gain may be realized in a sale to it, and the domestic subsidiary then could dispose of the patents without tax. This fact is alluded to simply to illustrate that this, as well as the other provisions of the bill, require careful and deliberate study.

One inequity which may result from the Treasury's proposal can be illustrated by the following example: Assume that foreign patents with an adjusted basis of zero are sold to a foreign subsidiary, that the corporate tax rate of the foreign country is 50 percent, and that the foreign subsidiary derives sufficient income from the patents to recover the purchase price and a reasonable profit.

Under the Treasury's proposal the U.S. corporation would incur a tax cost on this transfer of 52 percent of the purchase price irrespective of whether any income is derived from the patents. Any income derived from the patents by the subsidiary's manufacturing or licensing activities will be gross income for both foreign and U.S. income tax purposes.

To the extent that an amortization allowance is unavailable for foreign income taxes because of the laws of that country or annual accounting concepts, for example, double taxation will result. Upon the distribution by the subsidiary of its net after-foreign tax income there will be taxable dividend income to the American parent of this net after-foreign tax income plus the amount of the foreign tax (as a result of the proposed "gross up" provisions) except to the extent earnings and profits of the foreign subsidiary may be reduced by amortization of the cost of the patents. Should there not be a

sufficient amortization allowance to offset the subsidiary's cost of the patents in computing the subsidiary's earnings and profits, double taxation also will result.

At this juncture it is important to note that under the "miscellaneous provisions" of the proposed section 962, earnings and profits are to be—

determined according to rules substantially similar to those applicable to domestic corporations, under regulations prescribed by the Secretary or his delegate.

The foregoing probably presents the normal situation, and even there double taxation can easily result. Now assume the same example but that the patents are overvalued or the subsidiary is unable to generate sufficient income to offset its cost of the patents because of obsolescence. Even though (because of the high basis or low income) there is sufficient amortization allowance to cover the income derived from the patents for foreign income tax purposes and for the computation of the earnings and profits of the foreign subsidiary, nevertheless the parent will have paid a high tax cost to transfer them, although the subsidiary in fact incurred a loss with respect to the patents.

If the purchase price turns out to be too low, the Internal Revenue Service might easily assert a substantial tax deficiency against the U.S. corporation based on a new valuation at any time during the statutory period of limitations. If the period of limitations was lengthened this problem would be aggravated substantially.

It might be argued that these inequities which arise because the income derived from the foreign patents exceeds the amortization allowance for foreign income tax purposes and for computing earnings and profits—if available—could be avoided by the sale of patents for a percentage of the proceeds. However, there may be business reasons to require a lump-sum cash payment.

One would be to permit the parent corporation to convert its patents for cash. Another reason would be that foreign tax considerations require lump-sum payments. In Canada, for example, if the payment is on a lump-sum basis the transaction will not be subject to income taxes.

While article XI of the income tax treaty between the United States and Canada would limit the Canadian income tax on the proceeds of the sale to 15 percent in the event the parent corporation had no permanent establishment there, nevertheless the disposition of Canadian patents on other than a lump-sum basis would reduce the U.S. income tax rate to 37 percent.

Perhaps some confusion exists in this area from the assumption that ordinary income may be converted into long-term capital gains by the technique of selling foreign patents to a foreign subsidiary. This is not the case. The earnings and profits of the subsidiary fix the portion of the distributions to be taxed. Although the purchase price furnishes a basis for depreciation, in the ordinary situation this should be more than offset by the income to be derived from the patents.

The Treasury has an ample weapon in section 482 to preclude an overvaluation which would decrease the earnings and profits of the subsidiary. Thus there can be no diminution of the earnings and

profits of the subsidiary by this technique any more than in the case of the sale of any other depreciable asset to it. The only possible reason for the Treasury's proposal is to single out foreign patents and to preclude their being capital assets or section 1231 property when sold to a foreign subsidiary. As has been seen, careful consideration suggests the contrary treatment.

Senator ANDERSON. Senator Williams.

Senator WILLIAMS. No questions.

Senator ANDERSON. Senator Carlson.

Senator CARLSON. No questions.

Senator ANDERSON. You say Varian has acquired many foreign patents covering electronic and scientific instruments in these foreign countries.

Mr. COOPER. In these countries there are important patents held by Varian Associates.

Senator ANDERSON. Are those based on Varian's developments in this country?

Mr. COOPER. They are.

Senator ANDERSON. Were any of them done in connection with the Armed Forces?

Mr. COOPER. I cannot answer that question directly.

Senator ANDERSON. Like the Klystron tube? How did Varian develop that?

Mr. COOPER. The Varian brothers invented the Klystron tube.

Senator ANDERSON. Is it in any way associated with the defense efforts?

Mr. COOPER. Subsequently, but the initial invention was not sponsored by the Government.

Senator ANDERSON. You get certain rights because of inventions which you have handled in connection with the Defense Establishment, and you are worried about the transfer of these to a foreign country and the payment of tax upon that?

Mr. COOPER. I was unable to answer the question as to what patents were developed through the military effort. But there are other patents; that is, patents other than those covering microwave tubes, involved. There are also patents which relate to scientific equipment. Some of these microwave tubes have been developed as part of the defense effort.

Senator ANDERSON. I started to say that on page 2, this last paragraph starting out "Finally, it is to be observed," and so forth, you admit that you can get around the law if you want to, so if you can get around it why are you hurt by it?

Mr. COOPER. Does it really make any sense to enact a proposal which can easily be avoided?

Senator ANDERSON. It may not do any good in your case, but it might in some others. They may not have a readymade loophole.

Mr. COOPER. There may be other loopholes which I do not see. This is one that I found in a brief examination of the law, and as time passes others may be developed.

Senator ANDERSON. That is all.

Mr. Adams.

I am sorry, Senator Gore; did you have any questions?

Senator GORE. No questions.

Senator ANDERSON. All right, Mr. Adams.

STATEMENT OF WARREN S. ADAMS 2D, GENERAL COUNSEL, CORN PRODUCTS CO.

Mr. ADAMS. My name is Warren S. Adams 2d. I am general counsel of Corn Products Co. On behalf of this company, I submit this statement as a commentary on redrafted section 13 of H.R. 10650.

I appeared before this committee on May 3, 1962, and I want to thank the committee for permitting me to appear before it again. I do so, mindful of the fact that I am the representative of not only a great American corporation, whose business is truly international, but also of more than 10,000 employees and 70,000 stockholders, whose interests are our major concern.

The Treasury's redraft of section 13 of H.R. 10650 does not come to grips with the major problem in this area. And in at least two specific aspects of this major problem—as will hereinafter be detailed—it is purposelessly and masochistically, it seems to us, too restrictive.

Senator ANDERSON. Can you help us out? We have three members of the committee who do not understand that word "masochistically."

Mr. ADAMS. "Purposelessly and masochistically"?

Senator ANDERSON. Will you explain that to Senator Carlson, Senator Williams, and myself? Senator Gore knows, but we do not. [Laughter.]

Mr. ADAMS. I believe there was an Austrian author by the name of Dr. Masoch who wrote a famous book on the pleasures of hurting yourself.

Senator WILLIAMS. Pleasure of what?

Mr. ADAMS. Of hurting yourself.

Senator ANDERSON. You think this section then is designed to hurt the United States?

Mr. ADAMS. I do, very definitely so.

Senator ANDERSON. That is a glowing testimonial to Dr. Dillon and his associates.

Mr. ADAMS. As we understand it, the redraft provides generally that, if a U.S. corporation has European operating subsidiaries, the earnings of those subsidiaries are excluded from the reach of section 13. Thus, a European operating subsidiary may retain all of its earnings and/or use them as it sees fit, even lending them to other European operating subsidiaries or others, without the imputation of the earnings to the U.S. parent. So far so good.

But what about the U.S. corporation that has organized its European operating subsidiaries through a Swiss holding company? Under the redraft, if the operating subsidiaries retain their earnings, use them in their own businesses, or lend them to other operating subsidiaries in a mutually supporting effort, there is no problem under section 13.

Suppose, however, the operating subsidiaries declare a dividend to the Swiss holding company parent. To the extent that the Swiss holding company does not declare this income as a dividend to the U.S. parent corporation, such income will, under redrafted section 13, be imputed to the parent corporation.

Why should there be this difference just because there is a Swiss holding company intervening? There may be excellent reasons for

the existence of the holding company, reasons that would help the U.S. Treasury and not hurt it.

Reason 1: If the operating subsidiary's income—over and above what it needs for operations and expansion—is brought to Switzerland, the risks of adverse currency fluctuations are minimized.

Reason 2: If (case 1) the operating subsidiary's income is loaned by the operating subsidiary to another operating subsidiary, the interest on the loan will be received by the lending operating subsidiary at the high tax rate normally prevailing in its country. If, however (case 2), the operating subsidiary's income is brought to Switzerland as a dividend, and loaned by the holding company to another operating subsidiary, the interest on the loan will be received by the holding company at the low tax rate normally prevailing in Switzerland as compared to other countries.

Case 2 produces an obvious net income gain. This translates into more for investment and more eventual return. And when remittance is made to the U.S. parent corporation—which is inevitable, and will be made no sooner nor later than in case 1—there will not only be more income in the United States subject to U.S. tax, but the U.S. tax gatherer will be faced with a lower foreign tax credit, and thus will net more tax. There is nothing but gain for the United States (and no loss) in case 2 as compared to case 1 and, yet, under the redraft, case 1 escapes the reach of section 13; and case 2 does not.

Another situation (case 3)—and this one, as do both case 1 and case 2 above, intimately concerns my corporation. The Swiss holding company receives trademark royalties and service fees from operating subsidiaries.[1] In this situation, the royalties and fees are a deduction from taxable income in the high-tax country of the operating subsidiary and come into the holding company in Switzerland at its low-tax rate.

Here, as in case 2 above, is an obvious net income gain, and as in case 2, it translates into more money for investment and more eventual return. And when remittance is made to the U.S. parent corporation—which is inevitable, and will be made no sooner nor later than in case 1 or case 2—there will not only be more income in the United States subject to U.S. tax, but the U.S. tax gatherer will be faced with a lower foreign tax credit, and thus will net more tax. There is nothing but gain for the United States (and no loss) in case 3 as compared to case 1, and yet, under the redraft, case 1 escapes the reach of section 13; case 3 does not.

If the royalty and fee arrangement did not exist—and either may be canceled—we are back to case 1. The amount of the royalty or fee (now no longer payable) will be added to the income of the operating subsidiary and taxed as such. As a consequence, there is a net loss to the U.S. parent corporation, to U.S. foreign investment and return therefrom (which would be available for U.S. investment, too), and to the U.S. tax gatherer.

---

[1] Incidentally, in my corporation's case the trademarks and services are completely Swiss originated, developed, and provided, the contracts with respect to them long antedating our controlling interest in the holding company. It is also possible (but only upon payment at the outset of a substantial U.S. tax) to create this situation with U.S. originated trademarks and services.

The only one who gains by the dog-in-the-manger attitude of redrafted section 13 in this regard is the foreign tax gatherer. Is this any part of wisdom?

What is the answer to all this? We suggest that the answer is found most simply in facing the real problem involved—a thing which the Treasury redraft seems completely unwilling to do. The problem is the so-called tax-haven operation.

The very term seems to imply something devious, sinister, and opprobrious. Indeed, the fundamental assumption of the Treasury is that all tax-haven operations are bad. But this simply is not so. No one who professes to understand the problems of the legitimate foreign trader could possibly believe it to be so. In this connection, just look at cases 2 and 3 above. There certainly is nothing devious, sinister, or opprobrious in them. In fact, they make sound, good, economical horsesense.

Only in the last Congress was there a bill, H.R. 5, known as the Boggs bill, which would have legitimatized and sanctified tax-haven operations via a U.S. corporation. The bill did not become law—although it did pass the House—but this is a far cry from saying all tax-haven operations are bad.

Senator GORE. Did you appear in behalf of H.R. 5?

Mr. ADAMS. I did not, sir.

Senator GORE. Were you a supporter of it?

Mr. ADAMS. I had not gotten myself interested in it at that time.

I think I would have been a supporter of it, yes, sir.

The fact is that there is a substantial body of intelligent knowledge in this country that feels that most tax-haven operations are good. We urge that an attempt be made to segregate the good from the bad, and that any new legislation strike only at the bad.

Over and above the question, however, of whether section 13 has been redrafted to eliminate from its reach all appropriate situations—and we think it has been demonstrated that this is not the case, certainly as far as cases 2 and 3 above detailed are concerned—remains the question of whether there should be any section 13 legislation at all. We feel that the fundamental philosophy of this section is taking this country, as well as its tax policy, in a most unfortunate direction.

First, there is a definite attempt on the part of the Treasury to change the normal theory of corporate taxation which recognizes the separate identity and existence of the corporation—resulting in the taxation of income before it has been received (and even though it may never be received). Such a drastic change in a long-established tax theory, one that, so far as we know, is followed throughout the world, should not be made. That it should be considered at all is shocking, to say the least.

Second, one of the major goals that we should all be striving for, it seems to us, is to secure this country's stake in the Common Market. Forward-looking businessmen, who have thought deeply about this problem, feel that our future in this great and emerging mass market of Western Europe lies neither necessarily, exclusively, nor predominantly in exports of manufactured goods, for these will be made there probably just as well and efficiently as in the United States, but in our investments there. And yet the object of the Treasury's exercise is

to limit investments there. This cannot be right. Indeed, it is almost too awfully wrong to contemplate.

We earnestly request this committee, in the name of equity, the preservation of a well established and universally applied tax theory, and the long-term future of the foreign trade of the United States, to disapprove of section 13 of H.R. 10650—certainly in its present restricted form.

We earnestly request that if some legislation of this nature is not deemed too ill advised, this commitee (*a*) broaden section 13 to include cases 2 and 3 detailed above, or (*b*) order a study of tax-haven situations and the redrafting of section 13 to strike only at the bad ones, or (*c*) reorient section 13 to place only unreasonable accumulations (on a consolidated basis and including holding companies) or accumulations of more than 60 percent of net income within the ambit of the section.

The CHAIRMAN (presiding). Thank you, Mr. Adams.

Are there any questions?

Senator ANDERSON. I just wondered about this section here where you say at the very end of your statement that the committee might (*b*) order a study of tax-haven situations and the redrafting of section 13 to strike only at the bad ones.

There has been quite a little study of tax havens, has there not? Senator Gore has commented very frequently on it; I am sure it is on the basis of a study that has been done somewhere.

Mr. ADAMS. I would think there had been, Senator. But I see no evidence of it in the legislation which has been presented.

Senator ANDERSON. Have you any ideas for redrafting paragraph 13 to cover what you are talking about?

Mr. ADAMS. I think I will leave that to Dr. Danielian, if you don't mind.

Senator ANDERSON. I am sure he would appreciate that. [Laughter.]

I have nothing further.

The CHAIRMAN. Mr. Adams, I was detained and I just read your statement. In the last Congress, you say, there was a bill, H.R. 5, known as the Boggs bill, which would have legitimatized and sanctified tax-haven operations via a U.S. corporation.

What do you mean by "sanctify"? I did not think any tax haven could be sanctified.

Mr. ADAMS. Well, doubly blessed then, perhaps. It received another——

The CHAIRMAN. Do you approve of tax havens?

Mr. ADAMS. I do, sir; yes, sir.

The CHAIRMAN. You approve of them? In other words, you approve of escaping taxation when you should pay taxes?

Mr. ADAMS. I think we need a definition of terms. I think——

The CHAIRMAN. A tax haven has been supposed to be a situation whereby legitimate taxes were evaded.

Mr. ADAMS. I do not think so, Senator. That is not my definition of a tax haven at all.

The CHAIRMAN. What is your definition of a tax haven?

Mr. ADAMS. Well, perhaps I could give you an example of a bad tax haven. I think a sham corporation is a bad tax haven. It is not

necessarily a Lichtenstein corporation, it is not a Panama corporation, it is not a Swiss corporation. I think any place where earnings get accumulated where the corporation in which they are accumulated is a sham becomes a bad situation and one that should be attacked strenuously by the Treasury.

Senator GORE. Such as some foundations.

Mr. ADAMS. Senator, I do not know how all foundations operate, but I happen to be counsel to one. I think it has operated well.

Senator ANDERSON. You mean one that avoids taxation?

Mr. ADAMS. I do not think it is a problem of avoiding taxation. It seems to me that, in your wisdom, you granted an exemption for money that was put to a certain use, and as counsel for this foundation I make it my every effort to make sure that they put their money to the proper use.

Senator GORE. Would you mind using some word other than "wisdom"? [Laughter.]

Mr. ADAMS. I would not mind, no.

The CHAIRMAN. Well, a tax haven, is that the same as tax evasion?

Mr. ADAMS. No, it is not.

The CHAIRMAN. What is your definition of a tax haven?

Mr. ADAMS. Well, I think I can give you an example of it. In a Swiss holding company having operating subsidiaries, the Swiss holding company being owned by an American corporation; the earnings of the operating subsidiary can either be left in the operating subsidiary or they can be declared as dividends to the Swiss holding company. When they are in the Swiss holding company they are in a tax haven situation.

The CHAIRMAN. You mean tax evading?

Mr. ADAMS. I see no evasion in that at all. That is a good tax haven.

The CHAIRMAN. Well, the words "tax haven" have been used frequently, and I think most of the time to identify tax evasion. I do not mean illegal tax evading, but tax evasion that you take advantage of the law; whatever it may be, and you do not pay any taxes. Is that right or wrong?

Mr. ADAMS. I do not think that is correctly put, sir. I have given you the case of the Swiss holding company with operating subsidiaries. That, I think, is all right.

The CHAIRMAN. Then you go on to say that "we urge an attempt to be made to segregate the good from the bad, and that any new legislation strike only at the bad." Are these bad tax havens and good tax havens? Is that your position?

Mr. ADAMS. Yes. I think the sham situation is a bad situation. But a Swiss holding company which is owned by an American corporation and which has operating subsidiaries I do not believe is a bad tax haven situation, and I do not think should be classified as such.

The CHAIRMAN. I suggest that you use some other word because, to my mind, a tax haven indicates that there is a tax "avoidance"—I think that is the proper word—in other words, taxes that should be paid by a company under the customary method of taxation.

The tax haven is one that avoids those taxes even though they may do so legally under the present law.

There should be some——

Mr. ADAMS. Senator Byrd, I can only state that in case 1, which is the American corporation owning the foreign operating subsidiaries directly, the foreign subsidiaries there can retain their earnings. Cases 2 and 3 are but natural and logical extensions of it, and should be similarly treated.

The CHAIRMAN. One witness testified that in Panama he had a company with 17 different subsidiaries that did not pay any taxes, as I understood it.

It is a rather complicated thing.

I am anxious to know the facts. I do not exactly follow you when you say it is sanctified to have tax havens.

First, I think it is important to find what you think a tax haven is because the word "haven" carries with it the thought that it is a tax avoidance, does it not?

Mr. ADAMS. Senator Byrd, if you will just bear with me a minute: we have case 1, which is not reached by section 13.

We have case 2, which is the same thing as case 1, except there is a holding company intervening. There is no more or no less taxes paid or evaded or avoided in one case than in the other and yet case 2 is within the ambit of section 13, and all I am trying to say is that section 13 goes too far in that regard.

It takes the good with the bad.

Senator ANDERSON. Mr. Chairman, may I ask a question?

The CHAIRMAN. Senator Anderson?

Senator ANDERSON. I recognize that there might be a case 1 and a case 2, and if these two corporations are so handled that there is no tax avoidance, but is not the presence of the Swiss holding company the thing that makes possible all the real tax avoidance and the Lichtenstein corporation and things of that nature?

You may not use it for that, but is not somebody else using it for that, and the fact that you do not use it for that does not mean that everybody else is doing the right thing also.

Mr. ADAMS. I do not really know, Senator, how they are using it.

I am just telling you that we are using it for an obviously commonsense economical way or method of operation.

It is as straightforward as anything I can think of.

Senator ANDERSON. Suppose I go down to the hardware store and buy a revolver—and I do not know the firearms law in the District of Columbia—but I think I would probably handle that revolver all right and not cause any trouble, but there are other people that will take it and shoot people with it.

And as a result of that they require the registration of the firearms.

Now, you think that is bad, do you not, because good people can use it for good purposes?

Mr. ADAMS. As I understand the firearms law, there is a provision whereby the good people can get hold of firearms.

Senator ANDERSON. Yes; but they have to register. In my State it is part of the livelihood to have a good gun.

Mr. ADAMS. All I am saying here is I think you should find out the situations that are all right, and I think I have detailed two in cases 2 and 3.

And we would like to see those cases excluded from the ambit of section 13.

Senator ANDERSON. Then the Treasury Department should look at the corporation and say, "we believe these people are operating all right and so we will let them hang onto it, but we believe these people are not and, therefore, we will take their money away from them"?

Mr. ADAMS. There are a number of provisions, I believe, in the redraft that gives the Treasury exactly that discretion.

Senator ANDERSON. And you object to those provisions?

Mr. ADAMS. I normally do, yes.

Senator ANDERSON. Well, do you object to those provisions?

Mr. ADAMS. I think the less discretion the Treasury has to distinguish between taxpayers, the better the tax laws are administered.

Senator ANDERSON. Then you want the bad man to have the gun?

Mr. ADAMS. No, I think I would like to see a real attempt made to separate the two.

Senator ANDERSON. Well, now, what effort have you made to separate them?

Can you come up with the language?

Mr. ADAMS. Well, I am just not a tax expert——

Senator ANDERSON. Well, I know, but everybody says it is so simple; all that Treasury has got to do is to take a sheet of paper and write four or five words and it is all done.

Treasury says that it is difficult. You come in and say it is simple.

Why do you not demonstrate how simple it is? Would not that be a patriotic contribution?

Mr. ADAMS. I do not want to get——

The CHAIRMAN. Well, you defined, as I understand it, in toto the method of these tax havens and so forth and so on.

You think there should be no changes or reforms so as to collect taxes rightfully and properly, do you?

Mr. ADAMS. Senator Byrd, I defend absolutely cases 2 and 3 that I have detailed here.

I do not think anybody can find, really, anything wrong with them. As a matter of fact, they are so right and they make such good sense that if a person did not operate that way I think he would be derelict in his duty to his stockholders.

The CHAIRMAN. Well, you do not think there should be any effort on the part of Congress to close up any loopholes or whatever there may be in the foreign taxation law?

You want it to continue just as it is. Is that right?

Mr. ADAMS. Senator Byrd, I just do not consider cases 2 and 3 loopholes by any stretch of the imagination.

The CHAIRMAN. Do you consider any part of the methods of foreign taxation to have loopholes so far as you know?

Mr. ADAMS. I think strenuous administration, if that were really practical, would find our present tax laws adequate to handle the situations that existed where people are slipping away from paying their share of taxes.

The CHAIRMAN. But you do not favor any legislation?

Mr. ADAMS. Not of this kind, no, sir.

The CHAIRMAN. All right, sir.

Any further questions?

Thank you very much.

Senator GORE. Well, you made an interesting statement. You said that strong administration of the law, if possible, would be sufficient?

Mr. ADAMS. If it were practical, I said.

Senator GORE. Well, would you take a job as an Internal Revenue agent and go over to Lichtenstein and make some inquiries about how many corporate subsidiaries are located there and what their assets are? And——

Mr. ADAMS. Not I, no, sir; I have a good job.

Senator GORE. Well just as a patriotic duty, and assuming the Government is willing to double your salary for a couple of months, will you go to Lichtenstein to make a thorough inquiry there?

Mr. ADAMS. No; I do not think so, Senator.

Senator GORE. You might not come back. I would not really want to visit this upon you.

Mr. ADAMS. It does seem to me that when you have a law like the income tax law, that depends on the honesty of the reporting taxpayer, that you have got to depend upon that honesty or strenuous administration.

You have sections that require complete disclosure, but if you do not get the disclosure, I do not know what you can do beyond strenuous administration.

I do not think the answer is to pass a law that takes everybody to the cleaner.

The CHAIRMAN. Thank you, Mr. Adams.

Mr. ADAMS. Thank you, sir.

The CHAIRMAN. The next wwitness is Mr. H. J. Bowen, of Industrial Models, Inc.

Mr. Bowen?

Mr. BOWEN. Thank you.

STATEMENT OF H. J. BOWEN, PRESIDENT, INDUSTRIAL MODELS, INC.

Mr. BOWEN. I am H. Jefferson Bowen, from Wilmington, Del., and am president of Industrial Models, Inc.

I must apologize for not bringing multiple copies of my statement. I was not aware of the need for them here.

When I came down last night from Wilmington I was not quite sure of what this tax bill wants to accomplish and, after sitting here today, I am quite sure I do not know. But if its objective is to discourage foreign investments it will surely succeed.

If its objective is to improve the balance of payments, it will do this only for a very short period, if that. The evidence for that opinion comes from articles in the Christian Science Monitor of May 21, the Wall Street Journal of June 14, in which numerous authorities expressed this view. The testimony here today seems to make it unanimous, that discouragement of foreign trade will do a great deal of damage to our balance of payments.

Our company is almost too small to take up the time of this body, but it may throw some light on the overall question. We are very small, 200 employees and sales of less than $2 million. Half of this is in Europe. We started 15 years ago as a basement operation, with an investment of $75. We started in Europe 8 years ago, the previous administrations having encouraged this action.

These corporations are, if you like, children of the United States or economic soldiers, and they were told to go out and bring back goodwill and bring home the bacon, and they surely have been doing it.

In our case, we started with an investment of $13,000 in Europe. We have not been able to declare dividends because we need it for growth. Investment there now is about a quarter of a million dollars, and our growth is not yet completed.

The European countries agreed, when we went there, that they would return capital and dividends in dollars, and they are willing to return dividends on a quarter of a million in dollars although we only sent over $13,000.

This is a very small example.

Procter & Gamble, according to the Wall Street Journal article, sent over $11 million and they have brought back $47 million.

Du Pont has brought back $1.280 billion more than they sent.

The opinion of the Secretary of the Treasury, that it takes some 14 or 15 years to bring this money back, simply is not substantiated by the testimony of a good many international financial experts and corporations. Last year, for example, $5 billion was spent by American companies on new foreign expansion but only $1 billion came from the States.

The other $4 billion was out of foreign earnings or foreign loans.

Now, no company goes there unless they expect to get a return of, say, 20 or 25 percent on investment after taxation. There is no point in going there and taking the additional risks unless they get the higher return.

So if these last years figures are typical, where only $1 billion went out from the United States and $5 billion of new investments were made, a 20 or 25 percent return on this would almost return that $1 billion in a year, and not the 14 or 15 years that has been mentioned.

There is apparently a technical fault in section 13 other than those mentioned here today. We happen to have a holding company in Europe but it holds operating companies and not sales companies.

Our Dutch company owns the German and British and French companies because the Dutch company was there first and it had the capital to create the other companies. So it is a holding company, as well as a manufacturing company.

But it happens, under West German tax law, that you are taxed at a 15 percent rate if you distribute dividends and a 50 percent rate if you do not. This is German policy.

Therefore, it makes sense for our German company to declare dividends to the parent Dutch company (borrowing back growth capital) and, unfortunately for us, section 13 as now written assumes that this operation is the type that the bill wants to eliminate.

This means, therefore, that our dividends will be taxable and this means that we cannot grow without reinvesting these dividends. This, in turn probably means the slow death of our company. Either you grow or you die. There are two good reasons. One is that if you stagnate, your competition will soon overhaul you and drive you out. Secondly, if you stagnate, you will lose your keymen. If they see no growth they will go elsewhere and your company will decline.

There is one argument that I have not heard yet that I would like to call to your attention, and that is the impact of this bill on the foreign countries. If you walk down the street and puch a man in the belly without provocation that man is going to react, and I believe that this bill is a body blow to the foreign economies for this reason: Our little company has contributed to the treasuries of the Western European countries, about a quarter of a million dollars and, in

employment, we have 130 people there, who have contributed a similar amount of taxes.

If you magnify this by all the companies who have worked there, General Motors, Du Pont, and all the rest, it will discourage these people from growing. I believe these companies will decline.

They will put in future investment only to protect their present investment because there will be no further incentive to expand there. If these companies decline this will mean unemployment and a big loss of revenue to the European governments. The European governments encouraged American companies to come there with favorable legislation. If they see that no more investment is coming they are going to react. They may, for example, forbid the payment of dividends in dollars or the repatriation of capital in dollars.

How then can our company, and these other companies, pay taxes to the U.S. Treasury in dollars?

If the parent company at home is forced to do so, this could bankrupt them. So I beg that the committee consider, if they have not done so, the impact of this bill on the foreign countries involved.

We have 130 employees there. We think they are all friends of America. We are sure of it.

With their friends and relatives we probably have made 500 or 1,000 friends, and I would surely hate to abandon them.

They may regard it as a betrayal. They, too, have put in many years in serving us, and these other American companies there, and we surely must do everything in our power to protect these people and their opinion of us.

Thank you very much.

The CHAIRMAN. Thank you, Mr. Bowen.

Senator GORE. I would like to ask a question, Mr. Chairman.

The CHAIRMAN. Senator Gore.

Senator GORE. If your company is required to pay taxes annually on its profits you say that this would bring about the slow death or curtailment, at least, of further expansion in Europe?

Mr. BOWEN. Yes, sir.

Senator GORE. Then the present tax laws do operate as an incentive for investment in Western Europe?

Mr. BOWEN. Yes, sir.

Senator GORE. Do you have any employees in the United States? Does your company have any employees in the United States?

Mr. BOWEN. Yes, sir, we do.

Senator GORE. How many?

Mr. BOWEN. About 80.

Senator GORE. How long have you had that number of employees?

Mr. BOWEN. We started 15 years ago. We reached this number of 80 employees only about a year ago.

Senator GORE. How did your after-tax profits in the United States compare with your after-tax profits in your European operations?

Mr. BOWEN. Lower.

Senator GORE. Well, will you give us an illustration?

Mr. BOWEN. The reception to our products and service in Europe has been, I would say, better than here.

Europe badly needed the technology that we have to offer. And although we pay corporation taxes, ranging from 45 to 50 percent, the after-tax profits are, nevertheless, better than here.

Therefore, if we have extra capital, as long as this condition prevails, we would seek other opportunities there providing the risk is reasonable.

The risk return ratio is our criterion for investment. If the incentive is taken away, then we would be obliged to invest only in the United States.

Senator GORE. Well, the problems to which this legislation is addressed apply not only with respect to equity and fairness as among taxpayers, but also with respect to the balance of payments, the outflow of gold, the large unemployment problem we have in our country, and the lack of an unemployment problem in Western Europe.

You have just said here what, I think, is unquestionably the truth, though some people try to deny it, that the present tax laws operate as an incentive for investments in businesses, manufacturing, et cetera, and even for the movement of industries from the United States to Western Europe.

Now, from your personal standpoint this may not be bad, but those of us who have the responsibility of representing the American people, and who have some responsibility for the guardianship of the economy and prosperity, must be concerned with the overall problem.

And I, for one, wish to remove this incentive which you do not wish to see removed.

I thank you, sir, for making it so plain.

Senator WILLIAMS. Mr. Bowen, if I understood you correctly, you said that you thought our present tax laws provided some incentive for investment abroad, but I did not understand you to say that that incentive went to the point of encouraging the movement of businesses from this country to foreign countries.

Mr. BOWEN. Oh, no, sir, I did not say that.

We have not removed the business. We have created new businesses abroad.

Senator WILLIAMS. That was my understanding.

Mr. BOWEN. Our domestic business has grown parallel with the European business but not as fast.

Senator WILLIAMS. And your statement was that the tax laws are such that it would provide an incentive for us to invest abroad along with our investments in this country and not as a removal of the business from here to a foreign country.

Senator GORE. Well, Mr. Chairman, I did not impute to this gentleman that statement.

That is, however, an unmistakable fact. All you have to do is look at the typewriter industry to see that.

Senator WILLIAMS. Well, that may be the fact, but I thought I had undertsood the Senator from Tennessee's question as such, and I just wanted to get it straight what the witness' statement meant.

I think we have it clear.

Senator GORE. I think he succeeded in making himself remarkably clear, and I thank him for it.

The CHAIRMAN. The committee will recess until 10 o'clock tomorrow morning.

(Whereupon, at 4:15 p.m., the committee was in recess, to reconvene at 10 a.m. Tuesday, June 19, 1962.)

REVENUE ACT OF 1962

TUESDAY, JUNE 19, 1962

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

The committee met, pursuant to recess, at 10:05 a.m., in room 2221, New Senate Office Building, Senator Robert S. Kerr presiding.

Present: Senators Byrd (chairman), Kerr, Long, Smathers, Douglas, Gore, Talmadge, Williams, Carlson, Bennett, and Morton.

Also present: Elizabeth B. Springer, chief clerk.

Senator KERR (presiding). The committee will come to order.

The first witness is Mr. Kelley of the Proprietary Association.

Mr. Kelley.

STATEMENT OF AUGUSTUS W. KELLEY, CHAIRMAN, TAX COMMITTEE OF THE PROPRIETARY ASSOCIATION; ACCOMPANIED BY WILLIAM J. STETTER, VICE CHAIRMAN, TAX COMMITTEE OF THE PROPRIETARY ASSOCIATION

Mr. KELLEY. Senator Kerr, I am accompanied by Mr. William J. Stetter, the vice chairman of our committee.

Senator KERR. Well, you are on your own. You got in that shape by your own free will and accord and you will have to just get out of that the best way you can. [Laughter.]

Mr. KELLEY. I appear before this committee as chairman of the Tax Committee of the Proprietary Association.

The Proprietary Association is a national trade organization composed primarily of manufacturers of toilet preparations and trademarked drugs sold over the counter without the necessity of a prescription.

On April 4, 1962, I presented to this committee the association's views with respect to H.R. 10650, discussing at that time only two sections of the bill, one of which was section 13, relating to the taxation to U.S. shareholders of the earnings of controlled foreign corporations. I stated that we are opposed to the enactment of this provision because:

1. It would place American business at a severe competitive disadvantage with foreign owned businesses operating abroad and would, therefore, discourage U.S. business abroad.
2. It represents a radical and unwarranted departure from long established legal and tax principles and no compelling reason has been advanced by the administration to warrant such radical steps.
3. It is of doubtful constitutionality.

4. It introduces new and unique accounting concepts and would be a "horror" to administer both for the Government and the taxpayer.

5. It would encourage the formation of separate corporations in each foreign country, thereby reestablishing the importance of national barriers at a time when the United States in conjunction with its foreign allies is attempting to eliminate barriers in international trade.

We believe that all of these objections are also applicable to the amendments to section 13 now recommended by the Treasury Department.

According to Secretary Dillon's letter of transmittal, the Treasury's proposed amendments to section 13 were furnished to your committee "if it prefers the more limited tax haven approach."

The difficulty is that the expression "tax haven" is merely one of opprobrium which has no precise meaning. Until the Treasury Department makes clear what it is so avidly fighting by the use of this expression, it will be impossible to make concrete suggestions or to write appropriate legislation.

I would like to depart from my prepared statement at this point in view of the testimony yesterday on the subject of good and bad tax havens.

I would like to express our thoughts on this subject.

As used by the Treasury representatives, the phrase "tax haven" includes a multitude of factual situations, with an alleged taint of tax avoidance as the common denominator. We have classified these factual situations into four broad categories:

1. The use of tax haven companies to siphon off income generated in the United States to foreign countries which impose little, if any, tax on this income.

We sincerely believe this is a problem of allocating income, which is properly dealt with under section 482 and has no place in section 13 of this bill.

Section 482 as now constituted is adequate to handle this problem.

2. The use of foreign corporations organized under the laws of foreign countries with favorable tax rates which conduct legitimate business operations such as trading and servicing and all of whose income is truly earned abroad. This should not be a concern of the U.S. Treasury Department since the taxpayer is a foreign corporation, not subject to U.S. jurisdiction, all of whose income is earned abroad.

No other country in the world taxes a corporation of another country under these circumstances.

3. The use of foreign holding companies incorporated in foreign countries with favorable tax rates to own and control operating subsidiaries in other foreign countries. The foreign holding company serves, one to reduce foreign income taxes, and thereby increase the ultimate U.S. tax payable on dividends from the holding company; and two, to protect against currency devaluation such as in the case of Brazil.

The fourth category involves the use of a foreign subsidiary as a combination manufacturing and trading corporation.

And now, Senator, I will pick up at the bottom of page 2 of my prepared statement.

One of our members has a subsidiary corporation in the Netherlands which manufactures only certain products because it is not economical to manufacture a complete line of products in that country. Those products not manufactured in the Netherlands are purchased from a manufacturing affiliate in the United Kingdom. All these products are sold by the subsidiary in the Netherlands, and, since Belgium has for some years been very closely associated with the Netherlands in the Benelux Community, these products also are marketed by the Dutch company in Belgium.

This is a very normal arrangement growing out of business exigencies with nothing sinister about it. Yet, under section 13, the results of such trading business would be imputed to the parent company as "tax haven" income if it constituted more than 20 percent of the Dutch company's gross income in any one year. With the development of the Common Market in Western Europe, the number of similar business arrangements will multiply.

The disruptions to legitimate business arrangements, the accounting complexities and the legal controversies that would develop from this one provision alone, are frightening to contemplate.

In our opinion the Treasury Department's latest proposals would unjustly penalize legitimate foreign business operations, raise constitutional issues, and create problems with foreign governments. Therefore, we must continue to oppose section 13 including the recently proposed amendments.

In the interest of providing a constructive approach, we have selected those issues which we believe are of most concern to the Treasury Department and hereby submit our recommendations with respect to them.

Problem 1. The need to stimulate the domestic economy by reducing an alleged tax induced flow of capital abroad which is said to result in the exportation of jobs and capital available for domestic investment.

Answer. It has already been clearly demonstrated that American investment abroad has increased, not reduced, domestic employment. We know this is true of our industry. Witnesses before this committee and the Joint Economic Committee recently stated that there is no shortage of capital for domestic investment. If there is a pressing need to stimulate the domestic economy the way to do it is to encourage business by the removal of the specter created by Secretary Dillon that the domestic corporate structure will be the next attacked.[1]

Problem 2. The present flow of investment funds from the United States is adversely affecting the balance of payments.

---

[1] "As far as the tax law is concerned I do not think there is anything in this proposal that we cannot do equally with domestic corporations." Hearings before the House Ways and Means Committee on the President's 1961 tax recommendations, 87th Cong., 1st sess. 322 (1961).

Answer. Secretary Dillon has stated that this flow is temporarily and adversely affecting the balance of payments (although it has been proven that the long range effect is favorable).

We suggest two methods are available to correct this situation. First, foreign investment controls can be established. This would not conflict with Secretary Dillon's oposition to general currency controls. However, we believe that the imposition of any type of control is undesirable.

Second, incentives, not penalties should be offered to all currency producing operations to counter tax and investment incentives which have been offered by foreign governments to stimulate their economies. The Treasury Departments' current proposals on the taxation of foreign income are deterrents to the flow of money back to the United States.

Problem 3. The need for legislation to strike down sham and paper transactions as well as the problem involved in the allocation of income and expense between domestic and foreign related parties.

Answer. We believe that existing law if properly implemented by a thorough audit program, which has only recently been started, furnishes an effective answer to this problem. No further laws are needed. You cannot legislate away crime, abuses, or what have you. Proper enforcement of existing law is the answer.

In conclusion much has been said of the fact that the proposed legislation in the foreign field seeks to bring about tax neutrality or tax equality. We believe it can better be described as tax suicide. We earnestly recommend that H.R. 10650 be shelved and the whole matter be considered as part of the tax reform and tax reduction legislation which is forthcoming.

Senator KERR. In other words, you think it ought to be done but you think it ought to be done at another time.

Mr. KELLEY. I think that the present program which the Treasury offers should not be done, Senator.

Senator KERR. You say:

> We earnestly recommend that H.R. 10650 be shelved and the whole matter—

I presume you include 10650?

Mr. KELLEY. Yes, sir.

Senator KERR (continuing):

> be considered as part of the tax reform and tax reduction legislation which is forthcoming?

Mr. KELLEY. Yes, sir.

In other words, we think the Treasury ought to take another look.

Senator KERR. Are there questions?

Senator CARLSON. Mr. Chairman, just this:

Mr. Kelley has mentioned, as have many other witnesses before these hearings, section 482. It comes up for discussion at least in our consideration every time we have a hearing. I think if there is no objection, I would like to have placed in the record at this point, I am sure the Senator from Oklahoma is very familiar with it and

I would like to review my ideas on it; if you don't mind, I would like to have it placed in the record.

That is all.

Senator KERR. It will be printed in the record.

(Sec. 482 of the Internal Revenue Code of 1954 is printed below as requested by Senator Carlson:)

SEC. 482. ALLOCATION OF INCOME AND DEDUCTIONS AMONG TAXPAYERS.

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

Senator GORE. What are your operations in Liechtenstein?

Mr. KELLEY. Speaking for the Proprietary Association, sir, so far as I know there is not one member of the Proprietary Association which has an operation in Liechtenstein.

Senator GORE. That is all, Mr. Chairman.

Senator KERR. You appear as chairman of the tax committee of the Proprietary Association.

Are you connected with an operating company or are you merely a representative of a group of them?

Mr. KELLEY. I am sorry, sir. I perhaps should have identified myself. I am tax manager for Bristol-Myers Co.

Senator KERR. Well, I would like to have some information on the general level of foreign taxes paid by your company's foreign operations overall. Specifically what percentages of the income of your consolidated foreign operations is paid to foreign governments as income taxes?

Mr. KELLEY. Could I give you my understanding of the question, Senator?

You would like to know our effective tax rate on foreign income——

Senator KERR. Specifically, what percentage of the income of your consolidated foreign operations is paid to foreign governments as income taxes?

Mr. KELLEY. Yes, sir.

Senator KERR. Is that a clear question?

Mr. KELLEY. Yes, sir. What percentage of the income of consolidated foreign operations of Bristol-Myers is paid to foreign governments as foreign income taxes? Do I have it correct, sir?

Senator KERR. Is being paid to foreign governments as income taxes.

taxes?

Mr. KELLEY. Yes, sir; that is the way I have it.

Senator KERR. All right.

Mr. KELLEY. I will have to—I frankly, sir, have no answer offhand.

Senator KERR. Will you obtain it and put it in this record?

Mr. KELLEY. Certainly.

Senator KERR. What percentage of your profits after foreign income taxes are returned to the United States as dividends?

How much U.S. tax is paid on such dividends after allowance of the foreign tax credit by the United States?

(The following was later received for the record:)

JUNE 27, 1962.

Hon. ROBERT S. KERR,
U.S. Senate, Washington, D.C.

DEAR SENATOR: On Tuesday, June 19, I testified as chairman of the Tax Committee of the Proprietary Association before the Committee on Finance with respect to the proposed amendments of the Treasury to section 13 of H.R. 10650. At that time you requested that I send you certain information with respect to Bristol-Myers Co.

Set forth below are your questions and our answers. The information given is based on our experience in the last 2 years, 1960 and 1961.

Question 1. What percentage of the income of your consolidated foreign operations is paid to foreign governments as income taxes?

Answer. For all foreign subsidiaries combined, the percentage was approximately 42½.

Question 2. What percentage of your profits after foreign income taxes are returned to the United States as dividends?

Answer. Approximately 46 percent.

Question 3. How much U.S. tax is paid on such dividends after allowance of the foreign tax credit by the United States?

Answer. Approximately 1 percent. A substantial portion of the dividends from foreign corporations came from countries which impose a withholding tax. When these dividend withholding taxes are added to the foreign taxes deemed paid for credit purposes, the total foreign tax credit amounted to about 51 percent, leaving a U.S. tax payable of approximately 1 percent.

Very truly yours,

BRISTOL-MYERS CO.,
A. W. KELLEY, *Tax Manager.*

Now, you made some rather pointed but very general remarks about the expression "tax haven."

You said the difficulty is that the expression "tax haven" is merely one of opprobrium which has no precise meaning—

> until the Treasury Department makes clear what it is so avidly fighting by the use of this expression, it will be impossible to make concrete suggestions or to write appropriate legislation.

My belief is that the May 31, 1962, Treasury draft of section 13 is intended to be limited to covering only tax havens.

Do you believe that it has this effect and that it does not reach manufacturing or similar operations abroad?

Mr. KELLEY. Well, this gets down to a question of definition again, Senator Kerr.

One, I will agree with you, sir, it does not reach manufacturing operations abroad as such. But it does reach transactions abroad which have no connection with the United States.

Senator KERR. I am not talking about that.

Mr. KELLEY. And, therefore, I find difficulty, Senator, in understanding what is "tax haven" about that? It does not involve the avoidance of U.S. income taxes.

Senator KERR. That, of course, could be interpreted, if I wanted to be as critical as you are, as meaning that your criticism is based on the fact that you don't understand it.

Mr. KELLEY. I think I understand it, but I don't understand the philosophy behind it, Senator. I think the U.S. Treasury Department should be concerned only with the payment of U.S. taxes.

Senator KERR. That was not what you said, and I am glad to have you amend it. But do you believe that it does have the effect of not reaching manufacturing operations abroad?

Mr. KELLEY. Yes, sir.

Senator KERR. Now, then, if it reaches situations other than tax havens, can you identify what the situation or situations are that it does reach which do not constitute tax havens?

Mr. KELLEY. Well, in my opinion, and this again is a problem of definition, Senator, because perhaps the Treasury has a different definition of tax haven than I do, but I would not think that the example which we gave you in our statement referring to the Netherlands corporation that purchased from a British affiliate, and sold in Belgium, that that has any aspect of a tax haven about it. It is a perfectly normal business arrangement. But it would be treated——

Senator KERR. You know, I assume that all operations in trade and commerce whereby profit is derived is normal. I never did have the understanding that that which could qualify under the term of normality would thereby become eligible for exemption from taxation.

Mr. KELLEY. Well, I can only say, sir, I don't know what is tax haven, as the term is generally used, about that transaction. Taxes play no part in it. But the Treasury comes along and says, in effect, that the income from the sale of goods purchased from Great Britain and sold in Belgium will constitute foreign base company income, sales income, so that, therefore, a U.S. tax will be payable on that income.

Senator KERR. And that is then a situation which you regard as one that is not a tax haven, but which would be reached by this law?

Mr. KELLEY. Yes, sir.

Senator KERR. Do you know of any other situation?

Mr. KELLEY. Well, there could be other similar arrangements.

Senator KERR. I am not talking about what there could be. I am asking you if you could name any other situation that you regard as not being a tax haven but which would be taxable under the revised draft of section 13?

Mr. KELLEY. It is difficult for me to answer that question because I have never seen a precise definition. I have read all the committee reports and that sort of thing, but I have never seen a precise definition of tax haven.

Now, I have heard a tax haven company defined by a representative of the Treasury Department as a company which purchases goods outside the country of its incorporation and sells goods outside its country of incorporation.

Now, in many cases you will have companies that do that, the reason being that they will be incorporated in a foreign country which offers the most favorable laws not only from the standpoint of tax but also from the standpoint of operation.

As I pointed out in my testimony the last time on this section, it is quite customary to incorporate business corporations under the laws of Panama and then qualify them in another foreign country such as Venezuela where they will do all their business.

Senator KERR. And you think that the law should permit an American-owned corporation to be created in Panama, qualify in Venezuela, make profits, and yet never be required either to pay taxes on the income or return the income to the United States where it would be taxable?

Mr. KELLEY. I would say in answer to your question, I would not answer any question "never," Senator; it is too broad a statement.

What I would say, as a general proposition, is that the transactions which you have described are outside the U.S. jurisdiction. As a lawyer, I feel very strongly about basic legal philosophy. I think we would feel just as strongly if England started taxing American corporations which were owned by Englishmen.

The American corporation is subject to the American jurisdiction. Similarly a Venezuelan or English or whatever corporation you may wish to call it is subject to the jurisdiction of that country.

Senator KERR. But a corporation in this country that makes profit has to distribute the profit except as it is needed for its expansion.

Mr. KELLEY. All right, sir; well I will answer that on behalf of our association. For the most part we are largely publicly held companies, and even where are not, I think the same principle applies. Our stockholders, be we closely or widely held, are interested in dividends. We cannot just stick money off in some far corner of the globe and leave it there.

Senator KERR. No, but you can under existing law accumulate it there and leave it there.

Mr. KELLEY. I beg your pardon, sir?

Senator KERR. I say under existing law you can accumulate it there and leave it there.

Mr. KELLEY. That is correct, Senator.

Senator KERR. And you think you should be permitted to continue to do that?

Mr. KELLEY. You say continue to do it. We don't do it, Senator. I just stated the Proprietary Association members do not do it.

Senator KERR. I didn't say you did it, but I said you are permitted to do so and I ask you if you should be permitted to do so.

Mr. KELLEY. I would make a suggestion in that regard which has been discussed. This has not been cleared by my committee so I want it to be clear it is purely my own thought at this moment.

Senator KERR. I will make the same reservations about my statement. [Laughter.]

They are not binding on this committee.

Mr. KELLEY. You see, as a lawyer, Senator, I am careful about legalistics. If you will excuse me, sir, I try to be fair about this. But it is my thought which I have expressed before to members of the Treasury that if they are concerned about the problem of unreasonable accumulations abroad which is certainly not a problem of our

industry, then I would suggest an approach along the lines of section 531, which deals with unreasonable accumulations of domestic companies—apply it to foreign companies.

Senator KERR. Very good, Mr. Kelley. Are there other questions? Thank you.

Senator GORE. Mr. Chairman.

Senator KERR. The Senator from Tennessee.

Senator GORE. The clerk advises me that Mr. H. Neil Mallon, the chairman of the executive committee of Dresser Industries, has filed a statement for the record, which I have read. I find some statements in this presentation by Mr. Mallon on which I would like to ask a few questions and I request that the committee invite Mr. Mallon to appear in person to present this statement when the hearings are resumed.

Senator KERR. Mr. Mallon will be advised of the request of the Senator.

Senator GORE. I would like the committee to issue an invitation.

Senator KERR. I don't know of any procedure whereby the committee would do other than to express the desire of a member of the committee unless you are suggesting that he be subpenaed.

Senator GORE. Oh, no. I am not suggesting a subpena. But I was merely suggesting an invitation.

Senator KERR. I agree that the committee would advise him that the Senator from Tennessee, and are there others, who want to question Mr. Mallon?

It would seem the desire on the part of the Senator from Tennessee and Mr. Mallon will be advised.

(The statement referred to follows:)

JOINT STATEMENT OF H. NEIL MALLON, CHAIRMAN OF EXECUTIVE COMMITTEE, DRESSER INDUSTRIES, INC.; E. V. HUGGINS, EXECUTIVE VICE PRESIDENT, WESTINGHOUSE ELECTRIC CORP.; AND DONALD C. LEVIN, GENERAL COUNSEL, CARGILL, INC.

Each of the above-named representatives of the companies indicated appeared before or filed a statement with the Committee on Finance at its prior hearings on H.R. 10650. The effects of section 13 on their foreign operations, which involve annual exports of over a quarter of a billion dollars, are fully set forth in such statements. After study of the additional amendments to section 13 proposed by the Secretary of the Treasury on May 10, it is evident that the objections of the above-named companies to section 13 have not been met by the amendments proposed. Indeed, the proposed amendments would have an even greater detrimental effect on the export activities of these companies than would section 13 as now contained in H.R. 10650.

Without burdening the record with a restatement of the material previously presented, it is the purpose of this statement to suggest an amendment of section 13 which will in part preserve the existing tax treatment for foreign sales companies which are not shams or engaged in unsubstantial activity but are actively engaged in the promotion of export sales and are thus engaged in promoting America's interest in improving the balance of payments, fostering domestic employment, stemming the outflow of gold and aiding in the sale abroad of surplus agricultural products.

Memorandum Re Taxation of Export Trading Companies Under Section 13 of H.R. 10650

H.R. 10650 should be amended to grant a bona fide export trade corporation a limited exemption from the current taxation provisions of the bill. The amendment should be designed to—

1. Maintain the competitive position of U.S. exporters;
2. Provide incentive to increase exports;
3. Reduce pressure to establish foreign manufacturing plants;
4. Aid in the distribution of surplus agricultural commodities;
5. Increase employment in American factories; and
6. Eliminate tax abuses of sham tax haven subsidiaries.

I. FOREIGN TRADING COMPANIES AS AN EXPORT TOOL

The greatest potential for improvement in our balance-of-payments position is in increased exports. Yet a vital segment of our export trade is threatened with curtailment by H.R. 10650.

(*a*) *Functions.*—Many American companies sell abroad through foreign based trading companies. These companies perform a vital function. They promote export sales and service facilities in many parts of the world, staffed with management, sales, advertising, marketing, engineering, and service personnel who are familiar with foreign market conditions and practices and have the American viewpoint. They promote export trade by financing foreign customers' purchases of American-made products.

The income of these companies is predominately earned from the sale or use of American products.

(*b*) *Tax aspects.*—In the typical case, the U.S. company pays full U.S. tax on its profit in respect of goods sold through the foreign trading company. The foreign trading company pays a relatively lower foreign tax on its profit. The burden of U.S. tax does not apply until the trading company's profit is returned to the U.S. shareholders. Foreign competitors utilize similar export trading organizations and achieve the marketing and tax advantages which the pending bill would deny to U.S. exporters.

Foreign companies in competition with U.S. exporters use base company sales corporations even more extensively than do Americans. Over 1,600 non-American-owned base companies are located in Switzerland alone; American-owned Swiss-based companies total only 1,025. If the American trading companies are subjected to more burdensome taxation than their foreign competitors they will lose their ability and incentive to compete. They cannot compete if they have lower profit margins, reduced funds available for export promotion and a shortage of capital to provide customer financing which is so essential in effecting foreign sales. If the bill is passed, American companies will have no choice but to curtail their export trade or divert to foreign plants the manufacture of products now manufactured here. In either event our balance of payments, domestic employment, gold reserves, and Federal revenues will suffer.

(*c*) *Contribution to export promotion.*—Secretary Dillon has stated that $1 of foreign investment produces only 8 cents of exports per year. But the investment to which he refers is made up entirely of investment in foreign manufacturing facilities—from which exports flow only incidentally. Investment in a foreign trading company produces exports of many times its amount—since export promotion is its principal objective. If a foreign manufacturing facility fails to produce exports it can continue to operate. If a foreign trading company fails to produce exports it will perish. The favorable export-investment ratio of trading companies is demonstrated by the experience of the foreign-based trading companies utilized by such companies as Dresser Industries, Inc., in the field of manufacture of equipment for and provision of services to the chemical, petrochemical, oilfield drilling, and other industries, Cargill, Inc., with respect to agricultural commodities and Westinghouse Electric Corp. in the electrical appliance, machinery, and equipment field. The experience of these companies indicates the current export flow ranges from $2 to well over $10

per annum for each dollar of oversea investment and retain earnings in these foreign trading companies.

(*d*) *Distinction from "sham tax haven companies"*.—Despite this outstanding benefit to our balance of payments, which is typical of that produced by many comparable foreign trading companies, the bill would not affect direct investment in foreign manufacturing facilities and would discourage the promotion of export trade through export trading companies. Under the bill, all foreign based companies which derive income from the sale of goods manufactured in a country in which it is not incorporated to purchasers in a country in which it is not incorporated are treated as "tax haven" companies. No distinction is made between legitimate trading companies and shams. Thus, the foreign based companies which serve Westinghouse, Cargill, and Dresser, spend millions of dollars abroad on export promotion and devote millions of dollars of assets to the sale and service of U.S. products, are treated the same as a company with a registered office in Nassau, no significant export promotion expenditures abroad, and few assets other than a bronze nameplate on the wall of a Bay Street bank.

(*e*) *Importance of a foreign base.*—The sale of machinery, equipment, and agriculture products in foreign markets cannot be promoted effectively unless an aggressive sales organization and a skilled, well-equipped service organization is maintained at key locations throughout the world. Sales personnel must travel from country to country to promote sales, stimulate dealer activity and maintain customer relations. These activities must be conducted from a central foreign base. Wherever that base is located the bulk of its activities must be in third countries. Thus, by the bill's definition of "foreign base company sales income," a foreign selling company must either fragment its operations in an impractical manner or be subject to the current taxation provisions of the bill. In either event, U.S. exports trade will suffer.

II. PROPOSED AMENDMENT

The amendments proposed by Secretary Dillon would exclude from foreign base company income the income from rents derived in a trade or business from an unrelated person and income from the performance of services on behalf of an unrelated person. To the extent such rents and service income are in respect of the use or servicing abroad of U.S.-made products the United States will benefit in much the same manner as it would benefit from exports. There seems to be no basis for distinguishing between these activities and the activities of a foreign base company directly engaged in promoting exports. Both contribute to export trade, both require a centrally located foreign base of operations and both contribute to our balance of payments and to domestic employment.

The distinction that should be made in the bill should be between functioning, substantive foreign operating companies and insubstantial shams, not between foreign manufacturing companies, or rental and service companies, and foreign trading companies. Such a distinction can be made so as to protect the legitimate foreign trading company and stimulate an increase in their export promotion activities and, at the same time, foreclose the use of sham trading companies for tax avoidance purposes. The amendment we propose would make this distinction and thereby protect and enhance our vital export trade.

It is proposed that H.R. 10650 be amended to grant to an "export trade corporation" a limited exemption from the current taxation provision of section 13 of the bill.

(*a*) *Principles underlying proposed amendment.*—In order to qualify for such exemption as an export trade corporation, it should be required—

1. That substantially all of the income of an export trade corporation be from sources outside the United States—thereby insuring that it will be operating abroad.
2. That the major portion of its income be "export trade income," i.e., income from sales and services with respect to products manufactured, produced, grown, extracted, or developed in the United States and sold or used abroad. This will insure that an export trade corporation will be engaged primarily in activities which promote America's interests in improving the

balance of payments, protecting domestic employment and stemming the outflow of gold.

3. That an export trade corporation use its income for investment in property devoted to the production of export trade income and in financing foreign customers. This will insure that the earnings are devoted to fulfillment of the amendment's export promotion objectives.

In addition, section 6 of H.R. 10650, amending section 482 of the Internal Revenue Code, which gives the Commissioner of Internal Revenue broad power to reallocate income between related businesses, should be eliminated or amended in a manner which will avoid frustration of the purpose served by the export trade corporation provision and give assurance of a reasonable allocation of income to the export trade corporation.

(*b*) *Incentive to promote exports.*—The exemption of the qualified export trade corporation from section 13 should be directly related to the intensity of its efforts in promoting export sales and the use of its retained earnings for its investment in property devoted to export promotion. To the extent that its expenses directly related to export trade promotion do not amount to a required proportion of its income, and to the extent that its retained earnings are not invested in property devoted to export promotion, its income would be taxed currently to the U.S. shareholders. Thus, in order to obtain continuation of the existing tax treatment of foreign trading companies, an export trade corporation would be required to spend substantial sums on the promotion of export sales.

Under the bill, with amendments proposed by Secretary Dillon, a foreign manufacturing plant controlled by Americans could not use a foreign based sales company so as to defer tax on its selling income. The export trade corporation proposal would confine its benefits to companies engaged in selling American-made products. Therefore, the proposal would not only stimulate exports but would also induce greater concentration on sale abroad of products manufactured here, and deemphasize on sales of products manufactured abroad.

The required expense-income ratio and investment standards would provide a positive incentive toward intensification of export promotion activities. Such activities would, on the average, increase export sales and hence, export income. The increased export income would then have to be balanced by further export promotion expenses, so as to produce a spiraling of expanding exports, increasing profits, additional export promotion activity and, again, expanding exports.

Senator KERR. Mr. William M. Horne is our next witness.

STATEMENT OF WILLIAM M. HORNE, JR., CHAIRMAN, TAX POLICY COMMITTEE, MANUFACTURING CHEMISTS' ASSOCIATION

Mr. HORNE. I am appearing as chairman of the Tax Policy Committee of the Manufacturing Chemists' Association (MCA).

On my left is Mr. Raphael Sherfy, special counsel for MCA.

We wish to express our appreciation to the committee for this opportunity to present our views on the Treasury's new draft of sections 13, 15, 16, and 20 of H.R. 10650.

In our opinion the new draft is a substantial improvement over the previous Treasury proposals.

Senator GORE. You understand, of course, that the first recommendation of the Treasury is for repeal of deferral.

Mr. HORNE. We understand it.

Senator GORE. This redraft of section 13 is submitted for consideration only in the event the committee does not wish to do a thorough job.

Mr. HORNE. Senator, we understood there was never a statutory draft submitted to either the Ways and Means Committee or the Finance Committee on that point.

Senator GORE. On deferral.

Mr. HORNE. On complete deferral; yes, sir.

Senator GORE. You are misinformed. Such a draft was presented to the Finance Committee and I shall introduce it in the Senate today in order that it may be available for study in printed form.

Mr. HORNE. There remain, however, a number of difficult substantial and administrative problems. This is inherent in the nature of the Treasury's proposal to tax currently certain undistributed profits of controlled foreign corporations.

The present draft represents the fourth major Treasury version.[1]

Unfortunately, the Treasury has not restricted its changes in the May 31 draft to meeting the problems which taxpayers raised in the recent hearings of this committee.

Instead, the Treasury's May 31 draft has several new provisions which present additional complexities and administrative problems.

With the chairman's permission, I will file for the record a detailed statement of some of the administrative and enforcement problems which we foresee if the present draft is enacted. Because of these difficult problems, we urge that section 13 be deleted from the bill.

Senator GORE. Off the record.

(Discussion off the record.)

Mr. HORNE. We would like to emphasize that section 13 is not directed to prevention of U.S. tax avoidance. This is substantially the same point made by Mr. Kelley.

This is equally true with respect to the provisions enacted by the House and with respect to the provisions of the May 31 draft. Inherent in all of the Treasury's proposals is the desire to tax U.S. shareholders in cases involving avoidance of foreign income taxes.

We do not believe that our revenue laws should be used to prevent the possibilities of tax minimization in other countries. As long as U.S. taxes are not being avoided, the Treasury should not be concerned because U.S. business arranges its affairs to reduce its tax burdens abroad.

In many instances, foreign countries have specifically sanctioned certain methods of reducing tax liabilities. Section 13 would indirectly override these foreign laws or practices. It would impose U.S. tax liability on the undistributed profits which the foreign government saw fit not to tax.

To give a specific example, take the provision of the May 31 draft which states that a foreign branch of a controlled foreign corporation is to be treated as though it were a wholly owned foreign subsidiary of the controlled foreign corporation.

---

[1] The original Treasury proposal was contained in Secretary Dillon's testimony before the Ways and Means Committee on May 3, 1961. As a result of the Ways and Means Committee hearings, the Treasury substantially changed its approach and released a public draft on July 28, 1961. Taxpayers were invited to submit comments on this draft to the Treasury Department and to the Joint Committee on Internal Revenue Taxation. On Jan. 31, 1962, the Treasury made public a number of changes that it proposed to the July 28, 1961, drafts. However, when the Ways and Means Committee on Mar. 12, 1962, released the text of the language agreed upon for sec. 13 of H.R. 10650, substantially new approaches were taken from the previous Treasury drafts. Taxpayers had no opportunity to comment on these changes until the recent Senate Finance Committee hearings.

If a British manufacturing subsidiary of a U.S. chemical company sets up a sales branch in Belgium to sell its product in Belgium and Holland, the income of the Belgium sales branch would be treated as foreign base company income to the same extent it would be so treated if it were a foreign subsidiary.

As such, it would be subject to current U.S. tax even though the income was reinvested either in further sales outlets or in further manufacturing facilities in the United Kingdom. It is clear that this transaction has no connection with the United States. There is no avoidance of U.S. tax. Yet section 13 would impose a current tax on undistributed profits which, because of investment commitments or otherwise, might not be available for distribution.

This same Treasury's concern with avoidance of foreign income taxes comes into play in connection with another new provision in the May 31 draft. This is the exception for foreign corporations not availed of to reduce taxes (sec. 954(b)(4)). This section provides that the foreign base company income rules will not apply to an item of income where the Treasury is satisfied that the organization of the controlled foreign corporation receiving the income did not have "the effect of substantial reduction of income, war profits, excess profits or similar taxes."

This exception is not limited to foreign corporations organized to reduce U.S. tax liability. Instead, the Treasury is empowered to deny application of the exception if the Treasury believes that the organization of the foreign corporation may result in substantial reduction of any tax liability. This is contrary to favorable tax rulings previously issued by the Treasury under section 367 of the 1954 code.

Under this section, the Treasury has previously ruled in a number of cases that a foreign corporation was not formed for the purpose of avoiding U.S. taxes even though the ruling application clearly indicated that the foreign corporation would have the effect of reducing foreign taxes. The proposed section 954(b)(4) can effectively overrule these prior favorable tax rulings unless the phrase "substantial reduction of income, war profits, excess profits or similar taxes" is restricted to U.S. taxes.

The May 31 draft is more restrictive than the House bill in its effect on the less developed countries, such as the countries of Latin America.

Take, for example, a U.S. pharmaceutical company which has a manufacturing subsidiary in Argentina and a sales subsidiary in Venezuela which sells the output of the Argentine plant throughout the northern part of South America.

The income of the sales subsidiary would be subject to current U.S. income tax whether or not the income was reinvested in further distribution outlets or in other South American countries.

Another new problem under the May 31 draft arises with respect to income which is attributable to pre-1963 investments in less developed countries. Dividends and interest from qualified investments in less developed country corporations are excluded from foreign base company income to the extent they do not exceed the increase in such qualified investments generally for the taxable year.

The qualified investments, however, relate only to investments made after 1962. In the case of prior investments, the dividends and interest would be treated as foreign base company income. This has the

effect of penalizing investments already made in the less developed countries.

It is also questionable policy whether the determination of qualified investments in less developed countries should be made on a consolidated basis rather than on a company-by-company or country-by-country basis.

For example, assume that a U.S. chemical company has a wholly owned subsidiary in Brazil, S–1. The Brazilian subsidiary itself in turn has subsidiaries in Brazil (S–2) and in Argentina (S–3).

Each of these latter subsidiaries represent an investment of approximately $5 million made after 1962.

In 1965 the subsidiary in Argentina, S–3, pays a dividend equivalent to $100,000 to its parent company, S–1, in Brazil.

For nontax reasons the Brazilian parent, S–1, is forced to liquidate its subsidiary in Brazil, S–2. Under these circumstances there would be a decrease in qualified investment.

As a result, the dividend of $100,000 would be subject to current U.S. tax to the U.S. parent company even though it was reinvested by the Brazilian subsidiary, S–1.

With respect to the definition of a controlled foreign corporation, the May 31 draft eliminates some but not all of the problems raised in our previous testimony.

The U.S. stockholders may be taxed by reason of the new definition even though no U.S. group has effective control.

For example, the stock of a Belgian corporation is owned 45 percent by U.S. corporation A and 55 percent by a British corporation. U.S. corporation B, a competitor of U.S. corporation A, owns 10 percent of the British corporation. The balance of the stock of the British corporation is owned by British shareholders.

U.S. corporation B has no controlling voice in the management or policies of the British corporation. Under the stock attribution rules, 5.5 percent of the stock of the Belgian corporation owned by the British corporation is attributed to U.S. corporation B.

Because of this attribution, U.S. corporation A and U.S. corporation B together are deemed to own 50.5 percent of the stock of the Belgian corporation. The Belgian corporation is a controlled foreign corporation even though no U.S. group has effective control.

The May 31 draft raises difficult problems in interpretation of section 954. The problems can be best pointed up by the following examples.

First, assume that a foreign manufacturing subsidiary has substantial research facilities incident to its operations.

As a result it develops extensive foreign patents. The foreign subsidiary then licenses unrelated third parties under these patents. Would the royalty income from these licenses be considered foreign personal holding company income?

Second, assume that the foreign subsidiary is solely a research and licensing company. Would this change the result?

Third, assume that the foreign subsidiary buys patents from its U.S. parent company and then licenses unrelated third parties. Would the royalties under these licenses be considered foreign personal holding company income in the hands of the foreign subsidiary?

The ordinary income treatment on the sale of patents, know-how, et cetera, to a controlled foreign corporation, as provided in the May 31 draft, raises fundamental policy questions.

In whatever manner these policy questions may ultimately be resolved, we urge the committee to make it clear that taxfree transfers of patents and know-how can still be made if a tax ruling under section 367 is obtained. If the patents or know-how are transferred to a controlled foreign corporation which uses them in its business and if the transfer is not in avoidance of U.S. income taxes, then section 367 clearances should be given. Such transfers have a very favorable effect both on U.S. tax revenues and on the balance of payments.

Despite the substantial improvements made by the May 31 drafts, section 13 remains an inequitable and unnecessary provision. It is unnecessary because it, primarily, relates to the avoidance of foreign taxes and not to the avoidance of U.S. taxes.

It is inequitable because it places U.S. business abroad at a serious competitive disadvantage vis-a-vis its foreign competition.

Also, it imposes very costly administrative burdens on U.S. business operating abroad. It is impossible to tell at this time the full extent of those burdens. This is because the Treasury draft in at least 15 separate instances delegates to the Secretary the power to prescribe critical rules under which taxpayers must operate.

For these reasons, we respectfully urge the committee to delete section 13.

That concludes my prepared statement.

(The supplemental statement of Mr. Horne follows:)

SUPPLEMENTARY STATEMENT ON H.R. 10650 BY MANUFACTURING CHEMISTS' ASSOCIATION, INC., IN CONNECTION WITH THE ORAL TESTIMONY OF WILLIAM M. HORNE, JR.

The Manufacturing Chemists' Association is a national trade organization of more than 180 U.S. companies representing over 90 percent of this country's chemical production. On April 24, 1962, William M. Horne, Jr., chairman of the association's tax policy committee, presented oral testimony before your committee and submitted a more detailed statement for the record. This new supplementary statement, most of which was prepared for submission to the Commissioner of Internal Revenue, is directed mainly to the administrative and compliance problems presented by certain of the foreign income provisions, taking into account the modifications contained in the Treasury Department's May 31 draft.

This association is seriously concerned over the administrative problems presented by certain of the foreign income provisions which, we feel, would place an undue responsibility on the Internal Revenue Service as well as the taxpayer from the standpoint of compliance with the law affecting U.S. taxation of foreign income. Present experience indicates practical difficulties inherent in obtaining and presenting satisfactory evidence to permit preparation and audit of returns where much of the underlying accounting information is recorded on books of a foreign company maintained in accordance with foreign accounting concepts and recorded in foreign currencies.

H.R. 10650 and the Treasury May 31 draft would require information regarding foreign companies solely for U.S. tax purposes, information which would not be of value or interest to the foreign company. Such information would have to be available to all U.S. taxpayers with an interest in a controlled foreign corporation whether or not a U.S. tax abuse situation is considered to exist. Presumably records which are maintained solely to meet the needs of the U.S. taxpayer would be kept by its personnel or, at least, at its expense even though such records undoubtedly would have to be maintained abroad. Cases will arise where this procedure is neither feasible nor possible where one U.S. taxpayer does not have a majority stock interest in the foreign company.

In view of our concern with these administrative difficulties we have prepared the attached memorandum on certain problems which we foresee in practical application by the Internal Revenue Service and by the taxpayer of provisions incorporated in H.R. 10650 as presently drafted. In the course of preparation of the memorandum we have given recognition to modifications recommended by Secretary Dillon in his statement to the Senate Finance Committee on May 10.

The first part of the memorandum sets forth briefly selected areas of major difficulty which we foresee. Attached thereto are three appendixes illustrating in some detail and with examples the reasons for our concern.

COMPLIANCE PROBLEMS PRESENTED BY H.R. 10650

I. Section 6. Amendment of IRC section 482

New section 482(b) will require the taxpayer to keep accounting records to enable compliance at any time with a product-by-product determination of taxable income and of the statutory allocation factors.

Although these allocation factors would not be applied if the taxpayer can show an arm's length price, the taxpayer would have no current assurance that its price would be treated as an arm's length price.

This will require the maintenance of detailed property records and detailed income and expense records, both domestically and abroad, to furnish the information called for in the determination of (i) taxable income and (ii) the allocation factors.

These will be special purpose records which may not necessarily tie in with established accounting controls. This will make it difficult for Internal Revenue Service personnel to properly audit these records. It will also substantially increase the taxpayer's recordkeeping costs with respect to its own transactions and those of related foreign organizations.

To permit proper administration, the information required of the taxpayer should be based upon normal accounting records. Artificial allocations based on special purpose accounting records may lead to a breakdown of audit control. See appendix A for a discussion of customary financial and cost accounting practices and difficulties envisioned in presenting the required information.

II. Section 13. Controlled foreign corporations

This section unquestionably presents the utmost difficulties in compliance inasmuch as it would apply U.S. concepts of taxation to operations of foreign companies, located in and subject to the laws and tax procedures of foreign countries, doing business and recording transactions in foreign languages and foreign currencies. A number of the difficulties have been pointed out by witnesses at the hearings before the Senate Finance Committee. Secretary Dillon has stated that substantial modifications of this section are called for.[1] These comments are directed to three specific areas of potential difficulty in compliance which appear inherent in this form of tax proposal and not readily overcome by the indicated modifications.

A. Definition of controlled foreign corporation.—New subpart F, as drafted, would impose tax on every U.S. person owning stock in a controlled foreign corporation, and then, only with respect to certain income of such foreign corporation. Whether a corporation is a controlled foreign corporation may not be ascertainable if small shareholdings exist. Furthermore, a shareholder with a small stock interest would have practical difficulties in determining his pro rata share of income and earnings of the foreign corporation which are taxable to him. To resolve these questions apparently consideration is being given to restrict application of this subpart to U.S. shareholders who own a stock interest of at least 10 percent and who, in the aggregate, own more than 50 percent of the stock of the foreign corporation.

If so modified, the compliance problems are not solved for a shareholder who owns a stock interest of 10 percent or more and who requires specific information regarding income and earnings of a corporation during his period of ownership. Unless the shareholder is in a position to exercise effective control over the foreign corporation, he may not have access to company records or be

[1] Testimony of Treasury Secretary Dillon before Senate Finance Committee, May 10, 1962.

able to convince company management to furnish the detailed information called for by this proposal.

For example, four U.S. corporations may each own 15 percent of the stock of a foreign corporation, the other 40 percent being owned by a foreign corporation. The 15-percent ownership by each of the U.S. corporations would not permit any one of them to exercise effective control over the foreign corporation.

In practice, it is probable that the foreign shareholder with a 40-percent interest would be in a position to exercise management and control of the foreign corporation. Both the controlled foreign corporation and its foreign corporate shareholder understandably could object to the cost and effort required to determine information which is not in the interest of, and, in fact, may interfere with normal operating procedures of the controlled foreign corporation. Since the tax under this subpart is imposed only for the portion of the taxable year a corporation is a controlled foreign corporation, a daily determination of stock ownership becomes necessary. The U.S. corporation owning a 15-percent stock interest in a foreign corporation must establish whether more than 50 percent of the stock of such corporation is owned, directly or indirectly, by U.S. persons on any day of the taxable year.

The U.S. shareholders face substantial difficulties in determining whether these provisions are applicable to them, and a similar burden is imposed on the Internal Revenue Service in assuring compliance.

B. Sales income included in subpart F income.—New subpart F is designed to tax currently income of a controlled foreign corporation insofar as it is availed of to avoid taxes. Subpart F income includes certain sales income if, for the taxable year, it is equal to at least 20 percent of the gross income of the foreign corporation.

The income to be included is income from purchase of personal property from a related person and its sale to any person, or the purchase of personal property from any person and its sale to a related person where (*a*) the property which is purchased is manufactured, produced, grown, or extracted outside the country in which the foreign corporation is created or organized, and (*b*) the property is sold for use, consumption, or disposition outside such foreign country.

To enable its U.S. shareholders to comply, every controlled foreign corporation which does any business outside its country of incorporation would find it necessary to maintain product-by-product records with respect to purchases from or sales to related corporations tracing the flow of each product from its source to its destination.

Accumulation of such information would be necessary whether or not the subject sales income is equal to 20 percent or more of the foreign corporations gross income and without regard to the amount of any taxes paid to the country of incorporation or to other countries by the controlled foreign corporation.

This would require complex and costly recordkeeping on behalf of the U.S. corporation, something a foreign corporation conceivably could refuse to maintain. Even where they are maintained, such records present obvious obstacles to audit by the Internal Revenue Service.

Under this provision information, to be available, would have to be accumulated currently even though not used because the 20-percent limitation is applicable. See appendix B for a detailed statement covering this provision.

C. Determination of earnings and profits.—Secretary Dillon has recognized that there will be administrative problems in computing the earnings and profits of a controlled foreign corporation.[1] He has promised that the Treasury will provide clear administrative regulations in this area and that foreign corporations in computing earnings and profits will have elections which are available to domestic corporations.

Despite these encouraging assurances, we have substantial misgivings as to the ability of our foreign subsidiaries to compute their earnings and profits under U.S. standards.

Few, if any, foreign corporations maintain their records on the basis of U.S. concepts. To compute earnings and profits as required by section 13 of the bill,[2] a complete transformation of the accounting records back to the inception of the foreign subsidiary will be required. In many instances these records will simply not be available. The Internal Revenue Service is being asked to insure compliance with a statute that, in many instances, will prove impossible to

---

[1] Testimony of Treasury Secretary Dillon before Senate Finance Committee, May 10, 1962.

[2] Specifically, proposed secs. 952(a)(3) and 953(a)(1).

enforce. In those instances in which the records are available, the burden of compliance from the taxpayer's standpoint will be an onerous and costly one. U.S.-trained personnel will be required in violation of present policies of relying upon local personnel to the maximum possible extent. In those cases in which local foreign groups own substantial interests in the corporation, there is likely to be substantial opposition to the added accounting burdens imposed by the U.S. tax laws. At a minimum, the foreign interests will probably insist that these costs be borne exclusively by the U.S. controlling shareholder or shareholders.

To illustrate the compliance problem, the balance sheet of a United Kingdom subsidiary is analyzed in the attached exhibit (app. C) to raise some of the problems that will occur. The choice was deliberate. Here the subsidiary is operating in an English-speaking country with a relatively stable currency. The problems are substantially compounded by language difficulties, wide exchange fluctuations, and differing jurisprudential approaches.

III. Section 20. Information with respect to foreign corporations

Secretary Dillion has stated that section 20 needs to be modified.[3] He has recommended, for example, that U.S. officers and directors or U.S. subsidiaries of foreign companies should not be required to submit information on these companies if there are no substantial U.S. owners of these companies. He has further recommended that any information supplied under section 20 will be required only in accordance with the regulations in effect on the first day of a taxable year.

Incorporation of these recommendations into section 20 will represent a substantial improvement. Unfortunately, difficult operating and administrative problems will still remain. These include:

(1) The necessity for filing information returns each time there is a change in U.S. officers or directors of a foreign subsidiary.

Changes in the officers and directors of foreign subsidiaries do not on occasion become known, within the prescribed 90-day period, to the personnel in the U.S. parent company who are charged with compliance. Filing such reports on change of directors and officers will provide the Service with a large amount of useless reporting information and at the same time will place an unnecessary burden on U.S. tax administrators.

(2) The necessity for multiplicity of returns on the organization or reorganization of a foreign subsidiary.

Where a new foreign subsidiary is incorporated, there is no apparent reason why each U.S. shareholder, stockholder, and director should file identical information. The multiplicity of forms and information will add nothing to the Service's enforment procedures. Such duplication of information subjects both the Service and corporate tax compliance personnel to justifiable criticism from operating personnel.

(3) The open end requirement for further information under the proposed amendment to section 6038.

Since section 6038 has substantial penalties built in for failure to furnish information, the taxpayer should be clearly advised by statute of its responsibilities to supply information. The language of section 20 does not even limit this requirement of furnishing "similar or related" information to matters prescribed by Treasury regulation with full opportunity for hearing. The difficulties of compliance with present section 6038 which were brought to the Service's attention when it published its tentative regulations under the section should attest to the need for careful and detailed examination by taxpayers generally of any new reporting requirements.

IV. Sales and exchanges of patents, etc., to certain foreign corporations

The Treasury draft of statutory language of proposed amendments of H.R. 10650, dated May 31, 1962, would add a new section 1249 to the Internal Revenue Code. This would provide that gain from the sale or exchange after December 31, 1962, of a patent, invention, model, or design, a copyright, a secret formula or process, or any other similar property right to any foreign corporation by a U.S. person which directly or indirectly owns more than 50 percent of the voting stock of the foreign corporation will be taxed as ordinary income. A new section 1249(c) entitled "Other Transfers of Patent Rights, Etc., to Foreign Corporations" simply makes reference to section 482(a).

[3] Testimony of Secretary Dillon before Senate Finance Committee, May 10, 1962.

The Treasury explanation accompanying the proposed amendments indicates that the intention is to tax the sale of a patent, etc., to a controlled foreign corporation at ordinary income rates in cases where only capital gains or no tax would be paid under present law. It is stated further that this new provision would eliminate abuse by insuring that patents would be transferred abroad in arms-length transactions producing a full U.S. tax at the time of transfer or on an annual basis. The provision in section 13 of H.R. 10650, as passed by the House, which would have taxed to a U.S. person income realized by a foreign corporation, or income deemed to have been realized by reason of the use by a foreign corporation, of patents, etc., will now be eliminated.

The explanations of the purposes of this new provision do not accord with the proposed amendment to the code. Whereas the statutory amendment would only eliminate from capital gains treatment gain realized from the sale or exchange of a patent, etc., the explanation indicates that: (1) the new code section would insure that patents will be transferred abroad in arm's-length transactions; and (2) that the new provision would tax a sale in cases where no tax would be paid under present law.

The amendment to section 1249 would neither insure that transfers to a controlled foreign corporation were arm's-length transactions nor require that a tax be paid in every case. The tax consequences under present law of a sale of property to a controlled foreign corporation at less than fair market value are, to say the least, uncertain. Since no income is created by the transfer of property to another corporation, there would appear to be no basis for application of section 482 which deals with the allocation of income on transactions between related parties. In other words, the Commissioner cannot create income where none exists. Since the proposed amendment, in effect, deals only with tax rate, it is difficult to see how the proposed amendment to the code would in any way insure that patents, etc., are transferred to controlled foreign corporations only on an arm's-length basis.

With respect to the Treasury explanation that the new provision would tax the sale of a patent, etc., to a controlled foreign corporation at ordinary income rates in cases where no tax would be paid under present law, it is difficult to determine exactly what is meant. A sale of property would always involve a tax under existing law unless there was no taxable gain. Accordingly, the cited reference in the explanation must refer to a different situation. Patents, like other property, can be the subject of tax-free exchanges for stock involving foreign corporations under the liquidation and organization and reorganization sections of the code where, prior to the exchange, the Commissioner of Internal Revenue is satisfied that one of the principal purposes of the transfer is not to avoid Federal income taxes. However, an exchange is not a sale so that the Treasury draft apparently intends no change with respect to the applications of these provisions of present law. Of course, any property, other than stocks or securities, can be transferred to foreign corporations as a contribution to capital or paid-in surplus without the incidence of U.S. tax.

There is nothing in the proposed amendment to section 1249 which would apply either to tax gain on otherwise tax-exempt exchanges or on contributions to capital. However, the statement in the explanation is confusing and misleading and, it is feared, may provide the basis for an administrative ruling that any transfer of a patent or like property to a controlled foreign corporation has as its purpose the avoidance of Federal income tax within the meaning of section 367 so that gain on such transfers would always be subject to tax.

It is impossible to determine what policy motive underlies the proposal to tax the gain from the sale or exchange of patents, etc., to controlled foreign corporations at ordinary income tax rates. The property to be so treated would include almost any kind of intangible asset which a domestic corporation must transfer to its foreign subsidiary in order to compete in foreign markets. In cases where such assets could be transferred under present law in exchange for stock of the foreign corporation, the requirement that all such transfers involve a U.S. tax must certainly have an unfavorable effect on the ability of U.S.-owned subsidiaries to compete in foreign markets. Furthermore, if U.S. companies must invest cash rather than to contribute intangible assets to acquire stock in foreign joint ventures, the short-term effect on the balance of payments would be unfavorable. Such U.S. tax treatment would create an additional inequity because, in many cases, foreign governments will not permit a related foreign subsidiary to claim tax deduction for royalties paid to its parent companies.

There would seem to be adequate safeguards in the present law to prevent any abuses which may be involved in the transfer of patents and like property to controlled foreign corporations. Section 367, which requires prior clearance by the Commissioner of Internal Revenue before such transfers can be tax free, prevents the avoidance of tax in any case where the Commissioner is satisfied that this is one of the purposes of the transfer. It is our understanding that for some time the Commissioner has refused to issue a favorable ruling under section 367 where it appeared that the transferee corporation intended to sublicense the rights transferred by its U.S. parent rather than to use them in its own manufacturing operations. However, even this situation would be discouraged under the present draft since royalty income realized by a foreign controlled corporation would be taxed to the U.S. shareholder as subpart F income under section 951. This should effectively eliminate any abuse which presently could arise from the practice of assigning patents to foreign subsidiaries for the purpose of converting royalties from sublicensing from ordinary income if realized by the parent into capital gains when realized through a foreign subsidiary.

Proposed section 1249 also contains an odd, unexplained novelty, in the form of a "subsection (c)" which, by a mere cross-reference, legislates as to "Other Transfers of Patent Rights, etc., to Foreign Corporations." This type of cross-reference should be removed. If there is to be legislation as to "other transfers" it should be done in a forthright and clear manner, and in a way which informs taxpayers as to the purpose and desired results. It is impossible to ascertain the intent of this cross-reference from the section itself.

Appendix A

Compliance Problems Presented by New Section 482(b) in the Light of Customary Financial and Cost Accounting Practices

Section 482 providing for allocation of income and deductions among taxpayers would be amended by the addition of a new subsection 482(b) to prescribe methods for such allocation in the case of sales of tangible property within a group of organizations where at least one organization is domestic and one is foreign. Subsection 482(b) will not apply with respect to any sale of tangible porperty for which the taxpayer can establish an arm's-length price within the meaning of paragraph (b)(4). Inasmuch as 482(b)(4) would require considerable exercise of judgment, the taxpayer generally has no current assurance that its price is an arm's-length price. Therefore, the taxpayer must have information to determine taxable income of the group, with respect to sales of specific tangible property and the allocation factors related thereto where a foreign organization is involved in such sales.

Application of subsection 482(b) would require examination of intercompany transactions on a product-by-product basis and determination of taxable income on a product-by-product basis. The taxable income so determined would then be subject to allocation to members of the group. The method of allocation proposed would take into account certain factors (property, compensation, and selling and certain other expenses) assigned within and without the United States on a product-by-product basis.

An American manufacturing company may well produce hundreds of products with varying costs and at different plant locations, in part for domestic and in part for foreign markets. The sales price will not necessarily bear a uniform relationship to the costs of each product in view of special factors, factors which may also be considered in the income allocation (see last sentence of section 482(b)(2)(A)). In this complex atmosphere, practical difficulties are envisioned in establishing and maintaining business procedures and records to make information available for taxable income determination in accordance with the provisions of subsection 482(b). Each financial factor must be isolated as it relates to specific products and further identified with that portion of such products sold in international transactions. This determination involves property and income and expenses both within and without the United States, suggesting substantial difficulties in reaching a satisfactory determination with respect to each factor. Rather than dwell on each of these factors we propose at this point to explore in depth one particular factor, the determination of product costs and expenses.

Foreign accounting records presently do not develop income and costs on a product-by-product basis so that to accumulate this new data, special accounting procedures must be established. The problem of special cost data accumulation is accentuated for those taxpayers who do not determine unit costs within the framework of their present cost accounting systems.

How can companies operate without developing total unit costs?

The approach used by some companies is to determine profitability of a product only in relation to the level of directly assignable costs. Since most of the other costs are fixed by broad cost policy (i.e., research, size of sales force, size of administrative staff) independent of the short-term day-to-day sales volume, profitability is viewed in relation to the contribution to the total basket of all unassigned costs. Thus, any product which in the short term is making some contribution to the total unassignable costs is considered to be acceptable. In the longer term if the total contribution by all products becomes insufficient to cover the total unassignable costs, broad policy decisions are required (i.e., product or product line deletion or curtailment of the unassignable expense costs).

Under this approach to the problem, all unassignable costs are lumped together as a basket of costs and no assignment to specific products is made. While this limits the precision with which profitability by products can be analyzed, it is a fact of the operating environment to which the decisionmaking process must be accommodated. The problem of cost determination by product, which is envisioned in the provisions of new subsection 482(b), would require a computation which is not considered feasible by certain industry taxpayers for purposes of their own internal operations.

Assignment of research and selling costs to specific products

Research costs represent a major cost element in a number of industries as, for example, in the chemical-pharmaceutical industry. Frequently, however, research expense may not be assigned to any existing product. In addition, the ultimate assignment depends on the outcome of unknown future events (i.e., technical outcome of the research product and the commercial success of any product or process developed). The problem of research cost allocation is so complex that a workable solution of relating research cost to specific product has not been found in the industry.

The problem of assignment of research cost is further complicated where some products are developed through company research, others are manufactured under license agreements, and still others where the profit is substantially attributable to industry know-how; in this not uncommon situation, any arbitrary percentage assignment of research costs would produce an inappropriate result. Because of difficulties such as these, it has been general industry practice to expense research costs on a current basis. So difficult are the accounting problems involved that this expensing practice was concurred in by the Internal Revenue Service even before the advent of the 1954 code.

Marketing costs represent another substantial area of expense which industry cannot allocate reasonably on a direct basis. Substantial marketing costs are concerned with the original and early development of a market, with such costs leveling off as product acceptability and higher sales are established.

Another difficulty in the assignment of marketing costs arises from the fact that the marketability of an item overseas is influenced by the image of that product in the U.S. market. A leading U.S. product resulting from a substantial investment in U.S. marketing effort can have an enhanced position in oversea markets. Conversely, an item which becomes well established in the more developed oversea markets directly gains in U.S. markets by virtue of its recognition in competent circles abroad. This is particularly apparent in the ethical pharmaceutical areas where the recipients of the marketing effort are a professional medical group with established channels for an international exchange of current developments in the medical field. Where a product is introduced domestically, its introduction program overseas will be determined by experience gained from the costs of the U.S. introduction. Similarly, where a product is introduced overseas, there is a direct reference with respect to its domestic introduction.

Further, with respect to the assignment of marketing costs to products, there is a substantial timelag in that marketing costs may be incurred during one accounting period which show up in the profit results of a subsequent period. Additionally, many selling expenses other than specific advertising are directed to a general line of products. However, they cannot be assigned on an average basis since frequently there is greater emphasis on the more profitable products or product representing a particular problem at a given period of time (i.e., seasonal products, high inventories). Management normally considers that it is not practical to establish accurate product assignment records for this general type of selling effort.

An additional complication with respect to selling expense arises from the direction of the sales effort as, for example, the pharmaceutical industry practice of promoting sales through the medical profession rather than to the consumer. This results in a substantial amount of selling effort being devoted to image building rather than to an immediate sale of a specific product.

It is recognized that where overhead and indirect costs to be assigned on an arbitrary basis are some 10 to 30 percent of total costs, the arbitrary nature of the assignment may not be significant in the end result. But in a number of industries, as in pharmaceuticals, the proportion of allocable indirect and overhead costs may run from 70 to 90 percent of total costs. Thus, arbitrary assignment of such expenditures on a product-by-product basis could result in a material distortion of profit allocation.

Assignment of costs to products on a worldwide basis would be further complicated by widely diversified product mix between different entities involved in international transactions, divergent methods of manufacture and distribution, uneven participation in research programs by domestic and foreign companies, fluctuating currency exchange rates in certain countries and differences in accounting methods, as well as the problems of distance, communication, and language which affect transactions between countries.

Need for detailed property, income, and expense records

A number of the difficulties in determining income and allocation factors have been suggested when related to an accounting system which does not develop the basic cost data required by the proposed allocation method. Every taxpayer engaging in transactions contemplated by subsection 482(b) would be faced with a decision either to adopt its accounting system (and that of its foreign subsidiaries) to develop the required information, or set up certain special-purpose records to accumulate information related only to those sales to which section 482 might be applied. It is probable that the latter alternative generally would be preferable since it concerns only a fraction of the total transactions of U.S. and foreign entities.

The special-purpose records might consist of analyses setting forth as a minimum, in the case of the U.S. company, date of sale, customer name, description of product, package style, quantity, unit price, total price, and direct costs. Where this data is already accumulated by machine accounting, it may suffice to take off monthly totals of the foregoing information by customer and by product. Thereafter, the company is faced with the problem of assigning indirect costs and selling and research costs as previously outlined. In addition, some listing of property used in the production, distribution, and sale would be required. This could well be more formidable than the assignment of costs and expenses.

Similar records would be required of foreign subsidiaries in such form as deemed necessary by the taxpayer. Since foreign currencies will be involved, translation into U.S. dollars will be required, presenting some complication in the case of fluctuating currencies. The U.S. taxpayer will be put to the expense of setting up the special records both here and abroad, the added cost of currently maintaining such records, summarizing at yearend and presumably periodically auditing the records for accuracy. To the extent additional compensation and expense are incurred here and abroad in order to obtain the information required solely for U.S. tax compliance, the question arises whether

the added cost is assignable to the United States in effecting such business transactions.

Taxpayers would not choose to keep unnecessary records but, when they are required, would have to be assured that they are properly maintained. This does not appear to be an easy matter for internal control. Furthermore, the Internal Revenue Service would find it extremely difficult, time consuming, and expensive to audit such records and presumably would have to rely in large measure on the data presented by the taxpayer.

To avoid these difficulties and to permit proper and reasonable compliance by the taxpayer and audit by the Internal Revenue Service no information should be required which cannot be maintained conveniently on a current basis and from accounting records reasonable and normal in the taxpayer's business.

Appendix B

Foreign Base Company Sales Income of a Controlled Corporation—Case Study of Subsidiary of U.S. Corporation

In order to illustrate some of the practical difficulties confronted in determining certain sales income which may be taxable under subpart F, the typical situation of a foreign subsidiary should be considered. In this case the subsidiary is incorporated in and has manufacturing plants in a single large country.

As in the case of its American parent, subsidiary is not presently restricted as to where it acquires its raw materials, semifinished and finished products for sale. Similarly, it is not restricted in seeking customers and, accordingly, makes substantial sales outside the country of its incorporation. It is operated under an independent management which, undoubtedly, in large measure accounts for its profitable operations and ability to return substantial dividends to its American parent.

It is located in a developed country, but between 30 to 40 percent of its sales are for export. Its export sales in 1961 were to customers located in approximately 40 countries. Some of these sales were to parent and affiliated companies both within and without the United States. The balance of the sales were generated both within a foreign country and through customers in the country of incorporation who, in turn, had affiliates abroad. Undoubtedly, some of its sales to customers in the country of incorporation were destined for export to other countries.

Its line of products includes some 700 different items which were sold in 1961. Approximately one-third of these items were manufactured by subsidiary and the balance were purchased from affiliates and others for resale. In order to have a full line of products subsidiary would have to offer resale items to its customers until such time as it could economically manufacture the product itself.

The major source of subsidiary's material and products may be classified in the several groups set forth below:

(1) Finished products, manufactured, packaged, and labeled by affiliated companies in the United States and Canada and bulk materials from such affiliates resold by subsidiary without further processing.

(2) Finished products obtained from affiliated companies in the United States and Canada and packaged, labeled, and sold by subsidiary.

(3) Raw materials obtained from affiliated companies in the United States and manufactured and sold by subsidiary.

(4) Raw materials and finished products not of United States or Canadian origin purchased by subsidiary from other intercompany sources.

(5) Raw materials purchased locally and manufactured and sold by subsidiary.

(6) Finished products purchased from unrelated companies both within and without the country of incorporation of subsidiary.

It is obvious that a large volume of the sales of subsidiary would be classed as foreign base company sales income as defined in section 952(e)(2). To determine whether such income equals at least 20 percent of the gross income of subsidiary, it would seem necessary to trace, on a product-by-product basis, the flow from sources outside the country of incorporation to delivery to cus-

tomers outside of such country where an affiliated company is in anyway engaged in the purchase or sales transactions. In the case of certain products purchased in bulk and packaged and labeled by subsidiary, it msut be determined whether this is an includible or excludible sales transaction.

Only subsidiary would be in a position to determine the required information and it seems questionable whether in the present case this can be done reasonably and accurately. The U.S. parent would have to participate in any survey to determine whether such information could be obtained and presumably would have to assume the expenses of any recordkeeping installed to provide the information.

Accumulation of this information would be necessary whether or not the 20-percent test is met, not only to comply with the law but to have the support to enable audit by the Internal Revenue Service.

The foregoing case study is not unique but may be faced many times over by American companies with subsidiaries operating in foreign countries where effective income rates may be higher as well as lower than those currently in effect in the United States.

Appendix C

Analysis of Financial Statements of a British Subsidiary in Terms of Problems Presented in Computing "Earnings and Profits" Under U.S. Tax Concepts

(1) Freehold, leasehold, land, buildings, plans, vehicles, and furniture at 1930 valuation or subsequent cost less depreciation

It will immediately be seen that for U.S. tax purposes the 1930 valuation is meaningless. Furthermore, subsequent sterling cost would have to be revalued by determining first how the assets were acquired, and second, whether acquired before or after the September 1959 sterling devaluation date. The problem of tax basis is further complicated by the fact that a portion of these assets are located in European countries and were acquired in currencies of those countries, some of which have been subject to their own exchange variations. Some of the properties may also have been acquired by exchanges or trade-ins, giving rise to the inquiry whether, under the U.S. revenue laws in force on the date of the exchange or trade-in, a substitute or other basis applied and whether the book basis reflects the proper tax basis. In the case of a trade-in, the basis of the property turned in would likewise have to be established.

Following the determination of tax basis, we would then be required to turn our attention to the annual allowance for depreciation. Tax systems relating to depreciation vary between the United States and other countries as well as between and among such other countries. Some permit or require the application of methods completely foreign to the allowance granted under the tax laws of the United States. In order to determine current and accumulated earnings, a determination would have to be made as to the amount of depreciation allowable under U.S. tax laws applicable to each year subsequent to the acquisition date, even though the earliest acquisition may have occurred many years ago. Even in the case of property no longer on hand, it would in many instances be necessary to recompute depreciation applicable to it before its disposal.

Further, there is no provision in the bill as it now stands regarding the exercise of the many elections a U.S. taxpayer is required or permitted to make.. In the case of depreciation, these elections include the choice of methods in general, and, since 1953, the choice of one of the accelerated methods. Will the controlled foreign corporation be permitted to elect retroactively as well as prospectively one of these methods? Secretary Dillon has stated that the Treasury will permit foreign corporate earnings and profits to be computed with the benefit of elections similar to those which are available to domestic corporations. However, if foreign laws or other reasons prevent a revision of the corporation's records to the U.S. method, it is doubtful that it would be prac-

tical for the U.S. shareholder to make the election and attempt to keep running records of different depreciation reserves involving adjustments for dispositions. Retroactively, the data would generally not now be available to make such a recomputation.

(2) *Investments at cost less amounts written off*

Again, the problem is one of determining tax basis. Are the U.S. tax concepts to be applied to acquisitions that might, or might not, have qualified for a substituted basis? Also involved are the currency exchange problems to which reference has been made. How do we now determine whether the investment involved a reorganization under U.S. law, whether it was a "stock" or "security," and all the other questions which are complex enough in the case of current U.S. corporate transactions.

The balance sheet used as a basis for this memorandum shows that the investments are not carried at cost, but at cost less amounts written off. The nature of the write-offs, the times they occurred, and their effect would have to be determined with respect to each individual investment in order to determine tax basis for U.S. tax purposes.

The proper treatment of such items as dividends, stock splits, and similar corporate financial transactions would also have to be resolved. Each determination would necessarily be made in terms of prevailing currency exchange conditions as of the time the transaction occurred. While this is comparatively long in terms of sterling exchange restrictions, it will be much more complicated when the investments involve francs, marks, guilders, pesetas, and so forth.

(3) *Stocks at the lower of cost and net realizable value*

It will be noted here that even though we are dealing with a British corporation, interpretation is necessary.

The term "stock" refers to what in the United States would be called inventories. Again the question arises as to how inventories will be valued, a critical consideration in the determination of profits for any particular year as well as accumulated earnings in general. By choice, or by requirement, inventory methods employed by the foreign corporation may be at variance with those applicable under U.S. law. For instance, the inventories may not include any overhead or may include material on an unacceptable basis. In the United Kingdom, fixed overhead is frequently, if not usually, expensed. Further, we again have the problem of elections. Under U.S. law, taxpayers may elect, for example, the LIFO method of inventory and adhere to it thereafter. Will the foreign corporation be permitted to restate foreign inventories by retroactively electing LIFO? Will it be bound by cost if that method has been employed, or will it be permitted to elect cost or market? Assuming it may elect LIFO, for U.S. purposes, can a U.S. shareholder maintain the records required to give effect to LIFO independently of the corporate records themselves?

(4) *Debtors, bills receivable, and payments in advance*

Aside from currency exchange problems, the matter of elections again arise. U.S. corporations may elect for tax purposes to use the reserve method for bad debts. However, such election is to be made on the first return of the U.S. corporation. Will this election be made available retroactively to the foreign corporation? Will the fact that the foreign corporation, on its books or its annual reports, provides or fails to provide a reserve have any bearing on the right of election? How will the records be kept if the foreign taxing authority and the Internal Revenue Service differ on the reasonableness of the reserve? How will this or other elections be made by U.S. shareholders if they differ, as they well may. If there are two U.S. stockholders, one owning 40 percent and the other 25 percent of the stock, the first being in a loss position and the other in an income position, how and who will dictate the making of the elections?

(5) *Cash at bank and in hand*

This is the only item which does not present too serious a problem except for currency exchange adjustments. However, it is also generally the smallest item on the balance sheet.

(6) *Profit and loss*

We have not to this point touched on the profit and loss accounting of the foreign company. In the case of British companies and many others, this is customarily stated in a form so abbreviated and so at variance with U.S. customs

that it would almost appear impracticable to comment on it. However, it may be appropriate to mention some of the problems not previously referred to which will require solution in order to determine subpart F income.

One of the more important areas is that involving research, experimental and patent costs. Many foreign corporations expense all costs pertaining to patents. The bulk of these at least until very recently have not been allowable as deductible items under U.S. laws. It would therefore be necessary in the case of any company which had secured patents to determine the basis of such patents for the purpose of amortization. It is not unusual for foreign companies to make international patent arrangements of a very complex nature which would make determination of basis difficult in the extreme. Allied to this problem would be the proper treatment of research and experimental costs which again involves an election under existing U.S. law, an election no foreign corporation has had occasion to make. It must be remembered in this connection that there is no reason to expect such costs to be accumulated, segregated, and earmarked in a manner making identification easy. Anyone who has attempted to determine which foreign taxes are income taxes will appreciate the difficulty of identifying foreign accounts through the translation of the names used in foreign countries to describe them.

Another area of more than potential difficulty arises in those instances in which foreign corporations provide pensions for their employees. Obviously such pension plans were created in a form which would comply with the legal and tax requirements of the jurisdiction in which the employer operates. The foreign requirements will normally differ materially from the requirements to be complied with in order to obtain approval under the United States Code. It would be the rare instance in which a foreign plan would be acceptable under the U.S. requirements. Are contributions to pension and profit-sharing plans approved for foreign tax purposes to be disallowed because not approved by the Internal Revenue Service? For example, what effect will be given to contributions deductible under the foreign law but nondeductible as an advance or prepayment under the U.S. tax law?

Possibly one of the greatest difficulties in obtaining necessary data would relate to transactions which occurred in years long past as to which the foreign corporation had no reason to maintain long-term records. For example, in the case of past subsidiary liquidations, the acquired assets may have been placed on the foreign parent's books at appraised values or at some other valuation completely at variance with U.S. tax concepts.

Another such area giving rise to the same type of problem would be major expenditures for what under foreign law or customs were considered charges against current income such as repairs, but which under U.S. standards should have been capitalized and subjected to depreciation. It will be difficult, or, more fairly stated, impossible, in many instances for the U.S. shareholder to determine whether many years ago the foreign corporation charged to expense some large expenditure such as the cost of complete renovation of a building or plant, which under U.S. laws should have been capitalized.

In all that has been said up to this point, we have considered only the determination of annual income, and earnings and profits, of the foreign corporation. Under the bill, this is in reality only the first step. The earnings and profits of the foreign corporation would then have to be allocated to (1) subpart F income, (2) subpart F income invested in nonqualified property, (3) earnings other than subpart F income invested in nonqualified property, and (4) other earnings and profits.

It is not clear whether these accounts would have to be kept in foreign currencies or U.S. dollars, nor just what effect changes in the conversion value of the foreign currency from time to time would have on these accounts. Nor is it clear how fluctuations between these accounts would be treated.

The bill sets forth rules for the taxation of increases in amounts invested in nonqualified property but does not seem to deal at all with what happens when there is a decrease. It would appear possible that without any increase in the aggregate accumulated earnings, repeated increases and decreases in the relative amounts invested in nonqualified as compared to qualified property might result in the taxation of amounts in excess of the actual net increase in nonqualified investments.

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

Any questions?

Senator Morton.

Senator MORTON. Mr. Horne, I don't know whether your pages are numbered the same as mine but on page 5 of my draft, the effect on less developed countries, at the bottom of page 4 and then the concluding sentence in that paragraph on page 5, the income of the sales subsidiary would be subject to current U.S. income tax whether or not the income was reinvested in further distribution outlets in other South American countries.

I think you have made a correct statement there in your analysis of the May 31 draft.

Don't you think that is diametrically opposed to the philosophy of the Alliance for Progress, in particular Secretary Dillon's statement that we had to get $300 million a year from the private sector for investment to make thhe Alliance for Progress work?

Mr. HORNE. Certainly it puts substantial restrictions on it, Senator. That is correct. It seems to move in the opposite direction from the philosophy of the Alliance for Progress.

Senator MORTON. In other words, we implemented a program here last year, some of us are not too happy with the results, but at least we are all hopeful it will work and here we are asked to legislate in a tax matter to discourage that $300 million or a portion of that $300 million that the program itself envisages as being the responsibility of the private sector of the economy.

Isn't that statement of mine basically correct?

Mr. HORNE. That is correct, sir. This appears to be a completely different approach from the prior draft which would have permitted the reinvestment in the less developed countries.

So to that extent it seems to be moving in the opposite direction, even from the House bill.

Senator MORTON. Mr. Horne, several witnesses in the hearings have referred to the difficulties of applying to a foreign subsidiary the U.S. income tax rules for determining earnings and profits.

Do you consider this a problem under the May 31 draft?

Mr. HORNE. Yes, Senator; that is a very substantial problem. We have gone into that in considerable detail in our supplemental statement which I have requested permission to be filed with the record.

The reason that we have gone into such detail is that this is one of the really most difficult of the administrative problems presented by the old section 13 and it runs throughout the new draft.

In other words, you have to make these determinations based on facts going back to the beginning of your foreign corporation and you may not have the records still available to make these determinations. Also, the new May 31 draft says you have certain elections that you can make under U.S. tax concepts, but there are some very difficult questions as to when these elections are to be effective, how you would apply them and whether you would have the information to apply them even if you made them. Because of these very difficult problems we think this is one of the areas in which the administrative requirements are so difficult that it will be practically impossible to comply with them.

Senator MORTON. Then the problem is different from the determination of earning and profits for purposes of adjusting the foreign tax credit?

Mr. HORNE. Well, theoretically the determination of profits and earnings for foreign tax credit is the same. Of practical necessity the computation of earnings and profits for foreign tax credit is currently being done by using the actual earnings and profits of the foreign subsidiary under foreign law, rather than trying to go back and reconstruct an entirely new set of figures under U.S. concepts. If this procedure has been required of necessity in the case of foreign tax credit, it seems to us it would be demanded in the much more extensive and difficult determinations under section 13. Of course that would be contrary to the requirements of the legislation, so in effect the Treasury is asking for legislation which is going to be a nullity on the books if it is enacted.

And this, we think is bad legislative policy.

Senator MORTON. The Secretary, in testifying on another subject, said that he might have no objection to accepting criteria for the designation of developed and less developed countries.

Do you have any suggestions along that line, any type criteria that might be used?

Mr. HORNE. As we understand the draft, sir, the executive branch would determine by executive order which countries qualify under the description of the less developed countries, except of course, the statute, as drafted, specifies 21 countries not to be listed as less developed.

Now, if the committee were to consider this type of legislation, it might make more sense to say that all countries other than those 21 countries shall be less developed, and then permit the executive branch after sufficient notice to delete countries when they no longer qualify as less developed. At that time it might be desirable to have some kind of a review by the legislative branch such as the Congress does in reorganization plans.

That way you would give the maximum opportunity to taxpayers to plan their affairs in advance and of necessity revise their long-range policies for planning investments overseas. Furthermore, they would have a much greater degree of certainty than under the present language.

Senator MORTON. You have voiced a number of objections to this May 31 draft to section 13.

What would be your views as to the desirability of restricting the taxation of foreign based company income to those instances in which income is unreasonably accumulated in a foreign corporation and is not reinvested.

Which is along the same lines, I think, that Senator Kerr posed to the previous witness.

Mr. HORNE. Well, sir, our basic approach is that section 13 really isn't necessary. There is certainly ample authority under the present section 482, to reach the cases of tax avoidance. I know you are concerned with the avoidance of U.S. income taxes and I think I can assure you that the Internal Revenue Service, and the Treasury have ample authority under 482 to get at those cases.

It may be necessary to give them authority in some cases to get more information. But I think the recent legislation passed by the Congress will provide the information requested. As a practical matter we haven't really had a chance yet to see whether or not these additional information requirements, when they are fully enforced and

administered by the Internal Revenue Service will give the Treasury all that it needs to reach the tax abuse and tax avoidance case.

Essentially, section 482 operates as an in terrorem measure and it gives the revenue agent a chance to impose some very stringent ideas of his own as to what constitutes tax avoidance or as to when income is being diverted for U.S. income tax purposes.

So, I think there is ample control now in section 482 if the Treasury and Internal Revenue Service carry out their new program in administering that section.

So, I don't think that this section 13 is necessary. But if the committee did think something like section 13 had to be enacted we would hope there would be something like this unreasonable accumulations provision added to the foreign-based company income because I think it is only there that you have any real problems of accumulating funds abroad.

And this is essentially——

Senator MORTON. But you don't want to imply that 482 prevents, as it is today, the accumulation of unwarranted or unreasonable accumulation of capital abroad. I mean we would have to put something in.

Mr. HORNE. Well, that is true.

As a practical matter the publicly held corporation, simply does not keep its funds unreasonably accumulated abroad. It can't afford to. It has to reinvest them or bring them back. For this reason we feel, as far as the publicly held corporation is concerned, there will be no unreasonable accumulation. However, if additional legislation is thought to be desirable it could perhaps be enacted as an enlargement of the foreign personal holding company provisions relating to closely held corporations.

Senator MORTON. I agree with you there is no unreasonable accumulation of publicly owned corporations because the stockholders wouldn't hold still for it under our incentives which bring about investment in a foreign corporation or domestic corporation.

Stockholders meetings in this country are replete with demands upon management that they pay out more in dividends.

But there are those on this committee who keep harping on this point and what I am trying to develop is an answer to that argument just because it is permissible under the law to leave it there is no sign it is left there because of the pressures that generate from the investing public.

They wouldn't invest in such a corporation, if they are going to have all their money tied up in Switzerland, Panama or some place else. But there seems to be so much apprehension on the part of some on this committee that we ought to do something about this that I was wondering if it wouldn't be practicable to apply what we have with respect to domestic corporations rules of unreasonable accumulation apply to foreign subsidiaries of American corporations.

Mr. HORNE. If the committee thinks that that is a real problem under the existing practice, then perhaps the foreign base company income approach could be used to provide for current taxation to the extent that income is unreasonably accumulated. We really question whether that is necessary under existing law.

Senator MORTON. I am not too concerned either, but looking down the road ahead I just wanted to get your views on this because I know you have vast experience in this field.

Senator WILLIAMS. Would the Senator yield at that point?

Senator MORTON. I would be happy to.

Senator WILLIAMS. I think section 531 deals with questions of unnecessary accumulations and the question arises perhaps that does not apply to the accumulations of foreign subsidiaries and if I understand the question from the Senator from Kentucky right and one to which I would like to get the answer, how would you feel about amending section 531 if it needed to be amended to make it apply to the accumulation of earnings of foreign subsidiaries.

Do you think that would answer the problem?

Mr. HORNE. As I understand the question, Senator Williams, in effect you are saying, that to the extent that something needs to be done, you would attack the unreasonable accumulations through that particular section.

Now, irrespective of which section it is put into, I think the problem basically is whether there is any need for such a provision in the case of a controlled foreign corporation abroad which is owned by a publicy held U.S. company.

I think the answer clearly has to be "No," because the U.S. stockholders as Senator Morton pointed out, simply won't stand for the unreasonable accumulation of funds abroad. The publicly held U.S. company is quite different from a closely held company where a few individual stockholders might find some advantage in accumulating funds in a foreign pocketbook.

Senator WILLIAMS. I am inclined to agree with the Senator from Kentucky, if he will yield, this may not be the answer but I just raise the question as to how, in your opinion, an amendment to section 531 as suggested, would effect it.

Mr. HORNE. Mr. Sherfy might like to answer that.

Senator WILLIAMS. Which would answer this criticism we are getting sometimes as to excessive accumulation.

Whether there would be a better way to approach it or not, I don't know.

Thank you, I thank the Senator from Kentucky.

Senator MORTON. I think any other is a better way; I can't think of a much worse way than what we are trying to do in approaching it in this bill.

Any way would be a better way. In the first place, we are dealing with tax havens. Some people assume that any company that incorporates a subsidiary in any of these countries under the slang expression of a "tax haven," that they do so only to abuse a privilege and do so only because of tax motivation.

In this country, many companies were incorporated in Delaware and other States because there are many business advantages in that, and I think we have to look at this in that same broad sense.

If there is any way to spell out in this bill the abuses, and there are some, because of this tax haven operation, I would be for it. But this May 31 document leaves me just about as cold as the original proposal, and I am coming more to the opinion we will have to approach it, if we have to approach it at all, through forcing the foreign-owned

subsidiaries to pay out dividends when the accumulation is shown to be unreasonable and unnecessary for the expansion of their business in that country or in any other country, developed or underdeveloped.

I think that our balance of payments would be better off if we forget the section that we are discussing here now and I think another thing that you will find will be the costs from an administrative standpoint on the companies, the accounting costs and so forth, involved in this proposal. I am glad you have submitted this long supplement here and I hope we do put it in the record. I think it should be in the record. Those accounting costs will far exceed any possible recovery to the Treasury of the United States in dollars.

Mr. HORNE. That is correct.

Senator MORTON. I thank you, Mr. Chairman.

The CHAIRMAN. Any further questions?

Thank you very much, Mr. Horne.

The Chair will insert in the record these two documents:

Statement of William M. Adams for Sprague International, Ltd., and letter dated June 15, 1962, of Roy S. Jones.

(The documents referred to follow:)

STATEMENT OF WILLIAM M. ADAMS, FOR SPRAGUE INTERNATIONAL, LTD., ON H.R. 10650

I am William M. Adams, president of Sprague International, Ltd., a subsidiary of Sprague Electric Co., North Adams, Mass., a manufacturer of electronic components and equipment.

When I testified before this committee at the earlier hearings on H.R. 10650, I enumerated the various obstacles our company has encountered in trying to remain abreast of our foreign counterparts. At that time I stated that the foreign income provisions of H.R. 10650 thrust an unjust burden upon our company and the many other U.S. corporations which are attempting to compete effectively in foreign markets and suggested that section 13 of the bill passed by the House be deleted or substantially amended.

We were, of course, heartened when Secretary Dillon appeared before this committee on May 10 and indicated that substantial modifications would be made in the direction of alleviating the harsh and unreasonable elements of the section. However, when the draft of the Treasury revision of section 13 was released we were astounded to find that some of the revisions proposed by the Treasury are even more extreme and arbitrary than the measure that passed the House.

Our company appreciates the opportunity to appear again before this committee to express its views on these new proposals by the Treasury.

The Treasury proposes to revise that portion of section 13 of the House bill which would tax U.S. shareholders on a current basis with respect to income derived by a controlled foreign corporation from any exploitation abroad of U.S. developed patents, copyrights, and exclusive formulas and processes. Conceding the unworkability of its former approach, the Treasury would now deal with the problem at the time the patent or like property is transferred to the foreign company to insure "that patents will be transferred abroad in arm's length transactions producing a full U.S. tax at the time of transfer or on an annual basis".

Under the Treasury's proposal if such property is sold to the foreign company, payments to the U.S. parent would be taxed as ordinary income, rather than capital gains, as is normally the situation under existing law. Apparently the Treasury would expand the category of property which would be subject to this ordinary income treatment so as now to include patents, inventions, models, or designs (whether or not patented), copyrights, secret formulas and processes, and other similar property rights.

The proposed revision by the Treasury can fairly be criticized on these two major grounds:

(1) There is no logical or equitable basis for taxing a U.S. company at ordinary income rates in selling intangible property to a controlled foreign corporation where the sale of the identical property to any other party abroad or in the United States, including a controlled U.S. corporation, would produce capital gains.

(2) In most circumstances, any royalty income received by a foreign subsidiary from the licensing of such intangible property rights would be taxed currently to the U.S. parent as "foreign personal holding company income" under other provisions of section 13. In effect, then, the United States would first levy a tax at the time the patents or other rights are transferred to the foreign subsidiary, and thereafter tax royalties collected by the subsidiary from the licensing of these same rights. This consequence is especialy oppressive when it is considered that of the various intangible properties covered by the proposal normally only patents have the fixed life required to permit depreciation by the foreign company.

In a somewhat related area, the Treasury revision would create an additional category of income—called "foreign base company service income"—that would be taxed currently to the U.S. parent company even though earned by its controlled foreign corporation. "Foreign base company service income" is defined to include income derived by the foreign company in connection with the performance of technical, managerial, engineering, architectural, scientific, skilled, industrial and like services which are—

> (1) performed or furnished for or on behalf of any related person; and
>
> (2) are performed or furnished for, or in connection with business activities carried on by or on behalf of such related corporation outside the country of incorporation of the foreign company rendering the services.

Our company presently has two manufacturing facilities within the European Economic Community which receive technical and managerial assistance from a related corporation located in Zurich, Switzerland. Valid business reasons were the prime motivating factors which precipitated the establishment of the service operation in Switzerland. Such a corporate structure enables us to concentrate, in one entity, engineers with the requisite technical ability to resolve the problems which confront both manufacturing operations. Similarly, the managerial personnel are able to coordinate the activities of the two manufacturing companies and establish uniform policies for both.

We found that the centralization of the aforementioned services in a single entity eliminates the inefficiences and duplication of effort which are inherent when these functions are integrated into each manufacturing operation, especially in a situation such as ours where the manufacturing companies are in their embryonic stages. Furthermore, such a unification of technical and managerial ability in a single entity provides a solid base for further expansion of our foreign operations.

We chose Switzerland as a situs for this service entity for several business reasons. Geographically it affords a central location to the various countries which comprise the Common Market. Communications within Europe, as well as to the United States, are excellent. In addition there is a supply of local personnel with multilingual ability.

We readily admit that Switzerland also has a favorable tax climate and that such an arrangement results in some avoidance of foreign taxes. However, I believe that it should be emphasized that the taxes avoided or minimized are Italian and Belgium taxes and not U.S. taxes.

Apparently, under the new Treasury "foreign base company services income" proposal it is of no significance to the Treasury if the services rendered by the foreign company are bona fide and the compensation received by it entirely reasonable. Nor is it persuasive that in the usual situation, in which services are rendered by one foreign company for another, no avoidance of U.S. tax is possibly involved. As I view it, to impose a U.S. tax because certain foreign taxes have been avoided, (in our case Italian and Belgium taxes), is a preposterous position.

It is evident that the proposals which I have covered are directed toward the Treasury's objective of making foreign investment less attractive. However it should be kept in mind that many U.S. corporations have already made substantial investments abroad in establishing foreign corporate structures which will enable them to compete for foreign business on a parity with their foreign competitors. Accordingly, legislation designed to discourage and destroy the

utilization of such foreign entities with no corresponding increase to U.S. tax revenues is manifestly unfair.

Moreover, these proposals by the Treasury which will seriously impair the competitive position of the U.S. companies abroad appear unrealistic in light of the tariff wall presently being erected around the European Economic Community. This wall when it is completed will present an insurmountable barrier to the exportation of U.S. finished products. Suffice it to say, those corporations which are not on the inside of the wall will forfeit this market to their European-owned competition.

In addition, it is axiomatic that without manufacturing operations on the inside of the Common Market, U.S. companies will lose not only finished products exports but also the exportation of machinery, raw materials, and semimanufactured products, which is generated by the operation of a local manufacturing facility.

We urge that this committee reject the revision proposal by the Treasury. It was hastily drafted with only one goal in view, the curtailment of U.S. private business investment abroad. However, its operative effect also includes the loss of exports from the United States as well as the concession of major foreign markets to foreign-owned corporations. This is not the way for the United States to compete in the battle for world trade.

THE COCA-COLA EXPORT CORP.,
New York, N.Y., June 15, 1962.

Hon. HARRY F. BYRD,
Chairman of the Senate Finance Committee,
U.S. Senate Building, Washington, D.C.

DEAR MR. CHAIRMAN: This statement is submitted to you in connection with the hearings to be held by your committee on June 18 to 21 on certain amendments to the foreign income provisions of H.R. 10650 which were recently proposed by Secretary of the Treasury Douglas Dillon. A memorandum of the foreign income provisions in general of this bill was submitted to you on April 30, 1962. It is respectfully requested that this supplementary statement be made a part of the record of the above-mentioned hearings.

The section on which we wish to comment is section 13 of H.R. 10650, relating to controlled foreign corporations.

On May 10, Secretary Dillon reaffirmed his basic proposal for the general and complete elimination of deferral for controlled foreign corporations in developed countries. However, he apparently recognized that this extreme viewpoint would not prevail and made a number of liberalizing changes in certain details. We welcome these changes, which effectively limit section 13 to the general area of "tax haven" corporations. However, we suggest that a further limitation is necessary in order to prevent interference with certain legitimate business operations, which may properly be carried on by foreign subsidiaries of U.S. companies in so-called "tax haven" countries.

This can be illustrated by reference to the two best-known "tax haven" countries, Panama and Switzerland, which can be shown to serve and do serve a useful and legitimate function for U.S. business abroad.

For example, bona fide business operations may be carried on by a Panama subsidiary in the Colón free zone in the Republic of Panama. This zone is in a strategic geographical location for light processing and warehousing prior to reshipment to various countries in Central and South America. Such warehousing by a subsidiary of a U.S. manufacturer reduces the cost of carrying inventories to many small customers in Latin America who often have inadequate capital, and it permits them to be supplied rapidly when inventories are low. Panama imposes a low rate of tax on sale of goods reexported from the Colón free zone. It does not tax income from sale of goods which never come to rest in Panama, even though such sales are recorded on the Panama company's books.

Similarly, Switzerland is in a strategic geographical position to serve as sales headquarters for American businesses expanding throughout the European Common Market and neighboring countries in Europe. The Federal Government and a number of cantons impose tax at a low rate on income from sales made by Swiss selling companies of goods located outside Switzerland.

In both cases the "tax haven" companies serve a legitimate function; in Panama that of processing and warehousing near the customer, in Switzerland that of the headquarters for a selling organization for Western Europe.

Realistically, a distinction should be made between such operations, which serve a useful business purpose, and "tax haven" corporations which have few or no activities abroad. A reasonable line of demarcation is, in our opinion, whether the income from such activities is subject to a foreign income tax or would be subject to a foreign income tax if the country in which it operates were to impose such a tax. A similar test is imposed by the United Kingdom for qualification as an oversea trade corporation, which is entitled to deferral of United Kingdom income tax.

We, therefore, suggest the following:

(*a*) That there be exempted from the terms "foreign base company sales income" and "foreign base company service income," as defined in section 954 of the May 31, 1962, draft of the Treasury Department, income received by a controlled foreign corporation which is either subject to income tax imposed by any foreign country or, if operations are carried on by the controlled foreign corporation in a country not imposing an income tax, which would be subject to foreign tax if a tax similar to the U.S. income tax were imposed by that country. Income which does not meet these tests because of insufficient activity in any foreign country would be taxed currently to the U.S. shareholder.

(*b*) That there be exempted from foreign personal holding company income, for the purpose of section 954, interest and dividends received by a controlled foreign corporation from a foreign company in which it holds a stock interest of at least 10 percent, and 95 percent of the gross income of which meets the income tax test mentioned in *a* above.

Such provisions would in our opinion effectively differentiate between legitimate "tax haven" corporations and sham corporations having little or no activity abroad.

It should be noted that the use of controlled foreign corporations in low-tax rate countries serves ultimately to increase U.S. tax revenues when such profits are distributed, as the foreign tax credit attributable to such distributions is small.

Yours very truly,

ROY S. JONES,
Executive Vice President.

The CHAIRMAN. The next witness is Mr. Donald H. Gleason, of the National Association of Manufacturers.

STATEMENT OF DONALD H. GLEASON, CHAIRMAN, SUBCOMMITTEE ON TAXATION OF FOREIGN SOURCE INCOME OF TAXATION COMMITTEE, NATIONAL ASSOCIATION OF MANUFACTURERS

Mr. GLEASON. My name is Donald H. Gleason. I am assistant treasurer of Corn Products Co., New York, N.Y.

I appear here in behalf of the National Association of Manufacturers, as chairman of the Subcommittee on Taxation of Foreign Source Income of its Taxation Committee.

Mr. Harold H. Scaff, chairman of our taxation committee, appeared before you on April 3 in opposition to H.R. 10650 as a whole.

My statement deals with the May 10 amendments in their relation to the overall thrust of the administration's proposals for additional taxation of foreign business earnings.

Since the administration submitted these proposals to the Congress a year ago, we believe there has developed a better appreciation of the importance of foreign business operations to the national interest. Nevertheless, the administration has made no fundamental change in

its objectives as regards taxation in this area. On May 10, the Secretary of the Treasury stated to you:

> We remain convinced that our basic proposal for the general elimination of deferral for operations in developed countries would be the most equitable and appropriate policy.

We assume that use of the adjective "equitable" refers to the alleged "privilege of deferral." Equity requires, we feel, that a taxpayer should never be taxed on income before he receives it.

Also one might infer from the adjective "equitable" that the timing of the taxation of subsidiary income is now different as between foreign and domestic subsidiaries. This is not so. The foreign subsidiary pays its foreign taxes to the governing jurisdiction as its income is earned. The domestic subsidiary pays its domestic taxes as its income is earned. The parent corporation pays its taxes when it receives dividends from either source. It would be a discrimination to tax foreign subsidiary income in advance of dividend remittances.

Looking at the economic case made by the administration, it appears to seek, first, to force premature repatriation of foreign earnings on which current domestic tax would be paid, and second, to discourage new foreign investments—both in order to improve the balance-of-payments situation.

The record of hearings before this committee, and before the House Ways and Means Committee, is replete with evidence that precisely the opposite result would be achieved.

American industry wants to do all that it can to help solve the balance-of-payments problem.

However, it does not like being made the villain of the piece. The balance-of-payments problem is the result of our foreign economic policy since World War II.

For many years a primary objective of this policy was to run an adverse balance. While our policy is now the contrary, our commitments abroad continue. We do not mean to suggest an abrupt or wholesale elimination of these commitments, but we do believe that emphasis should be kept on the basic cause of the trouble and, especially, we believe that industry's role as regards the balance of international payments should be understood and appreciated.

Without the contribution of American industry to the favorable side of the international balance of payments, the problem today would be much aggravated.

Industry contributes to the favorable side of the balance in two respects:

First, by its exports; and

Second, by the income derived from its foreign investments.

These two factors are interdependent. Foreign investments pull exports with them, and exports increase the need for foreign investment. To achieve optimum volume and efficiency, the factors of production and marketing are just as inseparable in foreign business operations as they are in domestic. To attempt to favor one, and penalize the other, is but to penalize the whole. If foreign business operations are handicapped, by additional tax imposts or in other ways, there will be adverse effect on the balance of payments.

In his testimony before this committee on May 10 and 11, the Secretary of the Treasury seemed to be saying that it is necessary

to provide tax discouragement for contemporary exports of capital because our Government does not impose export controls on capital.

It is unthinkable that such controls should be contemplated in America. Equally we certainly should not consider doing indirectly that which we would not directly.

Suppose, however, that tax discouragement of foreign business operations had been instituted in this country in, say, 1950.

Could there be any question but that the balance of payments today would be even more adverse?

Facing the realities of the future, can we believe that there would be a different answer?

Turning now to the proposed amendments to section 13, as we understand them they would tighten up the proposed taxation of so-called tax haven operations, but would loosen up somewhat on the proposed taxation of the undistributed profits of foreign subsidiaries operating in developed countries.

This is a recession from the original effort to fully tax the undistributed profits of all subsidiaries in developed countries. The proposals then are in a sense an improvement over the original, in that a bad situation is made somewhat less bad.

The proposals make no distinction as between base companies which unquestionably serve our national interest and those which perhaps do not. We agree that question can be raised as to a base company utilized for the diversion of U.S. income. This is most frequently accomplished through improper intercorporate pricing. This practice can and should be stopped by more rigorous application of section 482.

The letterhead or paper company transactions can be controlled by the form-over-substance rules in the present case law.

The legitimate and proper use of the base company is to divert income from high income tax rate countries to low income tax rate countries. This is accomplished generally through royalty arrangements and/or service fee contracts; and also by trading operations.

Under these mechanics, tax deductions for example in France, Germany, and England become income in, let us say, Switzerland. The result is to reduce foreign taxes, and to increase the potential of U.S. taxes. By stifling these mechanics, American business would be placed at a disadvantage with its foreign competitors.

There would be a reduction in foreign generated capital and resulting adverse effect on the balance of payments. The U.S. revenue would suffer for two reasons: first, because of the lower capital accumulations to produce earnings, and second, because those earnings would be subject to higher tax rates abroad, leaving a smaller margin for tax in the United States.

How under any theory whatsoever the minimizing of foreign taxes can be anything but beneficial as a whole to the United States escapes us.

Aside from the fact that it would continue to prematurely tax certain foreign operations which are beneficial to the United States, the complexity of amended section 13 staggers the imagination.

It is impossible to believe that such provisions could be administered uniformly and equitably as between different taxpayers.

The May 10 amendments do not deal with the subject of gross-up, which would impose greater U.S. tax on dividends received by domestic corporations from foreign subsidiaries.

The record of hearings before this committee, and the House Ways and Means Committee, puts in solid dispute the alleged reasons of equity for this proposal.

In reducing after-tax earnings of American corporations, there would be less capital for both domestic and foreign investment. Gross-up would have the most adverse effect on business operations in the less developed countries where tax rates generally are in the middle range.

It would have the last effect on operations in major European countries where tax rates approximate our own, and in tax haven countries where only nominal tax rates obtain.

Whatever may be the justification for technical amendment of the tax law in regard to foreign business earnings, this matter should be deferred until the total thrust of legislation is limited to this objective. More specifically, there has not been, is not, and could not be an economic case for either increasing the tax load on foreign business earnings or for premature imposition of tax on such earnings. Any move in these directions simply wouldn't serve the national interest.

We therefore continue to oppose the complex of foreign tax provisions, including amended section 13 of H.R. 10650, and urge that they not be favorably acted upon by this committee.

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

Any questions?

Senator KERR. Your primary objection to the amended section 13 is contained in your one sentence on page 4:

> The May 10 amendments do not deal with the subject of gross-up, which would impose greater U.S. tax on dividends received by domestic corporations from foreign subsidiaries.

Mr. GLEASON. Sir, that is not my primary objection to the bill.

Senator KERR. Well, is that your secondary or your third one?

Mr. GLEASON. I object to it; yes, sir.

Senator DOUGLAS. Mr. Chairman.

The CHAIRMAN. Senator Douglas.

Senator DOUGLAS. I notice that the witness testifies in opposition to the May 10 amendment, but I thought what we had before us were the amendments of the May 31 contained in this document, and I wondered whether you——

Mr. GLEASON. You are quite right, sir. The document on May 31 came as a result of Mr. Dillon's testimony on May 10. I stand corrected.

Senator DOUGLAS. You make the same objections to the May 31 amendments as are contained here in your statement.

Mr. GLEASON. No; I would like to correct the record and have the record read that I am referring to the May 31 amendments.

Senator DOUGLAS. You are referring to the May 31 amendments?

Mr. GLEASON. Yes.

Senator DOUGLAS. Well now, in other words, you say that the administration has not altered its objective.

Mr. GLEASON. That is what Mr. Dillon said. He said, and I quoted him, that they haven't altered their feelings as to what should be done.

Senator DOUGLAS. Now, it is a question of feelings and a question of legislation.

Are you saying that the May 31 amendment does not differ materially from the previous proposals of the administration?

Mr. GLEASON. It differs in some respects, but in principle, no.

Senator DOUGLAS. Well, as I understand the May 31 amendment, they exempt the so-called active income derived from manufacturing, actual production of goods; and what they are primarily trying to do is to apply only to so-called tax havens.

Is it your contention that there should be no further legislation dealing with tax havens?

I notice in your concluding paragraph you said there should be no amendment whatsoever on the subject.

Mr. GLEASON. Any legislation, should be directed toward the abusive tax haven operations.

Senator DOUGLAS. You think there are abuses?

Mr. GLEASON. There certainly are.

Senator DOUGLAS. What are those abuses?

Mr. GLEASON. The abuses, as I said in my statement, sir, are where U.S. income is improperly diverted to a foreign corporation.

Senator DOUGLAS. Would you give us an illustration of that?

Mr. GLEASON. Certainly, sir.

Let us say a U.S. corporation forms a Panama or a Swiss company. It manufactures goods in the United States which it sells to that Swiss company at cost or less. The Swiss company then sells it to a customer either in Switzerland or in a third country at a large markup, which would include a very substantial proportion of what should be considered U.S. manufacturing profit on the sale.

That is an example.

Senator DOUGLAS. Is it your contention that the present law covers this?

Mr. GLEASON. It certainly is my contention, sir.

Senator DOUGLAS. Can you cite the passage?

Mr. GLEASON. Section 482.

Senator DOUGLAS. Would you read it, please?

Mr. GLEASON. I haven't got it with me, but I can almost remember it. It says——

Senator DOUGLAS. Go ahead.

Mr. GLEASON. It says, in substance, that the Secretary may allocate between affiliated corporations any credit, allowance, or other deduction so that the income of each of the affiliates will be more properly reflected.

Senator DOUGLAS. Have there been tax cases under those clauses?

Mr. GLEASON. There have been, sir.

Senator DOUGLAS. Pardon?

Mr. GLEASON. Yes, sir; there have been, sir.

Senator DOUGLAS. Have the cases been in favor of the Government or against the Government?

Mr. GLEASON. I assume that they have gone both ways, sir. There have been a number of cases.

Senator DOUGLAS. Then there is ambiguity in the judicial interpretation of this clause?

Mr. GLEASON. Well, possibly so, and there may have been a difference of opinion as to what is a proper measure of the income by the parties involved.

Senator DOUGLAS. Do you think it would be well to clarify this by legislation?

Mr. GLEASON. In the amended bill here, there is a tightening up of section 482.

Senator DOUGLAS. You are opposed to that?

Mr. GLEASON. The tax committee of the NAM has not expressed its opinion on this point. My disapproval is very mild, if any. I am not quite so sure, if the arbitrary rule which is set up, it will work. Incidentally, it has its origin in the old so-called Massachusetts formula developed by State income tax authorities, whose job it is to pick out a little piece of income earned by a corporation which may be operating in several States.

Senator DOUGLAS. But the official position of the NAM is hostile to any tightening up of this particular section?

Mr. GLEASON. Our position, sir, is that section 482, as it exists, if rigorously administered could do the job.

Senator DOUGLAS. But you would not favor strengthening the basic legislative provisions which might enable the Treasury to enforce it more vigorously?

Mr. GLEASON. Well, we certainly wouldn't do it by means of section 13. It has been argued by the proponents thereof that there is a need for section 13 because of the difficulties they have been having in administering 482.

Senator DOUGLAS. Exactly so.

Mr. GLEASON. Isn't that correct, sir?

Senator DOUGLAS. That is correct.

Mr. GLEASON. Well, I have been actively engaged in tax administration for 15 or 20 years. I have seen a number of amendments to our income tax statutes.

This, to me, represents the most impossible administrative problem I have ever seen. It is much, much worse than the old investment credit of the World War II excess profits tax.

Senator DOUGLAS. Do you admit there are great abuses in this tax haven?

Mr. GLEASON. I don't admit there are great abuses, sir.

Senator DOUGLAS. I see.

Mr. GLEASON. There are abuses, of course. But I would subscribe to what Senator Morton said here, that certainly section 13 isn't the way to combat them.

Senator DOUGLAS. What would be the way to do it?

Mr. GLEASON. I would have more rigorous enforcement under section 482.

Senator DOUGLAS. But you have already admitted that the courts in many instances have denied the Treasury the power to make these administrative rulings.

Mr. GLEASON. I think, sir, in some cases that the Treasury was trying to allocate some income which shouldn't be allocated.

Senator DOUGLAS. I see.

Mr. GLEASON. And that is the way the courts felt. Where there are quetsions of doubt, twilight zones in matters of interpretation, somebody must, in all fairness, be the referee.

Now, the Tax Court is the referee.

Senator DOUGLAS. But you don't believe in defining the purposes more precisely than is now the case under 482?

Mr. GLEASON. I don't understand. Define the purposes?

Senator DOUGLAS. You don't believe in drawing a distinction between manufacturing profits and so-called active profits, so-called passive profits derived from patents, advertising expenses, royalties, and the like.

Mr. GLEASON. Ordinarily, sir, U.S. income is not diverted to a foreign corporation.

The big abuse, sir, is in this area of improper intercorporate pricing between affiliated companies. That is where the important abuse is. The rest of it doesn't amount to anything.

Senator DOUGLAS. You don't believe anything should be done to control the profits derived from selling to a subsidiary in the Bahamas at a low price and that company later selling at a higher price abroad, and making profits which are then not subject to taxation?

Mr. GLEASON. All I am saying, sir, is that I believe that the tool that is in the law, section 482, is adequate if it is rigorously administered.

Senator GORE. Mr. Chairman?

The CHAIRMAN. Senator Bennett.

Senator BENNETT. Mr. Gleason, you make a very interesting statement.

You say:

> Aside from the fact that it would continue prematurely to tax certain foreign operations which are beneficial to the United States the complexity of amended secion 13 staggers the imagination.

You mean that your imagination is incapable of, has been staggered by, or do you have any comments about, the particular complexities that disturb you?

Mr. GLEASON. Well, I do, sir, and I am staggered because I literally lay awake nights wondering how it can possibly be administered; and I have very considerable administrative responsibilities in this area.

Its substance would be—that is the practical substance—that all foreign subsidiaries' income would have to be compiled in the accounting sense and all added together, individual subsidiary by subsidiary.

These would have to be converted to dollars.

The first problem is the subject of fluctuating foreign exchange.

Under the present statute, branches of domestic corporations have this problem, and it is a real rough one. I refer you particularly in this area to the Ways and Means Committee's Export Tax Panel tax compendium and hearings held a couple of years ago. Mr. William Patty, of Shearman & Sterling, was one of the panelists on the taxation of foreign source income. His paper deals exclusively with the problems of foreign exchange fluctuation in the measurement of profit and loss accounts in foreign currencies.

The one example that sticks in my mind, the example of a branch of a bank. It makes an entire difference to its profit and loss results for tax purposes if it rents a building or if it buys one in which to conduct its banking operations. With the ordinary business corporation, whether it does its local financing with long-term debt or short-term debt, depending upon which way the currency fluctuates, the result is entirely different. How can we keep track of it?

That is the first problem. You convert what income there was from foreign currency to dollars; then from that income—the income totals—you will have to deduct the so-called untainted uses, and also the current distributions, and then you get to the tax on the balance of the accumulated profits.

Mr. Horne, who just previously testified has submitted for the record 60-odd pages of problems, the legal problems.

This is why I say it horrifies me.

Senator BENNETT. Then you think the accounting problems are equally complex?

Mr. GLEASON. Oh, boy, they are awful, Senator! [Laughter.]

Senator BENNETT. Well, you puzzle me a little by saying the American branches already have these problems.

Mr. GLEASON. They do have these problems, sir. When a business is going to be set up abroad, the people who are setting it up have their choice as to forms.

What form they choose depends upon a lot of things. It depends on local laws and on U.S. laws, not only tax laws but also other laws. It depends also on whether there will be certain tax benefits which may derive through the branch form to offset domestic income, the depletion deduction, and the deduction for losses, and so on.

Without the proposed amendment, these factors tend to balance, and the taxpayer up to now has had his choice. This is all right if we want to encourage foreign operations.

But section 13 would impose upon the foreign subsidiary many of the undesirable characteristics of the branch operation, and it doesn't give it any of the desirable ones.

Senator BENNETT. And you think it would upset this potential balance on which choice can be made between the two forms, and I judge from what you say that you feel that many companies have chosen the subsidiary rather than the branch approach, not so much for tax advantages as to avoid the accounting complexities.

Mr. GLEASON. I wouldn't emphasize that too much, because, if the advantages, other than the accounting complexities, are sufficient, I am sure that accounting complexities are not going to control.

Senator BENNETT. It is a mix in any case.

Mr. GLEASON. Yes, it is a tremendous mix.

But getting back to my statement, sir, the Treasury has complained about their troubles with section 482. I don't see how the Treasury is going to administer section 13.

Senator BENNETT. You don't think they are any better at complexities than the taxpayer?

Mr. GLEASON. No, it is the same problem.

Senator BENNETT. It's the converse side of the same problem.

Mr. GLEASON. Yes.

Senator BENNETT. No other questions, Mr. Chairman.

Senator GORE. You are aware, I am sure, that this working draft of revised section 13 was submitted to the committee and circulated to you and others for comment and testimony.

Mr. GLEASON. Yes, sir.

Senator GORE. But that it was the secondary proposal of the Treasury.

Mr. GLEASON. Yes, sir.

Senator GORE. The President of the United States has recommended elimination of the deferral of tax liability on income earned abroad. The Secretary of the Treasury has recommended that. He testified at great length here.

Mr. GLEASON. Yes, sir.

Senator GORE. On his proposal. Indeed, he went so far as to agree that anything short of that would be piddling with the problem.

Now, I call to your attention the Secretary's letter of transmittal on the first page of the document which was circulated to you and other interested industry members, and I call this to the attention of all of our guests, both industry spokesmen and registered lobbyists. On page 1, the Secretary says this:

> The Treasury recommends in accordance with the President's message of April 20, 1961, and my statement of April 2, 1962, before your committee that deferral of taxation of income of controlled foreign corporations be eliminated.

It has been quite a surprise to me that in 2 days of hearings on the much milder tax haven approach with which certain members of the committee, I assume, and perhaps some people in the Treasury, thought industry would be satisfied, all industry spokesmen are still utterly opposed to doing anything in this field.

This is to advise you that some of us will insist upon the recommendation of the President and the Secretary of the Treasury. You say revised section 13 is unworkable, inequitable, unacceptable. So has everyone else.

Mr. GLEASON. If I may quote my statement, sir, it makes a bad situation somewhat less bad.

Senator GORE. Well, since this is so utterly unacceptable to a segment of our industry which operates abroad, then it seems to me there is no dividend in pursuing it. The most effective way of handling the problem is to eliminate the deferral privilege, and a fight will be made for that. I am surprised that no one in the past 2 days has testified on that point. The Treasury submitted draft legislation on that. I will introduce that draft today, and those of our guests who wish to make reference to it in the next 2 days of these hearings will be privileged to do so, although there has already been ample testimony on deferral.

(Senator Gore later submitted the following for the record:)

[H.R. 10650, 87th Cong., 2d sess.]

AMENDMENT Intended to be proposed by Mr. GORE to the bill (H.R. 10650) to amend the Internal Revenue Code of 1954 to provide a credit for investment in certain depreciable property, to eliminate certain defects and inequities, and for other purposes, viz:

On page 103, beginning with line 14, strike out all through line 18, on page 137 (section 13 of the bill), and in lieu thereof insert the following:

"SEC. 13. CONTROLLED FOREIGN CORPORATIONS.

"(a) IN GENERAL.—Part III of subchapter N of chapter 1 (relating to income from sources without the United States) is amended by adding at the end thereof the following new subpart:

"'Subpart F—Controlled Foreign Corporations

"'Sec. 951. Amounts included in gross income of United States shareholders.
"'Sec. 952. Limitations on amounts included in gross income of United States shareholders.
"'Sec. 953. Less developed country corporations defined.
"'Sec. 954. Withdrawal of previously excluded foreign base company income from qualified investment.
"'Sec. 955. Investment of earnings in United States property.
"'Sec. 956. Controlled foreign corporations.
"'Sec. 957. Rules for determining stock ownership.
"'Sec. 958. Exclusion from gross income of previously taxed earnings and profits.
"'Sec. 959. Special rules for foreign tax credit.
"'Sec. 960. Adjustments to basis of stock in controlled foreign corporations and of other property.
"'Sec. 960. Miscellaneous provisions.
"'Sec. 962. Inclusion on a consolidated basis of earnings and profits.

"'SEC. 951. AMOUNTS INCLUDED IN GROSS INCOME OF UNITED STATES SHAREHOLDERS.

"'(a) AMOUNTS INCLUDED.—

"'(1) IN GENERAL.—If a foreign corporation is a controlled corporation on any day of a taxable year beginning after December 31, 1962, every person who is a United States shareholder (as defined in subsection (b)) of such corporation and who owns (within the meaning of section 957(a)) stock in such corporation on the last day, in such year, on which such corporation is a controlled foreign corporation shall include in his gross income, for his taxable year in which or with which such taxable year of the corporation ends—

"'(A) in case of a controlled foreign corporation which is not a less developed country corporation (as defined in section 953(a)), his pro rata share (determined under paragraph (2) of the corporation's earnings and profits for such year; and

"'(B) his pro rata share (determined under section 955(a)(2)) of the corporation's increase in earnings invested in United States property for such year (but only to the extent not excluded from gross income under section 958(a)(2)).

"'(2) PRO RATA SHARE OF EARNINGS AND PROFITS.—The pro rata share referred to in paragraph (1)(A) in the case of any United States shareholder is the amount—

"'(A) which would have been distributed with respect to the stock which such shareholder owns (within the meaning of section 957(a)) in such corporation if on the last day, in its taxable year, on which the corporation is a controlled foreign corporation it has distributed pro rata to its shareholders an amount (i) which bears the same ratio to its earnings and profits for the taxable year, as (ii) the part of such year during which the corporation is a controlled foreign corporation bears to the entire year, reduced by

"'(B) the amount of any distribution received by any other United States person during such year as a dividend with respect to such stock.

"'(3) LIMITATION ON PRO RATA SHARE OF INVESTMENT IN UNITED STATES PROPERTY.—For purposes of paragraph (1)(B), the pro rata share of any United States shareholder in the increase of the earnings of a controlled foreign corporation invested in United States property shall not exceed an amount (A) which bears the same ratio to his pro rata share of such increase (as determined under section 955(a)(2)) for the taxable year, as (B) the part of such year during which the corporation is a controlled foreign corporation bears to the entire year.

"'(b) UNITED STATES SHAREHOLDER DEFINED.—For purposes of this subpart, the term "United States shareholder" means, with respect to any foreign corporation, a United States person (as defined in section 7701(a)(30)) who owns (within the meaning of section 957(a)), or is considered as owning by applying the rules of ownership of section 957(b), 10 percent or more of the total combined voting power of all classes of stock, or of the total value of shares of all classes of stock, of such foreign corporation.

"'(c) Coordination With Election of a Foreign Investment Company To Distribute Income.—A United States shareholder who, for his taxable year, is a qualified shareholder (within the meaning of section 1247(c)) of a foreign investment company with respect to which an election under section 1247 is in effect shall not be required to include in gross income, for such taxable year, any amount under subsection (a) with respect to such company.

"'SEC. 952. LIMITATIONS ON AMOUNT INCLUDED IN GROSS INCOME OF UNITED STATES SHAREHOLDERS.

"'(a) In General.—For purposes of section 951(a) the term "earnings and profits for the taxable year" means, in the case of any controlled foreign corporation, the earnings and profits as defined in section 316(a)(2) for the taxable year subject to the provisions of subsections (b) and (c).

"'(b) Exclusion of United States Income.—Earnings and profits do not include any item includible in gross income under this chapter (other than this subpart) as income derived from sources within the United States of a foreign corporation engaged in trade or business in the United States.

"'(c) Limitation.—For purposes of subsection (a), the earnings and profits of any controlled foreign corporation for any taxable year shall not exceed the earnings and profits of such corporation for such year reduced by the amount (if any) by which—

"'(1) the sum of the deficits in earnings and profits for prior taxable years beginning after December 31, 1962, exceeds

"'(2) an amount equal to the earnings and profits described in section 958(c)(3) accumulated for taxable years beginning after December 31, 1962 (determined as of the close of the taxable year).

For purposes of the preceding sentence, any deficit in earnings and profits for any prior taxable year shall be taken into account under paragraph (1) for any taxable year only to the extent it has not been taken into account under such paragraph for any preceding taxable year to reduce earnings and profits of such preceding year.

"'(d) Special Rule in Case of Indirect Ownership.—For purposes of subsection (c), if—

"'(1) a United States shareholder owns (within the meaning of section 957(a)) stock of a foreign corporation, and by reason of such ownership owns (within the meaning of such section) stock of any other foreign corporation, and

"'(2) any of such foreign corporations has a deficit in earnings and profits for the taxable year,

then the earnings and profits for the taxable year of each such foreign corporation which is a controlled foreign corporation shall, with respect to such United States shareholder, be properly reduced to take into account any deficit described in paragraph (2) in such manner as the Secretary or his delegate shall prescribe by regulations.

"'SEC. 953. LESS DEVELOPED COUNTRY CORPORATIONS DEFINED.

"'(a) Less Developed Country Corporations.—

"'(1) In General.—For purposes of this subpart, the term "less developed country corporation" means a foreign corporation which during the taxable year is engaged in the active conduct of one or more trades or businesses and—

"'(A) 80 percent or more of the gross income of which for the taxable year is derived from sources within less developed countries other than as foreign base company income or as previously excluded foreign base company income withdrawn from qualified investment in less developed country corporations,

"'(B) 80 percent or more in value of the assets of which on each day of the taxable year consists of—

"'(i) property used in such trades or businesses and located in less developed countries,

"'(ii) money, and deposits with persons carrying on the banking business, located in less developed countries,

"'(iii) stock, and obligations which, at the time of their acquisition, have a maturity of 5 years or more, of any other less developed country corporation,

"'(iv) obligations of the government of a less developed country,
"'(v) an investment which is required because of restrictions imposed by a less developed country, and
"'(vi) property described in section 955(b)(2); and
"'(C) is created or organized under the laws of one of the less developed countries in which property described in subparagraph (B)(i) is located.

For purposes of subparagraph (A), the determination as to whether income is derived from sources within less developed countries shall be made under regulations prescribed by the Secretary or his delegate and, for purposes of subparagraph (A) only, amounts previously excluded from foreign base company income withdrawn from qualified investment in less developed country corporations shall be treated as included in gross income.

"'(2) LESS DEVELOPED COUNTRY DEFINED.—For purposes of this subpart, the term "less developed country" means (in respect of any foreign corporation) any foreign country (other than an area within the Sino-Soviet bloc) or any possession of the United States, with respect to which on the first day of the taxable year, there is in effect an Executive order by the President of the United States designating such country or possession as an economically less developed country for purposes of this subpart. For purposes of the preceding sentence, an overseas territory, department, province, or possession may be treated as a separate country. No designation shall be made under this paragraph with respect to—

"'Australia
Austria
Belgium
Canada
Denmark
France
Luxembourg
Monaco
Netherlands
New Zealand
Norway
Germany (Federal Republic)
Hong Kong
Italy
Japan
Liechtenstein
San Marino
Sweden
Switzerland
Union of South Africa
United Kingdom

"'(b) FOREIGN BASE COMPANY INCOME.—For purposes of section 952(a)(2), the term "foreign base company income" means for any taxable year the sum of—
"'(1) the foreign personal holding company income for the taxable year (determined under subsection (d)),
"'(2) the foreign base company sales income for the taxable year (determined under subsection (e)), and
"'(3) the foreign base company services income for the taxable year (determined under subsection (f)).

"'(c) EXCLUSIONS AND SPECIAL RULES.—
"'(1) CERTAIN DIVIDENDS AND INTEREST FROM LESS DEVELOPED COUNTRY CORPORATIONS EXCLUDED.—For purposes of subsection (b), foreign base company income does not include dividends and interest received during the taxable year by a controlled foreign corporation from qualified investments in less developed country corporations (as defined in section 954(d)), to the extent that such dividends and interest do not exceed the increase for the taxable year in qualified investments in less developed country corporations of the controlled foreign corporation (as determined under subsection (g)).
"'(2) EXCEPTION FOR FOREIGN CORPORATIONS NOT AVAILED OF TO REDUCE TAXES.—For purposes of subsection (b), foreign base company income does not include any item of income received by a controlled foreign corporation if it is established to the satisfaction of the Secretary or his delegate with respect to such item that the creation or organization of the controlled foreign corporation receiving such item under the laws of the foreign country in which it is incorporated does not have the effect of substantial reduction of income, war profits excess profits, or similar taxes.
"'(3) ITEMS OF INCOME TO BE INCLUDED ONLY ONCE.—If an item of income would, but for the provisions of this paragraph, be includible as an item of income under more than one paragraph of subsection (b), such item shall be included under the paragraph specified by regulations prescribed by the Secretary or his delegate.

"'(d) Foreign Personal Holding Company Income.—

"'(1) In general.—For purposes of subsection (b)(1), the term "foreign personal holding company income" means the foreign personal holding company income (as defined in section 553), modified and adjusted as provided in paragraphs (2), (3), and (4).

"'(2) Rents included without regard to 50 percent limitation.—For purposes of paragraph (1), all rents shall be included in foreign personal holding company income without regard to whether or not such rents constitute more than 50 percent of gross income.

"'(3) Certain income derived in active conduct of trade or business.—For purposes of paragraph (1), foreign personal holding company income does not include dividends, interest, rents, and royalties which—

"'(A) are derived in the active conduct of a trade or business; and

"'(B) are received from a person other than a related person (within the meaning of subsection (e)(3)).

"'(4) Certain income received from related persons.—For purposes of paragraph (1), foreign personal holding company income does not include—

"'(A) dividends and interest received from a related person which (i) is organized under the laws of the same foreign country under the laws of which the controlled foreign corporation is created or organized, and (ii) has a substantial part of its assets used in its trade or business located in such same foreign country; or

"'(B) rents, royalties, and similar amounts received from a related person for the use of, or the privilege or using, property within the country under the laws of which the controlled foreign corporation is created or organized.

"'(e) Foreign Base Company Sales Income.—

"'(1) In general.—For purposes of subsection (b)(2), the term "foreign base company sales income" means income (whether in the form of profits, commissions, fees, or otherwise) derived in connection with the purchase of personal property from a related person and its sale to any person, the sale of personal property to any person on behalf of a related person, the purchase of personal property from any person and its sale to a related person, or the purchase of personal property from any person on behalf of a related person, where—

"'(A) the property which is purchased (or in the case of property sold on behalf of a related person, the property which is sold) is manufactured, produced, grown, or extracted outside the country under the laws of which the controlled foreign corporation is created or organized, and

"'(B) the property is sold for use, consumption, or disposition outside such foreign country, or, in the case of property purchased on behalf of a related person, is purchased for use, consumption, or disposition outside such foreign country.

"'(2) Certain branch income.—For purposes of determining foreign base company sales income (within the terms of paragraph (1)), in situations in which the carrying on of activities by a controlled foreign corporation through a branch or similar establishment outside the country of incorporation of the controlled foreign corporation has substantially the same effect as if such branch or similar establishment were a wholly owned subsidiary corporation deriving such income, then, under regulations prescribed by the Secretary or his delegate, the income attributable to the carrying on of such activities of such branch or similar establishment shall be treated as income derived by a wholly owned subsidiary of the controlled foreign corporation and shall constitute foreign base company sales income of the controlled foreign corporation.

"'(3) Related person defined.—For purposes of this section, a person is a related person with respect to a controlled foreign corporation, if—

"'(A) such person is an individual, partnership, trust, or estate which controls the controlled foreign corporation;

"'(B) such person is a corporation which controls, or is controlled by, the controlled foreign corporation; or

"'(C) such person is a corporation which is controlled by the same person or persons which control the controlled foreign corporation.

For purposes of the preceding sentence, control means the ownership, directly or indirectly, of stock possessing more than 50 percent of the total

combined voting power of all classes of stock entitled to vote. For purposes of this paragraph, the rules for determining ownership of stock prescribed by section 957 shall apply.

"'(f) FOREIGN BASE COMPANY SERVICES INCOME.—For purposes of subsection (b)(3), the term "foreign base company services income" means income (whether in the form of compensation, commissions, fees, or otherwise) derived in connection with the performance or furnishing of technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial, or like services which are—

"'(1) performed or furnished for or on behalf of any related person (within the meaning of subsection (e)(3)), and

"'(2) are performed or furnished for or in connection with business activities carried on by such related person outside the country under the laws of which the controlled foreign corporation is created or organized.

"'(g) INCREASE IN QUALIFIED INVESTMENTS IN LESS DEVELOPED COUNTRY CORPORATIONS.—For purposes of subsection (c)(1), the increase for any taxable year in qualified investments in less developed country corporations of any controlled foreign corporation is the amount by which—

"'(1) the qualified investments in less developed country corporations (as defined in section 954(b)) of the controlled foreign corporation at the close of the taxable year, exceeds

"'(2) the qualified investments in less developed country corporations (as so defined) of the controlled foreign corporation at the close of the preceding taxable year.

"'SEC. 954. WITHDRAWAL OF PREVIOUSLY EXCLUDED FOREIGN BASE COMPANY INCOME FROM QUALIFIED INVESTMENT.

"'(a) GENERAL RULES.—

"'(1) AMOUNT WITHDRAWN.—For purposes of this subpart, the amount of previously excluded foreign base company income of any controlled corporation withdrawn from investment in less developed country corporations for any taxable year is an amount equal to the decrease in the amount of qualified investments in less developed country corporations of the controlled foreign corporation for such year, but only to the extent that the amount of such decrease does not exceed an amount equal to—

"'(A) the sum of the amounts excluded under section 953(b)(1) from the foreign base company income of such corporation for all prior taxable years, reduced by

"'(B) the sum of the amounts previously excluded from foreign base company income withdrawn from investment in less developed country corporations of such corporation determined under this subsection for all prior taxable years.

"'(2) DECREASE IN QUALIFIED INVESTMENTS.—For purposes of paragraph (1), the amount of the decrease in qualified investments in less developed country corporations of any controlled foreign corporation for any taxable year is the amount by which—

"'(A) the amount of qualified investments in less developed country corporations of the controlled foreign corporation at the close of the preceding taxable year, exceeds

"'(B) the amount of qualified investments in less developed country corporations of the controlled foreign corporation at the close of the taxable year, to the extent the amount of such decrease does not exceed the sum of the earnings and profits for the taxable year and the earnings and profits accumulated for prior taxable years beginning after December 31, 1962. For purposes of this paragraph, if qualified investments in less developed country corporations are disposed of by the controlled foreign corporation during the taxable year, the amount of the decrease in qualified investments in less developed country corporations of such controlled foreign corporation for such year shall be reduced by an amount equal to the amount (if any) by which the losses on such dispositions during such year exceed the gains on such dispositions during such year.

"'(3) PRO RATA SHARE OF AMOUNT WITHDRAWN.—In the case of any United States shareholder, the prorata share of the amount of previously excluded foreign base company income of any controlled foreign corporation withdrawn from investment in less developed country corporations for any taxable year is his pro rata share of the amount determined under paragraph (1).

"'(b) QUALIFIED INVESTMENTS IN LESS DEVELOPED COUNTRY CORPORATIONS.—

"'(1) IN GENERAL.—For purposes of this subpart, the term "qualified investments in less developed country corporations" means property acquired after December 31, 1962, which is—

"'(A) stock of a less developed country corporation held by the controlled foreign corporation, but only if the controlled foreign corporation owns 10 percent or more of the total combined voting power of all classes of stock, or of the total value of shares of all classes of stock, of such less developed country corporation; or

"'(B) an obligation of a less developed country corporation held by the controlled foreign corporation which, at the time of its acquisition by the controlled foreign corporation, has a maturity of 5 years or more, but only if the controlled foreign corporation owns 10 percent or more of the total combined voting power of all classes of stock, or of the total value of shares of all classes of stock, of such less developed country corporation.

"'(2) COUNTRY CEASES TO BE LESS DEVELOPED COUNTRY.—For purposes of this subpart, property which would be a qualified investment in less developed country corporations, but for the fact that a foreign country has, after the acquisition of such property by the controlled foreign corporation, ceased to be a less developed country, shall be treated as a qualified investment in less developed country corporations.

"'(3) INVESTMENTS AFTER CLOSE OF YEAR.—For purposes of this subpart, a controlled foreign corporation may, under regulations prescribed by the Secretary or his delegate, elect to treat property described in paragraph (1) or (2) which was acquired after the close of a taxable year and on or before the close of the following taxable year, or on or before such day after the close of the following taxable year as such regulations may prescribe, as having been acquired on the last day of such year.

"'(4) AMOUNT ATTRIBUTABLE TO PROPERTY.—The amount taken into account under this subpart with respect to any property described in paragraph (1) or (2) shall be its adjusted basis, reduced by any liability to which such property is subject.

"'SEC. 955. INVESTMENT OF EARNINGS IN UNITED STATES PROPERTY.

"'(a) GENERAL RULES.—For purposes of this subpart—

"'(1) AMOUNT OF INVESTMENT.—The amount of earnings of a controlled foreign corporation invested in United States property at the close of any taxable year is the aggregate amount of such property held, directly or indirectly, by the controlled foreign corporation at the close of the taxable year, to the extent such amount would have constituted a dividend (determined after the application of section 954(a)) if it had been distributed.

"'(2) PRO RATA SHARE OF INCREASE FOR YEAR.—In the case of any United States shareholder, the pro rata share of the increase for any taxable year in the earnings of a controlled foreign corporation invested in United States property is the amount determined by subtracting—

"'(A) his pro rata share of the amount determined under paragraph (1) for the close of the preceding taxable year, reduced by amounts paid during the taxable year to which section 958 (c)(1) applies, from

"'(B) his pro rata share of the amount determined under paragraph (1) for the close of the taxable year.

"'(3) AMOUNT ATTRIBUTABLE TO PROPERTY.—The amount taken into account under paragraph (1) or (2) with respect to any property shall be its adjusted basis, reduced by any liability to which the property is subject.

"'(b) UNITED STATES PROPERTY DEFINED.—

"'(1) IN GENERAL.—For purposes of subsection (a), the term "United States property" means any property acquired after December 31, 1962, which is—

"'(A) tangible property located in the United States;

"'(B) stock of a domestic corporation; or

"'(C) an obligation of a United States person.

"'(2) EXCEPTIONS.—For purposes of subsection (a), the term "United States property" does not include—

"'(A) money, or deposits with persons carrying on the banking business, located in the United States;

"'(B) property located in the United States which is purchased in the United States for export to, or use in, foreign countries;

"'(C) any obligation of a United States person arising in connection with the sale of property if the amount of such obligation outstanding at no time during the taxable year exceeds the amount which would be ordinary and necessary to carry on the trade or business of both the other party to the sale transaction and the United States person had the sale been made between unrelated persons;

"'(D) any aircraft, railroad rolling stock, vessel, motor vehicle, or container used in the transportation of persons or property in foreign commerce and used predominantly outside the United States; or

"'(E) the amount of assets of an insurance company equivalent to the unearned premiums on outstanding business with respect to reinsurance contracts or insurance or annuity contracts—

"'(i) in connection with property or liability arising out of activity in, or in connection with the lives or health of residents of the United States, or

"'(ii) in connection with property not included in subdivision (i) as the result of any arrangement whereby another corporation receives a substantially equal amount of premiums or other consideration in respect of any reinsurance or the issuing of any insurance or annuity contract in connection with property or liability arising out of activity in, or in connection with the lives or health of residents of, the United States.

"'(c) Pledges and Guarantees.—For purposes of subsection (a), a controlled foreign corporation shall, under regulations prescribed by the Secretary or his delegate, be considered as holding an obligation of a United States person if it is a pledgor or guarantor of such obligation.

"'SEC. 956. CONTROLLED FOREIGN CORPORATIONS.

"'(a) General Rule.—For purposes of this subpart, the term "controlled foreign corporation" means any foreign corporation of which more than 50 percent of the total combined voting power of all classes of stock entitled to vote is owned (within the meaning of section 957(a)), or is considered as owned by applying the rules of ownership of section 957(b), by United States shareholders on any day during the taxable year of such foreign corporation.

"'(b) Corporations Organized in United States Possessions.—For purposes of this subpart, the term "controlled foreign corporation" does not include any corporation created or organized in the Commonwealth of Puerto Rico or a possession of the United States or under the law of the Commonwealth of Puerto Rico or a possession of the United States if—

"'(1) 80 percent or more of the gross income of such corporation (computed without regard to section 931) for the 3-year period immediately preceeding the close of the taxable (or for such part of such period immediately preceding the close of such taxable year as may be applicable) was derived from sources within the Commonwealth of Puerto Rico or a possession of the United States; and

"'(2) 50 percent or more of the gross income of such corporation (computed without regard to section 931) for such period, or for such part thereof, was derived from the active conduct within the Commonwealth of Puerto Rico or a possession of the United States of any trades or businesses constituting the manufacture or processing of goods, wares, merchandise, or other tangible personal property; the processing of agricultural or horticultural products or commodities (including but not limited to livestock, poultry or fur-bearing animals); the catching or taking of any kind of fish or mining or extraction of natural resources, or any manufacturing or processing of any products or commodities obtained from such activities; or the ownership or operation of hotels.

For purposes of paragraphs (1) and (2), the determination as to whether income was derived from sources within the Commonwealth of Puerto Rico or a possession of the United States and was derived from the active conduct of a described trade or business within the Commonwealth of Puerto Rico or a possession of the United States shall be made under regulations prescribed by the Secretary or his delegate.

"'SEC. 957. RULES FOR DETERMINING STOCK OWNERSHIP.

"'(a) DIRECT AND INDIRECT OWNERSHIP.—

"'(1) GENERAL RULE.—For purposes of this subpart (other than sections 954(b)(1)(A) and (B)), stock owned means—

"'(A) stock owned directly, and

"'(B) stock owned with the application of paragraph (2).

"'(2) STOCK OWNERSHIP THROUGH FOREIGN ENTITIES.—For purposes of subparagraph (B) of paragraph (1), stock owned, directly or indirectly, by or for a foreign corporation, foreign partnership, or foreign trust or foreign estate (within the meaning of section 7701(a)(31)) shall be considered as being owned proportionately by its shareholders, partners, or beneficiaries. Stock considered to be owned by a person by reason of the application of the preceding sentence shall, for purposes of applying such sentence, be treated as actually owned by such person.

"'(3) SPECIAL RULE FOR MUTUAL INSURANCE COMPANIES.—For purposes of applying paragraph (1) in the case of a foreign mutual insurance company, the term "stock" shall include any certificate entitling the holder to voting power in the corporation.

"'(b) CONSTRUCTIVE OWNERSHIP.—For purposes of section 951(b), 953(e)(3), and 956, section 318(a) (relating to constructive ownership of stock) shall apply to the extent that the effect is to treat any United States person as a United States shareholder within the meaning of section 953(e)(3), or to treat a foreign corporation as a controlled foreign corporation under section 956, except—

"'(1) In applying paragraph (1)(A) of section 318(a), stock owned by a nonresident alien individual (other than a foreign trust or foreign estate) shall not be considered as owned by a citizen or by a resident alien individual.

"'(2) In applying the first sentence of subparagraphs (A) and (B), and in applying clause (i) of subparagraph (C), of section 318(a)(2)—

"'(A) if a partnership, estate, trust, or corporation owns, directly or indirectly, more than 50 percent of the total combined voting power of all classes of stock entitled to vote of a corporation, it shall be considered as owning all the stock entitled to vote, and

"'(B) if a partnership, estate, trust, or corporation owns, directly or indirectly, more than 50 percent of the total value of shares of all classes of stock of a corporation, it shall be considered as owning the total value of all of the outstanding stock of such corporation. The application of this subparagraph shall not have the effect of increasing voting power of a partner, beneficiary, or shareholder, for purposes of subparagraph (A).

"'(3) Stock owned by a partnership, estate, trust, or corporation, by reason of the application of the second sentence of subparagraphs (A) and (B), and the application of clause (ii) of subparagraph (C), of section 318(a)(2), shall not be considered as owned by such partnership, estate, trust, or corporation, for the purposes of applying the first sentence of subparagraphs (A) and (B), and in applying clause (i) of subparagraph (C), of section 318(a)(2).

"'(4) In applying clause (i) of subparagraph (C) of section 318(a)(2), the phrase "10 percent" shall be substituted for the phrase "50 percent" used in subparagraph (C).

"'SEC. 958. EXCLUSION FROM GROSS INCOME OF PREVIOUSLY TAXED EARNINGS AND PROFITS.

"'(a) EXCLUSION FROM GROSS INCOME OF UNITED STATES PERSONS.—For purposes of this chapter, the earnings and profits for a taxable year of a foreign corporation attributable to amounts which are, or have been, included in the gross income of a United States shareholder under section 951(a) shall not, when—

"'(1) such amounts are distributed to, or

"'(2) such amounts would, but for this subsection, be included under section 951(a)(1)(B) in the gross income of,

such shareholder (or any other United States person who acquires from any person any portion of the interest of such United States shareholder in such foreign corporation, but only to the extent of such portion, and subject to such

proof of the identity of such interest as the Secretary or his delegate may by regulations prescribe) directly, or indirectly through a chain of ownership described under section 957(a), be again included in the gross income of such United States shareholder (or of such other United States person).

"'(b) EXCLUSION FROM GROSS INCOME OF CERTAIN FOREIGN SUBSIDIARIES.—For purposes of section 951(a), the earnings and profits for a taxable year of a controlled foreign corporation attributable to amounts which are, or have been, included in the gross income of a United States shareholder under section 951(a), shall not, when distributed through a chain of ownership described under section 957(a), be also included in the gross income of another controlled foreign corporation in such chain for purposes of the application of section 951(a) to such other controlled foreign corporation with respect to such United States shareholder (or to any other United States shareholder who acquires from any person any portion of the interest of such United States shareholder in the controlled foreign corporation, but only to the extent of such portion, and subject to such proof of identity of such interest as the Secretary or his delegate may prescribe by regulations).

"'(c) ALLOCATION OF DISTRIBUTIONS.—For purposes of subsections (a) and (b), section 316(a) shall be applied by applying paragraph (2) thereof, and then paragraph (1) thereof—

"'(1) first to earnings and profits attributable to amounts included in gross income under section 951(a)(1)(B) (or which would have been included except for subsection (a)(2)),

"'(2) then to earnings and profits attributable to amounts included in gross income under section 951(a)(1)(A) (but reduced by amounts not included under section 951(a)(1)(B) because of the exclusion in subsection (a)(2), and

"'(3) then to other earnings and profits.

"'(d) DISTRIBUTIONS EXCLUDED FROM GROSS INCOME NOT TO BE TREATED AS DIVIDENDS.—Except as provided in section 959(a)(3), any distribution excluded from gross income under subsection (a) shall be treated, for purposes of this chapter, as a distribution which is not a dividend.

"'SEC. 959. SPECIAL RULES FOR FOREIGN TAX CREDIT.

"'(a) TAXES PAID BY A FOREIGN CORPORATION.—

"'(1) GENERAL RULE.—For purposes of subpart A of this part, if there is included, under section 951(a), in the gross income of a domestic corporation any amount attributable to earnings and profits—

"'(A) of a foreign corporation at least 10 percent of the voting stock of which is directly owned by such domestic corporation, or

"'(B) of a foreign corporation at least 50 percent of the voting stock of which is directly owned by a foreign corporation at least 10 percent of the voting stock of which is in turn directly owned by such domestic corporation,

then, under regulations prescribed by the Secretary or his delegate, such domestic corporation shall be deemed to have paid the same proportion of the total income, war profits, and excess profits taxes paid (or deemed paid, if paragraph (4) applies) by such foreign corporation to a foreign country or possession of the United States for the taxable year which the amount of earnings and profits of such foreign corporation so incldued in gross income of the domestic corporation bears to the entire amount of the total earnings and profits of such foreign corporation for such taxable year.

"'(2) TAXES PREVIOUSLY DEEMED PAID BY DOMESTIC CORPORATION.—If a domestic corporation receives a distribution from a foreign corporation, any portion of which is excluded from gross income under section 958, the income, war profits, and excess profits taxes paid or deemed paid by such foreign corporation to any foreign country or to any possession of the United States in connection with the earnings and profits of such foreign corporation from which such distribution is made shall not be taken into account for purposes of section 902, to the extent such taxes were deemed paid by such domestic corporation under paragraph (1) for any prior taxable year.

"'(3) TAXES PAID BY FOREIGN CORPORATION AND NOT PREVIOUSLY DEEMED PAID BY DOMESTIC CORPORATION.—Any portion of a distribution from a foreign corporation received by a domestic corporation which is excluded from gross income under section 958(a) shall be treated by the domestic corporation as a dividend, solely for purposes of taking into account under section 902 any income, war profits, or excess profits taxes paid to any

foreign country or to any possession of the United States, on or with respect to the accumulated profits of such foreign corporation from which such distribution is made, which were not deemed paid by the domestic corporation under paragraph (1) for any prior taxable year.

"'(4) TAXES PAID BY A FOREIGN SUBSIDIARY.—If subparagraph (A) of paragraph (1) applies with respect to an amount included in gross income under section 951(a) for a taxable year, then such amount shall be considered a dividend for purpose of the application of section 902(b).

"'(5) INCLUSION IN GROSS INCOME.—

"'For inclusion in gross income of amount equal to taxes deemed paid under paragraph (1), see section 78.

"'(b) SPECIAL RULES FOR FOREIGN TAX CREDIT IN YEAR OF RECEIPT OF PREVIOUSLY TAXED EARNINGS AND PROFITS.—

"'(1) INCREASE IN SECTION 904 LIMITATION.—In the case of any taxpayer who—

"'(A) either (i) chose to have the benefits of subpart A of this part for a taxable year in which he was required under section 951(a) to include in his gross income an amount in respect of a controlled foreign corporation, or (ii) did not pay or accrue for such taxable year any income, war profits, or excess profits taxes to any foreign country or to any possession of the United States, and

"'(B) chooses to have the benefits of subpart A of this part for the taxable year in which he receives a distribution or amount which is excluded from gross income under section 958(a) and which is attributable to earnings and profits of the controlled foreign corporation which was included in his gross income for the taxable year referred to in subparagraph (A), and

"'(C) for the taxable year in which such distribution or amount is received, pays, or is deemed to have paid, or accrues income, war profits, or excess profits taxes to a foreign country or to any possession of the United States with respect to such distribution or amount.

the applicable limitation under section 904 for the taxable year in which such distribution or amount is received shall be increased as provided in paragraph (2), but such increase shall not exceed the amount of such taxes paid, or deemed paid, or accrued with respect to such distribution or amount.

"'(2) AMOUNT OF INCREASE.—The amount of increase of the applicable limitation under section 904(a) for the taxable year in which the distribution or amount referred to in paragraph (1)(B) is received shall be an amount equal to—

"'(A) the amount by which the applicable limitation under section 904(a) for the taxable year referred to in paragraph (1)(A) was increased by reason of the inclusion in gross income under section 951(a) of the amount in respect of the controlled foreign corporation, reduced by

"'(B) the amount of any income, war profits, and excess profits taxes paid, or deemed paid, or accrued to any foreign country or possession of the United States which were allowable as a credit under section 901 for the taxable year referred to in paragraph (1)(A) and which would not have been allowable but for the inclusion in gross income of the amount described in subparagraph (A).

"'(3) CASES IN WHICH TAXES NOT TO BE ALLOWED AS DEDUCTION.—In the case of any taxpayer who—

"'(A) chose to have the benefits of subpart A of this part for a taxable year in which he was required under section 951(a) to include in his gross income an amount in respect of a controlled foreign corporation, and

"'(B) does not choose to have the benefits of subpart A of this part for the taxable year in which he receives a distribution or amount which is excluded from gross income under section 958(a) and which is attributable to earnings and profits of the controlled foreign corporation which was included in his gross income for the taxable year referred to in subparagraph (A),

no deduction shall be allowed under section 164 for the taxable year in which such distribution or amount is received for any income, war profits, or excess profits taxes paid or accrued to any foreign country or to any possession of the United States on or with respect to such distribution or amount.

"'(4) INSUFFICIENT TAXABLE INCOME.—If an increase in the limitation under this subsection exceeds the tax imposed by this chapter for such year, the amount of such excess shall be deemed an overpayment of tax for such year.

"'SEC. 960. ADJUSTMENTS TO BASIS OF STOCK IN CONTROLLED FOREIGN CORPORATION AND OF OTHER PROPERTY.

"'(a) INCREASE IN BASIS.—Under regulations prescribed by the Secretary or his delegate, the basis of a United States shareholder's stock in a controlled foreign corporation, and the basis of property of a United States shareholder by reason of which he is considered under section 957(a)(2) as owning stock of a controlled foreign corporation, shall be increased by the amount required to be included in his gross income under section 951(a) with respect to such stock or with respect to such property, as the case may be, but only to the extent to which such amount was included in the gross income of such United States shareholder.

"'(b) REDUCTION IN BASIS.—

"'(1) IN GENERAL.—Under regulations prescribed by the Secretary or his delegate, the adjusted basis of stock or other property with respect to which a United States shareholder or a United States person receives an amount which is excluded from gross income under section 958(a) shall be reduced by the amount so excluded.

"'(2) AMOUNT IN EXCESS OF BASIS.—To the extent that an amount excluded from gross income under section 958(a) exceeds the adjusted basis of the stock or other property with respect to which it is received, the amount shall be treated as gain from the sale or exchange of property.

"'SEC. 961. MISCELLANEOUS PROVISIONS.

"'(a) EARNINGS AND PROFITS.—For purposes of this subpart, the earnings and profits of any foreign corporation, and the deficit in earnings and profits of any foreign corporation, for any taxable year shall be determined according to rules substantially similar to those applicable to domestic corporations, under regulations prescribed by the Secretary or his delegate.

"'(b) BLOCKED FOREIGN INCOME.—Under regulations prescribed by the Secretary or his delegate, no part of the earnings and profits of a controlled foreign corporation for any taxable year shall be included in earnings and profits for purposes of sections 952, 954, and 955, if it is established to the satisfaction of the Secretary or his delegate that such part could not have been distributed by the controlled foreign corporation to United States shareholders who own (within the meaning of section 957(a)) stock of such controlled foreign corporation because of currency or other restrictions or limitations imposed under the laws of any foreign country.

"'(c) RECORDS AND ACCOUNTS OF UNITED STATES SHAREHOLDERS.—The Secretary or his delegate may by regulations require each person who is, or has been, a United States shareholder of a controlled foreign corporation to maintain such records and accounts as may be prescribed by such regulations as necessary to carry out the provisions of this subpart.

"'SEC. 962. INCLUSION IN GROSS INCOME ON CONSOLIDATED BASIS OF EARNINGS AND PROFITS.

"'(a) GENERAL RULE.—A United States shareholder may elect to include in gross income under section 951 on a consolidated basis the earnings and profits (less his pro rata share of deficits) of controlled foreign corporations.

"'(b) REGULATIONS.—The Secretary or his delegate shall prescribe such regulations as he may deem necessary in order that the tax liability with respect to the earnings and profits (less deficits) of controlled foreign corporations for which the election provided for under subsection (a) is exercised and of each separate corporation, both during and after the period of such consolidation, may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the income tax liability and the various factors necessary for determination of such liability, and in order to prevent avoidance of such tax liability.'

"(b) TECHNICAL AND CLERICAL AMENDMENTS.—

"(1) Section 551(b) (relating to foreign personal holding company income included in gross income of United States shareholders) is amended by adding at the end thereof the following new sentence: 'The amount included in the gross income of any United States shareholder for any taxable year under the preceding sentence shall be reduced by such shareholder's

proportionate share of the undistributed personal holding company income which is included in his gross income under section 951(a)(1)(A) (relating to amounts included in gross income of United States shareholders) for such taxable year as his pro rata share of the earnings and profits of the company.'

"(2) Section 901 (relating to foreign tax credit) is amended by striking out 'section 902' and inserting in lieu thereof 'sections 902 and 960'.

"(3) Section 902(e) is amended to read as follows:

"'(e) CROSS REFERENCES.—

"'(1) For application of subsections (a) and (b) with respect to taxes deemed paid in a prior taxable year by a United States shareholder with respect to a controlled foreign corporation, see section 960.

"'(2) For reduction of credit with respect to dividends paid out of accumulated profits for years for which certain information is not furnished, see section 6038.'

"(4) Section 904(f) is amended to read as follows:

"'(f) CROSS REFERENCES.—

"'(1) For increase of applicable limitation under subsection (a) for taxes paid with respect to amounts received which were included in the gross income of the taxpayer for a prior taxable year as a United States shareholder with respect to a controlled foreign corporation, see section 960(b).

"'(2) For special rule relating to the application of the credit provided by section 901 in the case of affiliated groups which include Western Hemisphere trade corporations for years in which the limitation provided by subsection (a)(2) applies, see section 1503(d).'

"(5) The table of subparts for part III of subchapter N of chapter 1 is amended by adding at the end thereof the following:

"'Subpart F. Controlled Foreign Corporations.'

"(6) Section 1016(a) (relating to adjustments to basis) is amended—

"(A) by striking out the period at the end of paragraph (18) and inserting in lieu thereof a semicolon; and

"(B) by adding after paragraph (18) the following new paragraph:

"'(19) to the extent provided in section 961 in the case of stock in controlled foreign corporations (or foreign corporations which were controlled foreign corporations) and of property by reason of which a person is considered as owning such stock.'

"(c) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to taxable years of foreign corporations beginning after December 31, 1962, and to taxable years of United States shareholders within which or with which such taxable years of such foreign corporations end."

Page 164, after line 18, insert the following new section:

"SEC. . SALES AND EXCHANGES OF PATENTS, ETC., TO CERTAIN FOREIGN CORPORATIONS.

"(a) TREATMENT OF GAIN AS ORDINARY INCOME.—Part IV of subchapter P of chapter 1 (relating to special rules for determining capital gains and losses) is amended by adding after section 1248 (as added by section 16 of this Act) the following new section:

"'SEC. 1249. GAIN FROM CERTAIN SALES OR EXCHANGES OF PATENTS, ETC., TO FOREIGN CORPORATIONS.

"'(a) GENERAL RULE.—Gain from the sale or exchange after December 31, 1962, of a patent, an invention, model, or design (whether or not patented), a copyright, a secret formula or process, or any other similar property right in any foreign corporation by any United States person (as defined in section 7701(a)(30)) which controls such foreign corporation shall, if such gain would (but for the provisions of this subsection) be gain from the sale or exchange of a capital asset or of property described in section 1231, be considered as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231.

"'(b) CONTROL.—For purposes of subsection (a), control means, with respect to any foreign corporation, the ownership, directly or indirectly, of stock possessing more than 50 percent of the total combined voting power of all classes of stock entitled to vote. For purposes of this subsection, the rules for determining ownership of stock prescribed by section 957 shall apply.

"'(c) OTHER TRANSFERS OF PATENT RIGHTS, ETC., TO FOREIGN CORPORATIONS.—

"'For allocation, etc., of income by the Secretary or his delegate, in case of corporations owned or controlled directly or indirectly by the same interests, see section 482(a).'

"(b) CLERICAL AMENDMENT.—The table of sections for such part IV is amended by adding at the end thereof the following:

"'SEC. 1249. Gain from certain sales or exchanges of patents, etc., to foreign corporations.'

"(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 1962."

Mr. GLEASON. Certainly, the position of the tax committee of the NAM is that there in fact is no deferral, and consequently no privilege under the present statute, because the thrust of what you propose, sir, would impose a tax on income on a taxpayer before he gets it.

Senator GORE. I understand.

You think you have testified sufficiently on the recommendation of the Treasury in that regard.

Mr. GLEASON. I think that the testimony of the committee that was given on this subject—I didn't give it, sir—made it quite clear what the association's position is.

Senator GORE. Well, I agree that voluminous testimony has been given on the subject but I wanted the record to show, and for all present to understand, that this rewriting of section 13 is but a secondary recommendation of the Treasury Department.

Mr. GLEASON. Well, I understand that.

Senator GORE. And the President.

Mr. GLEASON. And as Mr. Dillon's statement to the committee here on May 10 says.

Senator GORE. To your knowledge are any of the other scheduled witnesses unaware of that?

Mr. GLEASON. Are any of them unaware of it?

Senator GORE. Yes; to your knowledge?

Mr. GLEASON. I doubt it very much, sir.

Senator GORE. Thank you, Mr. Chairman.

Senator KERR (presiding). Senator from Kentucky.

Senator MORTON. No questions.

Senator KERR. Mr. Gleason——

Mr. GLEASON. Yes, sir.

Senator KERR. You identified yourself as assistant treasurer of the Corn Products Co.?

Mr. GLEASON. Yes, sir.

Senator KERR. What percentage of the income of your consolidated foreign operations is paid to foreign governments as income taxes?

Mr. GLEASON. The percentage of the foreign income?

Senator KERR. What percentage of the income of your consolidated foreign operation is paid to foreign governments as income taxes?

Mr. GLEASON. About 20 percent.

Senator KERR. What percentage of your profits after foreign income taxes are returned to the United States as dividends?

Mr. GLEASON. Well, that has fluctuated from year to year.

But over a period of the last 10 years, we have—and I would like to correct my figures for the record if I am off——

Senator KERR. All right.

Mr. GLEASON. My recollection is that we brough in, of some hundred million dollars, which represented earnings over a period of 10 years, somewhere between 70 and 80 percent.

We have also been expanding our foreign businesses tremendously in the last 10 years.

Senator KERR. How much U.S. tax is paid on such dividends after allowance of the foreign tax credit by the United States?

Mr. GLEASON. The average U.S. tax on all of our foreign income after foreign taxes——

Senator KERR. I am talking about your foreign dividends.

Mr. GLEASON. Foreign dividends, and we have other types of foreign income, sir. It comes to approximately 10 percent, on the average.

Senator KERR. You mean approximately 10 percent of it is taxable or that you——

Mr. GLEASON. That is the U.S. tax paid on the income mix of dividends and royalties which carry foreign tax credits.

Senator KERR. In other words, you pay approximately 20 percent income tax to the foreign countries; is that what you said?

Mr. GLEASON. I would like to amend that statement. We pay about 40 percent taxes on the average to the foreign governments (a little bit over 40), and the U.S. tax on this income as it is repatriated is about 10 percent, which represents——

Senator KERR. That is 10 percent of the 60?

Mr. GLEASON. No; 10 percent, I am sorry?

Senator KERR. Sir?

Mr. GLEASON. I beg your pardon, sir.

Senator KERR. Well, my first question to you is, What percentage of the income of your consolidated foreign operations is paid to foreign governments as income taxes and you first said——

Mr. GLEASON. I should have said about 40 percent or a little over.

Senator KERR. About 40 percent.

Mr. GLEASON. 40 percent of the foreign income.

Senator KERR. You pay an income tax of approximately 40 percent on your earnings in your consolidated foreign operations to foreign countries?

Mr. GLEASON. That is right; 40 percent of the foreign income that is in the consolidation.

Senator KERR. Yes.

You pay that much to foreign countries?

Mr. GLEASON. That is right, sir.

Senator KERR. Now, then, what percentage of your profits after foreign income taxes is returned to the United States?

Mr. GLEASON. Well, last year——

Senator KERR. You said about 70 or 80 percent.

Mr. GLEASON. That is over a period of 10 years it is about 70 percent; last year it was over 90 percent.

Senator KERR. Now, then, the average has been about 70 percent.

Mr. GLEASON. Over the past 10 years, sir; yes, sir.

Senator KERR. So that you have returned approximately 70 percent of 60 percent of your foreign earnings?

Mr. GLEASON. I will accept your arithmetic.

Senator KERR. Well, if you pay 40 percent in taxes abroad, and you bring back 70 percent of what you got left, is that 70 percent of 60 percent? You have had all these years of figuring; I have had none. [Laughter.]

If my conclusions are inaccurate, correct them.

I seek no inaccuracies, I seek only to question you on the basis of accuracy as applied to the statements you yourself are making.

Mr. Gleason. All right, sir. I accept your statement.

Senator Kerr. Is that correct?

Mr. Gleason. We repatriate on the average, or have for the past 10 years, approximately 70 percent of our foreign earnings after foreign taxes.

Senator Kerr. Then if your foreign taxes have averaged 40 percent you have had approximately 60 percent left?

Mr. Gleason. That is right.

Senator Kerr. Is that correct?

Mr. Gleason. Yes.

Senator Kerr. All right; then if you repatriate 70 percent of that you are repatriating approximately 70 percent of 60 percent.

Mr. Gleason. That is correct.

Senator Douglas. The figure is 42 percent. [Laughter.]

Senator Kerr. I think it is, but I was just seeking to get it from the witness.

Mr. Gleason. Yes, sir.

Senator Kerr. Now, then, what percentage of that 40 percent, how much U.S. income tax, is paid on that 42 percent that you bring back, percentagewise?

Mr. Gleason. About 10 percent.

The Chairman (presiding). How much?

Mr. Gleason. Each piece of foreign income on the average that comes in bears tax credit equal to 40 percent of itself, maybe 42 percent. Uncle Sam gets 10 percent, because the difference between that 42 percent and 52 percent is 10 percent.

Senator Kerr. Is that 10 percent applied to the total or to the repatriated money?

Mr. Gleason. It only applies, as far as payment is concerned, to the repatriated money.

Senator Kerr. So that actually then it is 10 percent of 42 percent?

Senator Douglas. The figure is 4.2 percent. [Laughter.]

Senator Kerr. I am very grateful to the Senator from Illinois.

Mr. Gleason. All right, sir.

Senator Kerr. If the witness will validate the statement of the Senator as his answer, then that is marvelous.

Mr. Gleason. Yes, sir.

Senator Kerr. If he doesn't I would like to have him say so.

Mr. Gleason. Yes, sir. I will accept it.

Senator Kerr. Then it is about 4.2 percent tax you pay to this Government under the method that you are operating?

Mr. Gleason. That is correct.

Senator Kerr. Now, the Treasury advised the committee, and it is the belief of the Senator from Oklahoma, that the draft of section 13 submitted on May 31 was intended to limit section 13 to cover only tax havens.

Mr. Gleason. Yes, sir.

Senator Kerr. I take it you do not agree with it?

Mr. Gleason. I do not in one major area, sir.

Senator Kerr. All right. What is it?

Mr. Gleason. That is where a foreign subsidiary operating company in one country has a branch in another country, in which it may conduct manufacturing or sales operations. This gets down to defini-

tion. Under the statute, or the proposed amendments as I understand them, the income of that branch would be considered to be this so-called tainted earnings.

Senator KERR. Well, now, where is the word "tainted"?

Mr. GLEASON. It isn't there.

Senator KERR. Well, who so called it?

Mr. GLEASON. I do, sir.

Senator KERR. You do?

Mr. GLEASON. Yes, sir.

Senator KERR. Well, then, I think that the record should show that the term——

Mr. GLEASON. Might I clarify that use of the term?

It is tainted because it falls within the definition of so-called base company income and would be, therefore, subject to tax.

Senator KERR. Now, is that the only situation other than what you regard as a tax haven?

Mr. GLEASON. No.

Senator KERR. That would still be reached by the revised language of section 13?

Mr. GLEASON. I don't believe it is, sir.

For example, these operating companies may have perfectly legitimate other types of income, possibly trading operations, which I do not think should be hit, and also, service-fee income, for example, for services rendered in another country. These apparently would fall within the definition of so-called base company earnings.

Senator KERR. Is that the only other situation that you think it covers?

Mr. GLEASON. I just don't know, sir.

Senator KERR. Then——

Mr. GLEASON. There may be others. That is all that come to my mind.

Senator KERR. Well, you are a man who has admitted that you have imagination because you said it has been staggered. [Laughter.]

And by using both your knowledge and your imagination, can you tell the committee of any other situation than a tax haven that would be covered, than the two you have mentioned.

Mr. GLEASON. Well, I think that a foreign operating company should be permitted to conduct trading operations with its affiliated companies, that is trading in product.

Now, I want to make it quite clear, sir, that the reason that I don't think that the present draft should cover these things which we have just discussed is because they do not reduce U.S. taxes. They reduce foreign taxes; and I repeat I can't understand how under any theory whatsoever we should have legislation which would hamper the reduction of foreign taxes on U.S. business income abroad, because if we do, it can only, inevitably result in less later collections of U.S. taxes.

Senator KERR. The Senator from Oklahoma is limiting section 13 to covering only tax havens.

Mr. GLEASON. Yes, sir.

Senator KERR. And that is not binding on anybody but the Senator from Oklahoma.

Mr. GLEASON. Yes, sir.

Senator KERR. It had been my opinion, that the May 31 revised Treasury draft of section 13 conformed to that objective, and if the Senator from Oklahoma thought that when the deferral of taxation of controlled foreign corporations was eliminated that that went a long way in that direction, not just a little bit in that direction.

Senator GORE. Did you say "was"?

Senator KERR. Well, I was only referring to the quotation that you gave from the statement of the Secretary and attempting to interpret it in the same manner which you did. And I said that on that basis, I thought that that action by the Treasury or recommendation by the Treasury went a long way toward limiting the revised form of section 13 to covering only tax havens.

Senator GORE. Well, we can see from the barrage of dissatisfaction with even this extremely mild suggestion a demonstration of a lesson which I dare say President Kennedy has recently learned: It is dangerous to stroke the tiger.

Senator KERR. Well, I do not want to associate myself with that statement because I neither regard business as a tiger nor do I regard it as something that it is dangerous to stroke. [Laughter.]

Nor do I think that it should be denied the option of deciding whether or not it should be stroked or not stroked.

Senator GORE. Well, if I modify the adage to say it is dangerous to stroke the tycoon, would the Senator associate himself with that?

Senator KERR. I would say that is a term that is subject to so many diverse interpretations that I would not want to associate myself with it, because to me "tycoon" is not synonymous with business, and I do not think it is dangerous to stroke business whether it is tycoon or tiger, lamb or pussycat. [Laughter.]

Which is feline in origin but not tigerish in operation. [Laughter.]

Senator GORE. I think you went a little too far there at the last. I wanted to point out that this effort to revise section 13 at the suggestion of certain members of the committee, I believe, has failed to satisfy or mollify or quiet opposition to doing anything in this field.

The effective remedy is elimination of deferral.

My friend from Oklahoma says he wants to confine it to dealing with tax havens. I do not. That is only part of the problem. But we see that no one who has testified is satisfied even with that mild approach.

Senator KERR. It is not hard for me to understand how any taxpayer might be concerned about an increase in taxes nor is it hard for me to understand why an official of the Treasury should seek to eliminate primarily foreign tax havens.

I think we can encourage foreign business, I think we can encourage foreign trade, and do so on a basis that will not permit abuses which arise by means of what I regard as a tax haven, and I cannot conceive of American business presenting its case on the basis of seeking equity and yet doing so in a manner which can only be interpreted as seeking to protect the privilege that now exists for the creation and operation of foreign tax havens.

Mr. GLEASON. Might I make one comment, sir?

Senator KERR. Yes.

Mr. GLEASON. I think that the difference between us here insofar as tax havens are concerned is that we cannot conceive where a tax haven or a base corporation or whatever you want to call it (and it means many things to many people), where it serves solely to reduce foreign taxes, we can't see how any benefit is going to accrue to the United States by stopping it.

Senator KERR. There is a difference between us as to the statement that that is all that it serves. And I say this, the Senator from Oklahoma expects to offer an amendment which he thinks will eliminate even the possibility of that objection.

It may not get anybody's vote but his own, but he's going to offer it. [Laughter.]

Senator GORE. Mr. Chairman.

The CHAIRMAN. Senator Gore.

Senator GORE. I hope, sir, that you understand that this legislation has more than one purpose. One purpose is to promote equity and ness as among taxpayers, both corporate and individual.

It seems to me quite inequitable, quite unfair and unsound, to permit our citizens living abroad complete tax exemption on their earned income abroad.

Why is it that someone living in Nassau or Switzerland or Panama or wherever, while an American citizen, has any less responsibility for the defense of his country, or the welfare of his homeland than does a citizen who lives here?

It seems to me inequitable and unfair that our tax laws would reward a taxpayer, be he corporate or be he individual, who builds a factory in a foreign land, or, conversely, why we should penalize someone who builds a factory in Tennessee or Oklahoma as compared to one who builds a factory abroad, or who moves one abroad.

Now, this goal which I have in mind, and I will only take a moment to speak for myself here, of promoting equity and fairness among taxpayers wherever their income is earned, is but one of the goals. We have other problems: the balance-of-payments difficulties, the flight of gold. These are short term but serious problems.

Mr. GLEASON. Yes, sir.

Senator GORE. We have another, the problem of economic growth in the United States.

Now, all of you who have appeared here for the past 2 days have spoken eloquently of the great rewards and incentives and grandeur of growth and development in other countries, principally Western Europe. In fact, one witness testified yesterday that the return of his company was 25 percent on investment after taxes; and he proceeded to tell us that if Congress repealed this tax incentive for investment and development of business abroad, his company would not expand abroad.

Well, if it did not expand abroad, it just might expand here.

There is no unemployment problem in Western Europe. The rate of economic growth there is twice the rate of growth in the United States. We are in a situation, which you have described earlier, where it is no longer in our national interest for the Government to permit its citizens, corporate and personal, to invest anything, anywhere, any time for their own personal benefit if it is contrary to the national interest.

I can recognize, and do recognize, the problems which you and other individuals here have with respect to your individual businesses. It may put a crimp in your profits abroad, if you have to pay taxes. True, if you pay taxes on your foreign profits you will not be able to grow as fast abroad, as you would if no taxes were levied. That would be true here at home, too. But those of us who feel a deep responsibility to promote full employment here at home, to safeguard America's position in international exchange, and in trade, those of us who feel that it is fair and equitable to require taxpayers to pay income taxes, wherever profits are earned, have a broader view and we feel a broader responsibility.

You are speaking as a citizen and as a representative of an industry. I, if you will permit me to close this lecture, am speaking as a Member of the U.S. Senate, who has a responsibility far beyond that for which you have spoken.

This doesn't cost you anything. [Laughter.]

Senator WILLIAMS. I have one question.

The CHAIRMAN. Senator Williams.

Senator WILLIAMS. Mr. Gleason, as a representative of your company how much did you say you had returned over the past 10 years to the United States?

Mr. GLEASON. Seventy percent of $100 million, sir.

Senator WILLIAMS. During this same 10-year period, how much have you sent from this country for dollar investments abroad?

Mr. GLEASON. I don't have the figures.

Senator WILLIAMS. Approximately?

Mr. GLEASON. I would guess $15 million, maybe.

Senator WILLIAMS. $15 million?

Mr. GLEASON. Yes.

Senator WILLIAMS. In other words, the inflow of capital, the inflow from the earnings of your investments abroad, has exceeded your investments by about five times?

Mr. GLEASON. Oh, yes.

Senator WILLIAMS. And, therefore, the balance of payments has gained over this 10-year period as far as our Government is concerned about by this $85 million?

Mr. GLEASON. Absolutely, and don't forget that 4½-percent or 4.2-percent tax we were talking about here.

Senator WILLIAMS. That is correct.

That is all. Thank you.

Senator GORE. Well, you don't claim your company, however, is typical of the overall problem. Several people have come here and have given us testimony such as yours, that their particular company has done thus and so. But the overall statistics given us by the Treasury Department show quite a contrary story. And even if it were true that the balance of payments is favorable in the long run, we have the short-run problem of the balance of payments which is not helped this year or next year or perhaps for the next 5 to 10 years by new investment outflows. Present law serves as a subsidy and an incentive for foreign investments, particularly in Western Europe.

Mr. GLEASON. Well, sir, on this balance-of-payments question, there are very divergent opinions, on the part of the Treasury Department

on the one hand and some of the witnesses on the other, as to two points: first, how quickly the average investment pays for itself in the balance-of-payments sense—that is, vis-a-vis earnings—and also the second question is how much do these foreign investments stimulate exports immediately. There is a lot of conflicting testimony.

You will agree with me, sir, on this business of statistics, well, it is a numbers game. But our feeling is that the weight of the evidence, even in the very short term, I am speaking now for the National Association of Manufacturers, that stifling or inhibiting, foreign investments will be to our foreign exchange balance-of-payments detriment.

Senator GORE. I am sure you are entitled to your feelings about that.

Mr. GLEASON. Right, sir. I understand.

Senator GORE. The record, however, does not support that conclusion.

Senator WILLIAMS. Well, Mr. Gleason, just to see what the record does support, do you have at your disposal there the figures which would show the dollar outflow over the past 10 years for investments abroad by American companies.

Mr. GLEASON. I don't, sir. But they are already in the record.

Senator WILLIAMS. And the dollar inflow has greatly exceeded the outflow over this same 10-year period.

Mr. GLEASON. The most frequently quoted figure, I believe, is that the income from present and prior investments during the decade of the fifties or perhaps this goes up through 1960 exceeded the capital outflow for new investment by some 8 billion. That is the figure that sticks in my mind, sir.

Senator WILLIAMS. That is my understanding. I don't have the exact figure but it has exceeded it, and that your company, the pattern of the figures which you gave for your company were merely in line with the overall results of the investments abroad.

Mr. GLEASON. Yes, sir.

Senator WILLIAMS. Thank you.

The CHAIRMAN. Any further questions?

Thank you very much, Mr. Gleason.

Mr. GLEASON. Thank you, sir.

The CHAIRMAN. The leader of the Senate has called a meeting of the chairmen at 12:30, so we will recess until 2:30.

(Thereupon, at 12:05 p.m., the committee stood in recess until 2:30 p.m., the same day.)

AFTERNOON SESSION

The CHAIRMAN. The committee will come to order.

The first witness is Mr. Charles W. Stewart of the Machinery & Allied Products Institute.

Mr. Stewart, take a seat, sir.

STATEMENT OF CHARLES W. STEWART, PRESIDENT, MACHINERY & ALLIED PRODUCTS INSTITUTE

Mr. STEWART. Mr. Chairman, and Senator Carlson, my name is Charles W. Stewart. I am president of the Machinery & Allied Products Institute.

My associate is Mr. Healey, William Healey, staff counsel.

I ask leave of the committee to submit our statement in its entirety for the record, including its appendix, and I will attempt, in the interest of time and in deference to the very heavy schedule which confronts the committee, to highlight certain points, having in mind that the record will contain the full document.

The CHAIRMAN. It will appear following your oral presentation.

Mr. STEWART. I would like to refer back briefly to one or two colloquies that took place this morning in order to set the record in a little more balanced form from our point of view.

In the first place, as our statement indicates, we have no illusions about the main thrust of the Treasury position, and that the current supplemental recommendations are really presented in a somewhat reluctant or grudging fashion, with a clearly stated preference for an across-the-board removal of deferral.

We also have no illusions about the position which Senator Gore himself has taken on this subject, one with which we happen, respectfully, to disagree.

Secondly, it seems to us that in connection with Senator Kerr's questioning along the lines of what might be a reasonable and constructive approach to dealing with the abuse problem, much of what the previous witness said, in response to this questioning, we would certainly concur with.

But beyond that, we would like to make one or two very simple or central points.

In the first place, the words "tax haven" or "tax-haven income" are really not words of precision. Indeed, they mean different things to different people, and it is terribly important if we are to engage in a responsible way the issues of abuse, that we talk about precise types of operations, how they may be conducted or are conducted; what the Government resources are with reference to dealing with them, as distinguished from generalizing in such terminology as the "tax haven."

The questioning made the point, particularly Senator Kerr's, that there ought to be an effort made to draw reasonable lines of demarcation between legitimate business activity and improper techniques employed solely and primarily for the purpose of tax evasion insofar as U.S. taxes are concerned.

In being fully responsive to that suggestion, we can see nothing wrong with the notion and the objective. We do not feel that this bill, even in its amended form, as suggested by the Treasury, meets that objective. Indeed, it goes much farther. It does not confine itself to what we would prefer to call the abuse area, what others call the tax haven area.

With reference to Senator Gore's latter comment to the effect that the record makes a clear case on the issue of public policy issues, we dissent. We feel that the record does not make a clear case that the balance-of-payments problem would be substantially improved by the legislation offered by the Treasury Department. We feel that the record does not make a case that exports would be benefited by the proposals offered by the Treasury Department.

We feel that the record does not make a case that what is really being attacked here is the limited area of abuse.

We feel that a case is not made in terms of an improvement in domestic employment if these provisions were to be enacted; and I merely refer back to our prior, more detailed testimony on the general aspects of this bill with respect to those fundamental issues.

We find ourselves, therefore, gentlemen, in a position of responding to the new supplemental recommendations of the Treasury Department with the conclusion that in some respects they mitigate some of the penalties contained in H.R. 10650, and in others they sharpen the penalties.

In no way do they deal with the fundamental economic foreign trade and tax policy questions which are involved in the total legislation.

Indeed, it seems to us, to borrow President Kennedy's theme of his Yale address, that in this area of foreign taxation and the economics and commercial questions which underlie it, we need to disenthrall ourselves from an inheritance of truism and stereotype and seek an essential confrontation with reality.

We do not believe that the Treasury proposals meet that objective, and we urge the committee that what is really needed here is not a tinkering with H.R. 10650 a la the Treasury proposals, but rather a basic and fundamental rethinking of the entire approach to the economics of foreign investment and related taxes.

Now, with respect to the individual technical changes which are recommended by the Treasury Department, they are discussed in our statement in some detail, and I shall not go through the statement except to identify the points that we comment on and indicate the direction in which the Treasury would take H.R. 10650 through the medium of these new supplemental recommendations.

The proposal on the so-called pour over of earnings from developed countries into less developed countries is a tightening in H.R. 10650.

The proposal in the case of loss adjustments is within the context of H.R. 10650, some change in the direction of relaxation.

The provisions on royalty income from patents, exclusive formulas and processes, et cetera, have a mixed character. Some of them represent tightening and some of them represent relaxation.

The provision on sales and technical assistance income is a tightening; the provision on branch income is a tightening.

Certain changes in the area of manufacturing income represent relaxation within the context of H.R. 10650, as is the case with the modification of the definition of controlled foreign corporations and blocked foreign currency.

Within the context of H.R. 10650, our statement indicates that we would oppose certain of these changes as recommended by the Treasury, and concur in others insofar as they go and within the framework of H.R. 10650, but with the caveat that we believe that the framework is basically fallacious and these proposals in the net represent nothing more than tinkering, whichever direction they happen to move in.

Now, if you will examine our statement, you will note that beyond the definitive response to each section proposed by the Treasury for change, we include some single-spaced indented, parenthetical comment which goes to some of the broader issues that are involved in each one of the technical points that we comment on.

I think that by examining one or two of these discussions of general issues growing out of specific issues, you will recognize that respecting the broader questions, the most controversial questions, that are involved in this proposal of the Treasury in the form of its amended suggestions or its prior suggestions, actually no change has been made in the Treasury position of any consequence.

For example, in the case of the pour over provision, we have this to say:

In opposing this Treasury recommendation for these reasons—

Stated in our statement—

we do not wish to give the impression that the institute supports the concept of drawing a line in foreign tax policy between underdeveloped and developed countries. The distinction is wholly artificial. As we pointed out in detail in our oral and written presentation to this committee on April 4, generally speaking, sound and legitimate private investment wherever it takes place throughout the world should be accorded tax treatment similar to that available under the present law.

We might add that in one sense we can understand why Treasury makes this recommendation. The Department does not wish to concede, for purposes of its overall case on foreign earnings, that there are public policy benefits from investment in developed countries, including pour over of earnings into underdeveloped regions. It therefore contrives to defeat one of the Government's own objectives—encouragement of investment in underdeveloped areas—a wholly incongruous position under all the circumstances. Moreover, from the balance-of-payments standpoint, assuming a quick capital accumulation in a U.S. foreign base company in a developed country which generates funds available for reinvestment in an underdeveloped region, why would our Government prefer to encourage a fresh and separate outflow from the United States, assuming a company had the disposition to so invest directly in the underdeveloped area?

In a similar way, if you will look at the question of blocked foreign currency and the change which the Treasury recommends and which within the context of H.R. 10650 we feel is in the right direction, this recommended change by the Treasury in itself admits the differences in the character of a business operation when it is conducted in the United States versus being conducted outside the United States. And yet the differences in the conduct of business, depending on where business is carried on, are not recognized except in this indirect way.

We reach the broad conclusion, therefore, that the fundamental economic issues to which Senator Gore referred at the conclusion of the morning hearing need further examination from all viewpoints.

We feel that the record is not clear on the balance-of-payments issue and on related economic questions, as I mentioned previously.

In that connection, we would like to call attention of the committee to appendix A which is, we believe, perhaps, the most comprehensive effort to meet on economic, scholarly grounds the brief submitted by the Treasury as exhibit III to Secretary Dillon's testimony in support of the economic philosophy underlying H.R. 10650 or the more wide-sweeping recommendations of the Treasury which were referred to this morning.

It is our judgment that although it would be extreme to say that any analyst can draw absolutely certain conclusions based on the aggregate data which are available in this very complex field, the conclusions and, in particular, the assumptions which are embodied in this economic document are open to very, very serious question.

In an effort to be constructive in terms of giving the committee an opportunity to reexamine all of the issues that are involved here, not alone which are purely technical in character, we have placed this economic critique before the committee.

I would like, in conclusion, to concur completely in one point which was made this morning by the last witness; namely, that the question of the benefits in terms of improvement in U.S. tax-take that might accrue from the enactment of these provisions, in the light of the fact that really the benefits which are enjoyed by American corporations in low-tax countries are provided by the foreign countries as distinguished from the United States, is greatly overstated. I think that we would find that in terms of the practical impact of these provisions, the revenue changes would be inconsequential.

The impact, however, on the ability of American business to move aggressively and competitively and properly within the concept of our system would be very substantially impeded.

I have no wish to burden the committee with any further repetition of the content of our statement.

We appreciate, particularly during these busy times, the opportunity to come back and present our further views.

The CHAIRMAN. Thank you, Mr. Stewart.

Any further questions?

Mr. STEWART. Thank you.

Senator GORE. Do you think it would be properly within the province of the Government of the United States to require the conduct and actions of its citizens abroad to comport with the welfare of our country?

Mr. STEWART. I certainly think that this country is entitled to expect that conduct as a matter of course in a general way, and I think that, to the extent that it is essential to regulate, but only to that extent, should we regulate, whether we are acting in the foreign sector or in the United States. But I certainly have no basic difference with the philosophy that you are expressing.

Senator GORE. Well, you used the term "regulate," which is a term which some people seem to regard as abhorent. I do not. I am glad you agree that the country has a right to expect its citizens to conduct themselves, both at home and abroad, in a way that is commensurate with the welfare of the country.

To the extent, and only to the extent, that regulation is necessary to insure this end, you would accept regulation, and I think I would find myself in agreement with you on that.

You realize, of course, if you were a citizen of Japan or any other country, you would not be free to export your capital or, to put it another way, to invest your money, anywhere, any time, in any amount, in anything that might be to your personal benefit.

The first decision reached by the Government of Japan, and other countries, would be whether such a proposed investment on your part would be in the interest of that country. Unless it was, then you would not be given a license to make the investment.

If it did not harm the interests of the country, or better still, if it served the interests of the country, as the officials of that country would see it, you might then be permitted to follow the bent of your

own selfish interests. I should not use "selfish"—your own personal interests, let me put it that way.

If American corporations, if the American corporate structure and individual American taxpayers, continue to abuse the freedom which people enjoy in these fields and continue to resist the closing of any tax loopholes, it seems to me it may make inevitable the regulation which you say you would approve to the extent necessary.

Mr. STEWART. Well, may I comment?

Senator GORE. I am not trying to put you in a box about regulation——

Mr. STEWART. I do not feel constrained——

Senator GORE (continuing). To the extent necessary; and I agree you and I might have a different opinion as to what is necessary. But let me proceed for just a moment.

Mr. STEWART. Yes.

Senator GORE. So far as I am concerned, I think the time has already come for the Government to institute such programs. Other members of this committee hope to avoid it.

I think the administration, although I am not qualified to speak for it, hopes to avoid regulation by such measures as are now before this committee.

Yet the whole business community has come here for 2 solid days, in a solid phalanx of opposition against doing anything in this field.

Do you see what the end result is almost inevitably to be? Now do you want to comment?

Mr. STEWART. Well, I think we are in disagreement in almost every sentence.

Senator GORE. I though we started out—I tried to get with you right at the beginning. [Laughter.]

Mr. STEWART. Well, I was trying to put our viewpoint in the context of the public welfare which, I think, in deference to the business community, is not outside our ken or our interest.

I would comment, I think, in the following ways: In the first place, I think there is a fundamental difference of opinion a conscientious one, not one traceable by any substantial means to selfish business motivation, a fundamental——

Senator GORE. You understand I used the word "selfish" and withdrew it because it does have a connotation——

Mr. STEWART. I used it in a similar way.

Senator GORE. In a very small way I am in business, and I am in business for profit. I take it you are, too. That is the motivation of our free enterprise system. So I do not mean, to and I did not mean, to imply any critical comment with respect to pursuing a selfish interest.

Mr. STEWART. I am sure I did not mean to infer in any way that you did.

Senator GORE. Yes.

Mr. STEWART. The point I want to make is that there is a big gap between your concept, as I understand your view of this subject, of what is good for the public welfare and my concept of it.

It is not a question that I or my constituency or the business community as a whole are not interested in the public welfare. It is rather whether or not this particular piece of legislation is in that direction, and I think it is wholly appropriate for the business com-

munity to come before this committee on invitation, and ask the committee and itself in testimony drawn with a real effort to make a contribution, whether or not the fundamental economic, commercial trade, and tax policy issues which underlie this difference of opinion have been thought through, and whether or not we have the right answers.

It is our very sincere conviction, in the public interest, that this bill is based on a series of misconceptions as to what the facts of life are in this area of international trade and what the results would be that would flow from this legislation.

I recognize that from the standpoint of alternatives available, the Congress has many and, in its discretion and judgment, can choose between, if it wishes to go through the extreme which I hope it would not, regulation such as you have suggested; it may adopt H.R. 10650 in its form before it came to this committee; it may adopt a modified version; it might revert to what I consider a considerably preferable approach in the form of the joint committee staff work that preceded the reporting out of H.R. 10650; it might examine this issue from the standpoint of administrative attack, as has been suggested this morning; it might wish to strengthen section 482 in some way, administratively or legislatively or both, without reference to the provisions of H.R. 10650. I am aware of all these alternatives, and I am sure that this committee and the Congress will consider them before it acts.

But I cannot concede that the fundamental issues that underlie the action which the Congress will eventually take have as yet been satisfactorily resolved, and that is our principal mission here.

We are not here to suggest that the Government do nothing, nor to take the position that there are no abuses in this area, but to take the position that there are many considerations in the field of foreign trade which we do not believe have been ventilated properly.

It is for that reason, Senator, that we have attempted at great pains to analyze the fundamental economic philosophy under this bill which is contained in exhibit III of the Treasury testimony, and we find very great difficulty in accepting it.

Senator GORE. Well, I accept your sincerity, and in no sense have I intended to challenge it or your motives.

You spoke of alternatives. I am receiving letters now from servicemen who are serving their country abroad, wearing the uniform of the U.S. military service, and they complain that they are not allowed to spend the little salary that a GI draws.

Yet we place no inhibition at all on the amount of money that you can invest abroad, and your investment abroad of $1,000 takes the same amount of gold from this country as do the purchases of several servicemen.

You remember that an order was issued that forbade wives and children to join their husbands and fathers in Europe. I am told that this resulted—well, who can say it resulted—but at least there have been many homes broken up, and some divorces.

Yet we lost more gold when the Ford Motor Co. bought the automobile concern in England than we saved by refusing to permit the wives and children to join their fathers and husbands in Europe.

You have this kind of choice and you have some alternatives of which you spoke.

There are other choices to make. We must choose between things none of which may be exactly to our liking. Which would you choose if that were the alternative?

Mr. STEWART. Well, I would like to comment, first, on your——

Senator GORE. Let me ask the question.

Mr. STEWART. Excuse me.

Senator GORE. Which would you choose, granting the freedom of Ford Motor Co. to buy a subsidiary plant in some European country from which it ultimately expects to import into the United States products thereof, or granting freedom of wives and children to join their servicemen fathers and husbands in Europe?

Mr. STEWART. If I may say so, sir, I think it is an oversimplified choice, and I think—may I be responsive?

Senator GORE. Yes, and I will not—I have no power to require you to make that choice, and I really put the question to you to make the point. You need not express your views. I am sure if you had to choose you would be for motherhood and fatherhood and home. [Laughter.]

Mr. STEWART. I would like to have the liberty, if you don't mind, of commenting on the choice you offered here.

Senator GORE. Yes, indeed.

Mr. STEWART. I think, in the first place, that the balance-of-payments problem in the overall sense is a much more complex one than you implied it is through this comparison. I think that——

Senator GORE. Do you agree that $400 million spent abroad as the result of wives and children going to Berlin or wherever their husbands are, and $400 million sent to England to pay for the motor plant, would have the same effect on the drain on gold and the balance of payments?

Mr. STEWART. No, I would not agree, because it is an oversimplification of the economics of the problem.

I am not familiar with the details of the Ford case. I am aware of it, but I am not familiar with the motivation that was involved here nor with what the ultimate effects of that investment abroad will be.

I think it is quite premature to conclude that the primary objective, as you suggested it, may have been to import into the United States. There may be in terms of total benefit to the health of the Ford Motor Co. and its ability to employ in the United States, its ability to be a vibrant U.S. concern, as well as a powerful world entity, great benefits to the public welfare in the United States for this transaction having taken place. And to narrow this subject in terms of a particular transaction at a particular time seems to me to obscure the broader problems of the balance of payments which this country has to face.

I find myself in the position, when I cite an individual case which supports the strength of private investment, of being told that this is an isolated situation.

But when I referred to a situation like the Ford case as being an exceptional situation, people who criticize me for making an example of a single transaction feel that this develops a pattern upon which one can draw broad conclusions.

Now, I do not believe that this question can be resolved in terms of oversimplified comparisons such as the one you made.

I do not think that this country need make that choice in terms of a single set of facts, but it must make a very important overall choice.

It cannot operate its foreign economic policy in terms of on and off again thinking. It has got to think in balance of payments 5 years out, 10 year out, 15 years out.

One of the fallacies of this Treasury exhibit that I referred to is the fact that the analyst suggests that in terms of our balance of payments problem we should disregard completely the current flow into the United States of dollars produced by investments made some years ago. This is on the theory that we are currently in a box and we must look prospectively to the future only, and therefore we should disregard completely the payoff that this country is getting from having followed a policy of sound private investment outside the United States. So we start from now and move forward.

Now, this is the kind of thinking that this country cannot afford from a public welfare standpoint and unless we stop, and I say this very respectfully, Senator, because I appreciate your wish to make a point through this example, but unless we stop thinking in terms of these isolated examples, we are going to find ourselves in a real international trade fix 5 years from now.

Senator GORE. Well, let me give you another example. You may not particularly like this one, I will admit that. If you were going to travel abroad you would secure a passport, would you not?

If you wish to export a large number of commodities it would be necessary for you to secure an export permit or license, would you not?

Mr. STEWART. To certain countries of the world.

Senator GORE. Yes.

Mr. STEWART. But not many.

Senator GORE. Yet there is something sacred about money. We, without hesitation, put restrictions upon the freedom of a citizen himself to move freely. We require export licenses for large numbers of commodities to various countries. Yet people throw their hands up in horror at the very idea that there should be some limitation on the export of capital.

Now, how would you draw distinctions here? Do you think the freedom of the individual or the freedom of money is preferable, or is this another unwelcome choice?

Mr. STEWART. No; it is not an unwelcome choice at all. It is just an improper comparison, if I may say so. I do not mind making the choice.

Senator GORE. I think it is, too. I would prefer the personal liberty to the money liberty myself. I really do not think it is a proper comparison. But many people just think it is abhorrent for anyone to suggest that we even remove the tax subsidy for the export of capital.

What we are seeking here is not regulation of the outflow of capital; what we seek here is to place taxes in a position of neutrality. We want to take from those who wish to build factories abroad or invest abroad the tax incentive to do so.

We want to take out of the tax law a reward for someone who builds a factory in Belgium instead of in Virginia.

I do not know why we should penalize a person who invests in the development of his own country and reward one who invests in the development of other countries.

Now, you can choose between those if you would like.

Mr. STEWART. I would be delighted to, if I may.

Senator GORE. Well, then, after that, I shall desist.

Mr. STEWART. I hope I am not imposing on the committee. But——

Senator GORE. I am afraid I am.

Mr. STEWART. But I do not like to leave my position without dealing with some of the issues that are implicit in your statement.

In the first place, your concept of tax neutrality and mine are quite different. You would neutralize the tax situation faced by the U.S. domestic company and a U.S.-owned foreign company. This, to me, is not neutrality. It is a matter of neutralizing the U.S. company doing business overseas with his foreign competitor in the arena in which he has to do business.

Secondly, I would say that the business community at large, and with very few minor exceptions, does not enjoy a subsidy under the present tax laws.

Thirdly, I would say that the references to restrictions which were referred to are in most instances diplomatic matters. Certainly the passport is an exceptional situation. There are even some who, in terms of human liberty, question that.

The export control situation is a very narrow aspect of Government control, limited almost exclusively to the area of the Russian orbit.

I would say this in terms of philosophy: We are not comparing just money and people. We have got to understand in terms of international trade problems facing this country, just as we have to understand it domestically (a little bit more effectively, I think, than we do), that the two are not inseparable.

Money and capital produce job opportunities. American business cannot be divided up into domestic business in the United States and foreign business abroad. We should not try to rearrange business affairs in terms of motivating one sector and not motivating another.

You are going to find, Senator, and the committee will find this to be true the longer it deals with this subject, that in the area of foreign investment American business is following the very philosophy that the President has pronounced to be that philosophy underlying the foreign trade bill; namely, that we have got to have freedom of movement of trade in the world; that we have got to be able to move into a world position as a country engaged in international commerce; and that it does not make sense economically, politically, or otherwise for this Government to intrude on the normal flow of trade under those circumstances.

That is the philosophy—may I conclude—that is the philosophy of the foreign trade bill, and it is not the philosophy of the bill that is before this committee.

Senator GORE. I would like to answer that in just a moment. The trade bill does seek to liberalize the flow of commerce between nations.

The proposal of the Treasury is to remove a tax subsidy for the export of capital.

Instead of those two being antagonistic, they are complementary. A tax subsidy for the movement of industry, the export of capital, is the same thing in reverse as a tariff wall against the import of goods.

So I could not agree with you at all that they are antagonistic. The two measures are complementary and in no sense antagonistic to each other.

Mr. STEWART. We are in disagreement, sir. I would be glad to elaborate further.

Senator GORE. I think both of us have used enough time. Thank you.

Mr. STEWART. I apologize so much for intruding on the committee's time.

Senator WILLIAMS. Mr. Stewart, may I ask just one question. Over the preceding 10 years up to late 1961 or early 1962, is it not a fact that the American investments made abroad have been made with the consent, the blessing, and the encouragement of the administration in power?

Mr. STEWART. There is no question about it.

Senator WILLIAMS. Thank you.

Mr. STEWART. This represents a complete reversal of policy and one which does not involve the issue of a tax subsidy, as has been suggested.

Senator WILLIAMS. And when some people now speak of the investment of capital abroad as being something evil, is it not in direct contradicition to some of the programs that are being advocated at this same time? For example, in the Alliance for Progress program, I notice there has been over $1 billion obligated under that program for distribution within the next 12 months, and that will be an export of capital upon which there will be no return to us as taxpayers; isn't that true?

Mr. STEWART. Precisely, sir.

Senator WILLIAMS. No dollar return.

Mr. STEWART. The policies of this Government in this area, if this bill is acted upon favorably, are absolutely irreconcilable.

Senator WILLIAMS. One is a trend toward isolationism and the other is a trend toward more liberal trade.

Mr. STEWART. In terms, sir, if I may use a strong word, of our posture as an international trader, a position which this country, in a world sense, is just beginning to assume. It is just beginning to come into its maturity as an international trader. This bill will do more damage than any other single act could possibly do to disturb the growth and the strength of American industry in international trade. We must remember that American business cannot be cut up into pieces.

Companies operate as total entities; they do not operate as a company in one country and a company in another. It is a total operation.

When you do damage to a foreign operation you are doing irreparable harm to the domestic part of that business.

Senator WILLIAMS. I will conclude with just one thought. I think that we should separate our efforts to eliminate what may be a bona fide tax haven, and I use that term in describing a company which is established for the sole purpose of tax avoidance; and I think that they should be corrected, and I think that American industry would welcome an opportunity to support legislation that would correct it.

But I do not think that in correcting that we should establish a principle that all American investments abroad are something evil, because they have brought back substantial amounts of returns to this country in dollar volume ever.

Mr. STEWART. Not only in dollar volume but in terms of our total position as a country, in our relations with foreign countries in our economic effort internationally beyond the dollar mark.

Senator WILLIAMS. Far beyond the dollar volume I agree with that. But even on the dollar volume alone if you confine it to that they still have been a profitable operation from the standpoint of the Government and the taxpayers.

The CHAIRMAN. Thank you very much.

Mr. STEWART. My apologies to the committee.

Senator GORE. Mr. Chairman, before the next witness comes I would like a moment to reply to Senator Williams. I have not said that investment abroad was evil nor have I implied such.

Senator WILLIAMS. I did not say that you had. If you interpreted what I said as your having said that, I regret it because I was merely establishing a point.

Senator GORE. It is true, as the Senator has said, that there was a period when the Government of our country encouraged investment in Western Europe. It was our national policy to aid in the rehabilitation of Western Europe.

Now however the problem is different. Their rate of growth as I said this morning is twice our rate of growth.

The problem there is not one of unemployment; rather they are importing people to take jobs. Yet the Senator from Delaware apparently wants to continue the policy of subsidizing the movement of our industry to Western Europe when we have many depressed areas in this country.

The time when we needed to encourage the movement to Western Europe has passed. Indeed, the need for industrial development is elsewhere now.

Senator WILLIAMS. I appreciate the contribution of the Senator from Tennessee, and I do not want to get into an argument with him. But I must respectfully suggest that he may be busy if he confines his energy toward interpreting his own motives rather than the motives of some of the rest of us.

I recognize that the growth in Europe has been more rapid than it has in this country, but let us stop and recognize the fact also that Europe was destroyed 20 years ago, and they were growing from a much lower base and, naturally, they have had a more rapid growth. But I am one who still has great confidence in the American system in that we, in this country, can compete, and I do not think we can build a wall around the exportation of our products or our capital or such as you seem to advocate. That is just a difference of opinion. We both have a right to our own opinions.

Senator GORE. If you will just leave out the motives, we can interpret the effects of what each advocates.

It was on the ticker that you are offering to the President the passage of this bill, if we would leave out certain things, by adding the tax bill to the corporate rate extension bill.

Well, I would like to see some of the tax loopholes closed. I am not sure how the Senator feels about that, but I feel very strongly that a tax revision bill should eliminate some of the widespread favoritism in the tax law.

Senator WILLIAMS. On that point, let us quit. We are now in agreement. I will add you as a cosponsor to my amendment.

Senator GORE. The Senator has an amendment that cut the oil depletion. Of course, his amendment is in error in the first place. The percentage depletion formula has no relationship to the depletion of a resource. It is merely a formula for tax reduction.

If the Senator will join me in instituting instead of percentage depletion a cost depletion, then I think we would begin to get some place.

Senator WILLIAMS. Mr. Chairman, I suggest we call the next witness because it may be a long time before the Senator from Delaware and the Senator from Tennessee get together on a philosophy of taxation.

(The supplemental statement and appendix of Mr. Stewart previously referred to follow:)

SUPPLEMENTAL STATEMENT OF THE MACHINERY & ALLIED PRODUCTS INSTITUTE ON AMENDMENTS PROPOSED BY THE TREASURY TO SECTION 13 OF H.R. 10650

Presented to the Committee on Finance of the U.S. Senate by Charles W. Stewart, president, June 19, 1962

Mr. Chairman and gentlemen, I appreciate very much the privilege of appearing again before the Senate Finance Committee on H.R. 10650 as president of the Machinery and Allied Products Institute and chairman of the institute's affiliate organization, the Council for Technological Advancement. As you know, these organizations represent the capital goods and allied product industries of the United States, whose interest and involvement in foreign trade are broad and deep and of long duration.

We are especially appreciative of the committee's courtesy in scheduling these further hearings in view of its very heavy schedule. We take this to be not only a recognition of the necessity for obtaining comment on the Treasury's new recommendations but a reflection of the committee's concern over more fundamental issues involved in the foreign earnings provisions of H.R. 10650.

We are aware of—and we shall, of course, adhere to—the committee's desire to limit testimony to the Treasury's current proposals for amendment of H.R. 10650 as set out in the committee print of May 31, 1962. Nevertheless, any examination of these suggestions becomes meaningful only as we relate them to the sweeping and revolutionary legislative proposal of which they are a part. Hence, we feel obliged to examine briefly not only the patches represented by the Treasury's new proposals but the whole blanket of change in American foreign business activity which H.R. 10650, if adopted, would bring about.

As our principal statement of April 4 made clear, we think the foreign earnings provisions of H.R. 10650 are unsound and represent punitive legislation. Overall, the proposals now advanced by the Treasury would seem to amount to little more than a mitigation of some of the penalties and a sharpening of others.

It seems to us not without significance that the proposals now under consideration have been advanced somewhat reluctantly—even grudgingly—by the Treasury. The Treasury persists in its view that the solution can be greatly simplified by the abolition of tax deferral on foreign earnings. The Secretary's letter of transmittal recommends "in accordance with the President's message of April 20, 1961, and my statement of April 2, 1962, before your committee that deferral of taxation of income of controlled foreign corporations be eliminated." This same point of view was made repeatedly in the Secretary's statement before the committee on May 10, in which he said: "Adoption of this principle would eliminate a great deal of the complexity of section 13."

We think the foreign earnings provisions of H.R. 10650 represent not only bad legislation but stem from fundamental misconceptions of the nature and circumstances of America's foreign trade.

MYTHS IN THE AREA OF FOREIGN EARNINGS TAXATION

In his notable recent speech at Yale the President called upon his audience to "disenthrall itself from an inheritance of truism and stereotype" and to seek "an essential confrontation with reality."

We suggest that the foreign earnings provisions of H.R. 10650—including the supplemental proposals now advanced by the Treasury—are largely the products of myth and that the bill's authors are unwilling or unable to confront reality. Unquestionably, there have been certain abuses in the employment of so-called foreign tax havens. However, from the fact of a relatively limited area of impropriety has sprung the myth of widespread abuse. Quoting again from Mr. Kennedy at Yale, he said: "* * * the great enemy of the truth is very often not the lie—deliberate, contrived, and dishonest—but the myth—persistent, persuasive, and unrealistic." We think the President's words express far more eloquently that we can the nature of a developing body of mythology and that this concept can be applied equally well to the taxation of foreign earnings.

There is, for example, the myth of tax inequality. There is the myth that abolition of tax deferral will largely solve our international balance-of-payments problem. There is the myth that by punishing business abroad we may, by some process of bootstrap levitation, cure problems of international competition stemming from more fundamental causes, the examination of which may be acutely uncomfortable. There is the myth that foreign business is simply another kind of domestic business carried on abroad. There is the myth that the imposition of new burdens on foreign investment will result in the substitution of job-making domestic investment.

We suggest that it is high time for the Government to disenthrall itself from this mythology and to prepare for an "essential confrontation with reality."

The reality is that foreign business is different not simply in location but in kind from business conducted within the United States. The reality is that the massive burden of Government foreign aid and military assistance programs and America's inability to compete in export markets as effectively as it might by reason of high-cost production are the principal contributing factors to our imbalance of international payments. The reality is that American business invests abroad when it can no longer serve foreign markets by export from the United States, and to be denied the opportunity of serving those markets competitively by foreign investment will rarely result in substituted domestic investment. And finally, the reality is that such abuses as occur in the foreign tax area can be cured by administrative action or, at most, legislation far less drastic and sweeping than that represented by H.R. 10650.

Thus, we respond to the Treasury's newest proposals by reciting our original recommendation: The foreign earnings provisions of H.R. 10650 require a fundamental rethinking and these products of Treasury tinkering reflect no reexamination whatsoever of the basic issues.

Our detailed comments on the Treasury's proposals for amendment of section 13 of H.R. 10650 appear below.

THE TREASURY SECTION 13 TECHNIQUE OUTLINED

Under the Treasury's suggested changes to section 13 of H.R. 10650, a U.S. shareholder, that is, a U.S. person owning at least 10 percent of the stock of a controlled foreign corporation, would be taxed on his pro rata share of what is termed that corporation's "subpart F" income. A controlled foreign corporation would be one in which more than 50 percent of the total combined voting power of the stock is owned by U.S. shareholders.

Generally speaking, subpart F income would include income derived from the insurance abroad of U.S. risks and foreign base company income. The latter term would encompass foreign personal holding company income, foreign base company sales income, and foreign base company services income. Dividends and interest received from qualified investments in less developed country corporations would be excluded from the scope of foreign base company income, so long as they do not exceed the increase in such qualified investments for the taxable year.

In addition to subpart F income, the U.S. shareholder would also be directly taxed on his pro rata share of the controlled foreign corporation's net withdrawal of earnings from qualified investments in less developed areas, plus any investment by that corporation of its earnings in U.S. property.

REINVESTMENT OF FOREIGN EARNINGS IN LESS DEVELOPED COUNTRIES

In what is, in our judgment, a major policy change, the Treasury proposes to prevent what it terms the "pour over" of developed area foreign base company profits into reinvestment in less developed countries. This would be done by permitting exemption from direct taxation only in the case of earnings derived from less developed area investment. Under section 13 of H.R. 10650, in the form passed by the House, there would be no direct taxation of foreign base company earnings so long as they are reinvested in less developed areas.

We are opposed to this Treasury suggestion. It seems to us perfectly clear from the testimony offered to this committee that earnings from subsidiaries located in developed countries constitute probably the major source of the funds available for investment in enterprises located in the less developed areas of the world. We had assumed that the encouragement of private investment in less developed areas is one of the basic aims of the administration. If it is desirable to provide incentives for such investment through appropriate provisions in the Internal Revenue Code, it should be done in a way which is likely to prove effective. At the present time, earnings from less developed area investments are simply insufficient to provide the desired volume of new investment in such areas. Limiting the exemption for reinvestment in underdeveloped areas solely to earnings generated from such areas will, in our judgment, render completely ineffective any conceivable stimulative effect that this bill might have on encouraging private investment in less developed countries.

In opposing this Treasury recommendation for these reasons we do not wish to give the impression that the Institute supports the concept of drawing a line in foreign tax policy between underdeveloped and developed countries. The distinction is wholly artificial. As we pointed out in detail in our oral and written presentation to this committee on April 4, generally speaking, sound and legitimate private investment wherever it takes place throughout the world should be accorded tax treatment similar to that available under the present law.

We might add that in one sense we can understand why Treasury makes this recommendation. The Department does not wish to concede, for purposes of its overall case on foreign earnings, that there are public policy benefits from investment in developed countries, including "pourover" of earnings into underdeveloped regions. It therefore contrives to defeat one of the Government's own objectives—encouragement of investment in underdeveloped areas—a wholly incongruous position under all the circumstances. Moreover, from the balance-of-payments standpoint, assuming a quick capital accumulation in a U.S. foreign base company in a developed country which generates funds available for reinvestment in an underdeveloped region, why would our Government prefer to encourage a fresh and separate outflow from the United States, assuming a company had the disposition to so invest directly in the underdeveloped area?

LOSS ADJUSTMENTS

The Treasury's suggested revisions would permit, with respect to a controlled foreign corporation, the losses of 1 taxable year to offset the earnings of other taxable years. In addition, the losses of one controlled foreign corporation would be permitted to offset gains in the same year of other controlled foreign corporations. However, as we understand it, these intercorporate loss offsets would be limited to one direct chain of subsidiaries. We feel that this limitation should be removed and that losses and gains from all controlled foreign corporations of one American parent should be permitted to offset each other on a consolidated basis. In addition, we would suggest that the committee consider extending complete parity of treatment of losses between controlled foreign corporations and domestic corporations. For example, the net operating loss carryforward should be available with respect to pre-1962 earnings in computing controlled foreign corporation earnings under the bill.

In essence, we feel that the recognition of controlled foreign corporation losses accorded in the Treasury's suggested revision is desirable but it does not go nearly far enough in extending to controlled foreign corporations the same benefits accorded to domestic corporations in this respect.

Underlying this technical provision, which, as we point out, does not go far enough within its own context, is another fundamental issue which should be brought to the attention of the committee. The proposal made by the Treasury

moves in the direction of equating the tax status of controlled foreign corporations with domestic corporations. Obviously, on this reasoning one must go the whole route in order to put them in a position of parity. Hence, our suggestion that the provision does not go far enough in that light. On the other hand, we object as a matter of policy to attempting to equalize the positions of U.S. foreign based companies with U.S. domestic companies. Tax neutrality should be sought between U.S. foreign based companies and their competitors abroad.

Thus we agree with this technical change insofar as it goes within the framework of H.R. 10650, but continue to object to that broad framework. The fundamental question—namely, appropriate tax treatment in the overall sense for foreign base companies—should not be obscured by the discussion of these technical changes.

ROYALTY INCOME FROM PATENTS, EXCLUSIVE FORMULAS, AND PROCESSES, ETC.

The Treasury draft would make a considerable change in the handling of patent income.

Under H.R. 10650, patent income was singled out for the same treatment accorded certain insurance income—that is, direct taxation regardless of reinvestment in less developed areas. In addition, the House bill permits a certain part of the manufacturing income of a controlled foreign corporation to be attributed to the use of patents and formulas developed in the United States and taxed accordingly. The latest Treasury draft has dropped this approach in favor of one which would treat patents and certain royalties as foreign base company income and would require ordinary income treatment for gain recognized on the transfer of patents, inventions, or similar property by a U.S. parent to its foreign subsidiary.

Unquestionably, the Treasury revision in this area represents a mechanical improvement. The so-called imputed royalty provision would be nearly impossible to administer. But the scope of the relief provided by the Treasury's revision is, in our judgment, more illusory than real. For example, income from the use of patents by a related person in a country outside that in which the controlled foreign corporation is incorporated would continue—under the Treasury approach as under the House bill—to be attributed to the U.S. parent company and subject to direct U.S. taxation regardless of whether it was reinvested in less developed countries.

Thus, we agree with the Treasury's suggestion in this area insofar as it would eliminate the imputed royalty provision and would eliminate the singling out of patent income for special discriminatory treatment. But beyond that point, we are opposed to direct taxation on patent income abroad just as we are opposed to the proposed ordinary income treatment for gain of the transfer of patents and similar property to foreign subsidiaries.

Underlying such treatment of patent income is the concept that royalties received for patent or know-how agreements or similar arrangements are somehow abuses per se. We think it can be shown unquestionably that most transfers to foreign subsidiaries as well as to unrelated foreign corporations of rights in such intellectual property are as necessary to the conduct of manufacturing abroad as are direct investments in buildings, equipment, etc. As in the case of the developed country-underdeveloped country distinction we are inclined to think that the distinction made here is artificial and disregards completely the realities of doing business in the international field. Indeed, the patent or know-how agreement device is a common first step in moving through the customary evolution which begins with exports and ends with seasoned manufacturing facilities abroad.

In brief, the Treasury has removed two relatively narrow objectionable aspects of the treatment of patent income under H.R. 10650. No fundamental change has been made in the basic approach to patent income and there is no indication of an appreciation on the part of the Treasury Department of the legitimate contribution of patents, royalties, and related income to the overall role of American business in international trade.

SALES AND TECHNICAL ASSISTANCE INCOME

The Treasury would make no basic change in the House bill's imposition of direct taxation on sales and trading income. We note that the Treasury now proposes to add income from technical assistance and services to the "foreign base company income" category.

We vigorously disagree, as we indicated at length in our earlier statement to the committee, with the suggested treatment of patent income, sales and trading income, and technical assistance income as items of tax-haven income. We feel that the only proper approach in this area is one which is limited to dealing with abuses. This attempt to accomplish substantially by indirection the original administration proposal to extend direct taxation to all foreign subsidiary income should be rejected.

Branch income.—The Treasury proposals provide that, under certain conditions, sales income earned by a branch of a controlled foreign corporation outside the country in which the latter was located would be treated as having been derived by a wholly owned subsidiary of that controlled foreign corporation. We are opposed to this provision. We see no reason for permitting the Treasury in effect to disregard the form of business organization adopted by the controlled foreign corporation in such circumstances.

Both of these changes—that which relates to technical assistance and services and the new provision with respect to branch income—should be rejected. The committee will recognize, of course, that these changes represent substantial tightening of the provisions of H.R. 10650 and without justification or merit. In the same way that the basic philosophy of H.R. 10650 treats income from patents as something outside the realm of propriety and legitimate business activity, the new proposals of the Treasury would seem to give a similar status to technical assistance and service agreements. Why? Is not a technical assistance and service agreement entered into for wholly legitimate business purposes an essential part of the kit of international tools which American business must employ in order to challenge and meet its competition in the international arena? Thus, we have here another example of technical change, in this case in the direction of tightening, without any evidence of reexamination of the fundamental issues involved in the foreign earnings provisions of H.R. 10650.

MANUFACTURING INCOME

Under the Treasury proposals, the manufacturing income of controlled foreign corporations would be more favorably treated than under the House bill. Once it was determined that the income in question resulted from manufacturing or processing, it would not be subject to direct U.S. taxation unless invested in U.S. property. Moreover, manufacturing income would not be subject to downward adjustment resulting from the use of U.S. patents or formulas, nor would it be subject to the unrealistic requirement under the House bill that it be reinvested in the active conduct of the trade or business of the controlled foreign corporation.

These Treasury recommendations with respect to the treatment of manufacturing income are wholly desirable within the context of H.R. 10650.

We should not forget that overall this entire set of new Treasury proposals amounts to the substitution of bad proposals for some that are unquestionably worse. Moreover, the manufacturing income section, although improved by the latest Treasury recommendations, still reflects the line of distinction between manufacturing income and the income from patents, technical agreements, and services, which line of demarcation we consider wholly unacceptable and unsound.

DEFINITION OF CONTROLLED FOREIGN CORPORATION

The Treasury suggests what we believe to be an improvement in the definition of what constitutes a controlled foreign corporation. Under the House bill, a controlled foreign corporation might be one in which U.S. citizens hold over 50 percent of the company stock but in which effective control, nevertheless, is in the hands of foreign shareholders. The Treasury suggests, in effect, that the 50-percent requirement be computed only by adding together the interests of U.S. shareholders as previously defined, that is, those U.S. persons who own at least a 10-percent stock interest in the foreign company. Certainly this provision would be much more likely to insure that a controlled foreign corporation is one in which U.S. shareholders represent a controlling interest. We should add, however, that the definition remains defective in that there is no requirement that a relationship be shown among the U.S. citizen stockholdings that go to make up the 50-percent requirement.

We comment here within the narrow limits of H.R. 10650 on the merits of the proposed changes in definition of the controlled foreign corporation. We wish to enter and emphasize again our fundamental objection to the tax concept which creates the need for defining a controlled foreign corporation—except in the case of demonstrated abuse—in the first instance.

BLOCKED FOREIGN CURRENCY

The Treasury revisions provide that no direct U.S. tax be imposed on the earnings and profits of a controlled foreign corporation when it can be shown to the satisfaction of the Secretary or his delegate that it was impossible to distribute such earnings and profits because of currency or other restrictions imposed under the law of any foreign country. There was no provision on the effect of such restrictions in the House bill. We commend this Treasury suggestion, and urge its adoption by the committee. We can only voice the hope that, in the event of its adoption, the Treasury will liberally construe its authority in this area.

Again, within the context of H.R. 10650, we have attempted to comment on the merits of the proposal with respect to a blocked foreign currency. At this point we would like to suggest that when the Treasury admits the need for this change it really is in a sense recognizing one of the very important differences between operations outside the United States and operations within the U.S. borders. There are special characteristics attendant upon business in foreign areas, notably the increased risks and the intervention and restrictive practices of foreign countries. In short, this is a recognition by the Treasury of one of those myths to which we referred to earlier and also a recognition of the fact that you cannot achieve true neutrality under unequal conditions; hence, the search for tax neutrality between a U.S. domestic corporation and a U.S. foreign base company is inappropriate and illusory.

CONCLUSION

Through these comments, as suggested previously, we have attempted wherever possible to limit our testimony within the scope of these hearings and to be responsive to the committee's request for definitive comments and reactions to the specific changes proposed by the Department of the Treasury.

May we remind the committee that these changes really are placed before it conditionally, or to put it another way, reluctantly. The Treasury has said that most of the complexities of section 13 could be avoided by abolishing the deferral of taxation on foreign income. This then, in a sense, is its principal recommendation. We are wholly in disagreement with it for the reasons set out in detail in our prior statements before this committee and before the Committee on Ways and Means.

With respect to the specific comments which we have made on the new proposals before the committee we have offered them within the context of H.R. 10650 but with the caveat that in no way do the Treasury's proposals deal with the fundamental misconceptions, fallacies and serious policy errors which underlie the Treasury recommendations in their overall sense. We therefore ask again that the committee reject the philosophy and the content of the foreign earnings provisions of H.R. 10650 and, together with the executive branch, address the real problem and attack through proper administrative and, if necessary, legislative provisions, the limited abuse areas.

Before concluding this statement we should like to make a request of the committee. You may recall that the institute's prior testimony was made in a matter of 2 days following the testimony of the Secretary of the Treasury, which included an elaborate economic documentation and justification of the Treasury position. This justification took the form of exhibit III to Secretary Dillon's testimony and, judging from the content of the new proposals just submitted to the committee, there is no fundamental change in philosophy or economic rationalization of the Treasury recommendations in this area. The Treasury placed such emphasis on this economic groundwork for its position that we have felt it important to analyze this rationalization. The results of that analysis are included as an appendix to this statement together with the results of a survey on the relationship between private investment and exports prepared at the request of Senator Morton but not available in time for inclusion in the printed hearings. We ask that the full appendix be included as a part of this record.

This concludes our statement on the Treasury's new recommendations for amendment of section 13 of H.R. 10650. If we can be of further service to the committee or its staff in connection with the consideration of these great issues, the institute will make every effort to help.

(Appendix A to Machinery and Allied Products Institute Statement on Treasury Amendments to H.R. 10650)

Economic Effects of Directly Taxing Foreign Subsidiary Earnings—A Critique of the Treasury Position

I. INTRODUCTION

The Treasury in its testimony on H.R. 10650 before the House Ways and Means Committee on April 2 went to considerable lengths to justify on economic grounds Treasury proposals to tax directly earnings of U.S. subsidiaries abroad. This justification is spelled out in detail in exhibit III to the Treasury's written statement.

We will not attempt here to answer in detail all of the arguments presented in that document in support of the Treasury's position. Many of them are restatements of earlier Treasury assertions on which the institute testified before the Senate Finance Committee.

We do want, however, to consider in some detail that portion of exhibit III which analyzes the employment and balance-of-payments impact of U.S. direct manufacturing investment in advanced industrial countries. That analysis, which had not been presented in earlier Treasury testimony, is in our view based upon certain unrealistic assumptions which lead to conclusions that are misleading and, therefore, should not be accepted as a basis for action on H.R. 10650.

One further introductory comment should be made. We question whether any analysis on the basis of existing aggregate data is really adequate to measure the employment and balance-of-payments impact of direct investment abroad with any degree of accuracy and we prefer to rely upon the experience of individual companies. However, because those unfamiliar with the problem have not recognized this, we have attempted to show how drastically different the Treasury's conclusions would be—even using the same techniques and methods—were only two of their major assumptions to be modified.

II. A SUMMARY CRITIQUE OF TREASURY ARGUMENTS

Let us emphasize at the outset that we do not object to the Treasury's methodology as used in its analysis nor do we find any particular fault with the underlying statistical data. We feel in fact that it was a very thorough study and so far as we are concerned in this memorandum, we do not question the correctness of approach except as regards two of the major assumptions underlying it.[1]

Indeed, if the model constructed by the Treasury analysts were only for the purpose of facilitating further theoretical study of the relationship between U.S. direct manufacturing investment abroad, U.S. exports, and the U.S. balance of payments, the inadequacy of the assumptions underlying the model would not be a serious matter.

Unfortunately, however, that is not the case. The conclusions derived from the analysis are used in support of proposed legislation and for that reason it is essential that assumptions underlying the analysis reflect the facts as they are in the marketplace.

We wish to underscore that this is not merely a matter of fine or subtle academic distinctions between two alternative approaches. To illustrate this point, we have developed in detail a comparable analysis, but changing two of the Treasury's assumptions to show how greatly the conclusions are affected. It will be seen from the following summary that those conclusions are so vastly different as to merit the advocacy of an entirely different policy from that which the Treasury attempts to justify on the basis of their own analysis.

First, however, since we wish to deal with the Treasury arguments as presented in exhibit III and to take them up in the order dealt with by the Treasury (see pp. i-iv of exhibit III), we will consider other of the Treasury contentions before proceeding to discuss their analysis of the export, employment, and balance-of-payments impact of U.S. capital outflow into manufacturing facilities in the developed countries.

---

[1] We have raised no questions for purposes of this analysis concerning Treasury assumptions on such matters as earnings ratios and dividend ratios. However, we should point out that certain Treasury assumptions have also been questioned in a memorandum prepared by the staff of Senator Jacob K. Javits, Republican, New York. (See hearings before the Committee on Finance, U.S. Senate, on H.R. 10650, pp. 3889–3907.)

Tax neutrality

The Treasury states that tax neutrality is desirable in order to promote equity and the most efficient possible allocation of existing resources. It is implied that the American tax structure contributes to the artificial diversion of funds into low-tax areas abroad, thus violating the principle of neutrality. This can be avoided, says the Treasury, by directly taxing the earnings of our overseas subsidiaries at the same rates applicable to earnings of U.S.-based companies. It is concluded that the burden of proof for not following the principle of tax neutrality should be on those who wish to depart from such neutrality.

We agree with the last statement—namely, that the burden of proof for not following tax neutrality rests on those who wish to depart from it. We contend, however, that it is the Treasury which wishes to depart from tax neutrality rather than those who oppose the Treasury recommendations. This assertion is based on the view that taxes are more truly neutral when total tax liability is the same for earnings by a U.S. investment in a particular country as for earnings of a competitor company indigenous to that country.

It seems logical to suppose that for a businessman operating in the same investment climate, under the same government regulations, within the same market area, etc., as his competitors, tax considerations can often be the deciding factor in the success of the business. On the other hand where investments in two different economies are in question, each economy with its own investment climate, its own government regulations, its own wage patterns, its own transportation problems, its own raw material sources, the tax factor would logically be much less important relative to these other considerations. Our own member companies' experiences seem to bear this out. Hence, it follows that discriminatory tax treatment with respect to earnings generated within the same country will often deter investment by the company discriminated against. A differential tax rate applied to earnings generated in one country as opposed to earnings generated in another, on the other hand, will normally have little effect relative to other, purely business considerations where two entirely different economies are involved.

Validity of company data

Representativeness.—The Treasury questions the validity of evidence offered by companies in support of arguments with respect to employment and the balance of payments with the assertion that the behavior of one company or a group of companies is not ncessarily typical. We would not agree with the implication that industry's case is based on evidence supplied by only a small unrepresentative group of companies. In our view adequate company data have been offered in testimony in support of the industry point of view.

We might note, in this connection, that in response to a request by Senator Thruston Morton during our earlier testimony before the Senate Finance Committee, we undertook a survey of foreign investments and export activity among U.S. capital goods manufacturing companies (copy attached). The survey covered 456 companies, of which 229 responded. Of the 229 respondents, some 86 companies had investments in foreign manufacturing facilities, representing the bulk of institute member companies with investments abroad. Of these 86 companies, 82 supplied information indicating that their exports in 1961 (totaling $1,844 million) exceeded new capital outflows into their direct investments abroad (totaling $136 million) by more than 13 times, and exports from their U.S. plants to their own subsidiaries abroad ($495 million) exceeded new investments in those subsidiaries by more than 3½ times. Exports to developed countries (West Europe and Canada) by these same companies in 1961 totaled $786 million or more than eight times new capital outflow into their Canadian and European subsidiaries. And their U.S. exports to those subsidiaries in 1961 ($348 million) exceeded new capital outflow into those same subsidiaries by more than 3½ times. In view of the breadth of our membership, this would appear to be representative generally of companies manufacturing capital goods, and it supports the earlier industry testimony on these points.

Displacement effect of foreign-based production.—The Treasury also questions the usefulness of the evidence provided by companies on grounds that it leaves out one important element which cannot be readily measured—namely, sales of foreign subsidiaries which displace U.S. goods.

We agree that the displacement effect cannot be readily measured. However, the experience of most capital goods companies seem to bear out the point that the displacement effect is a very minor one and would not reduce significantly

the favorable impact of investment abroad. This matter is discussed at further length below.

Relevance of comparing current inflow with past outflow.—The Treasury further argues that the two types of flows being compared by individual companies, namely, (1) the outflow of capital and (2) divided and export receipts for a given period, are in good part not related to one another because the dividends and export receipts of one period have been generated by investment for many years prior to that period.

We believe this comment is not relevant since it does not address itself to the main problem at issue. The balance-of-payments situation in which the United States finds itself today is a continuing problem and in asking what the effect will be on the balance of payments of discouraging investment, one must not confine his attention to this year and next year. One must also ask how such a policy would affect our position in the late 1960's when our international commitments will continue to be heavy, judging by current policy statements of the administration. Or to state the question somewhat differently, it might be asked how such a policy of discouraging investment would have affected our position today if it had been put into effect in the early 1950's.

Our studies (based on the detailed analysis which follows) indicate that in the absence of U.S. investment in Europe and Canada in 1952 and subsequent years, our cumulative balance-of-payments deficit during 1952–61 would have been $559 million greater than it actually was, and in the year 1961 alone would have been greater by almost $216 million.

Consideration of the export, employment, and balance-of-payments impact of investment in the developed countries

As we have already indicated, we feel that the Treasury analysis of the export, employment, and the balance-of-payments impact of investment in the developed countries is based on certain unrealistic assumptions and on that account leads to estimates of the export and balance-of-payments impact of U.S. direct manufacturing investments in the developed countries which are far different from those which would be reached were more realistic assumptions adopted.

Before comparing estimates derived under the two differing sets of assumptions, it would be desirable to spell out wherein our assumptions differ from those of the Treasury and why.

Our assumptions differ from the Treasury's in two important respects. First, it is implied in the Treasury's analysis that a dollar of investment abroad has the same impact on exports no matter when invested. They assume, to take an example, that a dollar invested in French manufacturing facilities 20 years ago has the same impact on today's exports (assuming, of course, that it represents a still outstanding investment) as has a dollar invested last year. We cannot agree with this assumption.

The experience of capital goods companies suggests to us that, with respect to Europe, the impact of investment on U.S. exports diminishes over a period of time. It is only natural to expect that initial investments would create a substantial early demand for raw materials, intermediate goods, and finished products from U.S. manufacturers with which the subsidiary's parent has had contracts of long standing. However, as the years pass the subsidiary companies may be expected to manufacture more of their own supplies and to get greater quantities of supplies from local sources as local contacts are developed. Therefore, a much larger portion of exports in any given year should be attributed to newer investments and a smaller portion to more mature investments.

In deriving our own estimates we have assumed the following pattern as a realistic composite for the capital goods industries:

The impact of a dollar of investment in capital goods manufacturing facilities abroad is 6 percent less in the year following the year of the investment, and diminishes by 6 percent in each subsequent year until the fifth year following the year of investment after which there is no further diminution in the impact. From the fifth year forward the impact would thus be 70 percent of the impact in the year of investment. It would seem reasonable that a similar pattern would also be typical for other manufacturing industries.

A second assumption of the Treasury is that capital outflow into direct manufacturing into developed countries increases by 5 to 10 percent per annum indefinitely into the future. We feel that a more realistic assumption would be that the rate of such capital outflow will not increase significantly beyond cur-

rent levels. Our assumption is based upon the fact that investment flows to Europe are already exceedingly high and cannot be expected to increase further for more than 1 or 2 years at most. It is also based on the fact that investment flows to Canada have not increased in recent years and economic conditions in that country give no reason to expect such increases in the future.

We now turn to a comparison of estimates under the two different sets of assumptions.

Consideration of the Treasury analysis

Net export impact.—The Treasury, in its summary statement, asserts that the "available data on the economy as a whole" indicates certain facts—namely, that a dollar invested in manufacturing in Europe returns only 4 cents' worth of net exports annually, and a dollar invested in manufacturing in Europe and Canada together, divided in the proportion of 70–30, respectively (the ratio of new capital outflow in recent years), returns only 8 cents' worth of net exports annually. This is contrasted by the Treasury with a dollar invested in less developed countries, which yields over 40 cents' worth of "net exports" annually.

On the basis of our assumptions, we find that a dollar invested in industrial countries generates in the year of investment "once and for all" equipment exports totaling 26.5 cents and net exports of 14.2 cents in the form of raw materials, intermediate products, and finished goods. Exports then taper off quickly, under our assumption, until annual exports are somewhat less than the Treasury's estimate.

However, the early year impact is sufficiently great, according to our calculations, that, given a constant outflow of capital, the total export impact per dollar of investment would exceed the Treasury estimates for a period of more than 17 years from the time of the initial outflow. (We have not carried the analysis beyond 17 years.) Furthermore, if one were to accept the Treasury assumption that capital outflows will increase 5 or 10 percent annually indefinitely into the future—an assumption which we must reject as unrealistic for reasons discussed above—the Treasury estimate of net export impact would prove to be significantly understated for an even longer period.

One must also consider certain other factors favorably affecting U.S. exports which are not taken into account in the Treasury's data. In the first place, the Treasury's export impact estimate does not take into account the favorable effect of U.S. investment in the developed countries on U.S. exports to nonaffiliated companies abroad. Nor does it take into account the favorable effects of such investments on exports to U.S. subsidiaries abroad by other than the parent companies of those subsidiaries.

Furthermore, much of the favorable export impact of investment in the less developed regions is attributable to the reinvestment in those areas of earnings generated by direct investments in the developed countries. Hence, the total impact of investments in Europe and Canada is even further understated by the Treasury because of the failure to take into account this indirect impact.

The displacement effect of foreign subsidiary sales.—The Treasury, while admitting that their figures do not take account of "related exports" which go to other than foreign subsidiaries but are attributable to the existence of those subsidiaries (an important omission in our view), argues that this is probably more than offset by the displacement effect of foreign subsidiary manufacturing sales which may capture certain markets that would otherwise be served by the U.S. parent.

We disagree with this statement on grounds that the Treasury analysis underlying it overstates the replacement impact relative to the "related export" impact. The Treasury, in its analysis, discusses the replacement effect of production from all past investments which are still outstanding. The pertinent question concerns the impact of sales from future investments which would be affected by the proposed new legislation. An analysis undertaken in this latter context leads to substantially different conclusions. Furthermore, as we have already noted, the Treasury makes no reference whatever to the impact on exports of companies which ship, not to their own subsidiaries, but to the subsidiaries of other U.S. companies with investments in the developed areas. This impact is direct and significant, but is ignored in the Treasury analysis.

Effect on U.S. employment of directly taxing foreign subsidiary earnings.—The Treasury states that the low "export content" of investments in Europe and Canada means that directly taxing foreign subsidiary earnings in these areas

would have a favorable impact on employment in the United States because even if only a relatively small fraction of the dollars deterred from moving abroad were invested in the United States, the net effect would be positive.

They argue that, for example, if only 10 cents of every dollar deterred from investment in Europe were invested in the United States, the production, employment, and income generated in this country would be equal to that generated by the deterred investment. In the case of Europe and Canada combined, the comparable figure is 20 cents. They draw from this estimate the conclusion that to deter investment abroad will favorably affect income, production, and employment in the United States.

Information available to us concerning the experience of capital goods companies indicates that probably no more than 10 cents of every dollar deterred from investment abroad would be invested in the United States. Most companies invest in Canada or Europe, precisely because that is the only base from which they can effectively penerate many of the markets for their products. For such companies, direct investments abroad do not represent alternatives to direct investments in this country. In the absence of such investments, there would normally be no investment whatever in brick and mortar (as opposed to portfolio investment) because alternative opportunities are usually lacking. While investments in Europe and Canada no doubt represent alternatives to domestic investment in some cases, we doubt, as noted, that more than 10 percent of the money invested in those regions in recent years would alternatively have been invested in brick and mortar in the United States.

But beyond that, our analysis, based on our own estimates of export impact, and assuming a constant rate of capital outflow, indicates that even if 60 cents of every dollar deterred from investment in the developed countries as a result of direct taxation were to be invested in the United States, the loss of employment due to the reduction in net exports would exceed the gain in employment due to increased production from additional U.S. investment, and the adverse employment impact would become greater with the passage of time.

We should also point out that we have not taken into account in our estimate (nor did the Treasury consider) certain unmeasurable factors favorably affecting U.S. employment. Where a company's investment abroad is the only means of maintaining foreign markets—that is, where it has no alternative investment in the United States—the earnings from such an investment would not otherwise be available, and these earnings help to support parent activities in such areas as research and development and cost-cutting capital outlays. This in turn makes possible a higher level of employment in the domestic company than would otherwise exist. Furthermore, the U.S. business abroad frequently can benefit from having access to foreign research facilities and foreign talent in scientific and other areas. New technological developments in Europe and other foreign countries can then be applied in U.S. markets to contribute to rising U.S. living standards and the creation of new employment opportunities. When these additional factors are considered it will be seen that Treasury estimates of employment impact are understated by an even greater amount.

We must conclude therefore—in sharp contrast with the Treasury—that the adverse employment impact of imposing direct taxation on foreign subsidiary earnings would be substantial.

Balance-of-payments impact.—The Treasury analysis provides the basis for several assertions concerning the balance-of-payments impact of U.S. capital outflow into direct manufacturing investment in the developed countries which we feel are invalid because they are based on the same unrealistic assumptions.

(*a*) The Treasury stated that, on the basis of available evidence and under certain assumptions concerning the relation of inflows to a given capital outflow, our overall balance-of-payments situation would improve for at least 10 to 15 years ahead were foreign subsidiary earnings to be directly taxed.

Based on our assumptions, we find that there will indeed be a net improvement in the balance of payments in the early years following the imposition of direct taxation, but that by the fifth year following its removal there will be a net worsening in our payments balance on an annual basis which by the seventh year will have almost wiped out the cumulative benefits of the first 5 years. By the eighth year following the imposition of direct taxation, the cumulative effect will be a net worsening of our balance of payments which will continue to grow indefinitely. In view of the heavy international commitments to be undertaken by this country for at least the next decade and probably further, we cannot afford to sacrifice longer term benefits for these short term gains.

(*b*) The Treasury also estimates that for the period 1952–60 new capital outflow to Canada and Western Europe exceeded inflows related to that outflow (i.e., excluding the effects of capital outflows prior to 1952) in every year after 1953—in other words, that there was a cumulative widening of the deficit as a result of private foreign investment in those two areas. Hence, direct taxation could not help but have improved the situation. (Inasmuch as historical data cannot show the extent to which dividends, royalties, fees, and net exports are separately attributable to capital outflows only for the years 1952 forward, these figures had, of course, to be estimated.)

Our estimates, using the same Treasury figures, and adopting most of their assumptions (except for the two which we have discussed above) show, on the contrary, that a cumulative favorable balance was generated by 1958 and had reached $559 million by the end of 1951.

(*c*) The Treasury estimates as a "reasonable 'guess'" that direct taxation would have a net favorable effect on our balance of payments of $200–$400 million in the early years following the new legislation.

Our figures indicate, as already noted, that while the net effect would be favorable in the early years, it would be almost completely offset by the seventh year following direct taxation and the net adverse effect would become steadily greater thereafter, reaching huge proportions in later years.

Policies of other countries

The Treasury points out that most of the developed countries impose exchange control restrictions on new investments by their nationals as well as on repatriation of earnings from those investments. We hope that this is not an implied threat that such exchange restrictions will be applied in this country if deferral is not removed. We would also point out that under such a policy it has been the practice of foreign governments to provide that when their companies are allowed to invest abroad such investments are on equal terms taxwise with those of foreign competitors.

Companies which would be affected

The Treasury discusses in considerable detail why some companies will not be hurt by removing tax deferral. We would not disagree with the fact that some companies will be less affected than others. We are concerned, however, about those companies which are affected, especially inasmuch as they went abroad in good faith under a longstanding law.

The Treasury states that only those companies would be hurt for whom the tax inducement was and is an important reason for investing abroad. This is simply not true. Companies will be hurt whether or not they went abroad for tax reasons since removal of tax deferral would impose a substantial burden not borne by competitors.

The real issue

Finally, the Treasury, in concluding its summary statement, raises what we feel to be a false issue. They ask "whether or not it is in the national interest of the United States to subsidize, through tax preferences, the growth and/or maintenance of market shares of some of our subsidiaries which produce abroad in order that these foreign subsidiaries may retain their existing competitive position, at the expense of growth and production here in this country."

We would phrase the question rather differently. We would ask whether or not it is in the national interest of the United States to discourage capital outflow by preventing U.S. companies which cannot penetrate foreign markets from a U.S. base from competing abroad on equal terms with their foreign competitors. To discourage the outflow of capital in this manner would provide a short-term "solution"—much shorter than the Treasury contends—to a longrun balance-of-payments problem, and would, on the basis of realistic assumptions, adversely affect employment in this country.

MACHINERY AND ALLIED PRODUCTS INSTITUTE,
Washington, D.C., May 24, 1962.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: On May 3 we submitted to the committee the results of a survey of foreign investment and export activity among U.S. capital goods manufacturing companies undertaken as a result of a request made by Senator Morton in the course of our testimony before the committee on April 4. Our earlier letter made clear that the committee's hearing schedule and the time limitations attaching to the submission of material for inclusion in the printed hearings necessarily limited somewhat the scope of our initial response, although we believe it constituted a useful answer to Senator Morton's question despite these limitations.

Subsequently, we have received a considerable number of additional replies to our questionnaire on this subject, the results of which tend to confirm and extend those trends so evident in the first. We believe the committee will find this more comprehensive response of interest, and we are therefore taking the liberty of transmitting it herewith. A copy of the questionnaire employed is attached.

As Senator Morton's request (p. 677, part 2 of the hearings) recognizes, the information requested is of a confidential nature and has been most generously supplied on that basis by participating companies. Under these circumstances we feel sure that the committee will respect the privileged character of the information here summarized.

SUMMARY OF RESPONSES

The questionnaire was mailed to 456 companies on April 13 and by May 17 we had received 229 responses. Of these responses, 42 companies indicated no investments in manufacturing facilities abroad and no, or negligible, exports; 90 companies have no investments in foreign manufacturing facilities, but do export in significant volume; 86 companies do have investments in foreign manufacturing facilities; 11 respondents indicated time was not sufficient to develop adequate answers.

Of the 86 companies with investments in foreign manufacturing facilities, 69 indicated that at least some of their oversea facilities took the form of manufacturing subsidiaries; 31 indicated that some of their investments were in affiliated companies abroad; 7 stated that their investments were in foreign branches; and 10 indicated "other" when asked the form of their oversea investments. (As is apparent, several companies indicated that their investments took more than one form.)

In tabulating responses we have classified companies into (1) those which have no investments in manufacturing facilities abroad but do export, and (2) those which both export and have investments overseas. Table 1 shows total exports of capital goods manufacturers which have no investments in foreign manufacturing facilities during the period 1952–61; table 2 indicates exports of companies which do have such investments; table 3 shows the dollar volume of U.S. company investments in their foreign manufacturing facilities during 1952–61; and table 4 shows exports by U.S. capital goods manufacturers to their foreign manufacturing facilities.

There are certain qualifications which must be made with respect to the data. As regards tables 1, 2, and 4, the number of respondents reporting figures for individual years generally increased with each successive year. This is explained by the fact that many companies did not have figures available for earlier years. With each new year, a few additional companies were able to

report export data. In addition, some companies were able to report exports to some areas, but data were sometimes not available for other areas. In these cases the exports reported were included in total exports and the company was counted as a respondent company in the "total companies responding" column.

As a result of these gaps in reporting, the rise in exports indicated in the 3 tables during 1952–61 reflects to some extent an increase in the number of companies reporting for individual years. The number of companies reporting in each year is indicated in the next to last column of each table. Also, in the case of the dollar flow of investments to oversea manufacturing facilities (table 3), companies reported investment of U.S. dollars abroad in certain years but not in others. However, in most instances this reflects the fact that such investments were not undertaken, rather than a lack of available information. It should also be pointed out, in connection with table 4, that some companies which had invested prior to 1952, made no new investments subsequent to that time.

Finally, we should note that most companies were unable to provide information indicating the volume of exports by other U.S. companies to the respondent's manufacturing facilities abroad; this was aksed as part of question 7. Consequently, a summary of responses to this question was not made.

Given these qualifications, the data nonetheless are, we believe, of considerable interest as a reflection of the relationship between private investment abroad and American exports for a representative group of such investors.

HIGHLIGHTS OF THE SURVEY

1. Tables 1 and 2 indicate that there has been a substantial rise in exports since 1952 both on the part of companies without investments abroad and those with such investments.

2. A comparison of table 4 with table 2 shows that in 1961 over one-quarter of the exports of those U.S. capital goods companies covered in the survey, and which had foreign investments in 1961, were accounted for by sales to their own manufacturing facilities abroad.

3. A comparison of table 3 with table 2 indicates that the dollar value of U.S. exports by respondent companies with manufacturing facilities abroad has exceeded their additional investment of U.S. dollars in such facilities by a very substantial margin in every year covered. Thus, in 1961, the companies with investments in manufacturing facilities abroad indicated exports totaling $1,884 million while 58 of the 86 companies put additional dollars into their oversea investments totaling some $136 million. The value of exports was more than 13 times the value of new investments.

4. Confining attention to the industrial areas (Canada and West Europe), the excess of export values over new capital outflows is even more marked in the case of Canada than it is for the other areas. In the case of Europe, total exports also exceed new capital outflows in every year except 1960, although the excess of exports over capital outflow is not as great in the case of Europe as it is for other areas.

CONCLUSION

In conclusion the data suggest that U.S. investments in foreign manufacturing facilities have a strongly favorable impact on U.S. exports, at least in the case of the capital goods industries, and certainly the data seems to refute the claim that such investments serve to diminish exports.

Respectfully,

CHARLES STEWART, *President.*

TABLE 1.—*Total exports by U.S. capital goods manufacturers with no investments in foreign manufacturing facilities, 1952–61*

[Thousands of dollars]

Years	Number of companies by year [1]	Exports to Canada	Number of companies by year [1]	Exports to West Europe	Number of companies by year [1]	Exports to Latin America	Number of companies by year [1]	Exports to other countries	Total companies responding by year [1]	Total exports [2]
1952	55	$13,965	56	$17,956	55	$12,498	58	$21,368	58	$66,182
1953	57	12,958	58	13,095	56	11,850	59	24,315	59	62,513
1954	57	12,041	55	9,305	55	13,993	58	21,139	59	56,774
1955	58	15,699	58	16,447	57	17,242	64	20,633	64	70,813
1956	59	18,037	58	24,753	56	15,473	61	29,629	64	88,715
1957	62	21,776	60	26,305	60	23,687	62	43,463	68	116,334
1958	63	14,626	61	16,856	60	32,274	62	34,954	68	99,554
1959	64	19,614	66	17,687	62	36,515	63	41,922	72	116,595
1960	65	21,162	64	24,942	63	28,546	64	57,261	73	133,185
1961	68	18,409	68	34,333	68	40,419	64	55,580	77	153,600

[1] Where a company reported that information was not available for a given year, that company was not included among the respondent companies. Where a company reported information was not available for exports to a given area, but reported exports to another area in that same year, the company's exports were included for the area given and included in total exports for that year. The company in question was also included in the total of respondents for the area on which data were reported and in the total of respondents reporting total exports, but was excluded from the total of respondents for the area on which data were not reported.

[2] Total includes companies reporting total exports but giving no breakdown by geographic area.

TABLE 2.—*Total exports of U.S. capital goods manufacturers with investments in foreign manufacturing facilities, 1952–61*

[Thousands of dollars]

Years	Number of companies by year [1]	Exports to Canada	Number of companies by year [1]	Exports to West Europe	Number of companies by year [1]	Exports to Latin America	Number of companies by year [1]	Exports to other countries	Total companies responding by year [1]	Total exports [2]
1952	59	$262,027	61	$167,647	62	$376,831	62	$236,493	62	$1,067,175
1953	62	306,600	62	158,974	64	327,306	62	245,668	64	2,060,432
1954	61	260,763	64	178,843	65	365,337	62	246,758	65	1,071,134
1955	65	352,219	69	232,117	67	377,751	67	327,117	69	1,312,820
1956	72	450,676	71	246,190	70	474,416	72	344,204	72	1,558,872
1957	72	431,315	71	232,274	61	564,489	72	391,414	74	1,677,008
1958	74	388,724	72	184,885	72	438,805	73	308,326	76	1,375,731
1959	75	445,792	73	229,825	72	422,910	75	320,083	77	1,465,367
1960	77	421,476	77	341,402	77	527,543	80	473,363	82	1,809,530
1961	77	397,397	77	388,194	76	502,571	79	496,493	81	1,843,914

[1] Where a company reported that information was not available for a given year, that company was not included among the respondent companies. Where a company reported information was not available for exports to a given area, but reported exports to another area in that same year, the company's exports were included for the area given and included in total exports for that year. The company in question was also included in the total of respondents for the area on which data were reported and in the total of respondents reporting total exports, but was excluded from the total of respondents for the area on which data were not reported.

[2] Total includes companies reporting total exports but giving no breakdown by geographic area.

TABLE 3.—*Dollar volume of capital invested in foreign manufacturing facilities by U.S. capital goods companies, 1952–61*

[Thousands of dollars]

Years	Number of companies by year	Investment in Canada	Number of companies by year	Investment in West Europe	Number of companies by year	Investment in Latin America	Number of companies by year	Investment in other countries	Total companies responding by year	Total investment
1952	9	$1,567	13	$5,430	4	$100	7	$338	21	$7,435
1953	11	9,043	14	5,284	4	344	7	1,085	18	15,756
1954	10	1,864	18	8,790	5	1,513	7	528	22	12,695
1955	13	2,046	22	14,001	8	9,822	7	1,410	28	27,279
1956	14	8,603	22	32,036	8	13,350	9	2,399	27	58,076
1957	16	13,647	27	51,206	11	10,474	14	5,660	38	80,897
1958	19	7,599	29	22,070	13	31,121	12	4,809	37	58,194
1959	16	154,668	39	26,227	13	24,624	15	6,022	44	211,541
1960	20	6,564	45	423,892	18	34,654	15	8,608	54	471,896
1961	19	7,163	46	87,726	19	34,031	15	7,258	58	136,178

TABLE 4.—*Exports by U.S. capital goods manufacturers to their manufacturing facilities overseas, 1952–61*

[Thousands of dollars]

Years	Number of companies by year [1]	Exports to Canada	Number of companies by year [1]	Exports to West Europe	Number of companies by year [1]	Exports to Latin America	Number of companies by year [1]	Exports to other countries	Total companies responding by year [1]	Total exports
1952	19	$136,114	12	$36,807	2	$89,600	4	$41,559	28	$304,080
1953	19	182,946	16	44,369	2	60,390	4	36,461	29	324,166
1954	21	166,427	17	53,200	4	59,853	7	32,820	33	312,300
1955	21	225,349	19	81,366	5	71,860	8	46,578	34	425,153
1956	24	315,974	17	74,716	6	71,840	8	44,693	35	507,223
1957	28	269,837	22	60,276	8	92,035	10	47,855	40	470,003
1958	20	238,293	29	46,188	12	107,671	13	43,327	44	435,479
1959	32	253,418	41	53,741	13	110,438	13	31,106	49	448,703
1960	31	256,160	55	98,277	17	126,772	16	45,173	64	526,482
1961	32	231,827	58	115,692	16	110,438	17	37,025	65	494,982

[1] Where a company reported that information was not available for a given year, that company was not included among the respondent companies. Where a company reported information was not available for exports to a given area, but reported exports to another area in that same year, the company's exports were included for the area given and included in total exports for that year. The company in question was also included in the total of respondents for the area on which data were reported and in the total of respondents reporting total exports, but was excluded from the total of respondents for the area on which data were not reported.

MAPI SURVEY OF U.S. EXPORTS AND INVESTMENTS ABROAD

Name of respondent: ______________________
Title: ______________________
Company: ______________________
Please return completed form to Machinery & Allied Products Institute, 1200 18th Street NW., Washington, D.C.

CONFIDENTIAL

MAPI SURVEY OF
U. S. EXPORTS AND INVESTMENTS ABROAD

1. Does your company currently export from the United States?

☐ Yes ☐ No

2. Does your company currently have investments in manufacturing facilities overseas?

☐ Yes ☐ No

If the answers to questions 1 and 2 are "No," you need not answer the remaining questions. Simply sign and return the form.

If the answer to question 1 is "Yes," and the answer to question 2 is "No," answer only the first four questions.

If the answers to questions 1 and 2 are "Yes," answer all questions.

3. What percentage of your total U. S. (domestic) sales were your U. S. export sales in 1961? ____________

4. What has been the total dollar volume of your company's U. S. exports? (Please indicate by year and area.)

Year	Canada	Western Europe	Latin America	Other (Please Identify Countries)
		(thousands	of dollars)	
1952	$____	$____	$____	$____
1953	____	____	____	____
1954	____	____	____	____
1955	____	____	____	____
1956	____	____	____	____
1957	____	____	____	____
1958	____	____	____	____
1959	____	____	____	____
1960	____	____	____	____
1961	____	____	____	____

5. If you have manufacturing investments abroad, indicate the form of your investments.

- ☐ Subsidiaries
- ☐ Affiliated companies
- ☐ Branch form
- ☐ Other (Explain)____

____

____

____

6. What has been the dollar volume of your capital investment (all forms including machinery, etc.) from the United States in your manufacturing facilities abroad? (Please indicate by year and area.)

Year	Canada	Western Europe (thousands	Latin America of dollars)	Other (Please Identify Countries)
1952	$________	$________	$________	$________
1953	________	________	________	________
1954	________	________	________	________
1955	________	________	________	________
1956	________	________	________	________
1957	________	________	________	________
1958	________	________	________	________
1959	________	________	________	________
1960	________	________	________	________
1961	________	________	________	________

7. What has been the total dollar volume of (a) your company's U. S. exports to your company's overseas manufacturing facilities, and (b) total (all suppliers) U. S. exports to your company's overseas manufacturing facilities?

	Canada		Western Europe		Latin America		Other (please specify countries)	
YEAR	Company's U. S. Exports to Your Overseas Manufacturing Facilities	Total U. S. Exports to Your Overseas Manufacturing Facilities	Company's U. S. Exports to Your Overseas Manufacturing Facilities	Total U. S. Exports to Your Overseas Manufacturing Facilities	Company's U. S. Exports to Your Overseas Manufacturing Facilities	Total U. S. Exports to Your Overseas Manufacturing Facilities	Company's U. S. Exports to Your Overseas Manufacturing Facilities	Total U. S. Exports to Your Overseas Manufacturing Facilities
				(thousands of dollars)				
52	$	$	$	$	$	$	$	$
53								
54								
55								
56								
57								
58								
59								
60								
61								

The CHAIRMAN. All right.

The next witness is Mr. John Seath, International Telephone & Telegraph Corp.

Take a seat, sir, and proceed.

STATEMENT OF JOHN SEATH, DIRECTOR OF TAXES, INTERNATIONAL TELEPHONE & TELEGRAPH CORP.

Mr. SEATH. Mr. Chairman and gentlemen of the committee, my name is John Seath. I am director of taxes of the International Telephone & Telegraph Corp.

I appreciate this opportunity to express my views with respect to the Treasury Department working draft which was submitted to your committee on May 31, 1962. I shall limit my remarks to sections 13 and 16, and I shall speak entirely from the point of view of operating companies doing business overseas.

Before I get into the detailed comments on the various provisions of the Treasury draft, I should like to offer a basic comment as to the Treasury's concept of tax-haven income.

Section 13, as now constituted, attempts to define specific transactions as giving rise to tax-haven income regardless of the tax rate of the country in which such transactions take place. Obviously, such a transaction taking place in a country where the tax rate is almost as high as that in the United States, or higher, could not possibly be entered into for the purpose of reducing taxes. Yet it is still called a tax-haven transaction even though there could be little or no tax revenue to the United States if it were taxed by this country.

The whole concept of section 13 involves taxing earnings of foreign corporations which have not been remitted to the United States. There has been a great deal of talk about the laws of other countries but no specific information about them. In an attempt to assist this committee in its deliberations, we asked each of our company comptrollers to obtain information on capital export licensing, capital repatriation, earnings repatriation, use of tax havens, and taxation of unrepatriated earnings in their countries.

Their findings were that, while some countries license capital exports, almost none of them require a return of capital or earnings, and none of them tax unrepatriated earnings. A summary of their answers to our questions is attached to this statement in the form of a box score, together with a more detailed analysis of the answers. We believe they will prove enlightening.

If it is considered necessary to enact legislation to catch those organizations or individuals who have been avoiding U.S. income taxes by the artificial channeling of income to low-tax countries, this legislation could be written in such a manner as to make it impossible for these people to avoid U.S. taxes. It should not be written in such a manner as to interfere with the normal commercial and competitive practices in foreign markets against foreign-owned companies.

This interference arises from the fact that section 13 continues to place a heavy burden upon operating companies because, under the Treasury transaction approach, what is really operating income is included among items of "foreign base company income." If a

company does not have more than 20 percent of this so-called tax haven income, it is not covered by section 13. However, if a company has any complexity at all, it might readily have 10 percent of trading income and 10 percent of services income. In addition, it could easily have 5 percent of dividends, 5 percent of interest, or 5 percent of royalties, all of the proscribed type.

None of these in and of themselves would cause trouble but, when considered together, we have a company that would be considered as a tax haven which is difficult to reconcile with the verities of competitive life.

Now let me come to the specific provisions of section 13. Section 951(a) of the bill provides that a pro rata share of subpart F income earned during a taxable year will be included in the income of the U.S. shareholder unless distributed in the form of dividends. In some countries it is impossible to distribute such income as dividends in the year in which earned.

For example, in Germany interim dividends are not permitted and profits may not be distributed until the accounts for the year have been approved and a determination of the distribution of profits reached at the annual meeting of shareholders. This means that profits cannot usually be distributed until the end of March or April of the following year. Thus, section 951(a), requiring distribution of profits in the year earned in order to avoid the impact of section 13, clearly fails to appreciate the realities of corporate existence in foreign countries.

Therefore, if any such provision is to be enacted, an adequate period after the end of the year in which the profits are earned should be provided within which a qualifying distribution of profits may take place. The imposition of tax for the year in which profits are earned where the profits are distributed the following year is merely an acceleration of the tax-collecting process requiring the maintenance of additional accounting records which would not be required if an adequate period were granted for the distribution of profits.

Section 954(d) defines so-called foreign base company income and, under this concept, sales by a company which purchases products from a related company in another country and sells these products in a third country are called tax haven transactions. This is an attempt to impose a so-called tax haven concept upon the realities of competitive life on foreign corporations in foreign jurisdictions which have no contact with the United States other than through stock ownership. This provision should be modified since as it is now written it will effectively discourage the development of genuine sales subsidiaries which are necessary to enable American-owned corporations to compete effectively in the growing multinational trading areas of the world, such as the European Common Market.

For example, I.T. & T. has manufacturing subsidiaries in every country of Western Europe except Luxembourg and Greece. We have found the use of sales subsidiaries, which service the many manu-

facturing and operating companies in our I.T. & T. system, an absolute necessity for at least two purposes:

1. To eliminate the duplication of export marketing staffs at the operating level; and
2. To provide at one point a knowledge of the products of all of our manufacturing companies, the leadtime necessary at each factory, and the availability of products for delivery.

Such subsidiaries are used by our major foreign competitors for these very reasons and because their governments wish to foster exports in every way possible.

The goal of every American-owned company which goes into a foreign jurisdiction to conduct an operating business is to make as much profit as possible for its U.S. shareholders. The more profit it makes, the more it will ultimately bring home and the sooner it will recover its original capital investment. Thenceforth, it will make mounting contributions to our national balance of payments and tax revenues.

Every dollar which can be lawfully saved from foreign tax is a potential $1 contribution to our balance-of-payment account and a potential contributor of 52 cents to U.S. tax revenues. A more effective test than section 13 would be a test requiring a distribution of some portion of such profits which could easily be accomplished through modification of section 531 of the Internal Revenue Code.

The interest of the United States lies in helping U.S. firms maximize their foreign profits. This is especially true since some European countries, such as Holland, do not even tax repatriated earnings which their controlled foreign subsidiaries bring back. None of them attempts to reach into their foreign-operating companies and subject them to tax. If American firms are to remain competitive, they must be free to utilize every lawful means to offset the many advantages which European governments offer to their companies with respect to their foreign operations.

Accordingly, retention of this provision without modification would be damaging to the competitive position of American companies operating overseas.

Section 954(b) (4) states that, if it is established to the satisfaction of the Secretary or his delegate, a foreign-controlled corporation may be excluded from the impact of section 13 if it is not availed of to achieve a substantial reduction of income, war profits, excess profits, or similar taxes. It is not stated whether or not these taxes are U.S. or foreign taxes, but reference is to foreign, not U.S., taxes, as Secretary Dillon made plain in his testimony.

The U.S. Treasury Department has every right and duty to prevent siphoning of earnings from the United States in transactions which have both domestic and foreign attributes, but there would seem to be no justification for an attempt to police the tax incidence of transactions taking place wholly between third countries. This provision should be modified or restated to insure that if subsidiaries are located in a country, regardless of its tax rate, for sound operating

and competitive reasons and not primarily tax reasons, they are free of the impact of section 13.

Section 954(c)(4) excludes from foreign personal holding company income dividends, interest, rents, and royalties received by a controlled foreign corporation from a related company in the same country. The apparent purpose of excluding such income from the concept of passive income when paid by an operating subsidiary to an operating parent is most desirable. However, such income when paid by an operating subsidiary to an operating parent—whether or not it crosses international boundaries—should be excluded from the concept of tax-haven income, since operating companies do not choose tax havens but go where the market is.

I would suggest, in this respect, the adoption of further language providing that where a controlled foreign corporation derives more than 50 percent of its gross income from the active conduct of a trade or business, dividends, interest, rents, and royalties which it receives from a controlled foreign corporation which also derives more than 50 percent of its gross income from the active conduct of a trade or business, and in which it owns at least 10 percent of the voting stock shall not be included as "foreign base company income."

Section 954(e) describes so-called foreign base company services income. ITT, as we have stated before, has manufacturing subsidiaries in 13 countries in Europe. Obviously, not all of these companies maintain a full staff of highly qualified engineers, accountants, scientists, and managers. Therefore, it is incumbent upon those subsidiaries which do have the skills to provide their sister companies with whatever knowledge or services are necessary regardless of national boundaries.

In addition, ITT has telephone operating companies in the less developed countries which need engineering and scientific help from the manufacturing companies. The manufacturing companies should be allowed to render these services and to receive adequate compensation for such services without the imputation of conducting tax-haven operations.

"Foreign base company services income" is also defined to include industrial and commercial services. These terms are so broad that we have no idea what they are intended to cover. Conceivably, they could cover the performance of assembly or finishing operations by one subsidiary for another subsidiary in the ordinary course of business. If, however, the concept of tax-haven income should unfortunately include "services" income, I suggest that this definition be modified so that services rendered by a controlled foreign corporation be included only if it exceeds more than 50 percent of gross income. This should catch the abuse situations.

In addition, the definition of what constitutes industrial, commercial, and like services should be modified to make clear that the manufacture or processing of products from component parts purchased from related companies should not be regarded as "services" income.

To summarize, we believe that section 13 should be so modified that companies which are established for sound competitive commercial reasons will not be subjected to the onerous burdens of section 13. We also believe that what we have suggested today would put legitimate

operating companies on a footing equal with their foreign owned competitors.

Section 16: Section 16 treats gains arising on the termination of investment in foreign corporations as ordinary income. However, losses incurred on such termination are treated as capital losses. This "heads you win tails I lose" treatment is manifestly unfair. This provision will discourage investment in the less developed countries and will be incompatible with the objectives of the aid bill and the Alliance for Progress.

Accordingly, section 16 should provide that ordinary losses should be allowed at least to the extent of accumulated operating losses on the sale or exchange—including seizure and confiscation—of foreign subsidiaries.

(The annexes to Mr. Seath's statement follow:)

INTERNATIONAL TELEPHONE & TELEGRAPH CORP.

Analysis of capital export and earning repatriation requirements for European countries

	Capital export licensing (1)	Requirement for return on investment (2)	Repatriation of earnings required (3)	Use of tax havens permitted (4)	Any taxation of unrepatriated earnings (5)
Austria	Yes, from Austrian National Bank.	No	No	No	No.
Belgium	No	do	do	Yes	Do.
Denmark	Yes	do	do	Yes, if not controlled by Danish company.	Do.
France	Nominal	do	If dividend declared, yes.	Yes	Do.
Germany	No	do	No	do	Do.
Italy	Nominal	do	If dividend declared, yes.	do	Do.
Netherlands	do	do	No	do	Do.
Norway	Yes	do	do	do	Do.
Portugal	do	do	do	do	Do.
Spain	do	See col. (1)	See col. (1)	Yes, if not controlled by Spanish company.	Do.
Sweden	do	Possibly	Possibly, to extent not required abroad.	Yes	Do.
Switzerland	No	No	No	do	Do.
United Kingdom	Yes	Is considered in export license.	Possibly a fair return required.	do	Possibly, if tax being avoided.

ANALYSIS OF CAPITAL LICENSING, CAPITAL REPATRIATION, AND EARNINGS REPATRIATION REQUIREMENTS IN EUROPE AS DEVELOPED BY SYSTEM HOUSES

Export and repatriation of capital

England.—To the best of our knowledge, the British Treasury has no specific criteria covering the export of capital and each case is judged on its merits. Apparently the real tests are—

(*a*) The investment should show some revenue remittable within 18 months.

(*b*) The investment should create a demand for British exports after the initial investment such as production materials, etc.

(*c*) Apparently there is no requirement covering a capital payback arrangement.

(*d*) Profits on collateral exports are not included in the criteria.

(*e*) The Treasury has the right to review balance sheets of foreign holdings including overseas trading companies and can specify the amount of profit to be repatriated.

We have not been able to get any information concerning a rejection of a capital investment based on a required 3½ year return, and the Bank of England is unwilling to even discuss the situation. This reference was given by Secretary Dillon on page 102 of part 1 of the Senate Finance hearings, and he referred to a 2-year period based on dividends and exports.

Mr. Selwyn Lloyd may have made a statement that he is going to look into repatriation of oversea earnings, but this has not been followed by any specific instructions. The Exchange Act of 1947 still applies which means the Treasury can give notice to residents of the United Kingdom controlling investment abroad to remit an appropriate return on the investment. To the best of our knowledge there has not been any use of this rule.

Germany.—There are no limitations on the export of capital from Germany. The only requirement is a formal notice to the Ministry of Economics for statistical purposes. The fact is, German industry is encouraged to export capital. There are no requirements pertaining to return on investment.

Belgium.—There are no restrictions on export of capital. However, if such export of capital led to a basic change in Belgian manufacturing operations, it might have an unfavorable influence on business to be received from the Government. There are no requirements covering any required return on foreign investment.

France.—There is no limitation on the amount of capital that may be exported, but Government approval is required which is readily given. There is no requirement covering the amount of return on investment. The only requirement is that if dividends are distributed, they must be repatriated.

Holland.—Export of capital for investment requires approval of the Nederlandsche Bank which is usually given. There are no requirements covering return on investment or repatriation of capital.

Italy.—Export of capital is freely allowed under the following conditions:

(a) The foreign subsidiary is in the same business as the Italian company.

(b) The investment is intended to facilitate foreign activities of the Italian company.

(c) The total investment does not exceed the capital of the Italian company.

If these criteria are not met, prior authorization is required from the Ministry of Foreign Trade. There are no rules covering the amount or percentage of repatriation.

Denmark.—There are no criteria set up covering foreign investments but application for permission must be made to the Danish National Bank giving full details of the proposed investment and its prospects. Each case is considered separately on its own merits. There are no rules covering the amount or percentage to be repatriated.

Norway.—All transactions in foreign exchange require the prior approval of the Norges Bank. Each application is judged on its own merits with those investments showing prospects of favorable exchange income most likely to be granted. There are no rules covering the amount or percentage of profits to be repatriated.

Sweden.—Foreign investments require prior permission of the Swedish Government. While there are no set rules covering the amount or percentage of profit repatriation, these might be set in the permit for a foreign investment. Each case apparently is considered on its own merits.

Austria.—While there are no set rules on the amount or kind of foreign investment, the approval of the Austrian National Bank has to be obtained for each transaction. The approval of the bank apparently varies in accordance with the existing foreign exchange situation at the time of the proposed transfer. There are no rules covering the amount or percentage of profits to be repatriated.

Spain.—No permits are granted at the present time in Spain for capital exports.

Portugal.—Government approval is required for the export of capital and approval apparently depends on the circumstances involved in each case. There are no requirements covering the amount or percentage of profits to be repatriated.

Switzerland.—There are no regulations covering the export of capital and no regulations covering the amount or percentage of profits to be repatriated.

Taxation of unrepatriated earnings

There is no taxation of unrepatriated earnings in Belgium, Denmark, France, Germany, Italy, Holland, Norway, and Sweden. The conditions in the United Kingdom have been given above.

Use of tax havens in Europe

United Kingdom.—The Income Tax Act of 1952 requires that it be demonstrable that transactions are at arm's length or tax may be assessed on profits which would have been earned on a normal trading basis. However, the oversea trading company can be used in Britain and tax on profits delayed until such time as the profits are distributed to shareholders. This obviates the need to use tax havens.

Germany.—There are no objections to the establishment of sales subsidiaries abroad for the purpose of expanding export activities. The only rule is that if export prices charged to such a subsidiary are less than cost, the difference will be treated as an underhand distribution of earnings and taxed.

Belgium.—There are no restrictions on the use of subsidiaries in tax haven countries, and in fact, if the income of such company is subject to any income tax in its country of incorporation, dividends received in Belgium are subject to a reduced tax rate of 12 percent.

France.—The use of Swiss or other tax haven companies is permitted provided prices charged to such subsidiaries are not less than those in the domestic (French) markets. If prices are less than the domestic price, the difference might be treated as a hidden distribution of profits. This rule is not fixed and might be softened where important export orders are involved.

Holland.—There are no regulations covering the use of tax havens, but consultation with the fiscal authorities is considered advisable.

Italy.—There are no regulations to prevent the use of tax havens by Italian companies.

Denmark.—An application by a Danish company to invest in a Swiss or other tax haven company would not be granted. However, there are no regulations to prevent a Danish company from using a Swiss or any other tax haven company to foster exports if it is not controlled by the Danish company.

Norway.—A Norwegian company would be permitted to use a tax haven company if it could prove that bona fide transactions are involved and it would benefit the foreign exchange position of Norway.

Sweden.—Apparently in Sweden the same rules would apply as in Norway.

Austria.—Use of a tax haven is forbidden.

Spain.—It is possible that permission might be granted to set up a tax haven company to foster exports, but it is doubtful. However, a tax haven company owned by a company other than a Spanish company could be used.

Portugal.—There apparently are no Portuguese regulations covering the use of tax havens.

Switzerland.—There are no Swiss regulations to prevent the establishment of a tax haven in another Swiss canton or another country.

Average dividend payout as developed by system comptrollers

United Kingdom.—A Financial Times survey of 88 electrical and radio companies shows the following percentage of net profits distributed to shareholders:

	Percent
1959	42
1960	45
1961	48

Germany.—The distribution of profits runs between 50 and 60 percent.

Belgium.—Dividend payout by four important companies in our industry averages 40.4 percent on earnings, 8.5 percent on capital, and 5.5 percent on capital reserves.

France.—Average dividend payout is reported as 76 percent. (This seems incredible.)

Holland.—Average dividend payout runs from 40 to 50 percent.

Italy.—Average dividend payout is 56 percent.

Denmark.—Average percentage is about 30 percent although no official statistics exist.

Norway.—No information.

Sweden.—Due to existence of hidden or other reserves, no reliable figures can be reported.

Austria.—Average dividend payout in our industry is approximately 60 percent or 5 percent on capital stock.
Spain.—No reliable figures.
Portugal.—No information.
Switzerland.—No figures available.

The CHAIRMAN. Thank you, Mr. Seath.

Any questions?

Senator GORE. Which would you prefer, the Treasury's primary recommendation, the elimination of deferral, or this redraft of section 13?

Mr. SEATH. Well, you put me in the position of taking a choice between evils. The evil of the first choice is that if we go to the full elimination of deferral, within a very short period we would be out of business or our companies would be sold to foreign, other foreign, companies for the very simple reason that if your profits—you said you were a businessman.

Senator GORE. Very small.

Mr. SEATH. All right. It does not make any difference whether you are big or small, percentages do not change.

Secretary Dillon, in his testimony, said there was very little difference between a 40-percent tax rate and a 52-percent tax rate.

If you take two companies, each earning 10 percent profit before taxes, and apply a 40-percent tax rate to one and a 52-percent tax rate to the other, depending on which way you figure it, the difference in profit is 20 or 25 percent, and if your competitor has 20 or 25 percent more profit than you have, he can put you out of business very quickly.

Senator GORE. Well, you would not put me out of business as long as you were paying the tax on the profits you made, would you?

Mr. SEATH. If he can cut his prices down to the point where I am at a marginal business, I am much more valuable to him than I am to myself, to my stockholders in this country.

For example, we supply products principally to the governments of European countries. Our manufacturing companies in Europe supply principally to governments in these countries with telecommunications equipment.

Now, if we are put on the basis of our companies being subjected to a 52-percent rate, whereas their competitors in those countries owned by nationals of those countries are operating at a different tax rate, we cannot stay competitive, and the answer is that you do not get cash.

Senator GORE. This is inconceivable. I do not think you can demonstrate it at all. The tax would only apply to the profits you make in successful competition.

Mr. SEATH. True. But you won't be a successful competitor very long.

Senator GORE. Then you will not have taxes to pay.

Mr. SEATH. That is right. We will have to sell out to somebody else so they can make a profit which we cannot make.

Senator GORE. It does not follow at all; it does not follow at all. Unless you are profitably competing, you will owe no taxes.

Mr. SEATH. True.

Senator GORE. That is the same in this country as it is in any other country.

Mr. SEATH. That is right.

Senator GORE. It is the same internationally as well as nationally.

Mr. SEATH. Right.

Senator GORE. So what we seek to do, or what I seek to do, is to let you enjoy the American privilege of paying a tax on the profits you earn.

Mr. SEATH. Well, I think you have to look at it at a little farther than that.

Senator GORE. I understand that if you do not have to pay any taxes you can grow faster.

Mr. SEATH. Oh, sure.

Senator GORE. This business of taxes is really an inconvenience wherever it is applied. If you did not have to pay any tax on your business here at home you could grow a good deal faster, couldn't you?

Mr. SEATH. No, sir; I do not think that necessarily is true.

Senator GORE. Why don't we just abolish this inconvenience of taxes? You want to abolish it on your profits abroad. Why don't we abolish it here at home, too.

Mr. SEATH. I do not want to abolish it on our profits abroad. We pay taxes on our profits abroad.

Senator GORE. No; you only want to pay the tax when you bring profit home, and you may never bring it home, a lot of you have not brought it home, and you never will.

Mr. SEATH. I do not think that is true, sir. We do bring it home.

Senator GORE. Very little of it.

Mr. SEATH. No, sir; we bring a lot of it home.

Senator GORE. Well, I want you to pay taxes on it wherever you make it.

Mr. SEATH. We do.

Senator GORE. Annually.

Mr. SEATH. Annually.

Senator GORE. All right; we are agreed, Mr. Chairman. I think this is fine.

Mr. SEATH. We do pay taxes annually.

Senator GORE. Thank you.

The CHAIRMAN. What percent do you bring home?

Mr. SEATH. Pardon, sir?

The CHAIRMAN. What percent do you bring home?

Mr. SEATH. Over the years 1958, 1959, and 1960 we brought home approximately 55 percent of our net foreign income after taxes.

The CHAIRMAN. And the net income is after you deduct the taxes you pay abroad?

Mr. SEATH. That is right, sir.

Senator GORE. What percent of tax did you pay on what you brought home?

Mr. SEATH. It varies, sir, according to whether we made a profit or we had a loss in the United States.

Senator GORE. Well, can you give it to us for those years?

Mr. SEATH. Our average foreign tax rate over those years was between 40 and 42 percent. Therefore, the difference would be 10 percent. Actually we file consolidated returns, so the difference would be 12 percent, between 12 and 14 percent, sir.

Senator GORE. Now, the witness before you made the statement that his business is operated as a unit. I suppose you mean the same thing when you say you file a consolidated return.

Earlier in this hearing I demonstrated by the testimony of a representative of the Pfizer Co. that they had achieved an average tax rate of a little over 30 percent over a period of years, whereas their competitors in the drug field had been paying around 50 percent.

I learned after that testimony that its competitors had gotten wise, too; that they were now moving very vigorously into the tax haven operations, and that pretty soon they would be paying a going rate of approximately 30 percent also.

This is being done by tens of thousands of corporations, and yet everything that is proposed receives a phalanx of opposition.

Mr. SEATH. Well, I think you have to look at it this way, Senator: We have a company in Belgium. It has no American citizens in its employ. The only think we have to do with it is ownership of stock.

It has approximately 15,000 employees. It sells the bulk of its production to the Belgian Government. I do not see where this affects the United States.

Senator GORE. Well, whether it affects the United States or not, I do not think it lessens your responsibility to contribute proportionately to the defense and welfare of the country.

Mr. SEATH. I could not agree with you more. But we only own the certificates representing the ownership of that company. We do not own the assets of that company. We do not own the employees of that company. We cannot give them orders.

Senator GORE. But you derive benefits therefrom.

Mr. SEATH. We derive the dividends when we get them.

For example, in Germany, as I said in my statement——

Senator GORE. There is a constructive realization involved here.

Mr. SEATH. Well, we sure lost that company in World War II, and kept going. But we could not constructively realize any income.

Senator GORE. It came back to you, did it not?

Mr. SEATH. We got the company back, but we did not get its earnings back.

Senator GORE. Well, thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Mr. Seath.

The next witness is Mr. Elliott Haynes of Business International.

STATEMENT OF ELLIOTT HAYNES, EXECUTIVE VICE PRESIDENT, BUSINESS INTERNATIONAL

Mr. HAYNES. Thank you, Mr. Chairman.

Mr. Chairman, Senator Gore, my name is Elliott Haynes. I am executive vice president of Business International Corp. of New York. Our company strives to help industry operate effectively and profitably in international markets through two publications—Business International in New York and Business Europe in Geneva, Switzerland—and through research and roundtable discussions conducted for and organized on behalf of some 90 corporations. What I will say today, however, represents only my own views on the impact of the Treasury's latest version of section 13 of H.R. 10650 on American exports, employment, and balance of payments.

With your permission, I would like to depart from my prepared statement for a few minutes in light of the discussion here today.

We came down and we were urged to stick pretty closely to section 13, but the scope of these hearings has been broadened sufficiently so I would like permission for one or two words.

Senator Gore has said that investments by American corporations in Europe is bad for the Nation. I would say——

Senator GORE. No; I do not believe I said it that way.

Mr. HAYNES. Well, I will accept your amendment, Senator, whatever it is. You implied that it was bad, and I thought you said for the Nation, in terms of its balance of payments, in terms of exporting industries, and so on; am I correct?

Senator GORE. Well, I think your elaboration, your extended statement of my comments, is correct.

I would like to say that the legislation which I have proposed, and which the Treasury has proposed, does not seek to prohibit investment. It seeks rather to remove the tax incentive for such an investment.

I would go further and say that the volume of U.S. corporate investment in Western Europe today is not commensurate with the welfare of the country when we view that problem in the context of the balance-of-payments difficulty and the outflow of gold, and I think we now understand each other.

Mr. HAYNES. We do, indeed.

Senator, my response to that suggestion is to say that, far from there being too much volume of American private direct investment in Europe today, there is not nearly enough. I say this for the reason, and I think the record clearly substantiates it, that American companies, private industrial corporations, invest in Europe and elsewhere only when markets abroad are lost to them from exports from this country.

They invest under those conditions and, by so doing, and again the record clearly substantiates this, create export opportunities and, therefore, create jobs in these United States.

Now, I think, Senator, if a tiger can be allowed to stroke a Senator, that we should give you agreement, agree with you, that certainly it is well established that governments can regulate capital movements when the national interests so commands. This is well established, and has been for years.

On that score, however, I would like to say that some months ago I had an opportunity to ask a senior official of the United Kingdom Government if he agreed with Secretary Dillon's statement that at this moment in our balance-of-payments situation American private investment in Europe was bad for that balance of payments, would he think that the United Kingdom should restrict its capital outflow to the continent of Europe.

His reply was succinct. He said, "absolutely not, the United Kingdom would benefit in the very short run from such investment because only in that way can we maintain markets in this modern world."

"However," he said, "our margin from reserves in the United Kingdom treasury is so thin that we do have a time problem, that we must take this step which we realize is bad for us in the long run, a temporary step, of slowing down our capital movements, because

confidence in the pound disappeared we would lose so much income from banking insurance it would be grave for us. You," he said, "however, have a vastly greater cushion in your Treasury, and you are certainly not compelled as are we to take this admittedly bad temporary step of slowing down our balance of payments."

Now, the principle of the benefit to nations all over the world of the free movement of capital, Senator, is also unquestioned.

There is not a nation in the world, to my knowledge, that disagrees with the theory of the free movement of men, money, and materials as the best possible situation for every citizen in the free world.

Senator GORE. But few practice that.

Mr. HAYNES. This is embodied in the rules of the IMF. Our own Government takes the lead, Senator, in urging the Japanese, which you mentioned, the Italians, the governments of Europe, to liberalize their capital movements.

We are constantly pushing them to do it for the reason that it is good for them in the long run.

For the same reasons it is good for us, and I think the example of Switzerland which allows free movement of capital, which is a nation with an extremely grave balance-of-payments problem, has supported itself beautifully in the world economy by insisting on this free movement of capital in and out of Switzerland.

Senator GORE. Well, I appreciate your comment. I think these frank discussions may be a little more fruitful than the reading of heavy sentences.

Mr. HAYNES. I would like to make one other——

Senator GORE. Could I comment for just one moment?

Mr. HAYNES. Excuse me.

Senator GORE. You say that in your view the U.S. investment in Europe should be much greater, at a much greater rate, than it is now. I would like to examine that for a moment.

According to estimates I have seen, and surveys, the indications are that the U.S. corporate investments in Western Europe this year will be approximately $5 billion.

Now, do you think our balance of payments would be improved if that should be $10 billion instead of $5 billion?

Mr. HAYNES. Obviously, in the first year it would not, Senator. However——

Senator GORE. Now, that is—let us not ——

Mr. HAYNES. I would like to respond to that, if I may.

Senator GORE. All right. Let me first say that I recognize that there is a short-term problem and a long-term problem.

Now, you have just answered that obviously it would not this year.

Mr. HAYNES. In the first year.

Senator GORE. All right. How acute is our problem this year?

Mr. HAYNES. Not that acute, that is the point. We have what, $17 billion? There is not going to be a $10 billion investment overnight. There is not a conceivable opportunity—it is not conceivable that companies could find, develop, investment opportunities nor that they are that existent, Senator.

Senator GORE. I know. But you expressed the view that our balance of payments would be helped if we were investing at a greater rate in Western Europe than we are now.

Mr. HAYNES. That is correct.

Senator GORE. And you have indications, at least I have given you what I think is the indicated volume, this year, and I have asked you if our balance of payments would be improved if that were $10 billion this year, and you said not this year.

Now, I am ready for your other answer.

Mr. HAYNES. Fine, Senator.

If you will take the Treasury figures and study them very carefully, as undoubtedly you have, restudy them, I think you will find some interesting things.

For one thing, Treasury has never accurately, because it has been impossible for it to do so, measured the return in the first year or the first 18 months, indeed they never have accurately ever measured the return over any period, from direct private foreign investment in terms of fees, royalties, and return on exports to those foreign subsidiaries. This has never been done.

Even so, the figures are pretty good on return from direct private foreign investment.

It has been suggested, and I have yet to see it disproved, because the figures have not been collected, that, perhaps, even in the first year, in a normal year of U.S. direct foreign investment there might be almost a balance in outflow and inflow on that one year's investment. I am not talking historically now. The figures are certainly not clear on this point, Senator.

I would like to make a comment on your mention of equity and tax neutrality. I suggest, Senator, that this market is still the most luscious in the world. It is, by far, the easiest for Americans to make money in it. They are familiar with it. They do not have to go anywhere. They enjoy it here. They know the market.

The point I am making is that there is not any subsidy or incentive that is going to cause an American company to fail to grasp any investment opportunity in this country that really exists.

Instead, if I may——

Senator GORE. Yes.

Mr. HAYNES (continuing). By talking in terms of subsidies and in terms of neutrality between U.S. taxpayers here and U.S. taxpayers in the foreign operations, what you are doing is putting the American in one terrific bind abroad.

It is analagous, Senator, to my view of sending Americans abroad with 10-ounce gloves to fight a battle there with somebody who is barefisted merely because in this country we must wear 10-ounce gloves and, Senator, I simply fail to see the logic in this.

Senator GORE. In the first place, it may or may not be in this country's interest that one of our citizens puts on the gloves in Europe. It may be very beneficial, but then again it may not be beneficial at all. Indeed, it might be harmful.

I am not one of those who quickly equates every individual's personal enterprise abroad as being for the welfare and the interest of our Nation. It may or may not be.

Mr. HAYNES. Well, what I have said is that the record clearly proves to my satisfaction, and I have not seen evidence to the contrary, Senator, that direct private foreign investment in Europe creates jobs,

creates U.S. exports, does not export jobs, and does bring in foreign exchange that we badly need.

If this is true, then putting on the 10-ounce gloves on the companies that are going abroad to achieve those benefits in our national interest is a crime.

Senator GORE. There are indications that some investments abroad are beneficial to our national economy, and some are distinctly hurtful to our domestic economy. Neither of us would have difficulty in finding examples of either or both.

Mr. HAYNES. I would like to, if you could, Senator, find out what are those that are harmful.

Senator GORE. Well, from an economic——

Mr. HAYNES. From any standpoint.

Senator GORE. We are speaking now from the standpoint of international economics. The movement of a U.S. manufacturing industry abroad, losing jobs for American workmen here at home, and providing jobs for workmen in other countries instead can hardly be interpreted in my view as beneficial to our own people.

Mr. HAYNES. Senator, can you cite one example where that has happened?

Senator GORE. Yes. I can cite you many—the manual typewriter industry, for one.

Mr. HAYNES. Why did they have to move out of this country, Senator?

Senator GORE. Well, now, first, it is a question of whether they had to. I would not like to use any company, the name of any company or the name of the brand, but let me say this to you, and I will say this to my chairman and the ranking minority member of the committee. The most difficult competition that Americans, that American enterprise, can face from imports is the importation of a well-known American brand name article, an article which has public acceptance over many years with dealers, with retailer outlets.

If an Italian brand shoe or typewriter or monkeywrench were marketed in this country, it would have the necessity of building up retail outlets, of finding dealers, agents, salesmen, public acceptance. The advertising costs might be greater.

But when a concern, an American concern, that has for many years manufactured such a product, moves its factory abroad and keeps its sales force here, that, I say to you, is the most difficult kind of competition for American commerce to meet, and I do not think that it is in the interest of the country as a whole, although it may add to the profits of a few of our individual citizens.

Mr. HAYNES. Senator, I respectfully suggest—and I think I can state what happened in this typewriter field, and I suspect in other fields as well—I happen to be very close to a number of the companies involved in that. They would have loved nothing better than to stay here. They did not go abroad just because they wanted to.

They went abroad because the only alternative, Senator, would be to fly in the face of your desire for lower tariffs and ask for a big whopping protective tariff. This they did not do. There was a motion to do this, as you know, on the part of some typewriter companies. It failed. That was the alternative, Senator.

Senator GORE. Suppose we continue this trend. By and large, the same people who want the trade bill, to further reduce tariffs, are the people who are opposed to the levying of any taxes on the income they earn abroad.

Mr. HAYNES. Well, Senator, these companies that went abroad—let us assume there was not a raise in the tariff—would you suggest they just go out of business entirely? That was the alternative, either go abroad or get out of business entirely.

Senator GORE. Well, I am not going to go into that any further.

Mr. HAYNES. If somebody is going to import typewriters into this country, isn't it better that it be an American corporation owned by American stockholders operating abroad?

Senator GORE. Well, it is only a little better.

Mr. HAYNES. It is a hell of a lot better in my view.

Senator GORE. I am not so sure as far as the international economics of it are concerned. It may be worse. There may be a few stockholders who would benefit. But the loss of jobs and the gold that flows from the country——

Mr. HAYNES. But they lost them already.

Senator GORE (continuing). From the imports, may not be in the country's interests at all.

Mr. HAYNES. Those jobs were lost already. When the duty failed to raise, those jobs were lost before the foreign investment was made.

Senator GORE. You think we need to continue, you say let us continue, the tax subsidy?

Mr. HAYNES. It is not a subsidy, Senator. I disagree.

Senator GORE. Well, remission or exemption or——

Mr. HAYNES. Deferral.

Senator GORE. Deferral. Let us continue that? We had testimony yesterday from a citizen from Delaware that if Congress passed this bill or some bill that put a tax on his income earned abroad he would stop his expansion abroad.

He went on to tell us that his company was earning 25 percent on investment after taxes; that he could not do that well here. I doubt if he could either. But shall we just continue this?

Mr. HAYNES. Senator, I personally do not know a single company that has failed to invest here and seize an opportunity to make money in this market just because there was a higher rate of return somewhere abroad. They just do not do this.

Senator GORE. Were you here yesterday?

Mr. HAYNES. No, I was not.

Senator GORE. Well, I wish you were. What was the name of your citizen, Senator Williams?

Senator WILLIAMS. I do not recall, but there were about $250,000 involved in the total transaction. I think he said he had started out with $13,000 about 8 to 10 years ago. I do not know what the Senator is trying to prove, but I do appreciate his efforts. [Laughter.]

Senator GORE. I appreciate the contribution of my friend from Delaware. He is finally getting it down to terms where it is easy for me to understand. The man who invested $13,000 and, I believe you say had now ballooned it to a quarter of a million, with no taxes——

Senator WILLIAMS. No.

Senator GORE. Even though by some that is ridiculed as being peanuts, I think that is a rather substantial fortune, and I think that one of our citizens who has so prospered ought to have the privilege of contributing to the defense of his country.

Senator WILLIAMS. Get the record straight, the man had paid all of his taxes under existing law and his products were sold in the European market. What is wrong with it?

Senator GORE. Well, under existing law, that is the trouble; that is the trouble. Existing law does not require him to pay any unless he brings his profit home.

Mr. HAYNES. May I get into my testimony, Mr. Chairman? I am going to talk only about base companies, Mr. Chairman.

Senator GORE. May I ask a question before I leave—I must depart, I am sorry—would you prefer the primary recommendation of the Treasury and the President to repeal of the deferral privilege or section 13 as it is redrafted?

Mr. HAYNES. Both of them would have serious detrimental consequences for our national interests, Senator.

Senator GORE. You would not choose either?

Mr. HAYNES. Neither one.

Senator GORE. As between the two, would you have a choice?

Mr. HAYNES. I do not think I would. I think they are equally bad.

Senator GORE. All right.

Mr. HAYNES. There was, Mr. Chairman, a reference earlier today to so-called operating companies.

The implication was that base companies in Switzerland and elsewhere, trading subsidiaries, sales subsidiaries, were not operating companies.

It was even suggested by Senator Douglas that advertising activities and taking the credit risk produced passive income.

Well, this, I do not believe, can be sustained because certainly the efforts to find proper advertising media in Europe, and there are hundreds upon hundreds upon hundreds of magazines, is a very difficult one requiring expertise, real work on the ground, and so on. Similarly, taking credit risk requires real operating management abroad before that can be done properly.

I mention that because it is germane to my testimony, Senator.

Section 13, as now proposed, would hurt U.S. exports, hurt U.S. employment, and hurt our balance of payments. Eventually, and perhaps very quickly, it would hurt U.S. tax revenues. Finally, it would hurt U.S. foreign economic policy by slowing the contribution of U.S. industrial corporations to the development of the nations of Latin America, Asia, and Africa.

This is so because the new proposal strikes directly at a business practice that has proven its ability to expand U.S. exports substantially, thus creating new employment in the United States, and to swell the inflow into the United States of dividends, fees, and royalties as well as export earnings, thus helping to balance our international payments. I refer, of course, to base companies incorporated in Canada, Puerto Rico, Panama, Switzerland, and elsewhere, companies with real substance abroad that are buying and reselling the products of their U.S. parents, licensing and furnishing services to companies in third markets, and establishing plants abroad and receiving their

dividends for further reinvestment where needed to maintain or crack foreign markets.

This committee has heard much testimony on how foreign investment, far from exporting U.S. jobs, actually creates them. It has heard testimony from companies whose foreign base subsidiaries have increased the pace of this investment, so healthy for the U.S. economy, by boosting U.S. exports and foreign earnings. My own company, on April 25, showed the committee how 32 base companies, with a total equity investment from the United States of only $10.5 million, had, in the 2 years 1959 and 1960 alone, produced an inflow into the United States of $258 million through exports and $19 million in royalties, fees, and dividends.

Yet these are the very companies, not just so-called sham corporations, that the Treasury has now set its sights squarely upon as those that should pay current U.S. tax of 52 percent on their foreign earnings.

Because the Treasury has not produced—and, I believe, cannot produce—a shred of convincing evidence that these substantive base companies are anything but good for the US. economy, I will not belabor the point but rather explore a matter that seems to have concerned the committee during earlier testimony.

It is the suggestion that foreign base companies do not need deferral of U.S. tax on their unremitted trading profits in order to compete, since they must compete successfully to begin with to make those profits. This has a superficial logic, but it is a fallacy. The continued ability of any company to compete rests on what it does with its profits.

Those who support full taxation of cooperatives in this country do so partly because co-ops can run the taxpaying competition out of business by using their larger aftertax earnings to strengthen their distribution and sales activities. The same thing is true of U.S. sales subsidiaries in Switzerland and elsewhere that are facing a mounting number of similar sales subsidiaries set up by foreign competitors in low-tax countries such as Switzerland.

As the vice president for international operations of a west coast firm put it to me the other day:

> If my sales company in Zurich makes a $500 profit on the sale in France of a product from our U.S. plant, and my German-owned competitor across the street in Zurich also makes a $500 profit on the sale in France of his parent's product, and if he plows back all but 13 percent—representing the Swiss tax—of that $500 while I plow back what's left after a 52-percent U.S. tax, I won't stay in business very long.

Seen in this light, H.R. 10650 as now written, far from slowing U.S. erection of foreign plants, would actually create new pressures for their establishment by making export of finished U.S. products more difficult if not impossible. Adding to this danger is the fact that U.S. products, generally speaking, require greater expenditures in advertising, promotion, and selling in Europe than do European products because of such market factors as design and local consumer prejudices.

The chairman of this committee, you, Senator Byrd, following our testimony on 32 base companies, asked a very pertinent question, namely: What additional taxes would they have paid had H.R. 10650 been U.S. law? The answer which we, of course, forwarded to you

earlier, gives an indication of how section 13 as now written—with its extremely limited provision for reinvestment free of U.S. tax for base companies—would hurt the ability of these base companies to compete. These 32 earned about $53.7 million in 1959 and 1960 after payment of foreign taxes and dividends to the parent companies. Twenty million of this was invested in less-developed countries.

Under the new provisions, if all of this $20 million had come from dividends and interest paid by "related" companies in less developed countries, then only the remaining $33.7 million would be taxable in the United States—thus creating an additional tax of $11 million after allowing for the foreign tax credit. But, of course, the bulk of the $20 million came from sales income and/or income from industrial countries and would also be taxable under the new proposals.

If section 13 as now drafted is harmful to U.S. exports, U.S. jobs, and the U.S. balance of payments, what about the proposal now being talked about for an "escape hatch" to that section, which provides a sliding scale for required distribution of foreign earnings to the U.S. parent based on the amount of foreign taxes paid?

This proposal would be equally damaging to our national interest. It would torpedo our foreign sales subsidiaries' efforts to promote U.S. exports just as surely as would section 13 itself. And it flies in the face of the need for U.S. corporations to keep a good deal of their foreign earnings at the service of their international business at this critical moment in history.

As one top executive of a U.S. giant company put it:

> We have a respectable volume of business in Europe, but it's made up of many small sales of our various product lines; now that the Common Market is unfolding, we are facing European competitors backed by billions of dollars, with all that means in terms of financial resources, engineering, and service capabilities, and so on. If we don't expand our market penetration fast in Europe, we may be squeezed out altogether.

His remark could be echoed fervently by thousands of other U.S. firms; surely, this is no time to force U.S. subsidiaries abroad to pay high foreign taxes or bring home their foreign earnings when their parents do not need them.

Another suggestion has been that the power of the Treasury to reallocate income under section 482 should be strengthened, whether through a formula such as section 6 now provides or through some other formula. Any such formula, in our view, is bound to hurt many legitimate exporters. The first need is to make the sale, and this may occasionally require selling at or near cost. It is not rare for European firms to charge at or near cost from the producing division to the international division to the base company—leaving the latter, the base company, free to charge whatever the market demands, or will bear. Yet even today our companies are not permitted to sell at cost to their foreign sales subsidiaries even when an order depends upon it, whereas they could do so if they sold directly to the foreign unrelated buyer.

It could be argued that foreign sales subsidiaries, having received U.S. goods at low cost, would make and keep abroad an unconscionable amount of profits. This could be guarded against by a provision in

the code against unreasonable accumulation by foreign subsidiaries—which would also hit at sham or paper subsidiaries abroad.

But even here the dangers to our national interest are great: It would be hard to develop a formula of what is reasonable that would fit a wide variety of firms. Here, as in income reallocation, if anything is done at all it might best be limited to the compilation of a series of factors that the taxpayer, the Treasury, and the courts should consider. We should also make sure that the taxpayer does, in fact, have recourse to the courts.

What puzzles me, however, is how the notion gained currency that there is any crying need for reform in this area at all. In case after case that I know of, U.S. corporations have been reviewing their intercorporate pricing and charging policies to insure that they accurately reflect contribution to income; this penchant for accuracy has undoubtedly been strengthened by the new reporting requirements and by Treasury's avowed determination to use section 482 to the hilt.

As for unreasonable accumulation, I personally conducted a search in Switzerland a year ago of base companies that might have a few uncommitted funds lying about that could be put into short-term United Kingdom or other Treasury notes—and found absolutely none.

Putting all this together, it seems to me that the Treasury has set up its own Aunt Sally and is now busy trying to knock it down. What is needed is not new language on section 13 of this bill; rather, I would suggest that this committee put aside the foreign income provisions of H.R. 10650 for this year, take a good, hard look at the fundamental concepts involved—in terms of the national interest—and then, if it discerns a real need for reform that can be substantiated by facts, to set the able joint committee staff to drafting a bill that meets that need instead of striking a mortal blow at base companies abroad that are building U.S. exports, creating U.S. jobs, and swelling the inflow of urgently required foreign exchange.

The CHAIRMAN. Thank you, Mr. Haynes.

The next witness is Mr. Clarence F. McCarthy of Arthur Andersen & Co.

STATEMENT OF CLARENCE F. McCARTHY, PARTNER IN CHARGE OF TAX DIVISION, ARTHUR ANDERSEN & CO.

Mr. McCARTHY. Mr. Chairman and Senator Williams, my name is Clarence F. McCarthy of Wilmette, Ill. I am a certified public accountant and partner in charge of the tax division of Arthur Andersen & Co. Accompanying me are Gordon J. Nicholson, on my left, a CPA and partner in charge of coordinating all of our oversea tax departments, and Richard A. Hoefs, on my right, a CPA and manager in charge of coordinating our South American tax departments.

You will note at the end of my prepared statement that I have a technical supplement. I ask your permission to have that technical supplement incorporated in the record.

The CHAIRMAN. Without objection.

Mr. McCARTHY. Our firm is an international firm of certified public accountants organized as a partnership under the laws of the State of Illinois with its headquarters in Chicago, Ill. We have 31

offices in the United States and 24 offices in 19 other countries. The clients of our oversea offices include not only subsidiaries of U.S. corporations, but also corporations owned or controlled by shareholders who are nationals of countries other than the United States. We appear not on behalf of any client or group of clients, but solely as representatives of our firm.

My remarks will be restricted to the amendment recently proposed by the Secretary of the Treasury to section 13 of the pending tax bill.

Let us talk about base holding companies.

One of the apparent purposes of the proposed section 13 is to break up existing base holding companies and to deter the formation of any new ones. This will be accomplished by taxing to the U.S. parent corporation all undistributed net income of the base holding company.

The term "base holding company" is not used in proposed section 13. Let me define what I mean by it. A base holding company is one organized under the laws of a country with low tax rates and which in turn owns manufacturing and selling subsidiaries organized and operating in other foreign countries. Further, that base holding company actively manages and directs the operations of its subsidiaries from offices located outside the United States. In other words, it manages its business.

The principal advantages of a base holding company are these:

1. Proper line organization for supervision of international operations can be set up.
2. Foreign income taxes are saved.
3. More money is available either to plow back into the expansion of foreign operations or to pay up to the U.S. parent as dividends.
4. Averaging of foreign tax rates is achieved, so that maximum utilization can be made of the U.S. foreign tax credit upon payment of dividends to the U.S. parent.

Please note that this averaging could not otherwise be achieved until 1961 when the U.S. Internal Revenue Code amendment enacted in 1960 became effective and permitted the election of one overall limitation.

If this legislation is enacted, it is probable, very probable, that almost all such base holding company affiliated groups will be consolidated into one integrated foreign manufacturing and selling subsidiary. Why? Because proper line management of the operations will require that the former managing director of the base holding company continue to be able to directly control all manufacturing and selling operations. The effect of the consolidation of existing base holding company affiliated groups will be the payment of more foreign income taxes, less money available for expansion of foreign sales, less dividends to the U.S. parent, and less U.S. income taxes (the increased foreign taxes in most instances will be at an approximate rate of 52 percent).

Let us talk about trading companies. The proposed section 13 will tax U.S. shareholders on the undistributed income of controlled foreign trading companies. This result is accomplished primarily by including in foreign base company income (which is a part of subpart F income) "foreign base company sales income." In substance, this term is defined as being the purchase of personal property which has

been manufactured or produced in one country by a related person and then sold to or through a related trading company for use or consumption outside the country of manufacture or production. It would also apply where a controlled foreign corporation makes purchases in a foreign country from strangers on behalf of a related person, where the products are to be used outside of the country in which they were originally manufactured or produced.

This proposed section seems to assume that there is something wicked about all foreign trading companies and that all of them have been set up as tax haven devices to save U.S. taxes. Nothing could be further from the truth.

Broadly speaking, there are two categories of trading companies: (1) those set up as direct subsidiaries of U.S. corporations to sell the exports of the U.S. corporation and sometimes also to act as a purchasing agent for imports of the U.S. corporation, and (2) those set up either as direct subsidiaries or as sister corporations of foreign manufacturing companies.

Before getting into a discussion of the first category where the foreign trading company is a direct subsidiary of the U.S. parent corporation and is organized to handle exports of that corporation, I wish to dispose of a preliminary question. That is, why not sell U.S. exports directly in Europe to unrelated distributors? American businessmen have found that in order to develop any appreciable volume of export sales in countries some 3,000 miles away, it is necessary to use sales employees under U.S. control and direction, headquartered in an office in the area to be served, and preferably having a stock of goods on hand from which orders can be promptly filled. This means to have any real volume of export sales in Europe, a U.S. manufacturer must have an office there. That office must be set up either as a branch or as a subsidiary company.

There are many nontax reasons for setting up that office as a foreign trading company rather than a foreign branch of the U.S. parent manufacturing corporation. The company laws of almost all countries require that upon the establishment of a branch of a foreign corporation, namely, United States in this case, copies of the charter and bylaws of that foreign corporation, together with other financial data of the entire corporation, must be filed with a Government official and that either digests or the full text thereof then be published in newspapers within the country. In a number of countries, Norway for one, the stationery and invoices of a branch of a foreign corporation must indicate that the corporation is foreign, and it is not Norwegian, and that hurts.

In Brazil, and a number of other countries, financial statements showing the results of operation, not only of the branch in São Paulo, for example, but also of the entire corporation, must be published. In France, if the manager of the French branch of the U.S. corporation or any other corporation foreign to France, is a French national, then the president of the U.S. corporation must obtain a commercial card in order that the branch can engage in business. These are but a few unfavorable factors arising from setting up a branch in a foreign country. They can be obviated by setting up a foreign subsidiary, and that is why you find so many foreign subsidiaries.

Many foreign trading companies are set up with their headquarters in Switzerland, as you Senators have heard, and from the central office there salesmen go out into the Common Market and the Outer Seven soliciting orders for U.S. exports. We have heard the allegation that the principal purpose of setting up these foreign selling subsidiaries and locating them in Switzerland is to save U.S. taxes. No, the principal purpose for creating such a subsidiary is to increase U.S. exports, and the reasons for choosing Switzerland in preference to other continental European countries are these:

1. It is centrally located with excellent train and air transportation.
2. Its currency and government are stable.
3. Income taxes of other European countries are saved, which in turn produces more U.S. taxes both on dividend remittances and on the additional income generated in the States through the increased export sales. (If the trading company were set up, for example, in France, there would be no U.S. income tax payable on dividend remittances because of the high effective French tax rate of 57½ percent, and the interplay of our foreign tax credit.)

Let us turn now to trading companies organized as subsidiaries of foreign manufacturing companies, or as sister companies of such foreign manufacturers, for the primary purpose of selling abroad, outside the States, the products of those foreign manufacturers. Such trading companies again are organized in many instances for nontax reasons, but in some other instances are organized to save taxes—not U.S. taxes, but foreign taxes. We submit: What is reprehensible about a German manufacturing company setting up a trading company under the laws of Switzerland with its headquarters in Zurich to sell the products of that German manufacturing company throughout Europe? Certainly taxes are saved, but those taxes are German taxes, as Germany taxes the global net income of its entities, just like we do. The only effect is that, when the oversea earnings of these foreign subsidiaries are brought back to the United States, there will be more of them here and more U.S. tax to be paid.

The proposed taxation of oversea trading companies will prevent a Mexican manufacturing subsidiary of a U.S. company from selling to subsidiaries or sister companies organized in South America for resale by such companies. As another example, and I was just down there a month ago, Uruguay is a very small country in South America with almost no industry and one which has attempted to set itself up as the banking center of South America. If a U.S. corporation in the interest of carrying out the expressed foreign policy of the Alliance for Progress were to set up a manufacturing company in Montevideo, quite probably there would not be enough sales potential in all of Uruguay to make it economical to manufacture for sales only within that country. It would be necessary to also sell in Argentina across the river, and in Brazil to the east. If such selling were made to or through an Argentine subsidiary or a Brazilian subsidiary or sister company, the provisions of this suggested revised section 13 would come into operation. If, instead, branches were set up, for example, in São Paulo and Buenos Aires, then again the Commissioner would have the right to assert that such branches were operating in the same manner as trading companies and, therefore, the same rules should apply.

Those provisions of section 13 as suggested by the Treasury Department which pertain to the income of trading companies organized to sell products of foreign manufacturing subsidiaries of U.S. corporations, in our opinion, will—

1. In the case of trading companies operating in Europe or other developed areas, cause them to be merged into affiliated manufacturing companies with a resulting increase in foreign taxes, probably a decrease in sales of foreign goods arising from consolidation of all operations into one location, and a decrease in U.S. income taxes.
2. Make it more difficult for U.S. industry to assist in the modernization of underdeveloped countries, and probably deter some from going into such areas.

Proposed section 954(d)(2) authorizes the Internal Revenue Service to treat the income of a foreign selling branch of a controlled foreign manufacturing company as taxable foreign base company income to the same extent as if such branch were a trading subsidiary. Whenever the branch income of that foreign manufacturing company does not bear a tax of at least approximately 52 percent, the Internal Revenue Service is almost certain to treat it as a trading subsidiary. The effect will be, for example, to deter a U.S.-controlled Mexican manufacturer from setting up a selling branch in Venezuela to sell not only there but in Colombia and on the west coast of South America. In a nutshell, this provision will interfere with normal business decisions, will cause some existing branches to be abandoned with a resulting decrease in foreign sales, and will deter U.S. businesses from setting up manufacturing subsidiaries in any underdeveloped country which does not itself provide a sufficient potential market for the product. Further, any contraction in business of a foreign manufacturing subsidiary of a U.S. corporation usually means a contraction in sales of raw materials, partly finished goods, and accessories by the U.S. parent to its foreign subsidiary.

Let us talk about foreign corporations not availed of to reduce taxes. Under proposed section 954(b)(4) the Commissioner of Internal Revenue is given the power to determine that an item of income received by a controlled foreign corporation will not form a part of foreign base company income if "with respect to such item * * * the creation or organization of the controlled foreign corporation receiving such item under the laws of the foreign country in which it is incorporated does not have the effect of substantial reduction of income, war profits, excess profits, or similar taxes."

In application this exception will prove to be almost meaningless. It undoubtedly will be applied by the Commissioner only when the foreign corporation is a direct subsidiary of the U.S. parent and the effective foreign tax rate for foreign tax credit purposes is 52 percent or more. If a foreign manufacturer set up a plant in a depressed area of a European country, such as in Italy, Northern Ireland, Ireland, or Spain, and there received tax concessions, and if that manufacturing company happened to have some third country sales so that it had 20 percent or more of its income in the form of foreign base company sales, quite probably the Commissioner would not apply this exception because the overall foreign tax rate would be less than 52 percent. If the foreign manufacturer set up trading subsidiaries to

save foreign taxes, undoubtedly the Commissioner would not invoke this exemption.

If subpart F is to be retained, it would be much more equitable to provide that it shall not apply to any item or type of income if the purpose or the result of effecting the transaction to earn the income, including any series of transactions starting with the organization of the corporation, was to save foreign taxes or was primarily motivated by business considerations.

We believe the present law is sufficient to correct any abuses which may exist. Under the present rules, every foreign corporation must have substance and serve a business purpose. Otherwise, it will be treated as a sham, and its separate entity will be ignored for U.S. tax purposes. Mr. William H. Loeb, Assistant Commissioner of Internal Revenue for Compliance, in a speech before the American Management Association on April 25, 1962, stated that the Internal Revenue Service has been quite successful in the courts when it has been shown clearly that a particular organization serves no business purpose other than the elimination of U.S. taxes. He is quite correct. Further, in the case of intercompany sales the Commissioner has the authority under section 482, as presently written, to allocate gross income, deductions, credits, or allowances in order to clearly reflect the income of any related organization. In regulations promulgated only 2 months ago, he has adopted the arm's-length dealing principle.

The information returns as to controlled foreign corporations required by 1960 legislation (sec. 6038 of the code) are just now beginning to be filed with the Internal Revenue Service, because the amendment became effective only for taxable years beginning in 1961, and it happens to be the practice of our firm, and most large public accounting firms, to obtain extensions of corporate returns until at least June 15, so that most of these returns have just been filed.

Mr. Loeb stated that the absence of adequate information has been the principal stumbling block faced by the Internal Revenue audit people in enforcing compliance with the present laws. That stumbling block no longer exists, if it every did.

Enactment of the proposed restrictions on foreign trade contained in revised section 13 will not be fully implemented until regulations are issued by the Internal Revenue Service. In a large number of instances—I am told it is 17—the Commissioner has been delegated the task of providing the applicable rules. It is almost 8 years since the 1954 code was enacted, and we still do not have all the regulations. To flourish, business needs as much certainty as possible with respect to all applicable tax rules. The proposed legislation is novel and complex. Much litigation is bound to occur, and there will be no certainty on the tax rules for many years to come.

We respectfully submit that it would be best to postpone action on the pending tax bill until the Internal Revenue Service has had an opportunity to determine whether or not the information they are now receiving for the first time, when coupled with existing provisions of our laws, is sufficient to prevent abuses.

On the other hand, although we believe, in all sincerity, no new legislation is needed at this time, if this committee becomes convinced that additional legislation is needed, then we suggest that substantially

all alleged abuses could be reached by two relatively simple additions to the code:

1. Amend section 482 by inserting a new subsection to the effect that the separate entity of a mere investment or holding company organized under the laws of another country can be ignored where it is formed or availed of for the principal purpose of avoiding U.S. income taxes and not for the active conduct or management of a business or the business of controlled subsidiaries. Such a provision would codify and, perhaps, strengthen, the existing judge-made law pertaining to sham corporations. Further, this amendment would be in lieu of section 482(b) proposed in section 6 of the pending bill, and on which in a previously filed written statement we have expressed our adverse views.

2. Amend section 531 of the code to tax to controlling U.S. shareholders their pro rata share of any undistributed income of a foreign corporation formed or availed of to avoid U.S. income tax by failing to distribute dividends to its U.S. shareholders where the earnings and profits have been permitted to accumulate beyond the reasonable needs of the business and are available for distribution either from it or controlled subsidiaries.

Thank you, sir.

The CHAIRMAN. Thank you, Mr. McCarthy.

(The technical supplement previously referred to follows:)

SUPPLEMENT TO STATEMENT OF CLARENCE F. MCCARTHY, PARTNER IN CHARGE OF TAX DIVISION, ARTHUR ANDERSEN & CO.

If the Senate Finance Committee, contrary to our respectful recommendation, decides to go forward with adoption of the revised section 13 proposed by Secretary Dillon, then we submit for consideration the following additional points, most of which are technical in nature. The subjects discussed hereinafter are:

Earnings and profits.
Deficits in earnings and profits.
Source of income.
Dividends and interest from less developed country corporations.
Investment of earnings in U.S. property.
Blocked foreign income.

Section 962(a). Earnings and profits

To determine earnings and profits of a year and accumulated earnings and profits of a number of years according to rules applicable to the U.S. corporations, will produce U.S. taxation of nonexistent income.

The U.S. rules ignore inflation which has been much more rampant in foreign countries than it has been here. Inflation enters into the calculation of depreciation and through the pricing of inventories enters into the determination of cost of goods sold. U.S. tax rules are based upon historical original cost. Applying such rules to a country such as Brazil at the present time or for the past number of years can result in a determination of a plus amount of earnings and profits whereas in fact there may have been an economic loss.

Further, the use of U.S. rules ignores the fact that many methods for pricing inventories are required or permitted under the laws of foreign countries which are not permitted here under our tax laws and in many instances do not represent sound U.S. accounting practice. A base stock method was in use in France until the end of 1959 and is probably still used in many countries around the world. Such a method is not permitted under the U.S. Internal Revenue Code and the regulations.

There are also many types of reserves required or permitted under the laws of foreign countries. In the case of certain types of manufacturers, France permits a deduction both on the books and for tax purposes of a reserve for price variations. No such reserve is permitted here. Most civil-law countries require the establishment of a "legal reserve." Annually out of net income

companies must provide to such a reserve an amount equal to a specified percentage. The rate in France and most other countries is 5 percent. Such a reserve is unknown in the United States. There are also various types of reserves for employee fringe benefits, such as termination pay, which would not be recognized here under U.S. tax rules.

It would be better to provide that earnings and profits shall be the amount of taxable net income reported to or determined by the foreign government plus tax exempt income such as dividends and interest and minus nondeductible losses or expenditures incurred or accrued, using U.S. principles for the determination of accrual. In the case of a foreign country using a schedular method of income taxation, aggregate taxable net income with similar plus and minus adjustments could be used.

Section 952 (c) and (d). Deficits in earnings and profits

The subpart F income of any controlled corporation for a particular taxable year is not to exceed the earnings and profits of such corporation for that year reduced by deficits in earnings and profits of that same corporation for years beginning in 1963 and thereafter. Then section 952(d) provides that if a U.S. shareholder owns stock of a controlled foreign corporation and through the ownership of such stock is deemed to own stock in another foreign corporation, then any deficit in earning and profits of that second controlled foreign corporation should be used to reduce the earnings and profits of the first controlled corporation to determine its subpart F income.

There is no provision for an accumulation of deficits of the second foreign corporation to reduce earnings of the first foreign corporation where that first foreign corporation has one or more deficits in the intervening years. Further, it would seems equitable to provide that, in the case of each U.S. shareholder, he can aggregate all deficits and earnings and profits of all controlled foreign corporations to reduce aggregate subpart F income of all controlled foreign corporations.

Sections 957(c), 955(c)(1). Source of income

In the case of a corporation organized in U.S. possessions, or in the Commonwealth of Puerto Rico, the determination as to whether income was derived from sources within the possession or the Commonwealth, as the case may be, is to be made under regulations prescribed by the Secretary or his delegate. The Internal Revenue Code presently contains some rather well settled rules as to the source of income which are contained in sections 861 through 864. It would seem inadvisable to permit the Commissioner by regulations to promulgate other rules which, in turn, will require many years of litigation thereafter to settle their validity. In the meantime, businessmen operating Puerto Rican corporations or corporations organized under the laws of possessions will not know the tax rules applicable.

Again in section 955(c)(1) pertaining to the definition of a less developed country corporation, the Commissioner is to be given the authority to prescribe by regulation the rules to determine whether income is derived from sources within a less developed country. The same objection is pertinent.

Section 954(b)(1). Dividends and interest from less developed country corporations

Under this provision dividends and interest are taken into account in the gross amount, and the gross amount thereof must be reinvested in less developed country corporations in order that the dividends and interest may escape inclusion in subpart F income. It would seem that in determining the amount of the reinvestment there should be taken into account any foreign income taxes withheld on the dividends and interest and any expenses of the recipient directly attributable thereto.

Section 954(b)(5). Deductions

Under this paragraph the Secretary or his delegate is to prescribe regulations so that there may be taken into account deductions (including taxes) properly allocable to foreign personal holding company income, foreign base company sales income, foreign base company services income, and gross income to which section 954(b)(3)(B) applies. What types of deductions? Deductions ascertained under U.S. commercial accounting principles? Deductions ascertained under U.S. tax principles? Confusion will be to a major extent eliminated if deductions allowable under the income tax laws of the particular foreign country are those that are taken into account. Further, it should be made clear that all foreign taxes are to be taken into account.

Sections 952(b), 956, and 951(a)(1)(A). Investment of earnings in U.S. property

In the case of a foreign corporation not engaged in trade or business in the United States, section 881 of the present code imposes a 30-percent tax on amounts received from sources within the United States as interest (except interest on deposits with U.S. banks), dividends, rents, and other designated amounts. Under section 954(c) of the Treasury Department's proposal these amounts of dividends, interest, and rent then become personal holding company income and in turn part of foreign base company income under proposed section 954(a). Foreign base company income under proposed section 954(a) consists of foreign personal holding company income, foreign base company sales income, and foreign base company services income. Under proposed section 954(b)(3), if the total foreign base company income is less than 20 percent of gross income, the foreign base company income may be disregarded and results in no tax consequence to the U.S. shareholder.

Proposed section 951(a)(1)(B) taxes to a U.S. shareholder of a controlled foreign corporation his pro rata share of that foreign corporation's increase in earnings invested in U.S. property for such year.

These provisions taken together mean that a controlled foreign corporation in effect pays a tax of 52 percent on money invested in the United States and then has 48 percent left over for such investments. After the investment is made the U.S. Government obtains a 30-percent withholding tax on dividends and interest remitted abroad; and then finally there is imposed a 52-percent U.S. tax on that portion of the dividends and interest remaining after deduction of the 30-percent withholding tax and any foreign income taxes.

The effect of these provisions, of course, will be to influence a controlled foreign corporation to invest its surplus funds outside the United States and will, to that extent, adversely affect the balance of payments. If the intent of taxing any increase in investment in U.S. property is to tax disguised dividends, it seems that it might be a preferable substitute to treat any loan by a controlled foreign corporation, investment in stock of the U.S. parent corporation or a domestic subsidiary thereof, or the purchase of property in the United States for rental to the U.S. parent corporation or a domestic subsidiary thereof, as being in substance the payment of a dividend.

Section 956(b)(2)(C) treats as an investment in U.S. property, the ownership by a controlled foreign corporation of any obligation of a U.S. person arising in connection with the sale of property, if the amount of the obligation outstanding at any time during the taxable year exceeds the amount which would be ordinary and necessary to carry on the trade or business of both the controlled foreign corporation and the purchasing U.S. person had the sale been made between unrelated persons. Technically this means that on a credit sale by any foreign corporation to a related U.S. corporation, even at an arm's length price, a part of the debt or the account receivable by the foreign corporation will be an investment in U.S. property if a stranger might have paid all or part of the purchase price in cash immediately. This provision has the effect of deterring imports into the United States from foreign subsidiaries of U.S. corporations. Perhaps this result was intended. However, various officials of the Department of Commerce and of the Department of State have stated that the economy of the United States is dependent upon certain imports, principally raw materials not available in the United States. To the extent that such necessary imports from abroad are made by a controlled foreign corporation to a U.S. corporation for use by it in domestic manufacturing or assembling, it would seem that a harsh penalty is involved in this proposed section.

Section 962(b). Blocked foreign income

The Secretary or his delegate is to prescribe regulations setting forth the circumstances under which blocked foreign income shall not be included in the earnings and profits of a controlled foreign corporation, if it is shown that such income could not have been distributed to U.S. shareholders "because of currency or other restrictions or limitations imposed under the laws of any foreign country."

The Congress of Brazil presently has pending before it a bill which would levy a substantial amount of additional income and excess profits tax on the earnings of any Brazilian company which are not reinvested in Brazil. The effect of such a bill would be to discourage the payment of dividends. How-

ever, the bill in and of itself does not prevent the payment of dividends. Other countries experiencing balance of payment difficulties may well adopt this approach of Brazil. This point should be covered if this portion of the bill becomes law. Further, it should be made crystal clear that if dividend distributions can be made only in a foreign currency and only for deposit and utilization within the foreign country, then such foreign currency should be deemed to be blocked.

The CHAIRMAN. The next witness is Mr. F. V. Olds of the Chrysler Corp.

Mr. Olds, you take a seat, sir, and proceed.

STATEMENT OF FRANK V. OLDS, ASSISTANT COMPTROLLER, CHRYSLER CORP.

Mr. OLDS. Thank you, Senator Byrd and Senator Williams. My comments are going to come within the scope of your limitations of 10 minutes. I think it will be 9 minutes, Senator Byrd.

The CHAIRMAN. Fine.

Mr. OLDS. I have with me here Brian T. O'Keefe, manager of taxes of Chrysler Corp.

My name is Frank V. Olds. I am assistant comptroller for Chrysler Corp.

I appreciate this opportunity to appear before you to present our views in opposition to section 13 of H.R. 10650 for the current taxation of foreign-source income. Our objections apply to the original Treasury proposal, the presently proposed amendments, and, to a lesser degree, to the version passed by the House Ways and Means Committee.

No amount of revision (such as that suggested by the Treasury on May 31, 1962) can correct the fundamental economic fallacy on which this proposed legislation is based; that is, that it is detrimental to the economic welfare of the United States to merchandise abroad through a foreign trade company.

As a company engaged for many years in most phases of foreign commerce, we consider it our duty to state that section 13, either in its present form or with the Treasury's proposed revisions, would not be beneficial, but would, in fact, be injurious to the economic welfare of the United States. We believe that this committee is entitled to have all of the economic effects of this proposed legislation presented to them.

Arguments advanced by the proponents of section 13 are that it will:

1. Ease the balance of payment deficit;

2. Provide additional tax revenue to pay part of the cost of the investment credit; and

3. Retain jobs in the United States.

Even the revised proposal before you cannot, and will not, accomplish any of these objectives. On the contrary, if enacted, it would reduce U.S. jobs and tax revenues and increase the balance of payments problem.

Under the Treasury's revised section 13, U.S. tax would apply immediately to the trading profits of the marketer who sells in the foreign market products manufactured in the United States with high-paid American labor. Higher U.S. tax costs would be added to higher labor costs, transportation costs, foreign import duties, registration

fees, etc. As a result of this added financial burden, the marketer's competitive position would be adversely affected with the natural result that his business would decrease—decreasing also U.S. exports, jobs, et cetera. Such tax would apply irrespective of whether such profits were reinvested in the same business or a new business established in either the same or in other developed or less developed countries.

Proposed section 954(b)(4) provides an exemption if the foreign corporation can show that its use does not have the effect of reducing taxes, including foreign taxes. Therefore, if the use of a foreign trading corporation resulted in the avoidance of foreign taxes, the U.S. shareholder would be currently subjected to the higher U.S. tax rate. This provision encourages the payment of the foreign tax in order to avoid the higher U.S. tax. United States tax law should permit taxpayers to conduct their affairs at the lowest tax cost. This is especially true when the taxes minimized are those of foreign countries. If such legislation is enacted, a point in time may be reached where the United States would receive no tax revenue from foreign operations because of the foreign taxes equaling or exceeding the U.S. tax rate. Surely we must recognize that this course of action will neither increase U.S. tax revenues nor will it alleviate the balance of payments problem.

Chrysler Corp. is proud of its record as an exporter. We believe that our accomplishments in securing and retaining as large a foreign market as we can for U.S. produced products, in the face of ever-increasing foreign competition and foreign limitations and tariffs on imports, is in the national interest. We believe that there is a basic inconsistency in the Treasury espousing the investment credit to improve the competitive position of U.S. produced goods and, at the same time, urging the accelerated taxation of foreign trading profits, which would provide a serious competitive handicap for those same goods.

Nor do we believe that restrictions should be placed on the investment privileges of a corporation such as proposed section 954(b)(1) would provide. However, if the committee believes that it is desirable to have some limitations requiring reinvestment in less developed countries, we see no basis for a strict time limitation on such reinvestment as the 1 year provided in section 955(b)(3). An investment should qualify irrespective of the time made and a system of tax credits could be provided for qualified investment made after the tax return for the taxable year has been filed.

The Treasury has apparently taken the position that manufacturing abroad is more beneficial to our economy than trading abroad through foreign subsidiaries. This is true, only to the extent that it is the only natural economic means of doing business abroad, but it is not a substitute for exports. To further encourage exports from the United States, we recommend, at a minimum, that the 14-point tax incentive available to Western Hemisphere Trade Corp. be extended to U.S. corporations doing business anywhere in the world.

The fruits of our efforts over the years are best summed up by the testimony of Philip N. Buckminster of this corporation before the House Ways and Means Committee (vol. 4, p. 3301, of the June 1961, hearings before the Committee on Ways and Means):

Sales of U.S. vehicles abroad in the 10 years prior to 1958 steadily declined. Since 1958 and the establishment of Chrysler International in Switzerland, we have begun to reverse that trend for U.S.-built Chrysler products. In 1959,

excluding cars exported to Canada, we exported about 16,000 cars from the United States. In 1960, we exported some 26,000 cars. Truck exports rose from 15,000 units in 1959 to 22,000 units in 1960. With these gains, our products also achieved an increase in the percentage of U.S. exports. In 1961, we expect to do as well as or better than we did in 1960. These exports, of course, create U.S. jobs which would otherwise go to foreign competitors and in addition preserve existing jobs that might be lost * * *.

For the 1962 model year, our exports from the United States, other than to Canada, will be approximately 38 percent higher than they were for the 1961 model year. This is an increase of some $20 million which will have a favorable effect upon the balance-of-payments position of the United States.

Section 61 gives the Commissioner the power to tax income to the taxpayer which earned it and thereby disregard the corporate entity of sham operations; section 482, as amended by section 6 of H.R. 10650, would provide adequate means for reallocating income and deductions between related taxpayers; and section 6038 provides the Commissioner with the information needed to effectively apply sections 61 and 482. These sections allow the collection of taxes properly due to the U.S. Government.

In conclusion, the United States is suffering, not only from the strain of meeting the Russian economic and political threat, but from a vigorous competitive effort by the Western World, particularly the Common Market countries. This competition is aided to a substantial degree by tax and trade incentives granted by other governments to their businesses. The U.S. Government must cooperate with U.S. business in meeting these challenges so that the opportunities and benefits of maintaining a strong and growing position in international markets, including exports, may be realized.

Thank you, very much.

The CHAIRMAN. Thank you, Mr. Olds. I congratulate you on increasing your exports.

Mr. OLDS. We hope to do that more and more, Senator, and I think that is the only solution for our balance-of-payments problem. Some of the proposals that are made here are going to do, as I have said in my statement, just the reverse because our only solution really is to export more and more from this country and, in that way, I think we will improve our balance of payments.

Thank you.

The CHAIRMAN. The next witness is Mr. Daniel Dechert, American Chamber of Commerce of Italy. Take a seat, sir, and proceed.

STATEMENT OF DANIEL ORVILLE DECHERT, AMERICAN CHAMBER OF COMMERCE FOR ITALY AT MILAN

Mr. DECHERT. Mr. Chairman, Senator Williams, my name is Daniel Dechert. I am a member of the bars of the District of Columbia, the Commonwealth of Virginia, and the State of New York, and I am appearing on behalf of the American Chamber of Commerce for Italy.

I appreciate very much the permission to make some remarks to the committee on sections 13, 15, 16, and 20 as covered by the Treasury's draft of statutory language of proposed amendment, with accompanying explanations.

I wish to direct your attention mainly to section 13.

I submit that section 13, entitled "Controlled Foreign Corporations" is unconstitutional.

Section 13 of the Treasury draft still imputes to U.S. shareholders owning directly or indirectly 10 percent or more of the shares of stock of a controlled foreign corporation a liability for Federal income tax, on their pro rata shares of specified types of undistributed income of such foreign corporations. Therefore, section 13 of the Treasury draft, like section 13 of H.R. 10650 as passed by the House, contains provisions which would render it unconstitutional, and for this reason alone it is submitted that neither the Treasury draft, the section as now contained in the bill, nor any substitute imputing tax to the U.S. shareholders of a given percentage of stock of a foreign corporation merely because it is under the control of shareholders in the United States, should be approved by this committee.

The proponents of the provisions seem to rely on the decision of the Court of Appeals for the Second Circuit in *Eder* v. *Commissioner* (CA 2, 1943) 138 Fed. (2d) 27, decided in 1943, for the proposition that the ownership of stock in a controlled foreign corporation can justify attribution of pro rata shares of the foreign corporation's income to each U.S. shareholder who owns at least 10 percent of the stock. The *Eder* case involved Federal tax legislation of 1938 taxing U.S. shareholders, if constituting a described kind of restricted group and owning more than half in value of the shares of a foreign corporation the predominant income of which was passive income, such as dividends and interest, on their portions of the undistributed net income of such a foreign company which had so little substance from a business viewpoint that the court described it as an "incorporated pocketbook." The question of unconstitutionality of the statute was not even raised, in fact was expressly waived, by the plaintiffs in the *Eder* case, who argued solely that they could not be taxed on foreign income which could not be converted into dollars because of restrictions of foreign exchange control.

The committee report which accompanied the first enactment in 1937 of these provisions clearly shows that the tax was not to apply to a real foreign operating company. When the *Eder* case is analyzed in the light of the Supreme Court decisions concerning constitutionality, it is clear that it cannot be construed as a precedent for taxing the income of foreign operating companies to their U.S. shareholders.

The 16th amendment to the Federal Constitution empowering Congress to tax without apportionment incomes from whatever source derived, was adopted in 1913 as a consequence of the decision of the Supreme Court in *Pollock* v. *Farmer's Loan and Trust Company* (1895), 157 U.S. 429. In this case the Court held that a Federal taxing statute which applied to income from real estate was in effect a direct tax on the real estate, and accordingly, under the Constitution, had to be apportioned among the States in accordance with their population. Even after enactment of the income tax in 1913, the Supreme Court decided in 1920, in *Eisner* v. *Macomber* (1920), 252 U.S. 188, that Congress nevertheless had no power to tax without apportionment as income of the stockholder, a stock dividend of common stock on common stock, or the accumulated profits underlying it. The essential reason stated by the Court was that the stockholder had

received nothing out of the company's assets for his separate use and benefit, and had therefore obtained nothing that met the definition of income within the meaning of the 16th amendment.

In 1931, the Supreme Court, in a decision involving a taxing statute of the State of Wisconsin, *Hoeper* v. *Commissioner* ((1931), 284 U.S. 206), declared that an effort by a State government to tax A on the income of B was arbitrary, invalid, and in violation of the due process and equal protection clauses of the 14th amendment.

The Court of Appeals for the Second Circuit decided the *Eder* case in 1943 without reference to this background of Supreme Court decisions. In the *Eder* case, as indicated, the taxpayers, three members of the same family who owned a controlling stock interest in a foreign investment company, did not contend that the statute attributing tax to them on their shares of the corporation's income was unconstitutional as a tax against them on the income of the foreign corporation. Instead, they merely claimed that as Colombian exchange restrictions prevented distribution in dollars of the undistributed part of the company's income, the statute did not apply to them, on the theory that there was no constructive receipt by them of the income. The court rejected this argument on the ground that Congress had mean to deal harshly with such an "incorporated pocketbook"; and then itself gratuitously announced by way of a dictum, quite unnecessary to the decision of the case, that such an interpretation of the statute did not make it unconstitutional.

In addition to the *Eder* case, the proponents of section 13 seem to rely on *Helvering* v. *National Grocery Co.* ((1938), 304 U.S. 282), in which the Supreme Court rejected the taxpayer corporation's argument that the penalty tax against a corporation for accumulating profits for the purpose of avoiding surtax on its shareholders could not be applied to it because it had been organized for a legitimate business purpose. The Court found that a purpose existed to avoid surtax on the sole shareholder by causing the company to accumulate profits. By way of dictum, the Court said that "the sole owner of the business" could not prevent Congress from taxing him on the year's profits if it chose to do so. In this connection, however, it cited previous Federal tax acts, all antedating 1921, imposing tax on shareholders where corporate profits were accumulated for the purpose of preventing the imposition of surtaxes on shareholders.

Senator WILLIAMS. Mr. Dechert, would you yield for a question?

Mr. DECHERT. Yes, sir.

Senator WILLIAMS. I am going to make a friendly suggestion. If you wish to complete your testimony and read it you may do so. But may I call attention to the fact that this is a legal memorandum which we naturally would have to submit to the staff of the committee, and your analysis and your recommendations, are being made to two members of the committee, neither of whom is a lawyer, so I am wondering if in the interests of conserving your time it would not be just as well to present your statement for the record. But if you want to read it, you may do so. But as two nonlawyers, I am wondering how much we will really be able to follow the legal aspects.

Mr. DECHERT. Very well. You will put it in the record?

Senator WILLIAMS. Oh, yes, the whole statement will be put in the record, and I will be very interested in what our staff would have to say about it.

Mr. DECHERT. Very well. Of course, I accept the suggestion, Senator.

My second point is that the enactment of section 13 would conflict with treaty obligations of this country. Do you wish me to read any part of that, or would you like for me to submit it?

Senator WILLIAMS. I merely call your attention to the fact that you are discussing with two nonlawyers something which is a legal problem.

Mr. DECHERT. My principal contention is that the tax conventions to which this country is a party include the principle that the United States will not tax a corporation of the other nation except on income from sources within the United States, including industrial and commercial profits allocable to any permanent establishment in the United States; and that it will not tax its own citizens, residents, and corporations on the income of the corporations of the other nation until it is actually received as a dividend. That is the main point there, Senator.

This clause, I contend, envisages items of realized direct income, and not income of the sort envisaged by section 13 of the bill which, of course, is income that would not even be distributed when subjected to tax in this country because of imputations to 10 percent or more American shareholders.

In that connection I should like to quote a mere sentence from a recent legal opinion rendered to the American Chamber of Commerce for Italy by a committee composed of five eminent Italian lawyers in regard to section 13, showing the way that the European lawyers react to the proposals contained in section 13, and I quote:

> The different rules proposed in the bill pending before the Parliament of the United States, therefore, amount to a unilateral modification of important premises of the treaty, on which the Italian Government was definitely relying when negotiating and signing the treaty.

Then I next quote in the statement from a cablegram sent by the American Chamber of Commerce at Belgium to the chairman of this committee last March which reflects the same viewpoint of Belgian lawyers and, thereafter, I quote from a communication to the chairman of the committee from the American Chamber of Commerce in London which shows that the English, who have had the longest and most complicated experience in international trade and in matters of international taxation, have broadly two ways in which a United Kingdom corporation may do business abroad:

(*a*) Through a branch operation abroad; and

(*b*) Through a foreign subsidiary.

In case (*a*), the United Kingdom corporation is fully subject to United Kingdom tax on branch profits, whether remitted or not. In case (*b*), it is only liable to the extent of dividends paid by the foreign subsidiary. In common with most nations, the United Kingdom recognizes that the foreign subsidiary constitutes a separate legal entity outside its jurisdiction.

The enactment of section 13 would involve the de facto invasion of the jurisdiction of the 44 foreign nations or governments with which we have income tax conventions, as well as that of the Latin American countries which are signatories of the Charter of the Organization of American States.

I repeat very briefly what a preceding witness has said this afternoon, that in order that the United States collect the full tax to which it is entitled on income pertaining to various transactions in the international field, it appears to be necessary only that the existing provisions of section 482 of the Internal Revenue Code be made stringently enforced without amendment of such section, even if such enforcement involves some additional work for the Internal Revenue Service.

I expatiate on that in the paper, citing cases which applied the section very broadly.

Then, my third main point is, that there are additional elements of doubtful constitutional validity in the Treasury draft through (1) the discrimination in tax against U.S. shareholders in controlled foreign corporations deriving certain types of income in so-called developed foreign countries as distinguished from those deriving certain types of income from less developed countries, and as contrasted with controlled corporations in the United States, et cetera (sec. 951).

(2) The delegation of the taxing power to the President by authorizing him to designate from year to year less-developed countries and thus vary the tax on U.S. shareholders (sec. 955(c)(2)).

(3) The delegation to the Secretary of the Treasury or his delegate of the power to determine whether income is from sources in a less-developed country as distinguished from sources in a developed country or the United States merely by prescribing regulations (sec. 955(c)). These regulations may differ from the rules for determining income from sources within or without the United States prescribed by Congress in sections 861 and 862 of the Internal Revenue Code.

(4) The delegation to the Secretary or his delegate of the power to determine whether a U.S. shareholder will be subject to the presently applicable tax or the proposed tax by deciding whether the creation of a controlled foreign corporation, receiving an item of income that would otherwise be base company income, does not have the effect of a substantial reduction of income, war profits, excess profits, or similar taxes (sec. 954(b)(4)).

(5) The delegation to the Secretary or his delegate of authority to issue regulations requiring each person who is or has been a U.S. shareholder of a controlled foreign corporation to maintain such records and accounts as may be prescribed by such regulations as necessary for the imposition of the proposed tax (sec. 962(c)).

This is stipulated despite the fact that a U.S. shareholder is to be subject to the tax only if he has an interest of at least 10 percent of the stock in the controlled foreign corporation; and a U.S. minority stockholder may not be able under the laws of the foreign country to obtain from a corporation organized thereunder the information concerning its operation, the resulting income or loss, and the disposition of the income, that would be necessary for the shareholder in the United States to comply with such regulations.

Then, as to section 16, I think section 16 is discriminatory in treating gain from the sale of stock in controlled foreign corporations, which is really a capital asset, as if it were ordinary income, and the section is so closely related to section 13 that it is submitted that it should fall with the other section.

In conclusion, I should like to repeat, with modifications, what I said to the committee on May 4.

The provisions of the bill involving increased taxation of foreign income, inclusive of the Treasury's draft recommendation, have so little merit and involve such comparatively minor additional prospective revenue and are so incompatible with the Nation's general policy of fostering international trade, that it is earnestly recommended that they be dropped.

I thank you very much.

The CHAIRMAN. Thank you, Mr. Dechert.

Senator WILLIAMS. I assure you, Mr. Dechert, our staff will analyze all of the points you have raised.

Mr. DECHERT. Oh, yes; thank you very much. I appreciate that. I did not mean to be too technical, but I thought it was an important point.

(The prepared statement of Mr. Dechert follows:)

STATEMENT IN RESPECT OF PROPOSED TREASURY AMENDMENTS TO H.R. 10650 ON BEHALF OF THE AMERICAN CHAMBER OF COMMERCE FOR ITALY AT MILAN

(By Daniel Orville Dechert, Washington, D.C., member of the bars of the District of Columbia, Virginia, and New York)

Mr. Chairman and gentlemen of the committee, I appreciate the permission to make a few remarks to the committee on sections 13, 15, 16, and 20 as covered by the Treasury's draft of statutory language of proposed amendment, with accompanying explanations.

I. Section 13, controlled foreign corporations, is unconstitutional.—Section 13 of the Treasury draft still imputes to U.S. shareholders owning directly or indirectly 10 percent or more of the shares of stock of a controlled foreign corporation a liability for Federal income tax on their pro rata shares of specified types of undistributed income of such foreign corporations. Therefore, section 13 of the Treasury draft, like section 13 of H.R. 10650 as passed by the House, contains provisions which would render it unconstitutional, and for this reason alone it is submitted that neither the Treasury draft, the section as now contained in the bill, nor any substitute imputing tax to U.S. shareholders of a given percentage of stock of a foreign corporation merely because it is under the control of shareholders in the United States, should be approved by this committee.

The proponents of the provisions seem to rely on the decision of the Court of Appeals for the Secend Circuit in *Eder* v. *Commissioner* (CA 2 (1943), 138 Fed. (2d) 27), decided in 1943, for the proposition that the ownership of stock in a controlled foreign corporation can justify attribution of pro rata shares of the foreign corporation's income to each U.S. shareholder who owns at least 10 percent of the stock. The *Eder* case involved Federal tax legislation of 1938 taxing U.S. shareholders, if constituting a described kind of restricted group and owning more than half in value of the shares of a foreign corporation the predominant income of which was passive income, such as dividends and interest, on their portions of the undistributed net income of such a foreign company which had so little substance from a business viewpoint that the court described it as an "incorporated pocketbook." The question of unconstitutionality of the statute was not even raised by the plaintiffs in the *Eder* case, who argued solely that they could not be taxed on foreign income which could not be converted into dollars because of restrictions of foreign exchange control.

The committee report which accompanied the first enactment in 1937 of these provisions clearly shows that the tax was not to apply to a real foreign operating company. When the *Eder* case is analyzed in the light of the Supreme Court decisions concerning contitutionality, it is clear that it cannot be construed as a precedent for taxing the income of foreign operating companies to their U.S. shareholders.

The 16th amendment to the Federal Constitution empowering Congress to tax without apportionment incomes from whatever source derived, was adopted in 1913 as a consequence of the decision of the Supreme Court in *Pollock* v. *Farmer's Loan and Trust Company* (157 U.S. 429 (1895)). In this case the

Court held that a Federal taxing statute which applied to income from real estate was in effect a direct tax on the real estate, and, accordingly, under the Constitution, had to be apportioned among the States in accordance with their population. Even after enactment of the income tax in 1913, the Supreme Court decided in 1920, in *Eisner* v. *Macomber* (252 U.S. 188 (1920)), that Congress nevertheless had no power to tax without apportionment as income of the stockholder, a stock dividend of common stock on common stock, or the accumulated profits underlying it. The essential reason stated by the Court was that the stockholder had received nothing out of the company's assets for his separate use and benefit, and had therefore obtained nothing that met the definition of income within the meaning of the 16th amendment.

In 1931, the Supreme Court, in a decision involving a taxing statute of the State of Wisconsin, *Hoeper* v. *Commissioner* (284 U.S. 206 (1931)), declared that an effort by a State government to tax A on the income of B was arbitrary, invalid, and in violation of the due process and equal protection clauses of the 14th amendment.

The Court of Appeals for the Second Circuit decided the *Eder* case in 1943 without reference to this background of Supreme Court decisions. In the *Eder* case, as indicated, the taxpayers, three members of the same family who owned a controlling stock interest in a foreign investment company, did not contend that the statute attributing tax to them on their shares of the corporation's income was unconstitutional as a tax against them on the income of the foreign corporation. Instead, they merely claimed that as Colombian exchange restrictions prevented distribution in dollars of the undistributed part of the company's income, the statute did not apply to them, on the theory that there was no constructive receipt by them of the income. The court rejected this argument on the ground that Congress had meant to deal harshly with such an "incorporated pocketbook"; and then itself gratuitously announced by way of a dictum, quite unnecessary to the decision of the case, that such an interpretation of the statute did not make it unconstitutional.

In addition to the *Eder* case, the proponents of section 13 seem to rely on *Helvering* v. *National Grocery Co.* (1938), 304 U.S. 282, in which the Supreme Court rejected the taxpayer corporation's argument that the penalty tax against a corporation for accumulating profits for the purpose of avoiding surtax on its shareholders could not be applied to it because it had been organized for a legitimate business purpose. The court found that a purpose existed to avoid surtax on the sole shareholder by causing the company to accumulate profits. By way of dictum, the court said that "the sole owner of the business" could not prevent Congress from taxing him on the year's profits if it chose to do so. In this connection, however, it cited previous Federal tax acts, all antedating 1921, imposing tax on shareholders where corporate profits were accumulated for the purpose of preventing the imposition of surtaxes on shareholders. The court did not mention that because of the decision of the Supreme Court in *Eisner* v. *Macomber* in 1920, Congress, fearing it was invalid to impute a tax on corporate profits to the shareholders, even to penalize them for corporate accumulations intended to relieve the shareholders of surtax on distributions, had changed the law and laid the penalty tax on the corporation itself.

In 1943, the Supreme Court, in the case of *Moline Properties* v. *Commissioner* (1943), 319 U.S. 436 (1943), refused to allow the Treasury to attribute income from corporate transactions to the corporation's sole shareholder. The shareholder had received the proceeds of sales made by the corporation and deposited them in his own bank account. The Court would not allow the income to be treated as that of the shareholder, stating that so long as the corporate purpose "is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity." It stated as a basic rule that the corporate form may be disregarded in matters relating to the revenue only where it is a sham or unreal. In 1949, essentially the same principles was upheld by the Supreme Court in *National Carbide Corp.* v. *Commissioner* (1949), 336 U.S. 422. The Court declared in this case that complete ownership of stock in a corporation was of no significance in determining taxability of the shareholders.

In view of the facts in the *Eder* case, it is no precedent for the Treasury proposal to tax U.S. shareholders on income of those of the 20,000 or so controlled foreign corporations which are bona fide operating companies in the face of the Supreme Court's decisions.

II. The enactment of section 13 would conflict with treaty obligations.—The principles of U.S. law that a corporation is a legal entity distinct from its shareholders and that the shareholder is not taxable on the income of a corporation until it is distributed to him as a dividend are also found in the laws of the European countries (OEEC, Fourth Report of Fiscal Committee, 1961, hereinafter referred as as "Report," p. 19). They are embodied in article XX concerning the taxation of dividends in a model convention which the Fiscal Committee of the OEEC is framing (Report, p. 25). A high Treasury official of the United States has participated in the formulation of this article. The commentary on the article mentions that the article provides that nonresident companies are not to be subjected to special taxes on undistributed profits (Report, p. 46). This would seem to place a caveat on the type of tax proposed by the Treasury, because by becoming a member of the OECD on September 30, 1961, the United States agreed that the foregoing recommendation would apply to it (Report, p. 19).

In any event, these principles are already inherent in the tax conventions which the United States has concluded with most of the countries which are members of the OECD, as well as with the other governments among the 44 with which the United States has tax conventions in force. The main provisions in all these tax conventions are in substance that the United States (a) will not tax a corporation of the other nation except on income from sources within the United States, including industrial and commercial income allocable to any permanent establishment in the United States; and (b) will not tax its own citizens, residents, and corporations on the income of the corporations of the other nation until it is actually received as a dividend, in which case the United States is bound to grant its credit for foreign taxes provided, according to the case, on the date of signature or the effective date of the convention, or as otherwise specified. Most of the conventions contain a saving clause (borrowed from European conventions) which reserves to each contracting party the right, regardless of anything to the contrary in the convention, to include in the basis on which is taxes are imposed all items of income taxable under its revenue laws, as if the convention had not come into effect, subject to granting the relief from double taxation provided in its laws and the convention.

This clause envisages items of realized direct income, such as rents from real estate which are recognized as primarily taxable under the conventions in the country of source, but as also taxable in the country of domicile or nationality employing the jurisdictional theory, as such direct income of a true recipient. The clause is intended to require a country with a progressive scale of rates which has recognized that an item of income is taxable under the conventions in the other country as the place of source, to make allowance for the tax on the foreign source income in computing the effective rate of its own tax covering the same. It was never contemplated that this clause reserved to the United States the right to impose on its own citizens, residents, and corporations a tax based on undistributed income of a corporation of the other contracting country. Such a tax is contrary to the basic principles and purposes of a tax convention, i.e., to avoid then existing double taxation to the extent contemplated by the basic concepts inherent in the convention.

As regards the income tax convention with Italy, I quote the following comment contained in a recent legal opinion rendered to the American Chamber of Commerce for Italy by a committee composed of five eminent Italian lawyers in regard to section 13 of H.R. 10650:

"The different rules proposed in the bill pending before the Parliament of the United States, therefore, amount to a unilateral modification of important premises of the treaty, on which the Italian Government was definitely relying when negotiating and signing the treaty."

This opinion of the committee of Italian lawyers is similar to the position of Belgian lawyers reflected in a message dated March 21, 1962, addressed by the American Chamber of Commerce at Brussels, Belgium, to the chairman of the Senate Finance Committee:

"The American Chamber of Commerce in Belgium * * * wishes to draw committee's attention to * * * the following points on foreign source income * * * new tax proposals will violate the long-established principles of international fiscal laws as well as the spirit, purpose, and basic principles of existing tax treaties as outlined in our representations to the House Ways and Means Com-

mittee dated June 1 and November 30 * * * destroy the ability of American enterprise to compete in world market * * * surrender hard-won U.S. position, prestige, and technology to foreign interests * * * injure our foreign trade by sharply reducing export and shipping, * * * wipe out jobs dependent upon trade and upon foreign earnings now reinvested here * * * injure our balance of payments by killing off favorable flow of dollars from American investments overseas * * *.

Attention is called to the following statements appearing in a letter dated March 14, 1962, from the American Chamber of Commerce in London to the chairman of this committee:

"The American Chamber of Commerce offers serious objection to the proposed legislation for taxation of foreign subsidiaries' earnings. Its opposition is based primarily on the belief that such legislation would ultimately and inevitably corrode and even destroy the many bilateral agreements entered into by most of the nations of the free world to avoid the crippling effect of the burden of double taxation upon international trade. Our objections are no more than a plea for fair tax treatment of these subsidiaries based on their importance in America's economic and political leadership in the community of free nations.

* * * * * * *

"Quite apart from the protection afforded by bilateral tax treaties, the United Kingdom has never sought to tax the foreign earnings of a non-United Kingdom resident corporation, even though it may be a wholly owned subsidiary of a United Kingdom parent corporation. It recognizes that there are broadly two ways in which a United Kingdom corporation may do business abroad:

"(*a*) Through a branch operation abroad.

"(*b*) Through a foreign subsidiary.

In case (*a*), the United Kingdom corporation is fully subject to United Kingdom tax on branch profits, where remitted or not. In case (*b*), it is only liable to the extent of dividends paid by the foreign subsidiary. In common with most nations, the United Kingdom recognizes that the foreign subsidiary constitutes a separate legal entity outside its jurisdiction.

"Even in case (*a*) the United Kingdom has legislated some relieving provisions for oversea trade corporations (Finance Act 1957).

"This extends the principle of exemptions from United Kingdom tax to income arising to a United Kingdom resident corporation from trading carried on exclusively abroad, irrespective of whether a tax treaty is in existence or not, until and unless such foreign income is distributed to a United Kingdom resident other than an OTC.

"It will thus be seen that any proposal to subject to U.S. tax the undistributed earnings of a United Kingdom subsidiary is in direct conflict with the philosophy and the principles developed internationally in general, and by the United Kingdom in particular."

The enactment of section 13 would involve the de facto invasion of the jurisdiction of the 44 foreign nations or governments with which we have income tax conventions, as well as that of the Latin American countries which are signatories of the Charter of the Organization of American States. As Secretary Dillon has declared before this committee that "we are honoring our treaty obligations," it seems manifest that section 13 of H.R. 10650 together with the Treasury's suggested amendments thereto should be flatly rejected by this country as a member of the civilized polity of nations heeding its international commitments based on compact.

In order that the United States collect the full tax to which it is entitled on income pertaining to various transactions in the international field, it appears to be necessary only that the existing provisions of section 482 of the Internal Revenue Code be more stringently enforced without amendment of such section, even if such enforcement involves some additional work for the Internal Revenue Service. This section authorizing the Treasury to distribute, apportion, or allocate gross income, credits, and deductions among organizations under common ownership or control, whether domestic or foreign, in order to prevent evasion of taxes or clearly to reflect the income of such organizations, has been extensively applied by the courts. For example, in *Asiatic Petroleum Corp.* v. *Commissioner* (CA-2, 1935) 79 Fed. (2d) 234, certiorari denied 296 U.S. 645, a profit was allocated back to a domestic company which had sold at cost certain securities, already appreciated in value, to a related foreign corporation which then resold them at a profit. Also, in *Jesse E. Hall, Sr.* (1959), 32 T.C. 390, a

domestic manufacturer sold products, previously sold to an independent dealer at a list price less a 20-percent discount to its own foreign marketing subsidiary at manufacturing cost plus 10 percent, and the subsidiary resold to customers abroad at a markup ranging up to 900 percent and over. The court ordered an allocation back of profits.

III. There are additional elements of doubtful constitutional validity in the Treasury draft.—(1) Discrimination in tax against (*a*) U.S. shareholders in controlled foreign corporations deriving certain types of income in so-called developed foreign countries as distinguished from those deriving certain types of income from less developed countries, and as contrasted with controlled corporations in the United States (sec. 951), as well as against (*b*) U.S. shareholders in controlled foreign corporations which derive their income from sources solely within the country where they are created as distinguished from those deriving specified types of income from sources in other developed countries.

(2) Delegation of the taxing power to the President by authorizing him to designate from year to year less developed countries and thus vary the tax on the U.S. shareholders (sec. 955(c) (2)).

(3) Delegation to the Secretary of the Treasury or his delegate of the power to determine whether income is from sources in a less developed country, as distinguished from sources in a developed country or the United States merely by prescribing regulations (sec. 955(c)). These regulations may differ from the rules for determining income from sources within or without the United States prescribed by Congress in sections 861 and 862, I.R.C.

(4) Delegation to the Secretary or his delegate of the power to determine whether a U.S. shareholder will be subject to the presently applicable tax or the proposed tax by deciding whether the creation of a controlled foreign corporation (receiving an item of income that would otherwise be base company income) does not have the effect of a substantial reduction of income, war profits, excess profits, or similar taxes (sec. 954(b) (4)).

(5) Delegation to the Secretary or his delegate of authority to issue regulations requiring each person who is or has been a U.S. shareholder of a controlled foreign corporation to maintain such records and accounts as may be prescribed by such regulations as necessary for the imposition of the proposed tax (sec. 962(c)). This is stipulated despite the fact that a U.S. shareholder is to be subject to the tax only if he has an interest of at least 10 percent of the stock in the controlled foreign corporation (explanation, par. 1); and a U.S. minority stockholder may not be able under the laws of the foreign country to obtain from a corporation organized thereunder the information concerning its operation, the resulting income or loss, and the disposition of the income, that would be necessary for the shareholder in the United States to comply with such regulations.

IV. Section 16 is discriminatory and unfair.—Section 16, singling out sales, exchanges and redemption of stock in foreign corporations for ordinary income tax treatment, despite any limitation in the Treasury draft to gain measured by amounts of foreign corporate earnings and profits accumulated after 1962, is entirely without justification. It is an astonishing attempt at abandonment of the hitherto recognized principle that gain from sales and certain other dispositions of shares of stock is capital gain, and is a highly amateurish manifestation of Maginot Line mentality, scarcely meriting serious comment.

V. Conclusion.—It is submitted that all these dilettante provisions aimed at unorthodox increased taxation of foreign income or transactions connected with foreign corporations are unwise, unneeded, calculated to produce reprisals on the part of disillusioned foreign governments and deserving only the scrap heap as unworthy of a great nation dedicated to expansion of its world trade, as indicated by presently proposed legislation in this latter field at loggerheads with these tax proposals.

The CHAIRMAN. The next witness is Mr. Simon J. Nusbaum, European Common Market Development Corp.

Mr. Nusbaum, I hope you will condense your statement as much as you can.

Mr. NUSBAUM. Definitely, within the 10-minute limitation.

The CHAIRMAN. We have been here all day, and we have work to do back in our offices.

STATEMENT OF SIMON J. NUSBAUM, THE EUROPEAN COMMON MARKET DEVELOPMENT CORP.

Mr. NUSBAUM. Within the 10 minutes; promised.

Mr. Chairman and members of the committee, my name is Simon J. Nusbaum. I am a lawyer practicing in New York City, and have been for years active in the field of taxation of international trade and investments. I have been requested to present the following statement on behalf of an organization called the European Common Market Development Corp., which is located in New York City and whose president is an international business analyst, Mr. Allen B. Goldenthal.

This organization is probably the only one of its kind in this country specializing in furnishing the American business community with information, research data and other material relating to the European Common Market.

To comply with the 10-minute limitation, Mr. Chairman, I shall not fully follow the text of the written statement, but respectfully request permission to incorporate it in the record.

Because of our interest in the Common Market as such, and its relationship with U.S. business in its practical operations, we have taken a special interest in following the "foreign earnings" provision here under discussion. We have followed the various stages of this legislation, from the time of President Kennedy's tax message in the early part of 1961, through the original Treasury proposals, then the amended Treasury proposals, the extensive House Ways and Means Committee hearings, that committee's report on H.R. 10650, the extensive testimony given before this committee (Senate Finance Committee) in April and May of this year, and the latest stage thereof, to-wit, Treasury Secretary Dillon's statements on May 10–11, 1962, and his new statutory draft of May 31, 1962 which brought about the present reopening of the hearings.

With that knowledge, and if we may add, with reasonable knowledge of the general features of business taxation in and among the various countries of the Common Market, and looking at this matter not from the viewpoint of any particular business group, but from the point of view of the interests of the United States, we are very strongly of the conviction (1) that the principal feature of the Treasury plan, that is, the taxation of undistributed foreign earnings to U.S. controlling shareholders, remains a source of considerable, certain trouble, and (2) furthermore, that the Treasury's latest proposals, while claiming to curb some of the very serious defects which had become indisputable, for the most part confirm and magnify the complications and dangers inherent in the basic, revolutionary Treasury plan. We shall briefly comment on both these aspects of the problem.

Of the 22 sections of the tax revision bill of 1962—H.R. 10650—now before this committee, 12 deal with matters relating to foreign income or foreign property.

We shall confine ourselves to section 13, which is the most important of all, and which reflects the general revolutionary aspects of the Treasury package.

1. Perhaps the most significant feature in the most recent Treasury proposals (May 31, 1962) is the introduction, or revival, of a so-called overall exception (sec. 954(b)(4)) to the basic feature of section 13. The very existence of such an overall exception, left to the discretion of the Treasury in each individual case, would tend to throw some doubt on the seriousness or soundness of the grounds which had been advanced to justify this upheaval in international taxation principles.

The actual details of this overall exception raise new questions of the most serious nature. Several witnesses have testified about them yesterday and today, and because of the time limitation on this oral testimony, we refer for these and other technical matters to our written statement now in the hands of the committee, and also to a letter by a noted New York tax lawyer, Mr. Arthur H. Goodman, to the chairman of this committee, which we also submit herewith.

But our conclusion on the overall exception is, in view of the way it has been drafted, that in the midst of this literally revolutionary upheaval of a system of taxation under which American business has been operating abroad for decades, and has invested and operated more particularly in the Common Market countries for the past several years, there would now come into existence a further, very loose, and surely arbitrary area, in which the basic new system itself would not apply at all, and in which administrative discretion would be very wide, indeed.

2. As to the basic policy now propounded, and looking at same from the point of view of a responsible American organization dealing daily in Common Market problems, we respectfully wish to add a few comments to those made by so many witnesses.

We believe that the consequences of this new approach have, perhaps, not been fully realized, as yet.

No serious objection could be raised, either here or in enlightened leadership thinking in Europe, against the abolition or policing of notorious, real tax heavens for idle, nonproductive funds and income, accumulated for the distinct purpose of avoiding normal taxation anywhere. But many witnesses have pointed out that this can be done by actually enforcing, or if necessary, revising existing provisions of the code, and again we refer to our written statement as to the specific remedies.

But to try, Mr. Chairman, to accomplish this, and much more, some of it quite unintended it now appears, by taxing to U.S. shareholders the earnings of an independent legal entity, organized under the laws of civilized, well-developed countries, future partners of ours, having their own claims to taxation, is what has quite obviously shocked all business organizations, large and small, as well as the various bar associations and accountant groups in this country.

It may, therefore, not be surprising that a similar reaction can be detected in those foreign countries themselves, with actual consequences in Europe which might be quite surprising yet.

For, as has been so ably testified to by several witnesses here, European countries, including the six Common Market countries, which have practiced across-the-border taxation for a very long time—from the beginning of this century, surely—do not tax, and do not conceive own nationals.

On the contrary, as has also been pointed out, practically all of these countries favor foreign trade expansion and investments, by either not taxing at all, or taxing at a sharply reduced rate, the foreign earnings of their own national corporations.

3. There are two additional observations we should like to make, more particulalry from the point of view of U.S. business with and within the Common Market.

There has been some discussion as to whether this revolutionary tax proposal is in violation of the tax conventions which the United States has entered into with a number of countries. In the case of the Common Market countries, there can hardly be a doubt that arguments will be made of violation of certain specific provisions as such, and in any event, of the underlying principles and intent of these treaties.

One little noticed provision, for instance, contained in section 19 of the bill now before you, modifies section 1441 of the code by imposing a withholding rate of 20 percent on dividends and interests paid to nonresident aliens and corporations. This proposal, which of course derives from the general proposal in the bill regarding domestic withholding on dividends and interest, should be read in the light of the various tax treaties, which reduce the statutory withholding rate on those aliens to a rate of usually 15 percent, sometimes even less. But aside from this, the assertion of jurisdiction to tax which is embodied in section 13 is sure to lead, in actual practice, to conflicts with the signatories of these treaties, and the consequences of such unilateral action, without consultation or discussion between partners, could be quite serious and unexpected.

Finally, as has been noted by several Senators on this committee and by many other thoughtful persons, the policies embodied in section 13 should be carefully compared with, and weighed against, the proclaimed policies of the Trade Expansion Act of 1962, which will come before this committee in the near future. To promote exports, to announce and prepare for a negotiation of the utmost importance with the Common Market as such, to cooperate by way of consultation and, perhaps tomorrow, common action in the rest of the world with the OECD, does not seem compatible, neither in its principles nor in its effects on business, with the policy of contraction of investments underlying this tax provision.

To the extent that some foreign economic policies are invoked to justify this revolutionary breach of tradition in the field of taxation, it would be well to remember the broader and, it is believed, overriding policies of the Trade Expansion Act, and of our Government's wish to develop exports. It would be most unfortunate if expansion of trade were, perhaps unintentionally, accompanied by contraction of capital. Are we, besides the Trade Expansion Act of 1962, also to have, in this tax bill, a Trade Retrenchment Act of 1962?

In conclusion, it is respectfully submitted that the entire problem raised by section 13 be given careful consideration, reopened for study, and perhaps consultation; it could then usefully be solved in connection with next year's overall revision of the Internal Revenue Code.

Specifically, it is believed that by better enforcing and, if necessary, revising the statutory and regulatory provision dealing with unreasonable accumulations of earnings, with foreign personal holding

---

companies, with the definition of income from sources within the United States, and with the concept of corporations engaged in business in the United States, much of what is justifiably sought to be accomplished by section 13 could be done, efficiently and adequately, without raising the disturbing questions of principle and the appalling problems of interpretation of section 13, and without interfering with the spirit and pattern of tax treaties which so far have governed our dealings with many foreign countries.

By the same token, we could then also consult our future partners of the Common Market, with whom we shall be dealing on a broad basis very soon, indeed.

Thank you, Mr. Chairman.

Senator WILLIAMS (presiding). Thank you, Mr. Nusbaum.

(The prepared statement of Mr. Nusbaum, together with the letter of Arthur H. Goodman, dated June 15, 1962, follow:)

TESTIMONY OF SIMON J. NUSBAUM, ATTORNEY AT LAW, FOR THE EUROPEAN COMMON MARKET DEVELOPMENT CORP., NEW YORK, N.Y.

1. My name is Simon J. Nusbaum. I am a lawyer practicing in New York City, and have been for years active in the field of taxation of international trade and investments. I have been requested to present the following statement on behalf of an organization called the European Common Market Development Corp., which is located in New York City and whose president is an international business analyst, Mr. Allan B. Goldenthal. This organization is probably the only one of its kind in this country specializing in furnishing the American business community with information, research data and other material relating to the European Common Market. It also publishes a weekly newsletter, the European Common Market Newsletter, to which subscribe numerous major American firms, libraries, schools, etc., and which contains factual information relating to economic developments in and around the Common Market.

2. Because of our interest in the Common Market as such, and its relationship with U.S. business in its practical operations, we have taken a special interest in following the "foreign earnings" provision here under discussion. We have followed the various stages of this legislation, from the time of President Kennedy's tax message in the early part of 1961, through the original Treasury proposals, then the amended Treasury proposals, the extensive House Ways and Means Committee hearings, that committee's report on H.R. 10650, the extensive testimony given before this committee (Senate Finance Committee) in April and May of this year, and the latest stage thereof, to wit Treasury Secretary Dillon's statements on May 10–11, 1962, and his new statutory draft of May 31, 1962, which brought about the present reopening of the hearings.

With that knowledge, and if we may add, with reasonable knowledge of the general features of business taxation in and among the various countries of the Common Market, we wish to state at this point that in all objectivity, and looking at this matter not from the viewpoint of any particular business group, but from the point of view of the interests of the United States, we are very strongly of the conviction that the principal feature of the Treasury plan, i.e., the taxation of undistributed foreign earnings to U.S. controlling shareholders, remains very undesirable; and, furthermore, that the Treasury's latest proposals, while claiming to curb some of the very serious defects which had become indisputable, merely confirm and magnify the complications and dangers inherent in the basic, revolutionary Treasury plan.

3. Of the 22 sections of the tax revision bill of 1962 (H.R. 10650) now before this committee, 12 deal with matters relating to foreign income or foreign property. Most of these would bring about very serious changes in well-established rules affecting business and other relations with other countries, and have encountered much opposition from many quarters. As for us, we shall address ourselves especially to section 13, which has aroused unanimous opposition by all American companies, large and small, engaged in doing business abroad.

In the latest proposals now before you (May 31, 1962), the Treasury, having taken note that "a great deal of concern" had been expressed before this committee, finally recognized that "substantial modifications" were called for (Senate Finance Committee hearings on H.R. 10659, pt. 10, p. 4252, May 10, 1962). The Treasury now candidly recognizes what numerous experts had pointed out in vain for months, to wit that section 13, so hastily drawn in the first place, had by far bypassed its declared original purposes. In its limitless refinements, section 13, it its present form, had turned into a device tending to penalize and impede normal, well-established foreign business operations, and to jeopardize numerous pending and impending ventures and joint ventures between U.S. business, and industry in the Common Market. The various further subdistinctions, additions, and complications of the present Treasury proposals do not change this situation much, and in fact, superimpose several new uncertainties on the old.

4. Perhaps the most significant feature in these new Treasury proposals is the introduction, or revival, of a so-called overall exception (sec. 954(b)(4)) to the basic feature of section 13. The very existence of such an overall exception, left to the discretion of the Treasury in each individual case, would tend to throw some doubt on the seriousness or soundness of the grounds which had been advanced to justify this upheaval in international taxation principles.

The actual details of this "overall exception" raise new questions of the most serious nature. Secretary Dillon stated here on May 10, 1962, that in the absence of complete abolition of the so-called deferral privilege, it now became necessary "to avoid unintended coverage" of non-tax-haven situations, and thus (ibid., p. 4253), introduced the idea of "an overall exception to deal with situations where a controlled foreign corporation covered by the provisions of the bill has not been availed of to avoid taxes"; and he added that this would be desirable "from the standpoint of adding flexibility to insure a fair application of the base company income provisions in the cases where it is needed." Thus, in the midst of this admittedly revolutionary upheaval of a system of taxation under which American business had been operating abroad for decades, and had invested and operated, more particularly in the Common Market countries for the past several years, there would now come into existence a further, very loose and surely arbitrary area in which the basic new system itself would not apply at all.

So loose and uncertain is the scope of this "overall exception" that it can be noted that the statutory provision now submitted actually differs in a vital aspect from the purpose thereof as set forth by the Secretary. For while the Secretary, in effect, talked of an exception in fact based on the taxpayer's intent or plans (situations where a corporation * * * has not been availed of to avoid taxes), the statutory language sets forth a wholly different test, to wit, that the situation, and more particularly the choice of the place of incorporation, "does not have the effect of substantial reduction of * * * taxes." In the statutory language, apparently, an international tax inquest would have to be made, in each case presented to the Treasury, to determine the cumulative and perhaps interlocking tax effects of the corporate setup of the taxpayer. It is almost frightening to think that taxation of foreign business, or tax planning, would be governed by such rules, in this country, at this time. In addition, the statutory proposal would apply to each item of income, which surely would not facilitate matters either way; and there would always be the interesting question of what would be a "substantial" reduction of taxes, not to speak of the totally discretionary powers which, under this system, would be given Treasury agents in such intricate matters.

5. With or without this revealing "overall exception," we wish to make a few comments in the international angles of the policy grounds which have been advanced in support of the general principle underlying section 13.

No serious objection could be raised against the abolition, or policing, of notorious, real tax havens for idle, nonproductive funds and income, accumulated for the distinct purpose of avoiding normal taxation anywhere. But many witnesses have pointed out that this can be done by actually enforcing existing provisions in the code. Without doubt, a serious study would show that many of the situations presented at these hearings, such as, for instance, the income derived from royalties on U.S. patents, premiums on U.S. insurance risks, etc., could be properly disposed of in a reinterpretation, or even a revision, of the provisions in the code and in the regulations dealing with source of income (income from sources within or without the United States), and with the point

whether a foreign corporation is "engaged in business" in the United States. Similarly, many problems relating to "passive income" could be disposed of by expanding the rule against unreasonable accumulations of income, and the foreign personal holding provision of the code.

But to try and accomplish this—and much more, some of it quite unintended, it now appears—by taxing to U.S. shareholders the earnings of an independent legal entity, organized under the laws of civilized, well-developed countries having their own claims to taxation, is what has quite obviously shocked all the large business organizations, as well as the various bar associations and accountant groups, in this country. It may therefore not be surprising that a similar reaction, one of principle, can be detected in those foreign countries themselves. For, as has been so ably testified to by several witnesses here, European countries, including the six Common Market countries, which have practiced across-the-border taxation for a very long time—from the beginning of this century, surely—do not tax, and do not conceive of taxing, the earnings of a foreign, independent entity owned by their own nationals. On the contrary, as has also been pointed out, practically all of these countries favor foreign trade expansion and investments by either not taxing at all, or taxing at a sharply reduced rate, the foreign earnings of their own national corporations.

6. In the light of the Treasury's latest proposal on so-called tax deferral—which in fact is not deferral at all, it being more appropriate to call the proposed system one of tax anticipations—it seems proper to review the arguments propounded by the Treasury in favor of section 13, and against these to line up the objections which have been voiced against it from various quarters.

Essentially, the Treasury has justified the underlying philosophy of section 13 on three grounds:

(*a*) Tax neutrality, or equity. There is no point debating this issue at this juncture. It is the vaguest possible notion, which could be used to justify almost any amendment or suppression of the hundreds and thousands of special rules and exceptions of the Internal Revenue Code. To single out certain phases of foreign operations on the basis of so-called neutrality or equity, does not seem to be the policy most advantageous to the United States at a time when our whole economy is being geared for expansion both domestically and abroad. Furthermore, if neutrality in this area means equalization of taxes on domestic and foreign operations, neutrality becomes a purely metaphysical concept, in complete conflict with economic realities. These realities are the absolute need for American business to compete at advantageous terms in other countries, both by way of exports and by way of effective and competitive manufacturing to conquer foreign markets from within.

(*b*) Balance-of-payment problems. We shall abstain from entering this discussion, since a matter of high policy is involved. As these hearings have proceeded however before this committee, it has become obvious that the balance-of-payment problem is so vast and has so many facets that the matter of taxes on foreign earnings and foreign investments is only a relatively small part of the general picture. We do wish to say however that looking at this matter from the standpoint of the relationship between the United States and the Common Market, it is highly questionable whether unilateral tax action taken in this particular field will solve any problems at all, and will not create many more problems than the one thus attempted to be solved.

(*c*) It has been suggested in the same connection that what is also intended is to slow down U.S. investments in developed countries, and thus to contribute to investments and expansions at home. That expansion and modernization in this country is necessary and even urgent, is universally admitted. Many measures are in this respect proposed by the administration, but to include therein a revolutionary tax device, in a very limited area, is a serious matter, with serious consequences, and which has to be weighed against the disadvantages incurred now listed hereafter.

7. Rarely has a tax measure aroused such unanimous opposition on the part of the companies involved, large and small, trade groups, and bar associations in this country. It may be well at this point, without repeating the argumentation in each case, to present in capsule form the objections which have been voiced against the principle and the general lines of section 13. All of these objections, unfortunately, remain valid in the presence of Secretary Dillon's newest proposals:

1. Section 13 will discourage foreign commerce and reduce exports from the United States. If it does slow down investments in developed countries—and it would, therefore, no doubt also slow down investments in underdeveloped countries, contrary to what is hoped—it will of necessity interfere with the manufacturing and therefore sale of merchandise in foreign countries. Particularly in the Common Market, now viewed as a whole, American enterprise, sometimes alone, often in joint ventures, establish themselves in one country for the purpose of selling in other countries of the Common Market as well. This is the very essence and purpose of the Common Market, both for its members and outsiders. And yet, this is the time the Treasury chooses to declare war on multinational manufacturing and sales operations.

2. Section 13 establishes a revolutionary, unique, and most debatable principle in our income tax law.

3. Section 13 will unquestionably damage the competitive position of the U.S. business in foreign countries.

4. Section 13 attempts to apply our own concepts of earnings and profits, and our accounting concepts, to foreign corporations governed entirely by different laws, mostly in civil law countries.

5. Section 13 will not attain the purpose of bringing in revenue, as it is quite probable that those foreign countries tax rates are lower than ours will preempt the field and raise their rates for operations of U.S. companies within their territory.

6. The detailed rules of section 13 are so complicated that there is general agreement amongst accountants, lawyers, and businessmen that they will present enormous difficulties and uncertainties both in counseling and in operating.

8. Two final observations should be made more particularly from the point of view of U.S. business with and within the Common Market.

There has been some discussion as to whether this revolutionary tax proposal is in violation of the tax conventions which the United States has entered into with a number of countries. In the case of the Common Market countries, there can hardly be a doubt that arguments will be made of violation of certain specific provisions as such, and in any event, of the underlying principles and intent of these treaties. Enough of an argument can be made to raise some very serious questions as to the workings of these conventions in the future. One little-noticed provision contained in section 19 of the bill now before you, modifies section 1441 of the code by imposing a withholding rate of 20 percent on dividends and interests paid to nonresident aliens and corporations. This proposal, which of course derives from the general principle in the bill regarding domestic withholding on dividends and interest, should be read in the light of the various tax treaties, which reduce the statutory withholding rate to a rate of usually 15 percent, sometimes even less. But aside from this, the assertion of jurisdiction to tax which is embodied in section 13 is sure to lead, in actual practice, to conflicts with the signatories of these treaties, and the consequences of such unilateral action, without consultation or discussion between partners, could be quite serious and unexpected.

Finally, as has been noted by several Senators on this committee and by many other thoughtful persons, the policies embodied in section 13 should be carefully compared with, and weighed against, the proclaimed policies of the Trade Expansion Act of 1962, which will come before this committee in the near future. To promote exports, to announce and prepare for a negotiation of the utmost importance with the Common Market as such, to cooperate by way of consultation and, perhaps tomorrow, common action in the rest of the world with the OECD, does not seem compatible, neither in its principles nor in its effects on business, with the policy of contraction of investments underlying this tax provision. To the extent that some foreign economic policies are invoked to justify this revolutionary breach of tradition in the field of taxation, it would be well to remember the broader and, it is believed, overriding policies of the Trade Expansion Act. It would be most unfortunate if expansion of trade were, perhaps unintentionally, accompanied by contraction of capital. Are we, besides the Trade Expansion Act of 1962, also to have, in this tax bill, a Trade Retrenchment Act of 1962?

In conclusion, it is respectfully submitted that the entire problem raised by section 13 be given careful consideration, reopened for study, and perhaps consultation; it could then usefully be solved in connection with next year's overall revision of the Internal Revenue Code.

Specifically, it is believed that by better enforcing and, if necessary, revising the statutory provision dealing with unreasonable accumulations of earnings, foreign personal holding companies, definition of income from sources within the United States, and of the concept of corporations engaged in business in the United States, much of what is justifiably sought to be accomplished by section 13 could be done efficiently and adequately, without raising the disturbing questions of principle and the appalling problems of interpretation of section 13, and without interfering with the spirit and pattern of tax treaties which so far have governed our dealings with many foreign countries. By the same token, we could then also consult our future partners of the Common Market, with whom we shall be dealing on a broad basis very soon, indeed.

NEW YORK, N.Y., *June 15, 1962.*

Hon. HARRY FLOOD BYRD,
Chairman, Senate Finance Committee,
U.S. Senate, Washington, D.C.

DEAR SENATOR BYRD: This letter is intended as a brief treatment of certain of tl e provisions relative to the taxation of income of foreign corporations embodied in H.R. 10650 which is presently before your committee. The attempt herein is to deal with sections 13 and 16 of the bill in the light of the modifications proposed by Secretary Dillon since the passage of the House bill.

A discussion of the broad policy aspects of the proposed measure by Simon Nusbaum, Esq., of New York City, establishes certain salient reasons why the philosophy of the bill deserves further study before its enactment; Mr. Nusbaum's presentation, to which this letter is a supplement, will, I trust, receive the careful attention of the committee.

Section 16 of the bill.—Section 16 of the House bill, substantially modified in only one respect by Secretary Dillon's proposed changes, has awakened American business to the urgency of monetary liquidation lest the earnings and profits of a foreign corporation be virtually confiscated either upon sale of the stock of a foreign corporation or partial or complete liquidation.

That this concern, extreme as it is, is fully justified, becomes immediately apparent from a reading of the bill and of the testimony and proposals submitted by the Secretary of the Treasury.

The core of the difficulty is that a tax at capital gains rates is to be imposed on so much of the stockholder's gain, realized upon sale or liquidation, as does not exceed his share of the earnings and profits of the corporation realized prior to December 31, 1962; and at the same time a tax at ordinary rates on so much of such gain as is attributable to the earnings and profits realized later than December 31, 1962.

Difficult as legislation of this kind is to accept, it represents, oddly enough, a vast improvement over the House bill which would have taxed at ordinary rates all of the earnings and profits of the corporation in any of the eventualities aforementioned.

The term "earnings and profits" has a well-known meaning in our tax law. It is not, though this is sometimes overlooked, at all synonymous with taxable income. The difficulties of dealing with the phrase "earnings and profits" are, among others, the following:

(1) Earnings and profits include all tax-exempt receipts such as tax-exempt interest, proceeds realized on payment of the principal sum of a life insurance policy after the death of the insured, and other items which even in dealing with an American corporation are not part of the problem of measuring the tax on a stockholder's disposition of his interest in a corporation.

(2) Earnings and profits are reduced by Federal income taxes and the like; taxable income is not so reduced.

(3) Vastly different bookkeeping difficulties will arise if the House bill, or even the bill as modified by Secretary Dillon, is enacted. Under the House bill a blameless stockholder of such a corporation would be wholly unable to determine the amount of his tax because no bookkeeping system required under American tax law would afford the information necessary to arrive at the base of the tax.

In its apparent anxiety to reach the accumulated funds of foreign corporations in the event of liquidation or sale of their stock, the drafters of the bill have allowed a situation to arise which will actually cost the Government revenue.

In the case of an American parent with a foreign subsidiary, it is apparently assumed in the bill that a tax will be payable on the liquidation of the foreign subsidiary and that that tax is imposed by the bill itself. This is easily circumvented. In a situation where it is practicable for the parent itself to be liquidated, what can be done is to have the parent liquidated under section 337 of the Revenue Code of 1954 and the stock of the foreign corporation distributed to the parent's stockholders as any other assets of the parent will be so distributed. This will give the Government a capital gains tax on the fair market value of the stock of the foreign subsidiary. In no instance, even under Secretary Dillon's changes, will there be a tax at ordinary rates at all. That this is so is clear from the bill which provides that it applies only to those liquidations "to which section 331 applies" (sec. 16 of the bill). Where section 337 liquidation is availed of section 331 does not apply and, therefore, neither does the bill.

Less favorably treated would be the stockholders of a foreign corporation in cases where those stockholders are individuals. Such individual stockholders would, if a liquidation resulted in a gain, be taxed partly at ordinary rates.

There would seem to be no reason for a tax at ordinary rates on the liquidation of a foreign corporation or on the sale of its stock and this would appear to be true irrespective of when the liquidation or sale takes place. Any other approach merely hastens the liquidation of foreign corporations and the realization of a tax in the current year at capital gains rates.

Section 13 of the bill.—This section of the bill undertakes, in a form as complex as any verbal monstrosity the tax law has ever seen, to tax individual shareholders on the annual earnings of foreign corporations.

The reasons for the laborious difficulty with the language of the bill flow from its basic misconceptions. Among these misconceptions are the following:

(1) That a foreign tax credit really reduces the tax by the amount of the credit and effectively does away with a duplication of taxation, once by a foreign government and once by the United States.

(2) That a stockholder who has no power to compel a distribution of funds from a corporation should, nevertheless, be expected to pay a substantial tax based on the earnings of that corporation.

(3) That an individual who owns 10 shares out of a total of 100 outstanding shares of a corporation at the beginning of a year and is the 15th largest stockholder, may become taxable, and may be expected to pay the tax, when through no act of his he becomes one of only two stockholders of the corporation by the end of the year.

Perhaps the last item deserves a bit of explanation. Assume that a stockholder owns 10 shares out of a total of 100 at the beginning of the year and that the other 90 shares are held by more than a dozen other people, all in equal proportions; assume, further, that all of the other stockholders sell their shares to one individual, so that the entire 100 shares are now held by two people. The stockholder with the original 10 shares, who still has them, has through no act of his become subject to taxation because the corporation has now become a controlled foreign corporation within the meaning of the bill. The individual involved may have absolutely no way of knowing what the earnings of the corporation were and may yet be expected to report his share of those earnings on his return.

If it is wondered why taxpayers and their advisers are baffled, on occasion, by what the law expects of them and by what they are expected to know, it is provisions of this kind which are responsible for the bafflement.

Senator Jacob K. Javits of New York has proposed an amendment to the bill which would appear to deserve serious consideration. The amendment would tax the idle earnings of a foreign corporation and would allow the stockholder the deferral that he now enjoys until it appeared that there were funds of the corporation which were not needed in its business.

This line of thinking, suggested by the testimony of Leon O. Stock, who appeared before your committee on April 27, 1962, would adequately take care of the typical tax haven situations without discouraging or destroying the maintenance of American enterprise abroad. The proposed amendment, as framed by Senator Javits, would provide adequate safeguards against abuse and would at the same time not subject an American stockholder to an income tax which, if the traditional lines and accepted thinking of our tax law mean anything, should not be expected of him.

Your kind consideration of the aforestated points will be appreciated.

Very respectfully,

ARTHUR H. GOODMAN.

Senator WILLIAMS. The committee stands in recess subject to the call of the chairman.

(By direction of the chairman, the following is made a part of the record:)

AUTOMATIC POULTRY FEEDER CO.,
Zeeland, Mich., May 29, 1962.

Hon. HARRY F. BYRD,
Chairman, Senate Finance Committee,
Washington, D.C.

DEAR SIR: We understand that your committee intends to reopen public hearings on the foreign income provisions of H.R. 10650. As an American company engaged in a rapidly growing foreign trade, we would like to express our opinions in this matter which we judge vital to the interests of the United States.

Starting in 1958 with a one-man "bridgehead" in the Netherlands, we have developed a system of subsidiaries, licensed distributors, and partnerships which now extends into nine countries of Western Europe. All our European activities are supervised and coordinated by a wholly owned subsidiary, Big Dutchman (International) A.G., of Chur, Switzerland.

The Swiss company was established as a marketing, financing, and selling organization. The unique advantages offered by Switzerland for such a company, its excellent communications and banking facilities, have brought good fruits. By reinvesting the earnings of foreign operations through the Swiss company, we rapidly expanded our marketing activities, with the result that in 1961 we exported over $1 million of American-made machinery to Europe alone, bringing steady work to our many employees and suppliers in the United States.

Our small company, producing automatic poultry equipment, has made steady progress under the present tax laws. Most important, our progress has helped U.S. jobs and business. So why change the setup that produces such good results for all.

Sincerely,

JACK DE WITT, *President.*

COMMERCE & INDUSTRY ASSOCIATION OF NEW YORK, INC.,
New York, N.Y., June 5, 1962.

Re H.R. 10650, amendments proposed by the Secretary of the Treasury (draft, May 31, 1962). Disapproved.

Hon. HARRY F. BYRD,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D.C.

DEAR SENATOR BYRD: In a statement contained in the record of hearings on the subject bill, Commerce & Industry Association expressed its disapproval of sections 13, 16, and 20.

The amendments proposed by the Secretary of the Treasury appear to reduce the harshness of the House-passed version of those sections. However, because we disagree with the principle underlying them, we restate our opposition to sections 13, 16, and 20 even if amended as proposed by the Secretary.

Sincerely,

ARNOLD WITTE, *General Manager.*

SMITH KLINE & FRENCH OVERSEAS CO.,
Philadelphia, Pa., June 6, 1962.

Hon. HARRY F. BYRD,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D.C.

DEAR SENATOR BYRD: We understand that your committee will hold hearings to consider the statements made before the committee on May 10, 1962, by the Secretary of the Treasury with respect to H.R. 10650, the Revenue Act of 1962. We would like to present the following statement for the record:

(1) In his statement Secretary Dillon has continued the practice used by the Treasury during the entire history of this bill referring to the "deferral" of

taxes on income of foreign subsidiaries of U.S. corporations. This technique reminds us of the famous question, "When will you stop beating your wife?" There is no deferral of income tax because there is no income to the U.S. parent unless and until the foreign subsidiary pays a dividend. H.R. 10650 proposes the unprecedented step of taxing U.S. corporations for income which they have not received and may never receive. The Treasury has tried to obscure this by the use of the word "deferral," which implies that under present conditions tax due on income received was being deferred. We hope that the Senate will never lose sight of the fact that this is not so.

(2) We still believe that the provisions of the bill concerning income from U.S.-developed patents, copyrights, etc., are totally unworkable in practice for the reasons outlined in a letter we previously wrote to your committee and should be eliminated rather than modified. The statement in our letter of April 11, 1962, was as follows:

"The new bill provides that income earned by a foreign subsidiary on the basis of ownership of patents, copyrights, and exclusive processes essentially developed in the United States or transferred to a foreign subsidiary shall be treated as income derived from a U.S. exclusive process.

"How is the Internal Revenue Service to determine when a process is 'essentially developed in the United States'? In a great many cases a naked patent is of no value to a foreign subsidiary. The process has to be adapted to local conditions; the product has to be modified; local raw materials have to be tested before the process can be employed in producing a finished product acceptable to standards of each country.

"The Internal Revenue Service would have to fix an 'assumed rate of royalty' which would represent the profit; but, royalty rates differ from fractions of 1 percent of sales to 15 percent or even higher, depending on the degree of monopoly established by a patent, on the time saved by the knowledge of operating procedures, by the profit margin for which the product can be sold according to the necessity of obtaining patent licenses or other rights from third parties, and a great many other factors. These factors are hard enough to evaluate when it comes to making an actual deal with a third party. How can the Internal Revenue Service presume to establish a rate in a theoretical case?"

The Secretary's proposal to levy tax at the time a patent (or like property or right) is transferred to a controlled foreign corporation does not mitigate the "income determination" problem presently existent in H.R. 10650. In order to establish the income upon the transfer or sale of a patent, etc., a "fair value" would have to be placed on the patent itself. In making such determination of "fair value" the Treasury and the taxpayer would encounter substantially the same problems cited above.

(3) Concerning "B.3. Computation of earnings and profits": The Treasury ever since the introduction of the "deemed paid" foreign tax credit in 1918 has failed to develop "clear administrative regulations" for the computations of the earnings of foreign corporations in accordance with the rules developed for domestic corporations, for the reason that it is impossible. Many foreign corporations, by American standards, simply do not know what their earnings are. Rules and regulations must obviously apply to all taxpayers alike and for this reason it does not help to point out that the foreign subsidiaries of some large American corporations have excellent accounting systems. It is a fact that a good many corporations abroad are not even audited by outside auditors and of course American corporations own stock in such foreign companies also. How are they supposed to comply with the proposed law? However, even where adequate records exist, there are great problems in expressing foreign corporate earnings in U.S. tax and accounting concepts.

Another unsurmountable complication arises from the fact that exchange rates vary and that in the long run most currencies tend to depreciate in comparison with the U.S. dollar. It is easy to determine at what rate of exchange a dividend has been received but what is supposed to happen if there is "deemed income" as proposed in H.R. 10650 if this deemed income is then converted for U.S. tax purposes at a rate of exchange and if in a following year the value of the foreign currency declines? Is the U.S. taxpayer then supposed to compute a "deemed loss"?

(4) In case the Congress should decide to disregard the fact that H.R. 10650 breaks all tradition by taxing income not received, we believe that the other suggestions made in Secretary Dillon's statement would be beneficial and should be adopted.

Very truly yours,

K. A. SOLMSSEN, *Vice President.*

THE GLIDDEN CO.,
Cleveland, Ohio, June 4, 1962.

Hon. HARRY F. BYRD,
U.S. Senate, Washington, D.C.

DEAR SENATOR BYRD: During the past months I have followed and been increasingly troubled by the progress and development of H.R. 10650, now before the Senate Finance Committee. The consequencies and adverse effects upon American industry and economic life in general which will inevitably flow from the foreign income provisions of this bill seem so important I feel obligated to express my concern. Since my comments are based upon a lifetime of experience in a highly competitive industry, I hope my observations will be of interest.

I am deeply concerned over the damage which the proposed bill will inflict upon the export operations of U.S. companies. The tax burden of any company is just as surely a cost of doing business as are the costs of raw materials and labor. Under the present law, and throughout our tax history, no U.S. tax burden has been imposed on the income earned abroad by a subsidiary of a U.S. company until the subsidiary actually returned these earnings to its U.S. parent in the form of dividends. It was therefore possible for the subsidiary to use the unremitted earnings derived from the foreign sale of goods manufactured in the United States to meet the price competition of foreign-made goods. These unremitted profits were also available to expand the selling organization, facilities, and services the subsidiary could offer in connection with sales of the U.S.-made products, and thereby increase the sales and demand for products made in the United States.

The proposed law would close the door on this most important method of increasing U.S. exports, of meeting foreign competition, and of capturing new markets for goods manufactured in our country. Since foreign competitors have long enjoyed, and will continue to enjoy, the tax advantage which the proposed bill would destroy for American business, it seems clear that the export operations of American industry will be under an imposing, and perhaps insurmountable, competitive handicap. It appears elementary that this handicap will result in not only the loss of future markets for U.S.-made goods, but will cause the loss of existing export opportunities as well. Quite clearly, this loss will produce an immediate adverse impact on the companies and workers who depend on exports for a substantial portion of their business and employment.

The proposed throttling of U.S. export capability, particularly when coupled with the proposed lowering of tariffs on which some U.S. industry depends in order to sell their high-cost goods even at home, seems to indicate that a "sledgehammer" blow is about to be delivered to American industry. It is impossible for me to understand how the proposed foreign income provisions of this bill can help our balance-of-payments problem, contribute to healthy American industry, or produce additional tax revenue.

H.R. 10650 contains many provisions which are both inequitable and impose heavy burdens from the standpoint of compliance. A major inequity is presented by the imposition of a tax on income which is not, and which may never be, actually received. Currency may be blocked, income offset by future losses, currency devalued, and property even confiscated. The bill fails to give current recognition and tax relief to such situations.

The accounting and recordkeeping necessary to determine the tax attributes of different types of income and of different classes of stock, and the reconstruction of foreign books and records upon a U.S. tax basis pose many difficult accounting problems. An example would be the necessity, under the amendment to section 482, to identify and to allocate costs to each separate product, and for each separate sale.

In addition to the problem of compliance on the part of business, it seems quite likely that the bill would be impossible to administer on a fair and equitable basis due to the enormous discretionary powers delegated to internal revenue agents without adequate legislative guidelines. The "imputed royalty" provision of the proposed section 952(c) assumes the agents will possess the wisdom and knowledge of a mythical god.

As I am sure you will recognize, I have made reference to only a few of the problems, inequities, and undesirable consequences for U.S. business which may be experienced should H.R. 10650 be enacted. It is my sincere belief that this bill would produce results which are entirely opposite from those which are intended and desired, that it would stifle American domestic industry, and that

its provisions are grossly unfair and virtually impossible to administer equitably.

For these reasons, I urge you to review H.R. 10650 carefully, and to vote against its foreign income provisions.

Sincerely,

DWIGHT P. JOYCE,
Chairman and President.

BLAW-KNOX CO.,
Pittsburgh, Pa., June 8, 1962.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR SENATOR BYRD: We were pleased to learn that the Treasury has given further consideration to the draft of sections 13 and 16 of the revenue bill of 1962. It was gratifying to note from Secretary Dillon's letter of transmittal accompanying the draft of statutory language, with accompanying explanation, of amendments proposed by the Secretary of the Treasury on May 10, 1962, to sections 13, 15, 16, and 20 of H.R. 10650 that he has expressed consideration for the suggestions of witnesses during the hearings before the Committee on Finance.

However, we do not believe that the language submitted by the Treasury Department is satifactory to take care of serious inequities regarding sections 13 and 16.

Under the "Technique for taxing U.S. shareholders" (p. 2), there is a statement "Losses of one controlled foreign corporation in a chain of controlled foreign corporations are permitted to offset gains in the current year of other controlled foreign corporations." The statutory language to accomplish this stated purpose appears to be in sections 952(d) of the proposed amendments. We are fearful that this language will not take care of the situation where an American parent has one foreign controlled corporation operating at a profit and another directly owned foreign controlled corporation operating at a loss. We believe that as a minimum the controlled foreign corporation income or losses should be handled on a consolidated basis regardless of whether they are in a chain of ownership or in parallel subsidiary positions.

Even this change of languauge would not handle the problem of profit or loss from foreign subsidiary corporations in an equitable manner. It is our understanding that the tax philosophy behind the Treasury proposals with regard to sections 13 and 16 is that the controlled foreign corporation subpart F earnings should be taxed immediately to the American parent. It seems logical, therefore, that the Treasury must intend that these earnings be handled as though the foreign controlled subsidiary were a branch of the American parent or that the separate coroporate entity of the foreign controlled subsidiary should be disregarded—thus giving rise to imputation of earnings to the American parent. We believe it necessarily follows that it is highly inequitable to look through the corporate entity to tax the earnings of the controlled foreign subsidiary—but refuse to look through the corporate entity if the controlled foreign corporation is operating at a loss.

Our understanding of the operation of sections 13 and 16 and our objections to the bill as it now stands are shown by the tabulation of figures of a hypothetical case under which the American parent invests $100,000 in the foreign subsidiary; the subsidiary has losses of $10,000 per year for 3 years and profits of $10,000 per year for 7 years; at the end of 10 years the American parent sells the stock of the foreign subsidiary for $110,000. The tabulation is based upon the assump-

tion that the American parent has no capital gains to offset the resulting capital loss, and the effect of foreign tax credit has been disregarded in the computation.

	Capital	Earnings and profits	Net worth	Basis to American parent
Capital invested	$100,000		$100,000	$100,000
Losses $10,000 per year for 3 years		($30,000)	70,000	100,000
Profits $10,000 per year for 7 years		70,000	140,000	140,000
Selling price at end of 10 years				110,000
Loss: Nondeductible capital loss				30,000
Tax cost to American parent: Income imputed to American parent $70,000 minus $30,000 deficit in accumulated earnings and profits $40,000 taxable at 52 percent				20,800
Net return to American parent: $110,000 selling price of stock less $20,800 tax on imputed earnings				89,200
Cost of stock investment				100,000
Net loss for which there would be no tax benefit				10,800

It would seem to us that the Treasury Department has been working under the assumption that foreign subsidiary corporations are set up for the sole or primary purpose of tax benefits to be derived therefrom. We hope that your committee will stand firm against legislation which, based upon an overzealous desire to reach so-called tax haven income, results in unfair treatment to American taxpayers. If it would be helpful to your committee or to your technical advisers, we shall be happy to make a personal appearance or work with your technical advisers in the drafting of sections 13 and 16.

Very truly yours,

J. J. GIBBONS,
Assistant Treasurer.

AEROSPACE INDUSTRIES ASSOCIATION OF AMERICA, INC.,
June 8, 1962.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: In connection with the consideration by the Senate Finance Committee of H.R. 10650, the proposed Revenue Act of 1962, it is desired that the position of the Aerospace Industries Association with respect to the foreign income provisions contained in section 13 of such bill be brought to your attention and to the attention of the other members of the committee.

Member companies of this association have developed license arrangements, subsidiary organizations, and joint ventures in foreign countries, which activities are in direct support of the economic well-being of the United States and of the foreign countries concerned. Such activities supplement the mutual defense and other national security programs of the United States which are so vital to the free world stability. These international business activities have resulted in the return of dollars to the United States, the expansion of American export trade, and the creation of employment within the United States. The expansion of such activities greatly enhances the goal of increasing American industrial activities throughout the world and thereby substantially contributes in many ways to the national interest. Our Government in recent years has encouraged the development of foreign economies through the deployment of American industry investments abroad. Section 13 of H.R. 10650 will, if enacted, constitute a serious deterrent to the expansion of American trade in foreign countries and thereby the economic stability of the United States.

82190—62—pt. 11——19

Many member firms of this association conduct extensive export programs of commercial and military aeronautical and space equipment. At the present time, the Department of Defense is now encouraging companies in the aerospace industry to select European corporate partners to participate in future weapon systems programs in support of NATO. Such international undertakings require capital, and it is clear that section 13 of the Revenue Act of 1962 as proposed would eliminate many potential sources of capital for such purposes.

With the development of the European Common Market and the constantly increating competition which all American industry faces both domestically and abroad, it is paramount to our economic well-being that any foreign income taxing provisions contained in proposed legislation be established with reason and equity, and not discriminate against American industry. It is the considered opinion of this association that enactment of legislation on this subject of the nature contained in H.R. 10650 would have the result of drastically curtailing the development and advancement of the activities of this American industry in many areas of the free world.

It is requested that the views of this association, as contained herein, be made a part of the record of the hearings with respect to the foreign income provisions of H.R. 10650 and that these views be considered during the appraisal by your committee of such provisions.

Respectfully,

GEORGE F. HANNAUM, *Acting President.*

CATAÑO, P.R., *June 1, 1962.*

Hon. Senator HARRY F. BYRD,
Chairman, Finance Committee,
U.S. Senate, Washington, D.C.

MY DEAR MR. CONGRESSMAN: I am taking the liberty of suggesting and recommending an amendment to the House bill shown as the U.S. tax law. That all citizens residents of Puerto Rico be included as taxpayers for the Federal income tax and that the revenues be reimbursed to the Treasury of the Commonwealth of Puerto Rico in the same manner as the customs revenue, rum excise tax, and Federal employees income tax is done.

I am a U.S. Government taxpayer and a resident of Puerto Rico, who has never, and does not expect ever, to complain or to propose the exemption of Federal taxes in Puerto Rico.

Under other circumstances, I would not think of taking up a moment of your time. But things are such that I feel it a duty to have my say.

I write to you, moved by the most fervent desire that you should know more about taxes in Puerto Rico, and why I am not in favor with the formal request of Treasury Secretary, Mr. C. Douglas Dillon, urging tax bill exemption for Puerto Rico.

Since the year 1940, due to World War II, the progress in business and industry in Puerto Rico has been increasing so much that today the Commonwealth government has increased the yearly budget from $29 million in 1940 to $399 million for fiscal year 1962–63. The local income tax is higher than any State. But the income per capita is maintained at $600 which is a very miserable wage compared with the white-collar salaries.

Due to the industrial expansion, the agriculture has been abandoned and is dead. No hands are available for cutting sugarcane, for coffee harvesting and for planting tobacco, the three leading crops of the island.

Vegetables and native meats are scarce to the point where they are imported from nearby islands or from the mainland. In case of an emergency, the people may be doomed to starvation. This might create problems to naval transportation.

Another problem that has reduced agriculture work is the subsistence products delivered to this island by the U.S. Department of Agriculture and commissaries in all the towns of the Commonwealth. Having that free food, the farmworkers do not want to go back to the farms and this creates population problems in the towns.

Due to the industrial expansion, gambling at the horseraces 3 days per week has increased to $40 million per year. Gambling with the government lottery is about $54 million, totaling $94 million for this year.

Due to the advantage of FHA loans, the establishment of the Armed Forces Department and district, urban renewal, and aid received from the Federal Government, the industrial development program prepared or designed by the Federal agency, Puerto Rico Emergency Relief Administration during the years 1936 to 1940 and continued after World War II, have improved the economic conditions of this island so that today it is a well developed country.

Due to that expansion and to the very high profits obtained by the commerce and industry and the Commonwealth high taxes, millions of dollars have been invested in buildings and factories. Also new highways have been built under the Public Roads Administration program for better means of transportation.

Tax exempted factories pay very high salaries to their continental managers, superintendents, technicians, etc.

Those salaries, which are Federal income tax exempted, range from $8,000 to $25,000 or more a year. The Commonwealth government increased the annual salaries to their officials so that today the house speaker and president of the senate incomes are $16,500 each, the vice presidents and floor leaders $6,600, representatives and senators $5,400, not including per diem mileage and other expenses that are also paid separately to them; $14,000 is the salary for each cabinet secretary including allowances; in 1940 this salary was $4,800.

The higher government position salaries are higher than those of the following States: Virginia, North Dakota, Rhode Island, Montana, Massachusetts, Maryland, Maine, Kansas, Kentucky, Colorado, Arkansas, Delaware, etc., and whose income per capita is as follows in the same order: $1,848, $1,741, $2,228, $2,018, $2,519, $2,394, $1,900, $2,068, $1,543, $2,320, $1,341, and $3,013.

The government instrumentalities, agencies, or authorities pay salaries to their officials and white-collar positions ranging from $6,000 up to $25,000.

The economic conditions of the Commonwealth government are so excellent that a bill P. del S. 253 has been introduced in the senate increasing the salaries of the speaker and the president of the senate from $16,500 to $22,500, the comptroller to $20,000, chief justice from $16,000 to $22,000, planning board chief from $14,000 to $19,000; other 35,000 government employees will get salary increases. The Governor's salary will remain the same, $10,000, but $565,060 are assigned to La Fortaleza, Governor's office and residence.

In private business the salaries are very high and some of them include all allowances for domestic help, housing, cars, and in some cases, allowances for income tax for the individuals.

Almost all those salaries are higher than what is paid by the Federal Government to its employees in Puerto Rico.

Cost of living in Puerto Rico is about 60 percent higher than in the States, but everybody has money for gambling at the casinos, hotels, horseraces, lottery, bolita, and tickets for air traveling to the States and foreign countries, downpayments for purchasing anything as well as for paying $16,000 on loan basis for a house that in the State of Florida will cost about $9,000 with air conditioning and heating system, also for buying $4,000 U.S.-made cars, $250 State license plate when the cost of that same car anywhere in the States is $2,200. Nightclubs are crowded and very expensive, same as the hotels but people frequent them. Articles that you can buy in the States for $2 in Puerto Rico will cost $5. Lack of money is not a problem in this island. There is good income, to pay taxes.

All the above information is given very briefly to show the good economic conditions prevailing here.

Since 1951 I am filing my Federal income tax return and paying the Federal tax. Also I have to file the insular return and by claiming processes the U.S. Internal Revenue Office in San Juan refunds me the amount that I have to send to the insular treasury. For us, the Federal taxpayer residents of Puerto Rico, it is a very embarrassing condition to file two different returns for several reasons as follows:

(*a*) We pay higher income tax rate than the other citizens.

(*b*) Filing two different returns enforced by two different statutes reduces our deduction claim advantage.

(*c*) If the refund from Federal internal revenue is delayed, we have to pay interest and administrative charges from our income.

(*d*) If there is an audit claim from the insular government and takes more than the 3 years of allowed Federal Government time for claims we have to pay from our pocket, because claim period is over.

In Puerto Rico the insular income tax rate is higher than any State tax and is paid only by all "white collars" and "blue collars" whose income comes from salaries and wages that are reported and can be easily audited. The business and industry includes a very high operating percentage in the unit cost of the products, based on the percentage indicated in the tax rate schedules to obtain a 100-percent profit on all business incomes.

That is another reason for having a very high living cost. All product taxes in accordance with the Puerto Rican statutes are paid in the origin by the importer and they are the only ones to have the right to claim the deduction. Taxpayers have no advantage of sales taxes. The buyer of the product has to pay for all charges, expenses, taxes, transportation, management, losses, sinking funds, patron social security and their business income tax. All the above charges are included in the price of the products, from factory representatives, to wholesalers, dealers, merchants, and stores, always adding all the time before the product reaches the consumer. There are products priced 400 percent higher than in the States. Selling prices are not limited in Puerto Rico. If you want to live, you have to pay the posted price.

Since 1950 the Federal employees are the only citizens in Puerto Rico paying the national income tax. It is not fair that the other citizens, because they do not work for the Federal Government, do not have to pay the Federal tax. I understand that in the Virgin Islands everyone has to pay the tax. There is no reason for stateside corporations in Puerto Rico to be income tax exempted when they obtain high profits. I understand that one brassiere factory invested $78,000 and the first operating year the net profit was $173,000.

I am enclosing as enclosure A a photostatic marked printed copy of an advertisement published by the Economic Development, Commonwealth of Puerto Rico, with statements by Mr. Beardsley Ruml, that in my opinion are very antipatriotic, such as those marked items Nos. 3 and 4. That enclosure will show you the reason why a big battle is raging at Capitol Hill level to eliminate Puerto Rico from the U.S. tax law.

That enclosure is full of fallacies. I do not agree with their propaganda statements. In my opinion, item No. 2 should be considered as a childish statement in connection with the power of the two constitution protection.

Due to that propaganda, the stateside corporations have been promised that their businesses will be a 100-percent tax freedom and that workers' wages will be very low.

You can be sure that that is the reason why they are here. I do not consider them a tax-evasion group. If the tax is imposed in Puerto Rico, you will see that they will stay here with their businesses. To industry, Puerto Rico has a great advantage due to its climate and that the local workers are very productive, skillful, and their honesty is beyond question. I am very well acquainted with their qualifications, because from 1933 to 1939 I was the chief maintenance superintendent of the Puerto Rican American Tobacco Co., one of the leading and largest industrial companies during those days; also working for the Puerto Rican Railway Light & Power Co. in their construction and maintenance departments for powerplants, substation, and transmission lines.

The opposition of some leaders to Federal taxes in Puerto Rico is more a political matter rather than economical. They are fighting to eliminate a political commitment, because since 1952 they have been telling to 400,000 illiterate voters and others that "the United States cannot legislate laws affecting Puerto Rico unless the Puerto Ricans will consent." That statement has been spread over the island and outside.

I believe that the above narrative portions of this letter can be helpful for imposing the tax in Puerto Rico. I believe in taxes, because it is a duty of every citizen to contribute for better government management and collective welfare. Puerto Rico should not be Federal tax exempted. The best aid that Congress can give to Puerto Rico is to add the citizens' names in the Nation's taxpayer list. I believe that every good American citizen should pay the taxes. Those opposed to Federal taxes here should be considered as tax evaders and very poor American creed believers.

People in Puerto Rico have a great respect for Federal laws, and if the tax is included, it will be very helpful to the insular government, because the tax evasion is of more than $50 million a year.

My Federal income tax for 1961 was $1,200. In writing to you I have had in mind our President's tax program, and to do my part I say the following:

"Every American citizen should bear in mind that the United States expects from them equal duties for equal rights."

"Citizens must pay taxes to enjoy freedom."

I thank you in advance for any consideration that you might give to this letter.

Respectfully yours,

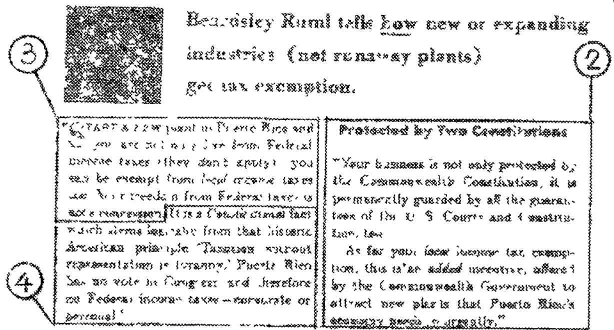
ANTONIO MAÑOSA.

P.S.—In connection with improper use of taxpayers' public funds, enclosures B through F and 1 through 6 are forwarded for information.

A.M.

(The above was made a part of the committee files.)

Why 402 U. S. manufacturers now enjoy 100% tax freedom in Puerto Rico



Beardsley Ruml tells how new or expanding industries (not runaway plants) get tax exemption.

"START a new plant in Puerto Rico and [illegible] you are [illegible] from Federal income taxes (they don't apply) you can be exempt from local income taxes [illegible] freedom from Federal taxes is not a [illegible]. It's a Constitutional fact which stems [illegible] from that historic American principle 'Taxation without representation is tyranny.' Puerto Rico has no vote in Congress and therefore no Federal income taxes—corporate or personal."

Protected by Two Constitutions

"Your business is not only protected by the Commonwealth Constitution, it is permanently guarded by all the guarantees of the U. S. Courts and Constitution, too.

As for your local income tax exemption, this is an added incentive, offered by the Commonwealth Government to attract new plants that Puerto Rico's economy needs so urgently."

How you gain from a new plant in Puerto Rico

1. A better return. Local tax exemptions, freedom from Federal taxes, and lower operating costs will all reflect favorably in your company's balance sheet. See table above.

2. Abundant, skilled labor. Puerto Rico's labor force totals [illegible]. The Commonwealth operates an ambitious vocational training program, which will [illegible] screen workers and teach them specific [illegible] to operate your machines. The adeptness of the Puerto Rican worker in learning precision skills may be judged by the fact that the following famous companies now have operations in Puerto Rico:

Remington Rand, St. Regis Paper, [illegible] Mills, International Latex, Carborundum Company, Shoe Corporation of America, United Drill and Tool, Sunbeam Electric, [illegible], Weston Electrical Instrument Company.

Corporate Tax Exemption

If your net profit after U. S. Corporate Income Tax is:	Your net profit in Puerto Rico would be:
$ [illegible]	$ [illegible]
[illegible]	[illegible]
[illegible]	[illegible]
[illegible]	[illegible]

Dividend Tax Exemption*

If your income after U. S. Individual Income Tax is:	Your net income in Puerto Rico would be:
$ [illegible]	$ [illegible]
[illegible]	[illegible]
[illegible]	[illegible]
[illegible]	[illegible]

*[illegible]

3. No currency or customs problems. Puerto Rico is a Commonwealth freely associated with the United States. It is an integral part of the U. S. economic system. You have none of the problems of operating from a foreign country. Movement of goods, money and people between Puerto Rico and the U. S. is as free as it is between the states of the Union. There's no duty on trade and the U. S. dollar is currency.

4. Low capital investment. New single-story low-rental factories are ready to occupy. The government will even build a special one for you on a very small down payment. Abundant electricity, gas and water are just waiting to be connected.

5. Ideal location. Puerto Rico is served by [illegible] ocean lines and [illegible] airlines. It is only [illegible] hours by air from New York—less than [illegible] from Miami. Goods are actually made in Puerto Rico one day and are delivered in Los Angeles the next. The climate is perpetual Spring. Temperature stays around the [illegible] 70's most of the year. Swimming, sailing and fishing are superb. Domestic help is plentiful.

Is Your Company Eligible?

To find out if your company is eligible for tax exemption in Puerto Rico, call our nearest office:

New York ... [illegible] ... [illegible] Ave.
Chicago ... [illegible] ... [illegible] Monroe
Los Angeles ... [illegible] ... [illegible] Wilshire

New booklet—free to manufacturers

Commonwealth of Puerto Rico
Economic Development Administration
579 Fifth Ave., New York 17, N. Y.
Dept. [illegible]

Mail me "Facts for the Manufacturer," your report of the advantages of Puerto Rico for plant location.

Name ____________
Company ____________
Product ____________
Address ____________
____

ENCLOSURE A

STATEMENT BY RAYMON H. MULFORD, PRESIDENT OF OWENS-ILLINOIS GLASS CO., ON AMENDMENTS TO SECTION 13 OF H.R. 10650 PROPOSED BY SECRETARY OF THE TREASURY DILLON ON MAY 31, 1962

Owens-Illinois Glass Co. wishes to register its continued strong opposition to the foreign tax provisions of H.R. 10650.

Although some of the unrealistic and objectionable provisions are eliminated by the Secretary of the Treasury's proposals, the proposed revision of section 13 would still make bad tax law. The Treasury's sponsorship of these provisions reveals its lack of understanding of the major contribution made to the U.S. economy, and to our balance of payments, by the oversea operations of American business.

Section 13, like other parts of the bill, is so vague and confusing that its enactment into law would lead to lengthy litigation that would be very costly to business and the Federal Government. We have no objection to the elimination of so-called tax havens which are sham operations, but section 13 would unjustly penalize legitimate business operations in low- or no-income-tax countries.

Even technically, revised section 13 is still inconsistent and inequitable. Section 954(b)(1) of the revisions gives no consideration to any commitments for dividends or interest now in effect. Since the revisions generally exempt pre-1963 transactions, the status quo should also be preserved on this type of pre-1963 commitment.

Exports are increasingly essential to the continuing growth and prosperity of American business. The foreign tax provisions that would remain in the bill under the Treasury's May 31 proposal hit directly at America's export business. Their enactment would leave business in a state of uncertainty, a condition which would have an especially bad effect on our economy at this critical period.

Owens-Illinois respectfully urges the committee to eliminate section 13 from H.R. 10650. Any changes that may be necessary in the taxation of American-owned foreign subsidiaries should be carefully studied in connection with the overall tax reform which, we understand, is scheduled for consideration in 1963. The proposals now advanced by the Treasury Department would have a very adverse effect on our balance of payments by stifling the type of foreign operations mainly responsible for an increasingly large flow of dollars back to the United States.

ILLINOIS MANUFACTURERS' ASSOCIATION,
Chicago, Ill., June 14, 1962.

To the Members of the Committee on Finance of the U.S. Senate, Washington, D.C.:

In response to your invitation and for insertion in the record, we are listing below the comments of the Illinois Manufacturers' Association to the amendments proposed by the Secretary of the Treasury to sections 13, 15, 16, and 20 of H.R. 10650. We sincerely appreciate the opportunity to present these comments to your committee and know that they will have your careful attention.

Our comments on the proposed Treasury amendments to H.R. 10650 are as follows:

SECTION 13

Section 13 completely disregards the recognition of separate corporate entities and results in the taxation of income to shareholders which may never be received. This may come about because of devaluation of foreign currencies, such as in Brazil, or the confiscation of corporate property and other assets, as was the case in Cuba.

In our opinion, the proposed section 13, if it were to be enacted as proposed by the Treasury Department, would constitute that Department as both the prosecutor and the judge.

Furthermore the language of this section is not precise and is vague in many significant areas. The proposed amendments by the Treasury in no way clarify these troublesome areas; in fact, the amendments contain language in 17 different places of section 13 to the effect that "the Secretary or his delegate" shall decide when a taxpayer has erred and when he has not.

These areas are so important that we do not believe Congress will want to permit the Treasury to, in effect, enact the tax legislation.

SECTION 15

No comment.

SECTION 16

We opposed this section in previous testimony before your committee and are equally opposed to the Treasury's proposed amendments. We can see no justification for treating the gain from the sale or exchange of stock in foreign subsidiaries in a manner different from gain from sales or exchange of stock in domestic subsidiaries.

SECTION 20

No comment.

Very sincerely yours,

J. R. BARNES, *Director, Tax Department.*

HOUSE OF REPRESENTATIVES,
Washington, D.C., June 13, 1962.

Hon. HARRY F. BYRD,
Chairman, Senate Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: I am writing to express my concern and the concern of the residents of the 20th Congressional District over the possible effects of H.R. 10650 on the future economic development of Puerto Rico.

In its present form section 13, which relates to the taxation of income of controlled foreign corporations, includes corporations operating in Puerto Rico. I am in full agreement with Secretary of the Terasury Douglas Dillon who stated before your committee "Puerto Rico and the Virgin Islands are not truly foreign areas and present special problems under U.S. tax law which can best be handled outside of the context of the treatment of controlled foreign corporations."

It is my hope that your committee will revise the present provision, so that Puerto Rico and the Virgin Islands are excluded from the provisions of H.R. 10650.

I will appreciate hearing your reaction and what the status of this provision is.

With best regards.

Sincerely,

WILLIAM F. RYAN,
Member of Congress.

STATEMENT OF THE CHICAGO ASSOCIATION OF COMMERCE AND INDUSTRY RELATIVE TO AMENDMENTS PROPOSED BY THE TREASURY DEPARTMENT ON MAY 10, 1962, TO H.R. 10650

In a letter dated April 26, 1962, the Chicago Association of Commerce and Industry strongly opposed those sections of the revenue bill of 1962 which would have placed U.S.-controlled corporations and/or citizens at a competitive disadvantage in foreign investment and foreign commerce, i.e., in the sale of goods, sale of know-how and technical data, and sale of services. The association feels that the changes suggested by the Treasury on May 10, 1962, would improve the bill as previously drafted, but that these changes are not sufficiently great to cure the inherent disadvantages and inequities in the foreign-income sections of the bill.

The association feels that, even assuming all the proposed amendments are adopted, the revised bill should not be enacted insofar as the foreign sections are concerned, for both technical and policy reasons. These reasons were described in detail in an appendix to the association's letter of April 26. However, the association would like to comment on the points set forth below.

TREASURY DISCRETION TOO BROAD

The Treasury's proposed revisions would increase the scope of "regulations to be issued," thereby creating the possibility of issuance of unwise rules not intended by Congress and making it difficult for a buisnessman to know the effects of transactions for many years. In view of the complexity of the subjects which would be covered by Treasury regulations, it is difficult to envision meaningful regulations being issued for many years and during that interim period members of the Chicago Association of Commerce and Industry who engage extensively in foreign commerce and investment would be without any

guide in the conduct of business other than the general words of the proposed bill.

Many regulations issued pursuant to the Internal Revenue Code of 1954 were not issued until late 1960 or early 1961 and a much worse record can be anticipated if the revenue bill of 1962 is enacted. For example, the Treasury would have to issue regulations defining how earnings and profits of foreign corporations are to be computed. This would appear to be an impossible or at best a time-consuming project, because in the almost 50 years of existence of the Federal income tax, the Treasury has not been able to define the concept "earnings and profits" in a regulation or elsewhere. The problems inherent in determining earnings and profits of foreign corporations whose records frequently are kept in a different way because of provisions of foreign laws, including foreign tax laws, and whose accounting systems may vary considerably from those used in the United States, are extremely complex and in some cases impossible of solution. Members of the association who have dealt with this problem in any way feel that it would create an administrative nightmare both for the taxpayer and the Treasury and would make compliance very difficult.

The broad discretion that would be given the Treasury to determine many years after transactions will have been consummated regarding not only regulations to be issued but also administrative findings regarding allocation of income, and definitions of tax avoidance in particular cases, is very disturbing to members of the association who will find it difficult to conduct foreign commerce where reasonably definite rules are not prescribed by Congress. One example should suffice to indicate that the fears of the association's membership are well founded. The Treasury has stated that it would be liberal in issuing rulings to taxpayers to permit them to rearrange tax free their foreign activities in order to conform to provisions of the revenue bill of 1962, if enacted. However, the actual experience of members of the association in obtaining rulings under existing provisions of the Internal Revenue Code creates considerable apprehension as to how this statement will be implemented, if at all. For over 25 years the Treasury viewed know-how as a transfer of property and in appropriate cases granted rulings to taxpayers permitting tax-free transfers of know-how to foreign corporations. However, despite this long history of interpretation, the Treasury in 1958 decided and subsequently announced that it would not rule on such transfers pending further study of this problem. After a long delay, the Treasury announced in December 1961 that the study was at last completed and that a comprehensive ruling would be published as to the Treasury's views on the nature of know-how, together with examples which in the Treasury's view would illustrate transfers not motivated by tax avoidance. However, another 6 months have elapsed since the announcement that a comprehensive ruling would be issued imminently and members of the association still have no guidance and still do not know what the Treasury's position is with regard to know-how, despite the fact that it is the position of the U.S. Government that transfers of know-how, particularly to underdeveloped countries, are in the best interests of the U.S. Government.

Accordingly, the association recommends that if legislation is considered necessary regarding foreign income, that the rules relative thereto be made reasonably definite so that the businessman is free to engage in foreign commerce with reasonable assurance as to the results of his transactions, and so that earlier and even more extreme proposals which have now been abandoned by the Treasury cannot in whole or in part be incorporated in regulations issued pursuant to the broad authority which would be given to the Treasury under the proposals dated May 10.

INEQUITIES IN MAY 10 PROPOSALS

The Treasury's May 10 proposals themselves include a number of inequities and distinctions without any policy basis. For example, the membership of the association includes domestic trading companies which purchase goods manufactured by others in certain States for sale in other States of the United States. However, under the Treasury's proposals, if such a trading company conducted the same type of business abroad through a foreign subsidiary, its trading income from purchases in one country and sales in another would be treated as tax-haven type income. There appears to be no justification for impeding the foreign trading activities of U.S. business through punitive tax measures.

Another obvious inequity in the Treasury's proposals of May 10 can be found in the comparatively favorable treatment accorded rental income as opposed to the treatment of income from technical services. The general treatment of

technical service activities, is most unfortunate in the view of the association because it is in the technical field that U.S. business must maintain its supremacy in order to maintain American wage rates and standards of living. Restrictions which affect technical service arrangements inevitably will be harmful to the best interests of the United States. The association feels that both rental and technical service income should be treated more favorably than now proposed by the Treasury.

The Treasury has not proposed any changes in its earlier position regarding the taxation of U.S. citizens residing abroad and seems to be unaware that if American business is to have substantial foreign sales and otherwise conduct foreign business, it must have reliable employees who are U.S. citizens living abroad. However, as in so many of its other proposals, the Treasury has ignored the practical realities faced by a businessman making foreign sales and earning foreign exchange, which add to the U.S. balance-of-payments position.

SUMMARY

In summary, the association feels that the amendments proposed by the Treasury on May 10, 1962, to sections 13, 15, and 16 of H.R. 10650, while in many ways a step in the right direction, are not adequate to deal with the defects in sections 6, 12, 13, and 16, and for that reason the association continues to oppose enactment of these sections. The association feels that the Treasury already has adequate authority to correct any abuses through so-called tax-haven operations, diversion of income, etc., through enforcement of existing provisions of the Internal Revenue Code without the necessity for affecting adversely the competitive position of all U.S. business in relation to its competitors.

If any legislation is considered necessary, the association recommends that the provisions be as definite as possible so that businessmen may conduct foreign commerce, thereby earning income and foreign exchange for the United States and creating jobs for U.S. citizens, without the fear that several years later the Treasury may issue regulations which change the tax results of the transactions.

STATEMENT SUBMITTED BY D. NELSON ADAMS, CHAIRMAN OF THE COMMITTEE ON TAXATION OF THE ASSOCIATION OF THE BAR OF THE CITY OF NEW YORK

Memorandum of comments on draft of statutory language of amendments proposed by the Secretary of the Treasury on May 10, 1962, to sections 13, 15, 16, and 20 of H.R. 10650

Although the committee notes that the Treasury draft rectifies certain of the inequities and deals with certain of the problems of interpretation and application of sections 13, 15, and 16 of H.R. 10650, as passed by the House of Representatives, many of the comments made by the committee in its memorandum dated April 26, 1962, are still apt.

SECTION 13

As respects section 13, the following points mentioned in the prior memorandum are not dealt with by the draft:

Problems of application and interpretation

1. Determination of amount to be included in gross income of a U.S. shareholder who owns stock in a controlled foreign corporation having several classes of stock or is deemed to own stock in a controlled foreign corporation by reason of an ownership interest in a foreign entity having more than one class of ownership interests.

2. Possible failure of section 13(b) to prevent double taxation in all cases where apparently intended, and reference in section 13(b) to personal holding company income rather than foreign personal holding company income, as apparently intended.

3. Manner in which gross income inclusion is to be characterized.

4. Possible construction of attribution rules to permit the same stock to be counted twice in determining ownership of stock by a single U.S. shareholder.

5. Failure to allow a special limitation for foreign tax credit to successors in interest, and possible double taxation of the amount of foreign tax paid by a foreign corporation receiving a dividend from a second corporation whose income has already been imputed to a U.S. parent.

Inequities

1. Disadvantage of controlled foreign corporations as opposed to branches of domestic corporations as respects deduction of foreign losses from domestic income and characterization of foreign income as capital gain or ordinary.

2. Failure to allow individual shareholders credit for foreign tax paid by a controlled foreign corporation even though its subpart F income must be included in their gross income.

3. Failure to make allowance for inability to distribute income because of contractual commitments or indebtedness incurred prior to the enactment of the bill.

Much of section 13, as amended by the Treasury draft, is aimed at transactions designed to avoid foreign taxes. Without commenting on the policy question of whether this is an appropriate objective of U.S. tax legislation, it is noted that these portions of the present draft cannot be justified on the ground of prevention of avoidance of U.S. taxes.

The committee also believes that, while the draft is less inequitable than its predecessors, its provisions are still so complicated and difficult of application that many unintended inequities and loopholes will be inevitable; and serious problems will be experienced by taxpayers and Government personnel in understanding and applying its provisions. For example, it may be necessary in a single case to apply the interrelated provisions of sections 952(a), 955(a), 956(a), and 959(c).

The draft also raises the following particular problems of its own:

1. The phraseology of section 951(a) is such that some question may arise as to whether or not a person must, on the last day of a taxable year, be both a U.S. shareholder and an owner of stock in order to be covered by the section. Presumably both tests were intended to be made as of such last day and clarification would be desirable.

2. Section 951(a)(2)(B) may be unduly restricted in its application. For example, would a reduction be made by reason of inclusion of an amount in gross income by another U.S. person under section 1248?

3. Section 952(c) should be clarified to insure that earnings and profits of the current taxable year which are described in section 959(c)(3) will not be regarded as "accumulated" earnings and profits and thus taken into account twice in determining the section 952(c) limitation.

4. Where a foreign corporation directly owns two or more foreign subsidiaries which are controlled foreign corporations it is not clear under section 952(d) whether or not a deficit of one is usable to offset profits of the other.

5. The determination under section 954(d)(2) of circumstances in which a foreign branch of a controlled foreign corporation has "substantially the same effect" as though such branch were a wholly owned subsidiary can be expected to involve substantial difficulties. This is an outstanding example of the creation of complexities for the apparent purpose of requiring payment of foreign taxes.

6. The mechanics of computing the amount of decrease in qualified investments in section 955(a)(2) are confusing. Is the reduction of the decrease in qualified investments by reason of losses on dispositions of such investments (which also reduce earnings and profits) to be applied before, or after, the limitation to earnings and profits found in the same subsection?

7. The parenthetical phrase in section 957(c) (1) and (2) referring to section 931 seems unnecessary since section 931 is not applicable to foreign corporations.

The committee also notes with concern the extent to which the Treasury draft of section 13 authorizes the Secretary or his delegate to prescribe regulations in substantive areas. For example, in addition to delegations which seem entirely appropriate, the following powers which in our view constitute a questionable delegation of legislative authority are conferred:

Section 952(d).—The Secretary is to determine the manner in which a deficit in earnings and profits of one foreign corporation may offset the earnings and profits of a second foreign corporation.

Section 954(b)(4).—The Secretary is to determine the circumstances under which a foreign corporation has not received foreign base company income because its creation or organization does not have the effect of substantially reducing foreign taxes.

Section 954(d)(2).—The Secretary is to determine the situations in which a branch or similar establishment has substantially the same effect as a wholly owned subsidiary corporation.

Section 955(b)(3).—The Secretary is to determine the circumstances under which an investment made after the close of the taxable year and within a period

to be determined by the Secretary shall be treated as having been made on the last day of the year.

Section 955(c)(1).—The Secretary is to determine the source of income for purposes of defining a "less-developed-country corporation."

Section 957(c).—The Secretary shall determine the source of income and the activities constituting a trade or business for purposes of exempting Puerto Rican or possession corporations from the definition of "controlled foreign corporations."

Section 960(a)(1).—The Secretary is to determine the manner in which the deemed paid foreign tax credit is to pass through to domestic corporations.

Section 961(a) and (b).—The Secretary is to determine the manner in which the basis of stock in a controlled foreign corporation is to be increased or decreased.

Section 962(a).—The Secretary is to determine the manner in which the earnings and profits of a foreign corporation are to be computed.

Section 962(b).—The Secretary is to determine the circumstances under which the blockage of currency will prevent an inclusion in the earnings and profits of a controlled foreign corporation.

SECTION 16

The amendments to section 16 reflect several significant changes which are for the most part responsive to criticisms of H.R. 10650 made by this committee and others.

1. Elimination of the practical retroactivity of section 16 with respect to earnings and profits appears highly salutary for the reasons set forth in the prior report of this committee. The ascertainment of earnings and profits will in many cases continue to constitute a difficult task, particularly where the date of disposition of stock is not the last day of a taxable year but the elimination of retroactive aspects of section 1248 should permit most corporations to make adequate provision for making determinations of their earnings and profits.

2. A significant change in the treatment of gain affected by section 1248 is the proposed coordination of treatment of the various types of dispositive transactions. Under the amendments, all section 1248 transactions would produce dividend income, whereas dispositions covered by section 1248(b) of the House bill would have produced gain from the sale of a noncapital asset.

The committee notes that the language "shall be included in gross income as a dividend," in proposed subsection (b), may create some ambiguity regarding whether dividend characterization is effective for other income tax purposes as well; e.g., the effect upon earnings and profits of the controlled foreign corporation.

3. The amendments would to some extent alleviate the hardships of individual shareholders who would otherwise suffer the combined burdens of progressive rates and unavailability of any credit in respect of foreign income taxes paid by their corporation. The remedy under subsection (c) consists of two alternative limitations on the tax under section 1248. The first limitation would generally produce a combined tax (corporate and shareholder levels) of 64 percent; and the second would limit the tax by reference to hypothetical distributions of the corporation's earnings and profits. These limitations appear sound in principle, although they possess certain technical defects, noted below.

4. The amendments also include a counterpart of section 337, applicable in determining the effect on earnings and profits of sales made in connection with a 12-month liquidation. Since no such provision appears to be needed with respect to those sales actually qualifying under section 337, its purpose and function are not wholly apparent.

5. The exemption of corporations organized under the laws of Puerto Rico or United States possessions, and of 10-year less developed country corporations, is entirely a matter of policy, upon which no opinion is expressed. It is noted that the exemption for Puerto Rico and United States possession corporations is not as broad as is stated in paragraph 5 of the explanation. This text indicates that all such corporations are exempt, whereas the effect of the statutory provision requires compliance with the tests of section 957(c) as a condition of exemption.

6. As is true under the House bill, earnings of the foreign corporation in the United States which have actually been subjected to U.S. corporate tax are included in the measure of the tax under section 1248.

TECHNICAL AND DRAFTING MATTERS

1. Section 1248(a)(2). The reference to section 954 should read "Section 957."

2. The limitation contained in section 1248(c)(1) in effect grants noncorporate shareholders a "deemed credit" for foreign income taxes paid by the controlled foreign corporation. The general purpose of this limitation is to restrict the amount of tax under section 1248 in such manner as not to exceed (on a corporate and individual basis combined) a 52-percent corporate tax followed by a 25-percent capital gain tax upon the remaining 48 percent of corporate earnings. It is noted that the technique utilized to accomplish this objective does not limit the rate of foreign income tax upon which a "credit" may be based.

A minor drafting hiatus in section 1248(c)(1)(A)(ii) could be remedied by identifying the taxable years first referred to therein as taxable years of the foreign corporation, which is presumably what is intended.

3. If it is intended that the adjustment for losses and distributions, under section 1248(c)(2), is to be made under regulations, rather than a case-by-case basis, this should be provided.

4. In addition to section 1248(d)(1), provision should also be made to eliminate from earnings and profits the amount of post-1962 earnings and profits included in the gross income of the same stockholder as foreign personal holding company income under section 551.

5. In section 1248(d)(3)(C)(iii), the phrase "more than 6 months" should read "not more than 6 months."

6. In the second clause of section 1248(e), the provision that the limitation of "such subparagraph" shall not apply seems inappropriate. It should instead be provided that the limitation of subsection (c)(1) shall not apply.

McDermott, Will & Emery,
Chicago, June 15, 1962.

Hon. Harry Flood Byrd,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

Dear Senator Byrd: We would like to submit the following comments on the amendments to sections 13 and 16 of H.R. 10650 which were proposed by the Secretary of the Treasury on May 1, 1962, for consideration of the Senate Finance Committee:

Section 13

1. Serious difficulties will be encountered by taxpayers in determining foreign base company sales income under section 954(d) in the case of a foreign corporation engaged in assembling, processing, or manufacturing operations where components for its products are purchased in the United States from "related persons." It would be difficult to trace United States versus foreign components through the manufacturing process, determine income realized from the sale of products containing U.S. components, etc. The difficulties in interpreting this section would, in our opinion, make it very hard to administer, particularly since accounting records must reflect transactions as they occur. If it is intended (the language is not clear) that manufacturing operations are to be excluded, the section should spell out what type of activity constitutes "manufacturing."

2. Even if the problems outlined above were eliminated, we question the advisability of attempting to separate out a portion of the income of a foreign corporation which is engaged in processing, assembly or manufacture of products containing U.S. components for taxation under section 13.

3. The pattern of development of many U.S. businesses abroad has started with marketing operations, and from this point has expanded to the subassembly and manufacture of some products using U.S. components. Many foreign concerns use the same approach in expanding their operations in other foreign countries. In many instances, this program is followed by U.S. business principally to permit or facilitate the importation of U.S.-manufactured products. These marketing activities therefore represent the first steps in legitimate foreign expansion, and not merely devices to minimize taxes.

4. Where a foreign subsidiary has substantial permanent marketing activities in foreign countries, legislation of the type proposed by section 13 would seem

inappropriate. People, offices, and distribution facilities abroad represent the same type of foreign investment as plants and machinery, and should be similarly treated for purposes of taxation.

5. In numerous instances, questions presented by these amendments are left to be answered by "regulations prescribed by the Secretary or his delegate." Earlier drafts of this legislation and Treasury proposals have proved unworkable due to the many technical difficulties and ambiguities contained therein. In the current amendments the Secretary now requests you to let him answer these questions and provide many of the ground rules by regulation. We seriously question the advisability of doing this for legislation as basic as that proposed. Over 7 years have elapsed since adoption of the 1954 code, and we still are waiting for final regulations under some sections. It will not be possible for businessmen intelligently to comply with any proposed legislation unless the legislation itself is sufficiently clear to permit compliance.

6. In many situations it would be impossible to determine and record where a product would be used, consumed, or disposed of.

7. If the profits on some products sold are and some are not treated as foreign base sales company income, separate profit and loss accounts would be required for each product or perhaps for each sale. This is not normally done, and would present fantastic problems of accounting detail, as well as considerable additional expense.

8. Section 954(d) would also treat as foreign base company sales income the income realized by a foreign corporation from the purchase and sale of products both manufactured and sold abroad. This represents a sweeping extension of our Government's authority to tax income.

9. Numerous comments made during the hearings before your committee have not been reflected in the new provisions. The proposed amendments fail to correct many of the serious technical deficiencies and errors pointed out in both testimony and written material.

10. Present legislation (sec. 482) gives the Internal Revenue Service an adequate tool to tax income of the type described in proposed section 13 to a related U.S. entity.

Section 16

U.S. source income realized by a foreign corporation should be eliminated from earnings and profits under section 1248(d) in the same manner as is income included under section 951.

The shortness of time has not permitted us to study thoroughly the amendments proposed by the Secretary of the Treasury. Our review of this legislation to date, however, indicates clearly that numerous basic problems are unanswered by the proposed amendments. We believe that it would be inadvisable hastily to adopt legislation of this magnitude without sufficient opportunity for the full development of these questions before your committee, particularly where it appears that the effect of the legislation may be to increase the flow of capital abroad for expansion of foreign manufacturing operations in lieu of the purchase of U.S. components, thereby reducing domestic employment engaged in the production of goods for export.

Respectfully submitted.

R. E. Murphy, Jr.

Statement by Charles J. Busick, Income Tax Administrator, New York, N.Y., Relating to Section 20 of H.R. 10650, Information With Respect to Certain Foreign Entities

We respectfully urge that the penalty provisions of proposed new section 6038 be modified to preclude unintended hardship which may in many cases result from the applicable language contained in H.R. 10650.

Although the proposal does not appear to affect significantly the penalty imposed by current law, it extends the reduction of foreign tax credit to include 10 percent of the foreign taxes paid directly by U.S. corporate taxpayers. Accordingly, as pointed out in correspondence to the committee's chairman, an inadvertent failure to supply information with respect to some insignificant foreign subsidiary (perhaps one formed to serve some peculiar requirement of local foreign law and capitalized at $1,000), could, under the proposal, result in a reduction of several million dollars in foreign tax credit attributable to foreign taxes paid by the domestic corporation.

The purpose of section 6038 is to require domestic taxpayers to report information concerning the activities of their foreign subsidiaries which could not be elicited directly from the foreign subsidiaries. It was deemed apt that the penalty for failure to report such information should be directed toward the credit which is attributable to the foreign corporations with respect to which the failure occurred. (See statements of Senator Gore, Congressional Record, May 31, 1960). H.R. 10650 would extend this penalty to the credit for taxes paid directly by domestic corporations. Irrespective of code section 6038, however, a domestic corporation is required to report fully with respect to foreign operations as well as domestic operations. Accordingly, the penalty under section 6038 lacks relationship to the reporting failure when the penalty is computed as a percentage of taxes paid directly by a domestic corporation.

We respectfully urge that the penalty provision under proposed section 6038 be changed so that it will bear a reasonable relationship to the reporting failure under such section.

Re section 13 of H.R. 10650, amendments proposed by Secretary of the Treasury on May 10, 1962.

NEW YORK, N.Y., *June 14, 1962.*

Hon. HARRY F. BYRD,
Chairman, Finance Committee,
U.S. Senate, Washington, D.C.

DEAR SENATOR BYRD: The Association of Casualty & Surety Companies and the National Board of Fire Underwriters have no objection to the elimination of tax-haven operations. Our original objections to section 13 of H.R. 10650 were because the bill not only eliminated the insurance tax haven, but also eliminated tax deferral on normal foreign subsidiary operations, thereby placing U.S.-owned foreign insurance operations at a disadvantage with foreign-owned competitors in the same markets. By memorandum dated April 11, 1962, we recommended certain amendments to improve section 13.

The proposed new language contained in the Treasury Department's draft distributed by your committee on May 31 contains many desirable changes which accomplish, in one way or another, many of the modifications we proposed. There are still a few areas of the bill, as it might be amended under the Treasury draft, which in our judgment require additional modifications.

A committee representing American insurance operations in the worldwide market has drafted the attached memorandum and proposed amendments to section 13. These will preserve the committee objective of eliminating tax havens and still permit American insurers to expand their worldwide operations on the same basis as other American enterprises.

Respectfully submitted.

ASSOCIATION OF CASUALTY AND SURETY COMPANIES,
ROBERT N. GILMORE, Jr., *General Counsel.*
NATIONAL BOARD OF FIRE UNDERWRITERS
J. RAYMOND BERRY, *General Counsel.*

EXPLANATION OF PROPOSED AMENDMENTS TO TREASURY DEPARTMENT DRAFT LANGUAGE

SECTION 13—H.R. 10650

Definition of insurance of U.S. risks

Although the Treasury draft improved the language of H.R. 10650 in this definition, the words are still technically deficient. They produce an unintended result by permitting construction to include insurance on foreign exposures connected with U.S. operations as "U.S. business." We recommend, therefore, that section 953(a)(1) (A) and (B) be amended to define U.S. business as that in connection with property in the United States or upon the lives of persons in the United States. In particular, the word "residents" should be changed to "persons" to avoid the necessity of an insurer having to check legal residence status of every prospect.

Section 953(a)(1)(B) still classifies insurance of wholly foreign exposures as U.S. business where this foreign business results from an exchange of U.S. business of comparable premium volume. We again urge the point that this

ignores the realities of day-to-day reinsurance transactions in the European market. European reinsurance business is customarily transacted on the basis of reciprocity and American-owned European reinsurers, in order to obtain business in the European market, must be prepared to comply with demands from European companies for business in exchange for that obtained. Thus, an American-owned company expecting to get a start in Europe must offer some business in exchange. Initially, the only business such a concern would have to exchange is retrocessions of American business obtained from its U.S. parent. Tax considerations are not involved.

Accordingly, section 953(a)(1)(B) should be modified to apply only to transactions not in the ordinary course of business which are entered into for tax-avoidance purposes. This is particularly important if the leeway provision referred to below is not substantially enlarged.

Leeway provision

The Treasury Department has recognized the principle previously urged by us that a certain amount of U.S. insurance and reinsurance business may legitimately find its way to foreign-owned subsidiaries apart from tax-avoidance purposes. In recognition of this, the Treasury included a paragraph at the end of section 953(a) which makes section 953 inapplicable where U.S. business of a controlled foreign insurer is less than 5 percent of total business. This 5-percent figure is too low to meet the legitimate requirements of U.S.-owned foreign fire and casualty reinsurers. We therefore recommend that the 5-percent figure be increased to the 30 percent recommended by us to your committee during the April hearings, at least so far as fire and casualty business is concerned.

In addition to the U.S. business that may be placed in a foreign subsidiary for reciprocity purposes described above, there is a certain amount of American risks which will be offered a foreign operating subsidiary by reason of its own sales activities in the European market. Such business originally found its way to foreign reinsurance markets through regular channels, completely apart from the parent and apart from any tax saving motives. The 5-percent figure is not large enough to cover such business, particularly in the case of a newer company.

On the other hand, if the leeway provision figure is raised substantially over the 5 percent, it will still leave immediately taxable any insurance tax havens, since such tax havens, where they exist, do not have any substantial non-American business. We know no case of a tax haven arrangement that would be continued under a leeway provision of even 40 or 50 percent.

We also wish to point out that the use of the 5-percent leeway provision singles the insurance business out, alone of all U.S.-owned foreign businesses, and applies an exceptionally harsh standard. Thus, under section 954(b)(3), in the case of any other kind of enterprise, if the total subpart F income is less than 20 percent of gross income, no part of the gross income is taxable under section 13.

We feel that the need for a comparable leeway provision for legitimate placement of U.S. business in foreign-owned subsidiaries is highlighted by the fact that in the absence of such leeway, these cessions of U.S. business are subjected to double taxation. We believe that the drafters have overlooked the fact business placed with an alien reinsurer (whether a U.S.-owned subsidiary or not,) is subject to documentary taxes under section 4371 of the code. These taxes are 4 percent of premiums on all direct fire and casualty business and 1 percent of all life, accident and health, and all reinsurance business. Documentary taxes are payable regardless of whether the business produces a profit or a loss. It may not be credited against U.S. income tax. The documentary tax was designed to be imposed in lieu of U.S. income tax on alient insurers. Thus, on a block of U.S. business taxable as subpart F income and producing a total profit of, say 4 percent of premiums after a 4-percent documentary tax, the 4 percent would be taxed at a rate of 52 percent, so that the combined amount paid to the Treasury on which would be a gross profit of 8 percent, would be 76 percent instead of the usual 52 percent. Possibly there is some justification for this double taxation feature as an added deterrent in the case of tax haven transactions. However, the illustration points up the justice of making certain that a bill should be confined only to the out-and-out tax haven, and that a substantial leeway be permitted for legitimate transactions.

Exception for foreign corporations not availed of to reduce taxes

The Treasury draft contains a desirable provision which permits the Secretary to make an exception for a foreign corporation where he is satisfied that the use of such corporation does not have an effect of substantial reduction of taxes. We do not believe it was the intention of the drafters to exclude the insurance business from this privilege and extend it to every segment of business other than insurance. However, since subpart F income is defined as including both (1) income from U.S. insurance, and (2) foreign base income, and since the exception applies only to foreign base company income, it has this unfortunate effect. This apparent drafting error could even cause the anomalous result of a single concern in the insurance business obtaining the exemption for part of its foreign income but not as to the balance.

Accordingly, we propose that similar language should be included as an additional subsection in section 953.

Technical error in definition of U.S. property

Section 956(b)(2)(E) proposes a desirable modification in excepting from the definition of "U.S. Property" the amount of assets of an insurance company equivalent to unearned premiums on outstanding foreign business. Since there are certain types of insurance policies, including life insurance policies, where the technical term "unearned premiums" is not sufficiently broad to include similar reserves for insurance obligations, we recommend that the amount be equivalent to unearned premiums and policy reserves on all outstanding business.

AMENDMENTS

1. Amend section 953(a)(1) (A) and (B), defining income from insurance of U.S. risks to read:

"(A) Against loss or damage to, or legal liability in connection with property, or upon the lives or health of persons physically present in the United States or

"(B) Against loss or damage to, or legal liability in connection with property, or upon the lives or health of persons, not in the United States as the result of any arrangement, not in the usual course of an insurance or reinsurance business, whereby another corporation receives a substantially equal amount of premiums or other consideration in respect of any reinsurance or the issuing of any insurance or annuity contract in connection with property or persons physically present in the United States, and the principal purpose of such arrangement is to secure the benefit of a reduction of income otherwise taxable as provided in this section."

2. Change the figure "5 percent" to "30 percent" where it appears in the last paragraph of section 953(a) so that the paragraph reads:

This section shall apply only in the case of a controlled foreign corporation which receives during any taxable year premiums or other consideration in respect of any reinsurance or the issuing of any insurance or annuity contract described in paragraph (1) in excess of 30 percent of the total of premiums and other consideration received by it during such taxable year in respect of all reinsurance and issuing of insurance and annuity contracts."

3. Amend section 953 by adding subsection (c) as follows:

"(c) EXCEPTIONS FOR FOREIGN CORPORATIONS NOT AVAILED OF TO REDUCE TAXES.—For purposes of subsection (a), income derived from the insurance of U.S. risks does not include any item of income received by a controlled foreign corporation if it is established to the satisfaction of the Secretary or his delegate with respect to such item that the creation or organization of the controlled foreign corporation receiving such item under the laws of the foreign country in which it is incorporated does not have the effect of substantial reduction of income, war profits, excess profits or similar taxes."

4. Amend section 956(b)(2)(E) to read as follows:

"(E) the amount of assets of an insurance company equivalent to the unearned premiums and policy reserves on outstanding business."

SUPPLEMENTAL STATEMENT ON BEHALF OF THE AMERICAN PAPER & PULP ASSOCIATION, SUBMITTED BY ROBERT E. O'CONNOR, EXECUTIVE SECRETARY, CONCERNING SECTION 13 OF H.R. 10650, THE REVENUE ACT OF 1962

On April 26, 1962, Mr. G. Kenneth Crowell, executive vice president and a director of Kimberly-Clark Corp., of Wisconsin, appeared before the Senate Finance Committee on behalf of the American Paper & Pulp Association, the overall national association of the paper and pulp industry. Mr. Crowell's testimony was specifically concerned with section 13 of H.R. 10650 which was and is opposed by the pulp and paper industry.

On May 31, 1962, the Secretary of the Treasury submitted to the Honorable Harry F. Byrd, chairman of the Committee on Finance, proposed amendments to section 13. This suplemental statement is submitted to the Senate Finance Committee in lieu of further personal appearance, and we request that it be included in the published hearings on H.R. 10650.

We have carefully studied the latest draft of section 13 submitted by Secretary Dillon, which provides that certain undistributed income of controlled foreign companies is to be included in the income of U.S. shareholders in the year the income is earned by the foreign corporation, whether or not it is distributed.

As pointed out in the explanation of amendments recommended by the Treasury Department to section 13, "the basic pattern here is largely the same as in section 13 of H.R. 10650." The American Paper & Pulp Association continues to oppose strongly both section 13 as contained in H.R. 10650 and section 13 as it would be amended by the Treasury Department recommendations.

Secretary Dillon's letter transmitting the recent revision of section 13 states that while the Treasury Department adheres to its recommendation for the eliminaion of tax deferral, the revised draft of the section is submitted as "an aid to the committee if it prefers the more limited tax-haven approach." During the consideration of H.R. 10650, the term "tax haven" has been used rather loosely to describe what the Treasury Department labels as tax avoidance by American business operating abroad, and the Secretary's testimony before this committee suggests that this "limited approach" is aimed primarily at certain illegitimate or questionable practices. While the details of this legislation have been discussed and debated, the inference that the American business community is engaged in questionable tax avoidance practices has gone unchallenged.

Section 13 does not deal with questionable tax-avoidance practices. In fact, the section has nothing to do with tax avoidance as that term is generally used. Section 6 of H.R. 10650 deals with the problem of artificial intercompany pricing practices which in some cases may involve tax avoidance. To the extent that such practices do exist, the Treasury's concern is justified. But this is a separate problem and should not be confused with the objectives which the administration seeks to accomplish under section 13.

It should be emphasized that section 13 deals with business practices which have developed within the spirit and the letter of our existing tax laws. It has become popular to refer to the present tax treatment of foreign subsidiaries as involving the "privilege of tax deferral." The administration has referred to this feature of existing law as a special incentive favoring foreign investments. However, this tax treatment is based on fundamental principles which have been in our tax laws since their inception. Since 1913, our tax jurisdiction over a corporation has been determined on the basis of whether it is foreign or domestic. Under this principle, a foreign corporation is taxable only on its U.S. income. Where shareholders of a foreign corporation are U.S. taxpayers, the U.S. tax on their share of corporate profits is deferred until the profits are distributed as a dividend. This so-called tax deferral results from the recognition under our tax laws that a corporation and its shareholders are separate taxable entities. This principle, long a part of our tax laws, applies equally to domestic and foreign corporations.

It is these two principles of taxation—namely, the limitation of our tax jurisdiction over foreign corporations and the recognition of separate corporate entities—which the administration is presently attacking.

As viewed by the administration, the enactment of section 13 will assist in achieving the following policy objectives:

(1) The improvement of our international balance-of-payments position;

(2) A greater degree of tax equality between U.S. and foreign business operations of Americans; and

(3) The removal of opportunities for tax avoidance.

We respectfully submit that the bill will not achieve any of these objectives, and will very likely have a harmful effect on the U.S. economy in the long run.

BALANCE OF PAYMENTS

It is our firm belief that a reduction in the outflow of foreign investments which would result from the enactment of section 13 in any form, can only bring a corresponding reduction in the return of dollars to this country. The less we invest in the future in foreign countries, the less we must expect in future income. Moreover, in addition to discouraging future investments, section 13 would place an added burden upon existing investments previously made with the encouragement of our Government. It would handicap the ability of present foreign-affiliated companies to compete in their own countries. Our industry's foreign affiliates would inevitably have to bear greater taxes than those borne by their local competition. Their ability to compete would be seriously weakened as their plants and equipment grow older and less efficient than their competitors'.

Changes in our tax laws which would discourage foreign investments could hardly be consistent with a sound, long-range policy, since it is these investments which will ultimately build a strong return flow of income to the United States and strengthen our balance of payments situation for the future.

It is unlikely that the proposed changes in the tax law would, in fact, be effective in increasing the return of dollars to the United States on a short- or long-term basis. To the extent that this is an objective, it is based on the erroneous assumption that the primary basis for retaining income abroad, whether it be derived in the form of royalties, interest, or dividends, is an overall tax advantage. It is extremely doubtful whether significant amounts are retained abroad for tax reasons. Profits are retained abroad to expand the capital of existing business operations or to provide funds for new investment opportunities.

TAX EQUALITY

The assumption that equality of tax burden should be measured by the U.S. income tax system is unwarranted. Equality in this form will create discrimination against our own business operations abroad. A foreign subsidiary may be paying income taxes at effective rates equal to or greater than the U.S. rate. In such cases, nothing is achieved by taxing foreign subsidiary profits on a current basis because the U.S. tax will be wiped out by our foreign tax credit.

Where the foreign income tax is less than the U.S. tax, the foreign country may rely heavily on other forms of taxation for additional revenue. The administration's theory that a dollar earned by American business abroad should bear the same tax burden as a dollar earned at home assumes that the foreign tax credit under our law will adequately compensate for foreign tax burdens. However, this will occur only when the taxing jurisdictions have comparable tax systems. Where turnover and excise taxes account for major sources of revenue, as they do in many European countries, a credit for income taxes cannot achieve equality. Any limitation, such as that proposed by section 13, would aggravate the possibility of double taxation under existing law. Parenthetically, it should be noted that the gross-up amendment (sec. 11), similarly will aggravate double taxation problems in this area.

To require the American-owned subsidiary to pay additional taxes beyond those imposed upon its competition would have the practical effect of destroying competitive participation by American enterprise in world trade at the very time the President is urging the Congress to grant new tariff cutting authority to the Chief Executive. Moreover, section 13, whether in the form passed by the House of Representatives, or as proposed to be amended by the Treasury Department, is inconsistent with the objectives of the Trade Expansion Act, designed to liberalize international trade. Just a few days prior to his election as President, in November 1960, President Kennedy declared:

"It is becoming abundantly clear that * * * we must increasingly look to private business as an important contributor of development capital and a chief source for the establishment of a sound, long-term balance of payments position.

"One major objective of my administration, therefore, will be encouraging the expansion of U.S. exports and investment abroad. As I have previously indicated, my administration will have a Secretary of the Treasury who will support, not thwart, practical measures to give effect to this objective. * * *

"* * * I believe we can formulate new policies to increase substantially the flow of private investment abroad and enlarge its contribution to the vital interests of the United States in world affairs."

We concur in this statement by the President and in these views. The American Paper & Pulp Association urges the committee to reject section 13 so that tax equality between American business and its foreign competitors can be preserved.

If the revised section 13 is enacted, it may well encourage American business to increase the movement of manufacturing operations abroad. Under present administration thinking, it appears that this is the only way to assure tax equality with foreign competitors.

TAX AVOIDANCE

The administration takes the position that the passage of section 13 is necessary to reduce opportunities for tax avoidance.

To the extent that avoidance of U.S. tax is a problem, it results, as we indicated, from artificial pricing practices between American companies and their foreign snbsidiaries. The Treasury Department has tools under existing law to deal with this problem and section 6 of the present bill is intended to strengthen these. Why then does section 13 seek to tax amounts which are properly attributable to activities of a foreign subsidiary? There is such a great disparity between section 13 and the alleged tax avoidance that it is difficult to tell what lies behind the provision.

The administration also indicated that it is concerned with the possibility that a foreign subsidiary might effect a reduction in foreign taxes. It is not clear why the United States has an interest in the extent to which an American-owned foreign subsidiary competing with European-owned companies minimizes foreign taxes. The reduction of foreign taxes reduces the foreign tax credit and will increase the ultimate U.S. tax imposed at the time of reparation. The present system enhances the possibility of increased revenues. In any event, the answer to this problem does not lie in imposing unilateral penalties on the current profits of foreign-based, American-owned business operations.

In conclusion, we would like to comment briefly on the harmful political consequences of section 21 of the bill, which provides for the abrogation of our existing fiscal treaty obligations in order to make room for the provisions of section 13 (as well as other sections). At the present time, the United States has tax treaties with almost all the countries of Western Europe. American business operating abroad receives significant tax concessions from these countries under the treaties. Unilateral abrogation of our obligations under these agreements may result in retaliatory measures at a time when cooperation with the European Community is vital.

AMERICAN & FOREIGN POWER CO., INC.,
New York, N.Y., June 15, 1962.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

MY DEAR SENATOR BYRD: We appreciate this additional opportunity afforded us to present the position of this company on the amended sections 13 and 16 as released in the committee print of May 31, 1962.

Our testimony on April 27, 1962, before your committee dealt with sections 11 (gross-up), 13 (foreign income) and 16 (capital gains taxed as ordinary income) of H.R. 10650 as passed by the House of Representatives.

As investors in Latin America for almost 40 years, we were gratified that the Treasury Department in the proposed amended sections 13 and 16 did meet some of the objections to H.R. 10650 which were harmful to investment in that less developed area.

We still have some problems with section 13 in addition to our basic objection to the principle of taxing the U.S. shareholder on undistributed income. In particular, we are most anxious that the interest paid by the Argentine and Mexican Governments on long-term obligations issued in payment for properties sold to them be excluded from the definition of foreign personal holding company income. Under amended section 13, such interest would be subject to current taxation to the U.S. parent company.

Although we must reinvest the proceeds of these sales in less developed countries, the interest on these obligations would not be eligible for the exclusion

from current U.S. taxation because it would not constitute income from a less developed country corporation. The original section 13 provided that this interest would be eligible for investment in less developed countries. We believe the staff of the Treasury Department will support a change in section 13 to correct this situation.

In dealing with the exclusion for reinvestments made in less developed country corporations, the Treasury Department amendments limit the reinvestment exclusion to income from investments acquired after December 31, 1962, even though investments acquired prior to that date would meet all the other requirements of a less developed country corporation with the exception of the date of acquisition. It is urged that no sound basis exists for limiting this exclusion to new investments.

While permitting income to be invested in obligations of companies operating in Latin America, the statutory language of amended section 13 precludes investments in other types of property considered qualified investment under the original section 13. The permissible investments are now limited to stock and obligations of at least a 10-percent owned "less developed country corporation." This may be considered a necessary limitation, but it would seem that as long as the income is derived from less developed countries and is reinvested in less developed countries, this should be sufficient to qualify the income for exclusion from current taxation to the U.S. shareholder.

We are submitting herewith a more detailed statement on the changes we would suggest to sections 13 and 16 of H.R. 10650. We respectfully request this letter and statement be made a part of the record of the hearings on H.R. 10650 presently being held by the Committee on Finance.

Sincerely yours,

KENNETH B. SPRAGUE, *Vice President.*

STATEMENT SUBMITTED BY KENNETH B. SPRAGUE, VICE PRESIDENT, AMERICAN & FOREIGN POWER CO., INC., CONCERNING AMENDMENTS PROPOSED BY THE SECRETARY OF THE TREASURY ON MAY 10, 1962, TO H.R. 10650

American & Foreign Power Co., Inc., is a domestic corporation with subsidiaries, both foreign and domestic, operating in 10 Latin American countries. From its inception in 1923 the company, through its subsidiaries, has been primarily engaged in the supplying of electric services abroad, principally in Latin America.

Within the last 4 years, subsidiaries of American & Foreign Power have found it necessary to sell their utility properties in Argentina and Mexico to the Governments or governmental instrumentalities of these countries. The Governments of these countries regarded the transactions as a conversion of the investment from utility properties to other properties and in each case required reinvestment in the countries as a condition of the sale. In each case, the contract of sale provides for semiannual payments over a period of 15 years and such reinvestment must be made within a reasonable time after payments are received.

In addition, in the last 3 years subsidiaries of American & Foreign Power have had properties expropriated or seized by governments in Cuba and Brazil without receiving compansation up to the present time. Of course efforts continue to be made to secure adequate compensation.

Section 13. Controlled corporations—Comments concerning the taxation of interest received on obligations of governments of less developed countries

Section 13 of H.R. 10650 as originally passed by the House of Representatives would have permitted, subject to unnecessarily severe restrictions, a controlled foreign corporation receiving interest payments from the Government of Argentina or Mexico to reinvest these payments in a trade or business carried on in a less developed country or in stock of a corporation engaged in a trade or business in a less developed country without subjecting the interest received to U.S. income tax.

However, under the proposed amendments submitted by the Secretary of the Treasury on May 10, 1962, this right of reinvestment without U.S. taxation of interest on obligations of governments of less developed countries would be eliminated.

Under section 13 of the bill, the Secretary's proposed section 954(a) defines "foreign base income" which is taxed to the U.S. shareholders of the controlled foreign corporation as including foreign personal holding company income which includes interest income. An exclusion is allowed at proposed section 954(b) for dividends and interest from qualified investments in less developed country cor-

porations which, in turn, are reinvested in qualified investments in less developed country corporations. Since a qualified investment in a less developed country corporation as defined at proposed section 955(b) is restricted to corporations at least 10 percent of whose stock is owned by the controlled foreign corporation, such a qualified investment in a less developed corporation cannot include obligations of a foreign government. Therefore, under the Secretary's proposal, interest from a foreign government or its instrumentalities cannot qualify as being received from a qualified investment in a less developed country corporation and such interest when received by a controlled foreign corporation must be taxed to such corporation's U.S. shareholders.

It would appear inequitable to permit some controlled foreign corporations to receive interest and dividends from qualified investments in less developed country corporations without taxation to the U.S. shareholders when the same privilege is not extended to another controlled foreign corporation which finds itself in the position of receiving interest on obligations of a foreign government of a less developed country solely because such government purchased or expropriated a business enterprise owned directly or indirectly by this controlled foreign corporation. This is particularly true where it is necessary for the controlled foreign corporation to reinvest the proceeds in the less developed country.

The Secretary of the Treasury is not unmindful of the fact that under unusual circumstances or in times of involuntary transfer of investment it may be necessary for a foreign subsidiary to hold obligations of a government of a less developed country and has provided in his proposed amendment at section 955(c) under the definition of "less developed country corporation" a subsection pursuant to which 80 percent of the assets of such a corporation could consist of obligations of the government of a less developed country.

It is submitted that an exclusion from foreign personal holding company income should be granted in the unusual case of interest received by controlled foreign corporations on obligations of governments of less developed countries so that such interest would not be subjected to U.S. income tax. This could be accomplished by adding a new paragraph to section 954(c) which would provide in effect that foreign personal holding company income does not include interest on obligations issued by foreign governments of less developed countries, their instrumentalities or agencies.

It is believed that the Treasury Department will support in principle a modification to meet this problem of U.S. taxation of interest received by controlled foreign corporations from governments of less developed countries.

Section 13. Controlled corporations—Comments concerning the definition of "qualified investments in less developed country corporations"

Section 13 of H.R. 10650 as originally passed by the House of Representatives would have permitted a controlled foreign corporation receiving dividends and interest from an investment in a less developed country (regardless of whether such investment was acquired before or after December 31, 1962) to reinvest such dividends and interest either in a trade or business carried on by the controlled foreign corporation in a less developed country or in stock of a corporation carrying on a trade or business in a less developed country without subjecting such dividends and interest to U.S. income tax.

However, the proposed amendments submitted by the Secretary of the Treasury on May 10, 1962, contained the two following restrictions, among others:

(1) The investment in a less developed country corporation from which the dividends and interest are received must be made subsequent to December 31, 1962 (proposed sec. 955(b)(1)); and

(2) The controlled foreign corporation may not reinvest in assets in a trade or business carried on by the controlled foreign corporation itself in a less developed country (proposed sec. 955(b)(1)).

The first of these two requirements denies tax exclusion to dividends and interest from investments in a less developed country corporation merely because these investments were in existence prior to December 31, 1962. This discriminates against income received by the U.S. investor who has risked his capital in less developed country enterprises in the past.

Since it is the policy of our Government to stimulate investments in less developed countries under the Alliance for Progress program, it would appear desirable to permit reinvestment of all dividends and interest received from less developed country corporations regardless of when the original investment generating such dividends and interest was made. This could be done by merely striking the words "acquired after December 31, 1962" from the Secretary's proposed section 955(b)(1). The proposed section 954(b)(1) requires that

excluded dividends and interest from investments in less developed country corporations be reinvested in the same taxable year as received; therefore, this change would not provide any loophole in the law.

The second restriction, which would require a controlled foreign corporation to reinvest excluded dividends and interest in a second corporation engaged in a trade or business in a less developed country rather than in a trade or business carried on by the controlled foreign corporation itself in such a country, seems to provide an additional and unnecessary obstacle to foreign reinvestment. This could be remedied by adding a subparagraph to section 955(b)(1) permitting such reinvestment directly by the controlled corporation in its own business.

Section 16. Gain from certain sales or exchanges of stock in certain foreign corporations

Under section 16 of the bill, proposed section 1248 would tax a U.S. shareholder's gain on the sale or liquidation of the stock of a foreign corporation as ordinary income to the extent of the allocable portion of the foreign corporation's earnings and profits accumulated after December 31, 1962.

An exemption is provided at section 1248(d)(3) that this rule of taxation will not apply in the case of a U.S. corporate shareholder which has held for 10 years the stock of a less developed country corporation that has qualified as such for the same period. However, to meet the requirements for this exemption, the U.S. corporate shareholder must prove that at no time during such 10-year period has any individual owning 10 percent or more of its stock transferred any of his stock other than by bequest or interstate succession. Further, it is provided that if any other corporation owns stock of the U.S. corporate shareholder, the shareholders of such second corporation will be deemed shareholders of the U.S. corporate shareholder for the purpose of meeting the 10-percent test. This placs an impossible and unnecessary burden of proof on a large U.S. corporate shareholder whose stock is listed on the New York Stock Exchange and is, in turn, held by thousands of shareholders. It is submitted that this requirement should not be imposed where the stock of the U.S. corporate shareholder is widely held.

CAMPBELL SOUP CO.,
Camden, N.J., June 18, 1962.

HON. HARRY F. BYRD,
Chairman, Senate Finance Committee,
New Senate Office Building,
Washington, D.C.

DEAR SENATOR BYRD: We would appreciate your causing the attached supplemental statement to be inserted in the record of the hearings presently being conducted by the Senate Finance Committee on the revenue bill of 1962 (H.R. 10650).

Very truly yours,

E. M. NUCKOLS, Jr.,
Vice President, Administrative Services.

SUPPLEMENTAL STATEMENT BY CAMPBELL SOUP CO. CONCERNING SECTION 13 OF THE REVENUE BILL OF 1962 (H.R. 10650)

This statement supplements our statement of April 27, 1962, and it is directed to the draft of an amended section 13 of H.R. 10650 submitted to the committee by the Secretary of the Treasury on May 31, 1962.

Our earlier statement pointed out that the bill would have the inequitable and probably unintended effect of denying recognition to unrecouped net operating losses by foreign subsidiaries in some situations. Apparently the Treasury Department recognizes the justice of this protest because "greater recognition of losses" is among major changes intended to be effected by its new draft.

The Treasury Department draft does make some progress in this direction. By dropping the provisions on investments in "nonqualified property," the problem of pre-1963 losses by foreign subsidiaries doing manufacturing as well as selling has been eliminated. A serious problem remains, however, as to pre-1963 losses by foreign sales subsidiaries. Section 952(c) of the draft provides that the subpart F income of a foreign subsidiary included in the gross income of its U.S. parent shall not exceed its earnings for the year reduced by the amount by which the sum of deficits for prior years beginning after December 31, 1962, exceeds untaxed earnings accumulated for years beginning after such date.

By denying recognition to losses by foreign sales subsidiaries before the effective date, the Treasury Department draft retains much of the capricious effect of the bill. For example, if a foreign sales subsidiary lost $1 million in 1962 and made $1 million in 1963, the U.S. parent corporation would have to pay a tax on the $1 million of 1963 earnings even though there was actually no money that could ever be made available to it or its stockholders. However, if this sequence of events were moved either backward or forward 1 year—i.e., the loss was in 1961 and the recoupment in 1962, or if the loss is in 1963 and the recoupment in 1964—no taxable income would be recognized.

The effect is to single out for penalty a group of U.S. companies having foreign subsidiaries with actual sales operations which have not yet become sufficiently profitable to recoup their starting up losses, as compared with those that either have already recouped their starting up losses or may have start up losses after the effective date. It is the genuine operating company engaged in sales which is likely to have starting up losses, while the sham or tax-haven corporation is most likely to have been operated on a break-even basis.

To correct this inequitable situation and to permit consistent applications of the longstanding and uncontroversial principles of section 172 of the Internal Revenue Code recognizing net operating losses, it is respectfully urged that the draft of statutory language incorporating amendments recommended by Treasury Department to section 13 of H.R. 10650 should be amended as follows:

In proposed section 952(e), strike paragraph (1) and substitute therefor:

"(1) The sum of the deficits in earnings and profits for those years in which there were deficits during the five prior taxable years exceeds."

STATEMENT OF W. L. ZIMMER III, ATTORNEY AT LAW, RICHMOND, VA., ON SECTION 13 OF H.R. 10650

The writer is of the opinion that there should be no legislation at this time similar to that proposed by section 13 of H.R. 10650.

The history of the foreign business income provisions of this bill presents the disturbing picture of the Treasury Department claiming urgent but unproven need for tax legislation to prevent the "export" of U.S. jobs, to stop the adverse flow in our balance of payments, and to produce "neutrality" or "equality" in the taxation of income earned abroad and in the United States.

Testimony before the Senate Finance Committee establishes that foreign investment has increased employment in the United States and that discouragement of foreign investment will damage the U.S. balance-of-payments position in the long run. There are indications that the Treasury now concedes these points, together with the inadvisability of attempting to control a possible short-term disadvantage in balance of payments by means of tax legislation. Indicative of a change in the Treasury's position is its abandonment of its proposal to tax income of a foreign manufacturing subsidiary before such income is returned to the U.S. parent through dividends. Accordingly, it is submitted that section 13 should be viewed in its true perspective, that is, as a revenue measure; and it is in this light that we must test the Treasury's contention that legislation of this kind is needed to effect equality in taxation of foreign and U.S. income.

By its modified proposals the Treasury is advocating that the United States extend its taxing powers to income which has never been realized by a U.S. taxpayer, either actually or constructively. With the exception of the foreign personal holding company provisions, this is a complete departure from the rule existing since 1913 that the undistributed profits of a nonresident, foreign subsidiary are not subject to tax. It is strange that the Treasury has just recently discovered the "inequality" of this situation. The fact is that no inequality exists since, until distribution of the profits, the parent company has realized no income.

A U.S. company does not realize income when its foreign subsidiary receives dividends, interest, rents, and royalties from other foreign corporations, related or otherwise; nor does it realize income when the subsidiary earns service fees or trading profits abroad in transactions with related corporations. Of course, when the arrangements and transactions between a U.S. parent and its foreign subsidiary result in the allocation abroad of income that is properly attributable to the U.S. parent, there is tax avoidance which should be eliminated. This avoidance, which is not believed to be widespread, usually takes the form of improper pricing practices and unjustifiable passing of service fees and patent

and know-how royalties between the domestic parent and a foreign subsidiary, resulting in the taxation in a low-tax foreign country of income properly allocable to the United States. However, the avoidance can be cured by a vigorous and intelligent application of section 482. It may well be that amendments to section 482 and in other limited areas would give the Commissioner a more effective, but still equitable, weapon to prevent tax avoidance with respect to foreign income. But any such legislation would not seem to be justified on the case that the Treasury has made to date; certainly the Treasury has not established a basis for the radical changes proposed by section 13.

Your committee will receive from others detailed discussion of many aspects of section 13. Although the section as drafted is subject to much criticism, both technical and substantive, for the sake of brevity the writer, in dealing specifically with the draft, will direct himself only to those provisions which would include certain sales income in foreign base company income.

Section 13 would include in foreign base company income (taxable to the U.S. parent) sales income of a foreign subsidiary derived in connection with transactions between the subsidiary and related persons where the purchased property is produced outside of the country of incorporation of the subsidiary and is sold for use outside of such foreign country. This approach indicates that the Treasury Department is not acquainted with, or ignores, the practicalities of operating in a foreign market.

In entering a foreign market, the general practice has been to sell through local distributors. In many instances this method of marketing has produced unsatisfactory profits, but it has served as a means of introducing one's products in a foreign market with a minimum investment. Frequently, the next step is the formation of a foreign subsidiary to purchase finished or semifinished goods from its U.S. parent for sale in the foreign market. Local manufacture is often not resorted to by U.S. industry unless it is required to meet or better local competition.

For a number of years, a Virginia corporation represented by the writer has sold its products in Latin America through distributors. The company has recently determined that the proper promotion of its products calls for the establishment of sales offices and sales personnel under its policy control in several Latin American countries. The most efficient method of conducting this sales operation is by means of a single foreign sales subsidiary with offices in the several countries. The decision to use one corporation was influenced by the recent organization of the Latin American Free Trade Association. Panama was selected as the country of incorporation of the sales subsidiary because of the clear and modern corporate laws of that country. This Panamanian subsidiary has been registered to do business in Colombia, where it maintains a sales office and sales force. It is planned to have it conduct similar operations in other Latin American countries. The subsidiary will purchase products in final packaged or bulk form from its U.S. parent (the Virginia corporation) for sale in final packages in foreign markets, except in instances where importation into a foreign country is prohibited or unfeasible because of import restrictions or burdensome duties or exchange regulations. Where importation of a particular product is impossible or unfeasible, it is planned to have the product manufactured by a local, reputable concern in accordance with the specifications of the U.S. parent.

If, under the method of operation described above, 20 percent or more of the Panamanian subsidiary's gross income is from sales of products purchased from its U.S. parent and sold for use outside of Panama, the subsidiary will have foreign base company income (after allowance of allocable deductions) subject to taxation by the United States. This result can be avoided by organizing separate sales subsidiaries in each country of operation. However, country-by-country incorporation would be expensive and contrary to sound and efficient business methods. The only possible avoidance of U.S. income tax in the above-described operation is through improper pricing methods between the U.S. parent and its subsidiary and the failure of the parent company to make proper charge to the subsidiary for use of its patents, trademarks, and know-how. These matters are subject to control through the application of section 482. There is no justification for including in the taxable income of the U.S. parent income realized by its Panamanian subsidiary from its legitimate selling operations in Latin American countries.

The Treasury may contend that the sales income of the Panamanian subsidiary will not constitute foreign base company income since the circumstances will warrant a finding by the Internal Revenue Service that the creation of the

subsidiary does not have the effect of substantially reducing income taxes (sec. 954(b)(4)). It is submitted that the exception provided by this section falls far short of that certainty of application to which a taxpayer is entitled in the determination of tax liability, particularly when the taxpayer's operations, though not resulting in tax avoidance, are within the ambit of a taxing statute and can only be removed therefrom if facts difficult of ascertainment are established to the satisfaction of the Internal Revenue Service.

The writer has dealt at some length with the sales income provisions of section 13 because these seem to present one of the most startling and unjustifiable hardships resulting from the proposed taxation of foreign income. Because of numerous other technical and substantive deficiencies of section 13 (which will surely be developed by others) and for the more basic reasons initially stated, the writer urges that no legislation be enacted at this time in this area. The matter requires considerably more study than has thus far been evidenced by the Treasury Department.

Statement of Dan Throop Smith, Professor of Finance, Harvard Graduate School of Business Administration on H.R. 10650

Mr. Chairman and members of the Senate Finance Committee, I appreciate this opportunity to appear before you once again on the subject of the proposed taxation of undisturbed income of foreign subsidiaries. This aspect of H.R. 10650 is so very significant both from the standpoint of the principles involved and its impact on the opportunity for American business to participate in world economic developments that it fully deserves the intensive examination which this committee is giving it. I shall make my comments very brief.

The revisions proposed by the administration in the committee print of May 31 make section 13 less bad than it was before. I have intentionally said "less bad" because any statement to the effect that the proposed changes make it better or represent an improvement might carry the implication that the basic concept of it is good.

Unfortunately, the administration proposal for full taxation of all undistributed income of all foreign subsidiaries is reiterated in Secretary Dillon's letter of transmittal included in the committee print. This proposal seems not only to be founded on an unacceptable principal but to be based on misconceptions as to its economic consequences. Since the revised language of section 13 is still referred to as a "more limited" approach, I feel at liberty to criticize this reiterated basic objective of the administration. Under the circumstances, the adoption of any legislation in this area by the Congress will inevitably be regarded both in this country and abroad as a partial acceptance of this unfortunate aberration in tax policy.

We are still confronted with the desire to extend the U.S. tax jurisdiction over the unrepatriated income of foreign businesses organized abroad and conducting all of their business outside of the United States, merely because they are owned in whole or in part by U.S. corporations. This attempt to extend our tax jurisdiction into foreign countries is without precedent and seems to be without any theoretical justification. There is no indication that other countries would enact similar legislation, though they might get satisfaction and some real amusement if the United States adopts legislation which would impose U.S. tax penalties on American business trying to hold its own in the increasingly competitive world markets, including conspicuously, the Common Market of Western Europe.

This proposal could only be justified on grounds of shortrun expediency, and it is not even well-founded on this basis. It is argued that a curtailment of direct corporate investment abroad is in the national interest because it will improve our balance of payments. The extensive evidence already placed before you about the large amounts of repatriated income from foreign subsidiaries, and the extensive exports which are made to and because of such foreign subsidiaries, indicates the longrun disadvantage to the Nation of any artificial restraints upon corporate investment abroad.

Any improvements in the balance of payments from curtailed investment would be, at most, for a short period of time. And foreign investment is not something which can be turned off and on. Investment decisions, if they are to be effective, must be made freely to take account of expanding markets, technological developments, and new moves by competitors. A postponed investment is likely to be a lost opportunity as competitors move in. Even the existence of a power to control foreign investment will be discouraging because it will add to the inherent uncertainties existing in all foreign investments.

The administration in other pending legislation has wisely stressed the need for greater freedom in world trade. This tax legislation which would restrict our traditional freedom in world investment seems completely inconsistent. The legislation concerning trade is on the right track: this legislation is on the wrong track. And it is a misconception to think that restrictions on foreign corporate investment would benefit our longrun balance of payments.

The second misconception which seems to underlie the basic proposal is that foreign demands for goods will somehow have to be met by exports of finished commodities from the United States if American companies do not establish foreign subsidiaries. The time has long since passed, if it ever existed at all, when American business had a monopoly of product design, technological know-how, and a sufficiently broad domestic market to justify economical large-scale production.

The most casual observation in Western Europe, not to mention the inroads into our domestic markets of manufactured products from Europe and Japan, show conclusively that there are plenty of businesses owned abroad which have the imagination, the financing, the technological equipment, and the scale of production necessary to produce at competitive prices. The rapid progress in the Common Market increases the scale of local markets abroad.

There are few, if any, products for which it is not economically feasible for someone to produce abroad to satisfy local demands. With the competition as rigorous as it is and the inherent difficulties which we as foreigners face in any economic activity abroad, it is frankly hard to see how any government can rationally propose by its own laws to put its own businesses at a competitive disadvantage with local competitors in foreign countries.

Now there are some abuses through the use of foreign subsidiaries, as I stated in my previous testimony. The creation of foreign subsidiaries to reinsure American risks is certainly an artificial devce which seems to have no possible justification other than a transfer to a low-tax foreign jurisdiction of income which clearly arises entirely in the United States. There are also tax advantages in foreign investment companies and in foreign trusts which seem unduly generous and call for corrective legislation.

In earlier testimony I suggested that it might be appropriate to single out passive foreign holding companies and tax American parent corporations on their undistributed income on the grounds that they are generally unnatural corporations created primarily for the tax advantages. In some respects the proposed statutory language is moving in this direction, but the changes seem to have been made grudgingly by excluding particular forms of income of active businesses. So long as there is not a real renunciation of the whole idea of taxing active businesses, adoption of legislation in this area would, to repeat, involve an acceptance of an aberrant policy.

Section 954(d) represents a specific example of unjustified and unsound extension of American tax jurisdiction. I simply do not understand on what theoretical basis or for what practical reason there can be any desire to extend our tax jurisdiction to the undistributed sales profits earned abroad on goods produced in one foreign country, sold through a distributor in a second foreign country to consumers in a third foreign country. If the countries in which the goods are manufactured and sold are willing to let profits be imputed to an intermediate low-tax country, there is that much more profit to be brought into the United States eventually and that much less foreign tax to be applied against the ultimate U.S. tax. We stand to gain as a nation both in the balance of payments and in the national revenue. If this is the way business is carried on abroad, why should American subsidiaries not be able to compete on the same terms, especially when we gain both foreign exchange and tax revenue in the process.

It may be that there should be an agreement among the principal industrial nations to prevent tax advantages from the use of intermediate sales corporations. But if this is to be done, we should start out to get the agreement while everyone can still make use of the device, that is while everyone has something to give up or concede. If we first place American business at a competitive disadvantage by unilateral action, other countries are more likely to want to hang on to their advantages and thus be less likely to agree to joint restraints.

On this whole subject I should like to reiterate one point which has been made previously by others as well as myself. Legislation to extend our tax jurisdiction over the foreign operations of foreign companies, merely because they are the subsidiaries of U.S. corporations, does not even seem likely to bring in much net revenue to the U.S. Treasury. In conversations with acquaintances in

Western Europe during a trip which I made earlier this year for the purpose of trying to learn more about the attitudes and practices on the taxation of foreign income in European countries, I was asked many times if I did not think that foreign countries would find ways of enacting their own legislation to absorb any new taxes which the United States attempted to impose upon U.S.-owned subsidiaries in their respective countries. I had to admit that it seemed quite likely that they would find ways to impose such taxes and these taxes would, of course, be creditable against U.S. taxes.

The net effect then would be an invitation by this country to other countries to impose discriminating taxes against U.S.-owned subsidiaries. To the extent that the invitation was accepted, and it seems reasonable that it would be, there would be an immediate increase in revenue to foreign governments and our own Treasury would receive lower net taxes when the profits were eventually repatriated. This combination of results could hardly be said to be in our own interest from any standpoint. But this result would seem to follow from the misconceived proposal designed to secure some form of theoretical and abstract tax neutrality.

The succession of administration proposals for specific provisions concerning the taxation of foreign income indicate the difficulty and uncertainty of dealing with the subject in a manner that will not do more harm than good. You have now, for example, in section 954(e) a completely new provision to tax on the basis of "foreign base company services income." Some service income might be reasonably included even in a strict definition of holding company income, but the broad definition in 954(e) seems likely to include a good deal of active business income. At least any new departure such as this needs more examination than it can be given in the brief period since it was first proposed by the administration.

In view of such uncertainties and because even the present language seems still to be based on the unsound objective of taxing the undistributed income of active businesses to the extent that this may be politically feasible, it would seem desirable at least to put the whole subject off until another year and until legislation can be drafted which will clearly be confined to the real areas of abuse to the extent that they exist.

If any legislation is adopted in the future, I urge that it be so strictly related to the prevention of abuses that there should be no fear or concern that it would impose tax penalties which would handicap active American-owned businesses in competition with other businesses abroad or that it would invite other countries to impose their own discriminatory taxes against U.S.-owned subsidiaries.

STATEMENT BY KENNETH A. LAWDER, TREASURER OF W. R. GRACE & CO., WITH REFERENCE TO AMENDMENTS TO H.R. 10650

In its attempt to reach so-called tax-haven income, the Treasury Department's basic position is still arbitrarily to tax currently all income of every character received by foreign corporations owned by U.S. interests. Although we recognize that there are abuses in the foreign area, we believe that the Treasury's proposal is not only unsound, but also inequitable. We believe that the United States cannot constitutionally tax earnings of legitimate foreign business corporations to their U.S. shareholders, until received as dividend distributions from the foreign corporations. Our position in this regard was set forth in detail in our statement submitted to this committee under date of April 30, 1962, at the original hearings on H.R. 10650.

However, the amended section 13, suggested by the Secretary of the Treasury on May 31, 1962, for consideration by this committee, still proposes to tax currently sales and service income of legitimate foreign business. The amendments proposed by the Secretary have removed manufacturing operations from the scope of the Treasury's proposal to tax foreign income currently. This would make the bill less objectionable than it was. However, we feel strongly that the legitimate oversea business of U.S.-controlled foreign corporations includes not only manufacturing, but also selling and servicing. It is often necessary to provide technical services to the foreign vendee in order to obtain and hold the business. We are therefore opposed to the provision under which sales income or service income related to the distribution and sale of goods manufactured in one foreign country to persons in another foreign country is made taxable currently to U.S. shareholders.

American business is in competition with foreign business in most foreign countries, and none of these competitors is subject to the tax treatment proposed by the bill and by the Secretary's amendments. The extra burden will, in our opinion, place an unjustified restraint on American business in its attempt to compete with foreign competition. Furthermore, the records required for proper compliance with section 13 would impose an almost impossible administrative burden on U.S. taxpayers with foreign operations. The amendments proposed by the Secretary have done little to alleviate this burden, which will be beyond the capacity of many corporations to bear. The complexities of the bill are such as in themselves to present a strong argument against its enactment. We believe that its enforcement would break down of its own weight.

As pointed out in our statement of April 30, 1962, to this committee in the hearings on H.R. 10650, we believe that section 482 of the present law, together with the forms 2952 now being filed for 1961 and subsequent years by all U.S. taxpayers with foreign affiliates, will provide the Internal Revenue Service with adequate information to enforce section 482 effectively and tax the earnings of "sham" foreign operations currently.

We cannot see how there is any avoidance of U.S. taxes when goods manufactured in a plant in one foreign country (say Germany) are sold in one or more other foreign countries through a central sales and distribution corporation not organized in the country of sale. We do not think there is any justification for taxing this income currently, particularly when it would not, even under the Secretary's proposed amendments, be taxed currently if the German corporation made the sales directly from Germany. As a practical matter, it is not always possible to have a separate selling organization for each manufacturing plant or for each country, and it is often more efficient and economical, businesswise, to have a single sales or service organization covering a number of different countries. There seems to be no reason to penalize this type of income when no U.S. tax avoidance is involved. That a separate selling or service organization may permit savings in foreign country taxes cannot justify taxing legitimate foreign business income currently in the United States. Certainly, there is no abuse, or U.S. tax avoidance, in minimizing foreign taxes. To the contrary, greater U.S. taxes will accrue to the U.S. Treasury as the earnings are distributed as dividends.

Although we do not approve the concept of taxing so-called "foreign base company sales income" and "foreign base company services income," if the committee should decide that these items of income should be taxed currently, we believe that, in determining the amount to be taxed currently, a deduction from subpart F income should be allowed for investments in less developed country corporations. In addition, we believe that a similar deduction should also be allowed for "foreign personal holding company income" invested in such corporations. Such a provision is included in the House bill, but has been excluded from the Treasury amendments.

We call particular attention to section 955(b)(1) of the Secretary's proposed amendments, under which investments in stock or obligations of less developed country corporations are deductible only from those items of interest and dividends from such countries which would otherwise be taxable currently under the Secretary's amendments. We see no reason why the investments in obligations of less developed country corporations which qualify for this deduction should be limited to those having a maturity of 5 years or more, in view of the fact that subpart F income withdrawn from investments in such corporations is immediately taxed currently, unless again so reinvested. The restrictions proposed by the Treasury Department on qualified investments in the less developed countries are hardly compatible with the objectives of other branches of our Government to stimulate the flow of private capital into friendly less developed countries and in particular with the stated policy in the Foreign Assistance Act of 1961 and the Alliance for Progress program for Latin America.

We strongly urge that the definition of "less developed country corporation" be amended by deleting the requirement of section 955(c)(1)(C) under which such a corporation must be organized in one of the less developed countries in which the corporation's assets are situated. We believe it is unnecessary to make such a requirement if the corporation's assets and income qualify in all other respects. We have found by experience that for sound business reasons, including stipulations by partners or investors as a condition to committing funds to finance a project in a less developed country, it may be necessary to incorporate the company in a country other than the one in which the operations are to be carried on.

We are concerned that the determination, under section 955(c)(1)(A) of the Secretary's amendments, as to whether income is derived from sources within less developed countries, is to be made under regulations prescribed by the Secretary for making such determination. It is our view that the principles presently applicable in determining source of income should be the criteria for this determination and that the statute should so state. Otherwise we believe that the Secretary, in view of his recent litigation on the subject, will take a position in conflict with the present statutory and court-developed source rules.

In connection with the Secretary's proposed amendments to section 16, we believe that if gains on disposition of stock are to be taxed currently as dividends, to the extent of realized earnings and profits, losses on such disposition should be deductible as ordinary losses to the extent of the deficit in earnings and profits since 1962 or while the stock was held by the taxpayer, as the case may be. However, we believe that the whole concept of section 16 is unsound and inequitable.

SUPPLEMENTARY STATEMENT OF FINLEY J. GIBBS, ON BEHALF OF THE AMERICAN CHAMBER OF COMMERCE OF THE PHILIPPINES, COMMENTING ON SUGGESTED CHANGES IN SECTIONS OF REVENUE BILL OF 1962 INVOLVING FOREIGN SOURCE INCOME

My name is Finley J. Gibbs. I am a partner in the law firm of Gibbs & Gideon, with offices at 220 Bush Street, San Francisco. I was born in the Philippines, practiced law there and am still actively interested in Philippines matters. I have previously submitted a statement on behalf of the American Chamber of Commerce of the Philippines protesting against the original sections of the revenue bill of 1962 involving foreign source income. The chamber has asked me to submit a supplementary statement with regard to the changes to those sections which have been proposed by the Treasury Department.

Generally speaking, the suggested changes do not eliminate the fundamental evils of the sections on foreign source income but merely ameliorate them to a degree. These sections as originally drafted were virtually a death sentence to the growth of small American businesses in less developed countries, such as the Philippines. The Treasury Department in drafting the new sections has taken some tentative steps in the right direction but they do not go far enough and unless further changes are made the result will still be to stunt the development of any new businesses of this class.

Since the basic principles of the sections remain the same, there is no point in repeating the arguments contained in my original statement. I will instead limit my observations to the proposed changes in section 16. These, though they may eliminate some of the obviously inequitable provisions of the original draft, still impose upon the small businessman a number of unfair and unwise penalties which will effectively deter him from initiating any foreign enterprises.

A. The proposed changes in section 16 still discriminate against American-owned foreign corporations as compared with American-owned U.S. corporations

Section 16, as originally drafted, proposed to tax as ordinary income (at rates up to 91 percent) all gains from sale, liquidation, or other disposition of stock in foreign corporations, which were at least 50 percent owned by Americans, provided the taxpayer owned at least 10 percent of the stock. The only limitation was that the gain taxable at such rate would not exceed the amount corresponding to the undistributed profits earned by the corporation since 1913.

The revised draft now suggested by the Treasury Department: (1) eliminates its retroactive effect; (2) establishes certain limits on the tax to reduce its cumulative effect; and (3) exempts from section 16 stock held for 10 years in foreign corporations in less developed countries.

The proposed limit on the tax is the lesser of: (1) 52 percent of undistributed corporate earnings plus a capital gains tax on the remaining 48 percent, or a total effective rate of 64 percent; or (2) a tax equivalent to that which would have been paid by the taxpayer had the earnings of the corporation been distributed as dividends in the years in which earned.

The first limitation on the tax applicable under section 16 was apparently designed to approximate the tax to which an individual American is subjected in this country if he operates in corporate form and then sells his stock.

This limitation does not, however, achieve such equalization but taxes the American owner of a foreign corporation, particularly a small corporation, more heavily than the owner of a U.S. corporation. This is because a U.S. corpora-

tion is taxed at 30 percent only on the first $25,000 a year of its earnings. The 52-percent rate applies only to the surplus. Thus, if a U.S. corporation accumulates earnings at a rate of only $25,000 a year the effective tax on its stockholders, should it liquidate, is 30 percent plus 25 percent of the remaining 70 percent, or a total of 47½ percent. This is substantially less than the 64 percent applied by section 16. No reason is seen for this discrimination against American owners of foreign corporations.

B. Even if the tax under section 16 were equivalent to tax on U.S. corporations, section 16 would seriously handicap American owners of foreign corporations as compared with foreign competitors

Even if the suggested change to section 16 were further modified to completely equalize the treatment of American owners of foreign corporations with American owners of U.S. corporations, section 16 would still create a serious handicap to Americans in competing with foreign businessmen. In most foreign countries, businessmen who are citizens of such countries, or citizens of countries other than the United States, pay only the lower local taxes. For example, the British businessman in the Philippines pays no taxes to the British Government, but only to the Philippine Government. The same is true of the Chinese, and as far as we know, the Swiss and most other nationalities.

It has been argued that since section 16 applies only upon the sale or liquidation of an American-owned foreign corporation it would not handicap its competitive position. This assumes that an American businessman abroad would never liquidate or sell his business in order to go into a new business in the same country. Most businessmen, during their careers, enter into successive enterprises disposing of one in order to acquire another. Each time an American did this he would be severely penalized under section 16 as compared with his foreign competitors.

C. Proposed exemption from section 16 of shares in less developed country corporations is unreasonably restricted

The proposed exemption of shares held in corporations in less developed countries is a step in the right direction but the requirement in the proposal that an American must hold such shares for 10 years to qualify for the exemption is unreasonable. The only apparent reason for the 10-year limitation is to deter Americans from creating short-lived foreign corporations to carry on one-shot operations in foreign countries without paying the U.S. corporate tax.

We feel that the period is much too long and a 3-year period with provisions similar to the "collapsible corporation" rule would be much more appropriate.

In addition to shortening the holding period a sale or liquidation should be permitted within the holding period if the funds are reinvested within a less developed country. Otherwise section 16 would freeze American businessmen abroad into one enterprise and destroy their flexibility.

Furthermore, the definition of "less developed country corporations" contained in the bill which restricts such corporations to those earning 80 percent of their income from sources within such countries could be interpreted to exclude corporations which have substantially all of their operations within such countries but which export the products of such countries. Since exports as well as imports are of extreme importance to less developed countries this definition should be revised to avoid any doubt that this class of corporation is included within the exemption.

D. Section 16 violates sound foreign policy with regard to less developed countries

Even if section 16 were further amended as suggested above it would still create artificial restrictions on the investment and development of American businesses in foreign countries. We believe this is poor foreign and economic policy as to any foreign country.

As to less developed countries, there are compelling reasons for encouraging, rather than discouraging in any way, the development of American business enterprises. Direct Government aid in such countries has not only proved expensive but impossible to administer effectively. The investment of private American capital on the other hand has been of tremendous benefit to less developed countries. It has spread American know-how, American business methods, American culture, and American ideals. It has benefited the United States directly by stimulating exports, increasing the assets and income of its citizens. It has also made available to the United States sources of raw materials which might otherwise have fallen into unfriendly hands.

Only Americans with a large degree of initiative and pioneering spirit are willing to live under the difficult conditions existing in most less developed countries and risk their capital there. If they are to be under tax handicaps not only as compared with their local competitors, but as compared with Americans in this country, they would have to be quixotic indeed to start a business abroad.

To discourage this economical and mutually beneficial form of aid to less developed countries and to substitute in its place direct Government subsidy would be the worst kind of shortsightedness.

E. Revenue bill penalizes American investments under American control as compared with investments under foreign control

Not only section 16 but the other sections of the revenue bill with regard to foreign source income create a dichotomy between American investments in foreign corporations controlled by Americans and American investments in foreign corporations controlled by foreigners. If the foreign corporation is controlled by foreigners, American investments are subjected only to local taxation until liquidated and then only to capital gains rates. If a foreign corporation is controlled by Americans, the penalties of section 16 and of the other sections are applied. Whether intended or not, the revenue bill will result in penalizing American management as compared with foreign management of American capital.

The surrender of American control of American investments would be completely impractical in less developed countries since there is a great deficiency of able and trained foreign executives in such countries. This is one of the primary reasons why such countries are less developed and why American management with its methods and know-how is as badly needed there as American capital.

F. Complications of revenue bill alone are enough to discourage all but large corporations doing business abroad

A glance at the sections in the revenue bill on foreign source income suggested by the Treasury Department should be enough to convince anyone that they are extremely complicated and difficult to understand or apply. They create a Frankenstein of redtape. Aside from their penalties, this alone would be enough to discourage any small businessman. Only large corporations with expert legal and accounting staffs will be able to understand and carry them out.

If it is felt that these sections are essential, some provision should be made exempting smaller or individually owned corporations. Several precedents for preferential treatment to shareholders in small corporations already exist in the Revenue Code as to U.S. corporations.

CONCLUSION

In conclusion, we wish to reiterate our belief that the investment of private American capital and know-how in underdeveloped countries is the cheapest and most mutually beneficial form of foreign aid. While it is possible that section 16 and the other sections of the revenue bill dealing with foreign source income could be modified in a number of ways to reduce the penalties applied to American investors in American-controlled foreign corporations, any handicap through penalties or redtape imposed by these sections on legitimate American operations in less-developed countries would be extremely unwise.

WASHINGTON, D.C., *June 18, 1962.*

Hon. HARRY F. BYRD,
Chairman, Senate Finance Committee,
Washington, D.C.

DEAR SENATOR BYRD: We are writing you regarding H.R. 10650, the short title of which is "Revenue Act of 1962." The specific section of the bill on which we would like to comment is the new code section 1249 proposed by the Secretary of Treasury on May 10, 1962.

Our firm actively participates in formulating plans for the development and expansion of the businesses of many clients, domestic and foreign. It is primarily in the interest of those clients that we respectfully request consideration by the committee on the following views with respect to this proposed new code section.

Proposed section 1249 apparently would tax as ordinary income the gain from the transfer to foreign-controlled corporations, by sale or exchange, of patents, designs, copyrights, secret formulas, and similar property. While the language of this proposed section is not entirely clear, it is apparent from the Treasury's general description of its recommended amendments that this provision would apply in cases where only capital gains tax or "no tax" would be paid under present law. We are particularly interested in the cases where "no tax" would be paid under present law.

Before a taxpayer can utilize the provisions of subchapter C of the code and obtain nonrecognition of gain with respect to transfers of property to a controlled foreign corporation, the Secretary of the Treasury or his delegate must be satisfied that the exchange in question is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax. Where the taxpayer establishes that there are substantial bona fide business purposes for the transfer other than the saving of U.S. tax, it is the well-established policy of the Treasury to make the advance determinations required by code section 367.

One can only conclude from the proposed new section 1249 that the Treasury now sees tax abuse in the same type of transaction with respect to which it has in the past issued numerous determinations, after careful examination, that avoidance of Federal income tax was not a significant factor.

Rarely will a foreign subsidiary manufacturing operation be established which does not use patents or processes or designs provided by the parent company. In such situations, the procurement by the new business of these asset is just as essential to its success machinery and equipment. There is attached hereto as exhibit I a press release, dated June 6, 1962, by the Agency for International Development. The facts are such as to make it manifest that a transfer of assets to the Turkish company, referred to in the release, by the United States Rubber Co. is not and should not be regarded as an "abuse" such as section 1249 purports to correct. Nevertheless, under this proposed new code section, the United States Rubber Co. would be deemed to have ordinary income even before the Turkish business got underway if it were to transfer to that business such assets as are described in section 1249 and if, in the opinion of the revenue agent who examined the transferor's return, the stock received by it had a value in excess of the basis of assets transferred.

We believe that one of two steps should be taken:

(1) The bill should state specifically that there is no intention to change the existing rule under which the patents and other property mentioned in new section 1249 can be transferred tax free to a foreign corporation where the Treasury is satisfied that tax avoidance is not one of the principal purposes of the transfer.

(2) Alternatively, if it is the desire of Congress to prevent all transfers of such patents and other property to controlled foreign corporations, then Congress should pass a law, outside of the Internal Revenue Code, prohibiting all such transfers, whether they result in gains or losses, and providing appropriate penalties for violations. (We do not believe that this is the desire of Congress.)

Not only does the proposed new section constitute a radical and unjustified departure from the existing rules under the code, but it is a far more stringent, unworkable, and inequitable one than that which it replaces.

In the typical situation, the patents, etc., which are transferred tax free under section 367 are exchanged for stock of a controlled foreign corporation, and the foreign corporation will use them in its own manufacturing operations. For example, Argentine patents might be transferred to an Argentine corporation which would use them in an Argentine manufacturing operation.

The proposed amendment would require these Argentine patents to be valued at the date of transfer. But normally the best evaluation that anyone could make on that date would be only a wild guess. It would not be until years later that a meaningful valuation could be made, when there has been experience in manufacturing and marketing in the specific circumstances.

The complications and litigation which will arise if a valuation of stock becomes necessary under such circumstances are apparent. It would be quite unusual if a domestic corporation entering into an arrangement to establish such a business did not make some transfers of assets to which section 1249 would be applicable. At the time of the transfer the ultimate success cannot be accurately foreseen. The stock of an untried venture, in an uncharted sea, cannot be valued by any set rule or formula. Any speculative projection of earnings of

82190—62—pt. 11——21

the going business will at best be vulnerable to challenge. Nor will litigation in one case afford a precedent in another. In a vast number of instances the earning power of these foreign corporations will be dependent upon many variable economic factors which cannot be projected with any accuracy.

If the apparent purpose of the provision is to be accomplished to any appreciable degree and if additional revenue is to be obtained by reason of the enactment of section 1249, Government valuations of stocks of the foreign corporations must be overly optimistic and reflect speculative values. Taxation of theoretical future earnings is far more objectional to taxpayers than taxation of visible or actual earnings.

In addition to the practical problem relating to the valuation of shares of stock which may be received for the "proscribed" assets, another difficulty will arise. In many cases domestic corporations have idle machinery and equipment, representing excess capacity. Those assets can often be used by the foreign controlled corporation embarking on a program. If, in addition to transferring them for stock or stock and other consideration, the domestic corporation in the same transaction transfers the proscribed assets, the question arises as to the allocation of the total consideration received for the "package" to the two classes of assets so as to ascertain the amount of the ordinary income and the amount of gain which will either be nonrecognizable or will be treated as capital gain. Therefore, three valuations will become involved. The resolution of these extremely technical and difficult problems may well offset in cost any additional revenue growing out of the transfer of patents and an application of section 1249 to that transfer.

The above discussion is directed to the difficulties of administration, assuming that the final economic result would justify embarking upon the establishment of a foreign business despite the penalizing tax consequence of so doing.

Our experience with clients leads us to believe that in a vast majority of cases the agreement of foreign persons willing to help finance these projects is dependent upon the furnishing of patents, formulas, know-how, etc., by the U.S. shareholders. Moreover, foreign interests are often unwilling to agree to percentage royalty payments. We believe that if taxpayers are faced with the alternatives of paying tax on the basis set forth in proposed new code section 1249 or of refraining from entering into arrangements for the transfer of patents, etc., to foreign corporation, the tendency will be to adopt the latter course. We have already encountered this attitude.

We strongly urge that industrial expansion abroad, and the concomitant ability of American industry to compete in the growing foreign markets, should not be blocked or impeded by legislation which penalizes U.S. investors by withdrawing the tax treatment presently applicable to investors in domestic and foreign enterprises alike.

Even if it should be decided to withdraw the present capital gain treatment accorded the sale or exchange of patents, processes, etc., the availability of subchapter C of the code should not be disturbed in cases where, pursuant to code section 367, the Secretary or his delegate determines that avoidance of Federal income taxes is not one of the principal reasons for the transfer.

Yours very truly,

LYBRAND, ROSS BROS., AND MONTGOMERY.

[For immediate release, June 6, 1962]

AGENCY FOR INTERNATIONAL DEVELOPMENT

OFFICE OF PUBLIC AFFAIRS

"COOLEY LOAN" HELPS BUILD NEW TIRE PLANT IN TURKEY

An Agency for International Development loan agreement to provide $5.3 million in Turkish currency to a Turkish subsidiary of the U.S. Rubber Co. for construction of a new tire plant was signed today in Washington. The plant is expected to meet a third of Turkey's tire needs.

The Turkish subsidiary, U.S. Royal Lastik, A.S., 60 percent owned by U.S. Rubber and 40 percent by Turkish investors, will build the tire plant at Adapazari. Local production is expected to save a significant amount of Turkey's foreign exchange. Besides the loan funds, U.S. Rubber and its Turkish associates will make direct investments for new machinery and equipment.

The loan agreement was signed for AID by William S. Gaud, regional administrator for the Near East and south Asia. E. G. McFadyen, treasurer of U.S.

Rubber, represented his company and G. S. Daily represented the Turkish investors.

The loan, to be made in two installments, is one of AID's so-called Cooley loans, named for Congressman Harold D. Cooley of North Carolina. These use local currency proceeds of sales of U.S. agricultural products to provide capital financing for private industry in the less developed countries. To be eligible for an AID Cooley loan, an oversea firm must be associated with a U.S. based company, The program is designed to encourage U.S. interests to invest overseas.

The tire plant to be built by U.S. Royal Lastik will have an ultimate production capacity of 250,000 tires a year. In addition to making truck, bus, and passenger tires, the plant will produce about 560,000 pounds of tread rubber material annually.

The AID Cooley loans for the Turkish tire plant are the first such loans to be made in an industrially developing nation of the Near East and south Asia region.

WASHINGTON, D.C., *June 15, 1962.*

Re section 13 of H.R. 10650—Amendments proposed by the Secretary of the Treasury on May 10, 1962.

Hon. HARRY F. BYRD,
Chairman, Finance Committee,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: The American Life Convention and the Life Insurance Association of America wish to submit a brief statement concerning the amendments proposed by the Secretary of the Treasury on May 10, 1962, to section 13 of H.R. 10650, relating to controlled foreign corporations. These organizations have a membership of 306 life insurance companies in the United States and Canada, representing 94 percent of the legal reserve life insurance in the United States.

In our statement of May 2, 1962, at page 4028 of the hearings, we had suggested that section 13 be limited to tax-haven operations and the so-called foreign reinsurance gimmick. The amendments to section 13 submitted by the Secretary of the Treasury to you on May 10 follow substantially this approach. Thus, we are in agreement with the general principles reflected by the latest draft of section 13. There are, however, two matters which we believe merit further consideration by the Senate Finance Committee.

The first of these matters relates to the definition of "United States property" in section 956(b). Section 956(b)(2)(E) as now proposed would specifically permit a foreign insurance company subsidiary to invest in U.S. property an amount of assets equivalent to the unearned premiums on its outstanding non-U.S. business. We believe the Treasury Department has, quite properly, recognized the need of a foreign insurance subsidiary to invest a substantial portion of its assets in the United States without incurring any adverse tax consequences. The concept of unearned premiums, however, is basically one which relates to the fire and casualty insurance business. Unfortunately, this limited approach is of only slight benefit to the life insurance business in that the reserves it maintains on its policies are primarily life insurance reserves. In order to give comparable treatment to both segments of the insurance business, the Treasury Department should recognize that investments in the United States are proper to the extent of unearned premiums and life insurance reserves. In this way, there would be no discriimination between life companies and fire and casualty companies.

Recommendation.—It is suggested that section 956(b)(2)(E) be modified as follows:

"(E) the amount of assets of an insurance company equivalent to the unearned premiums and *life insurance reserves* on outstanding business with respect to contracts which are not described in section 953(a)(1)." [New material in italic.]

Our second comment relates to the proposal in section 953(a) for a de minimis rule of 5 percent with respect to income derived from the insurance of U.S. risks. In our original statement of May 2, we had suggested that a 10-percent de minimis rule would adequately cover certain legitimate situations in the life insurance business which we believe neither the Congress nor the Treasury intended to cover. Although the adoption of a 5-percent rule affords some relief

in this area, we believe a 10-percent rule would be a more reasonable recognition of these legitimate cases.

We should appreciate the inclusion of this statement in the record of the hearings.

Respectfully submitted.

AMERICAN LIFE CONVENTION,
GLENDON E. JOHNSON,
General Counsel.
LIFE INSURANCE ASSOCIATION OF AMERICA,
EUGENE M. THORÉ,
Vice President and General Counsel.

WHITMAN, RANSOM & COULSON,
New York, N.Y., June 15, 1962.

Re H.R. 10650: Section 13. Controlled foreign corporations

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR SIR: This letter is a request that section 13 of H.R. 10650, relating to controlled foreign corporations, be deleted from the bill.

We are of the opinion that there is grave doubt as to the constitutionality of the tax levied by section 13. This aspect, however, has been adequately documented both in material submitted to the Committee on Finance by a number of witnesses and also in an article by John W. Dowdle, Jr., titled "Can Domestic Shareholders Be Taxed on Foreign Corporate Earnings Prior to Distribution?" in Taxes—the tax magazine for June 1962, which article we recommended to your attention. Therefore, in this letter, we confine our comments to the difficulties we envisage in the administration of section 13.

The writers, as practicing lawyers, interested in efficient administration of the income tax laws, are of the opinion that section 13 is so devised and constructed as to be almost impossible of application as intended.

The principal administrative obstacles stem from the requirement that income of the foreign corporation be defined in Internal Revenue Code terms, although books and records of the corporation are kept and income determinations made according to the accounting principles which may differ greatly from those generally accepted in the United States; the problem becomes even more acute where there is a substantial foreign minority ownership. This requirement may in fact necessitate two sets of books, plus two separate annual audits, probably by different groups of auditors.

Many of the requirements and limitations of section 13 are in terms of earnings and profits. Section 962(a) would provide that earnings and profits of a foreign corporation be determined according to rules substantially similar to those applicable to domestic corporations. However, it should be noted that the Internal Revenue Service has never published any comprehensive set of rules or regulations for determining earnings and profits of domestic corporations.

The greatest difficulties, however, will derive from the scope of the provision—the definition of "controlled foreign corporation," a concept basic to the entire proposed scheme of taxation. A "controlled foreign corporation" is defined as a corporation in which more than 50 percent of the total combined voting power is owned by U.S. shareholders each of which owns, directly or indirectly, at least 10 percent of the combined voting power or of the total value of outstanding shares. There is implicit in this definition an assumption that a community of interest and purpose would exist among the several minority (10 percent) U.S. shareholders and that they could and would cooperate to exercise the control to which their over-50-percent aggregate voting power would presumably entitle them. The validity of this assumption is questionable, if only for the reason that the importance of tax impact, both in dollars and as a relative factor, will carry a different weight with each.

However, even should there exist a clear voting majority, the presence of even a small minority interest, domestic or foreign, could present problems where making a distribution to shareholders or investing in qualified property is not clearly in the best interests of the corporation as contrasted with the private interests and obligations of the shareholders. Any judicial determina-

tion of such "best interests" would of necessity be in the courts of a foreign country and under the tests of foreign standards; in all probability the adverse party, the minority interest, would be a national of the foreign jurisdiction.

The existence of a minority interest thus may limit or preclude both qualified investment so as to avoid taxation and repatriation of earnings so as to provide the wherewithal with which to pay the tax. Failure to distribute will defeat the Treasury's professed purpose of improving the balance of payments. Efforts to persuade minority interests to acquiesce in dividend distributions or qualified investments could result in frictions detrimental to the business and to the U.S. shareholders' investment.

The added difficulties attributable to existence of a minority interest suggest that different statutory treatments may be called for where the foreign corporation is a wholly owned subsidiary and where it is not, with complete rejection perhaps of any plan to tax foreign-controlled corporations in which substantial foreign minority interests exist. The wholly owned subsidiaries could then be taxed on an improper accumulation basis.

The above comments and suggestions have been made from the writers' professional experience. The writers, as American citizens, are further convinced that the enactment of section 13 (or of any comparable provision) will be detrimental to the economy and welfare of the United States, and suggest that consideration be given to liberalization of taxation of repatriated foreign source income.

Respectfully submitted.

JAMES K. POLK.
GERALD D. GRODEN.

AMPEX INTERNATIONAL,
Redwood City, Calif., June 15, 1962.

COMMITTEE ON FINANCE OF THE SENATE,
New Senate Office Building,
Washington, D.C.

GENTLEMEN: In the latter part of May we wrote to all Members of the Senate urging that each Senator seriously reconsider the proposed foreign tax provisions of the Revenue Act of 1962 (H.R. 10650). Since that time, the amendments to section 13 of H.R. 10650 proposed by Secretary Dillon on May 10 have been published, and your committee clerk has invited testimony, preferably written statements. Senator Bartlett, of Alaska, has registered our firm with the committee clerk to give written testimony, and we respectfully submit the following:

The general principal of currently taxing the undistributed earnings of a foreign corporation that happens to be controlled by U.S. shareholders is not equitable. To tax U.S. shareholders on the undistributed earnings of foreign corporations in which they own stock amounts to deprivation of property without due process of law because the U.S. shareholder is taxed on what he has no power to demand and has not received. (A 10-percent U.S. shareholder in a foreign corporation which happens to be 51-percent owned by U.S. interests has insufficient voting power to compel the payment of a dividend sufficient to pay the U.S. tax.)

Although Secretary Dillon has stated that nontaxation of undistributed profits of controlled foreign corporations is a peculiarly American phenomenon, the facts do not support his statement. For example, it has been conservatively estimated by one international affairs publication that there are approximately the same number of non-U.S.- and U.S.-owned "base companies" in Switzerland. The non-U.S.-owned companies count among their number those that are Japanese owned as well as Western European owned. The fact that the home governments of these non-U.S.-owned "base companies" assess no tax is not a matter of accident or legislative oversight; in many cases, the same governments supplement nontaxation of the undistributed profits of foreign sales affiliates by granting reduced tax rates on export income earned by local manufacturing companies which do not have foreign sales affiliates and sell direct to oversea customers. The rate of economic growth from exports in Western Europe and Japan is a testament to the effectiveness of tax incentives as a means of stimulating foreign trade.

The proposed revisions to H.R. 10650 make a distinction between a "foreign base company" and an "operating company." The former generally are sales affiliates who buy 100-percent U.S.-manufactured goods and resell them overseas.

The latter are those that are engaged in both manufacture and sale of products abroad. In an effort to make the legislation more acceptable, Treasury's principal revision has been to provide that a U.S.-owned "operating company" shall be allowed to reinvest its earnings anywhere in the world except the United States without current U.S. taxation. In other words, the revisions offer a tax incentive for U.S. business to set up manufacturing plants abroad and to keep reinvesting the earnings of such plants abroad. This would obviously result in fewer U.S. jobs at the factory level—the sector of our labor market with the highest unemployment rate.

The imposition of a 52-percent tax on the oversea profits of foreign sales companies will force U.S. business to choose between turning away from foreign markets (which would reduce U.S. employment and investment) or establishing oversea manufacturing companies (which would do likewise) in order to obtain U.S.-tax deferral under Treasury's proposed revisions to H.R. 10650. Once oversea manufacturing companies have been established, it can be predicted with reasonable certainty that a part of their output will be used to supply the U.S. market, further depriving American labor of jobs and also depriving Treasury of any tax on the manufacturing profits of the foreign companies.

President Kennedy has stated that businessmen must recognize and deal with current economic realities for what they are and not in terms of useless cliches. We submit that a prime example of the useless cliche is Treasury's "tax haven" characterization of those foreign sales companies that buy and resell U.S.-manufactured goods. The fact that these foreign sales companies in many cases pay foreign taxes on their trading profits at lower than the 52-percent U.S. rate enables them to offer such U.S.-manufactured goods for sale at prices competitive with goods of German, Japanese, and other foreign origin. There is no economic reality which must be faced more squarely than the economic reality of low-priced foreign goods that are available in almost every world market, including the United States. This economic reality will not be successfully dealt with by the proposed tax legislation in its original or revised H.R. 10650 form.

What can be done to assure that U.S. business will pay its fair share of U.S. taxes, keep its manufacturing plants in the United States, and aggressively sell its U.S.-manufactured goods in oversea markets? In response to Treasury's request for suggestions we offer the following proposals:

1. Manageable regulations should be promulgated under existing section 482 of the Internal Revenue Code to eliminate intercompany pricing abuses between U.S. companies and their foreign affiliates.
2. Investment tax credits for U.S. plant investment should be approved.
3. U.S. tax should be assessed on the undistributed oversea earnings of foreign affiliates of U.S.-manufacturing corporations ony where such foreign affiliates unreasonably accumulate their earnings.
4. Tax incentives should be granted to the U.S. manufacturer who exports direct to nonaffiliated customers.

We submit that if the suggestions made above are adopted, the United States would have a tax law which would: (1) Be equitable; (2) not penalize U.S. firms doing business internationally; (3) help the balance of payments; (4) increase employment and investment in the United States; and (5) increase taxes in the long run.

We urge that you seriously reconsider the implications of this proposed legislation. As it now reads, it is a threat to American business—at home and abroad.

Respectfully submitted.

B. A. OLERICH.

SIGNODE STEEL STRAPPING CO.,
Chicago, Ill., June 15, 1962.

Hon. HARRY F. BYRD,
Chairman of the Senate Finance Committee,
Senate Office Building, Washington, D.C.

DEAR SENATOR BYRD: I am convinced that the foreign tax provisions of H.R. 10650, which are to come before the Senate Finance Committee on June 18, are not in the best interests of the company I represent or of the U.S. economy as a whole. I feel that the complex provisions of this proposed legislation will do nothing more than perhaps increase tax revenues in the short term at the expense of depressing our economy and our revenues over the long term.

The imposition of a U.S. tax on all foreign earnings, thus forcing repatriation of funds regardless of all other considerations, will certainly reduce further

foreign investment and the earnings which would accrue therefrom. It is difficult to see how this can fail to deter our economy. This provision apparently fails to take into consideration the fiscal and financial needs of U.S. enterprises abroad or the effect of foreign laws which may relate to repatriation of funds.

The approach to imputed income from royalties, patents, etc., obviously makes double taxation of a very real danger. The assessment of a U.S. tax is certainly no deterrent to a foreign government which may rule such items as not deductible.

It also appears undesirable to further broaden the highly discretionary powers of Internal Revenue as they relate to allocation of income and the President who could, under this bill, alter tax administration through defining of developed and less developed countries.

There are other particulars in which H.R. 10650 is objectionable. Basically, however, instead of strengthening our economy, this proposal will certainly curtail further investment abroad and will seriously penalize many companies whose progressive drive has already put them into foreign markets.

I would like to urge you to oppose H.R. 10650 in the interests of the continued development of the U.S. economy as it operates in the field of international trade and commerce. I have also written to Senators Dirksen and Douglas of Illinois on this subject.

Sincerely,

JOHN H. LESLIE.

STATEMENT ON H.R. 10650 SUBMITTED BY E. W. KUHLMAN, CATERPILLAR TRACTOR CO.

This statement is submitted to express my views on the amendments to section 13 of H.R. 10650 proposed by the Secretary of the Treasury on May 10, 1962, which are contained in the committee print dated May 31, 1962.

I am manager of the tax department of Caterpillar Tractor Co. with headquarters in Peoria, Ill. The company and its subsidiaries manufacture and sell throughout the entire free world earthmoving machinery. In 1961 Caterpillar's consolidated sales were $734 million consisting of sales of $398 million in the United States and $336 million, or 46 percent, in the rest of the free world.

We have wholly owned subsidaries operating manufacturing plants in Australia, Brazil, France and Great Britain, but a substantial portion of the products sold abroad is exported from U.S. manufacturing plants.

Approximately 12,000 of Caterpillar's 31,000 employees in the United States are dependent upon our exports for their livelihood. In addition we have 5,000 suppliers in the United States. Those suppliers also have a vital stake in our export business.

Because of the importance of the export business to Caterpillar, its employees, its shareholders, it suppliers and the U.S. position in world trade, I testified before your committee in opposition to sections 6 and 13 of the bill. (See Hearings before the Committee on Finance, U.S. Senate, 87th Cong., 2d sess. on H.R. 10650, pt. 8, p. 3564.)

The amendments proposed to section 13 by the Treasury are described by the Secretary as "technical improvements in the application and mechanics of the House bill." The Treasury amendments to the section do not eliminate our objections. We opposed section 13 of H.R. 10650 as passed by the House, and we continue to oppose such section as amended by the Treasury.

We are in accord with the principle of penalizing tax avoidance through the use of foreign subsidiaries which contribute little, if anything, toward earning the profit on the entire transaction and which accumulate profit beyond the reasonable needs of the foreign business of the entire enterprise.

Internal Revenue Service has ample authority under the present Internal Revenue Code to reallocate income among related corporations and to disregard corporate entities in the case of "sham" corporations. Internal Revenue Service should use the full potential of the present law in its enforcement program in the area of foreign subsidiaries.

In view of the authority of the Internal Revenue Service under the present law covering this area, we see no need or justification for amendment of the Internal Revenue Code at this time.

This approach will not jeopardize the economic future of U.S. business in world markets, will not aggravate the balance-of-payments problem and will not diminish U.S. tax revenues.

The sound solution to improving the position of U.S. companies in world markets is the expansion of exports which could be made possible by adoption of the administration's proposals on trade and tariffs as contained in H.R. 9900. (We supported this bill in testimony before the House Ways and Means Committee in March 1962.) In addition, U.S. industries such as Caterpillar need controlled foreign corporations for the support and furtherance of exports supplemented by manufacturing abroad. Given this combination of easier access to foreign markets and foreign manufacturing to meet the competition which cannot be overcome by U.S. exports, U.S. industry can provide more jobs at home, earn more profits at home and abroad, and bring back more foreign earnings as these are realized and thus pay more U.S. income taxes.

AMERICAN BOOK PUBLISHERS COUNCIL, INC.,
AMERICAN TEXTBOOK PUBLISHERS INSTITUTE,
Wahington, D.C., June 19, 1962.

Hon. HARRY FLOOD BYRD,
Chairman, Senate Finance Committee,
The Senate, Washington, D.C.

DEAR SENATOR BYRD: On May 3, I sent to you for inclusion in the printed record of the hearings on H.R. 10650 the attached statement on section 13 on behalf of the American Book Publishers Council and the American Textbook Publishers Institute proposing two amendments to the bill.

Since that time the Treasury Department has submitted a proposed revision of section 13 which has been distributed by your committee. We have examined this Treasury proposal and find it does not meet the proposals of the book publishing industry as presented in our statement of May 3. However, if your committee should adopt the Treasury revision of section 13 as a working basis, it would be necessary for us to revise our proposed amendments to conform to the new Treasury draft.

This revision of our proposed amendments is attached, and we would appreciate your placing this letter and our revised amendments into the printed record of the hearing dealing with section 13 of the bill.

Sincerely yours,

ROBERT W. FRASE.

EXPORTS OF AMERICAN BOOKS—STATEMENT OF THE AMERICAN BOOK PUBLISHERS COUNCIL AND THE AMERICAN TEXTBOOK PUBLISHERS INSTITUTE PROPOSING CERTAIN AMENDMENTS TO SECTION 13 OF H.R. 10650

This statement is submitted by the two principal associations of book publishers in the United States. The American Book Publishers Council is composed of companies publishing general and trade books. The American Textbook Publishers Institute has as members companies publishing textbooks and reference works. The members of these two associations do an annual business of well over $1 billion per year (of which some $90 million is exports). This is over 90 percent of the business done by American firms in these fields.

THE BACKGROUND

Since the close of World War II it has been the policy of the U.S. Government to encourage public and private activities designed to project to peoples abroad a full and fair picture of American life, and to project especially a picture of the educational, scientific, and cultural achievements of the American people. The battle for men's minds is now considered a central factor in the strategy of U.S. foreign relations.

The operations of the U.S. Information Agency, now spending over $100 million a year, are perhaps the best known among the various U.S. efforts in this area. The Department of State carries on an extensive program of educational and cultural exchanges; it has helped to stimulate the scholarship and fellowship programs which bring more than 40,000 advanced foreign students a year to the United States, although the great majority of these students are financed by sources other than the U.S. Government. Because USIA libraries could not possibly secure adequate distribution abroad of U.S. books and periodicals the Congress 10 years ago established an information media guarantee program to help publishers and others with their currency conversion problems; this program still functions in certain countries in which normal sales are not possible. Under the AID and Alliance for Progress programs, great emphasis is being

placed on the development of education as an important requisite for economic progress. Still another example of the special role books and other cultural materials are recognized to play in modern foreign relations is the Florence Agreement, a treaty approved by the U.S. Senate which exempts such educational materials from tariffs. Some 35 other countries have adhered to this treaty.

The publishing industry has been proud to play its part in the nationwide effort to present America at its best and most thoughtful. In addition, as one of the most rapidly growing export industries, it is making a contribution on the financial side of the balance-of-payments problem.

That America must be presented at its best becomes increasingly clear. The French Government was first in the field of what might be called cultural propaganda, with activities to advance the teaching of the French language and to promote French art, dating back to near the turn of the century. Between the two World Wars the German Government launched a program of subsidizing distribution of German scientific and technical reports, on the theory that trade follows the book. The British entered the field with their British Council. Now, of course, the Soviet are striving to outdo all other nations in the scale and scope of their efforts to push and promote Russia and Communist books throughout the world.

THE PROBLEM

Books published in the United States, and notably those which can be classified as "educational," "scientific," and "cultural," have enjoyed increasing receptivity abroad in recent years, largely because of their intrinsic merit. They are distributed increasingly in countries where English is not the native language, as well as in English-speaking countries, and of course in developed countries as well as underdeveloped countries (and many would rate the value of this to the United States at least as high in the former as in the latter). Our book exports have been growing in the postwar period at a rate of over 10 percent per year and we now rank only slightly behind Great Britain in this export field.

American publishers are now learning how to take greater initiative in selling abroad. Some have established foreign subsidiaries, and others will follow if present experiments are successful. This expansion abroad, actual and potential, could be blocked or handicapped—perhaps inadvertently—if one portion of H.R. 10650—the Revenue Act of 1962—is approved by the Senate in the language adopted by the House. We refer to section 13 of the bill which would require the immediate taxation of U.S. publishing companies as well as others for the earnings of their foreign subsidiaries unless certain technical requirements were met.

It is a simple thing for U.S. companies to capitalize on a few quick sales in the oversea markets and then withdraw. However, it is another thing to leave the profits in the foreign countries and plow them back into the building of a permanent distribution center for U.S. educational and informational media. With this in mind, it is submitted that those features of the new tax bill which impose an immediate U.S. income tax on the profits of foreign subsidiaries of American companies engaged in distributing educational and informational media abroad are out of harmony with the objectives of U.S. foreign policy and contrary to the best interests of the United States. Such proposals, if enacted, could cause American companies in these fields to "pull in their horns" and to look to the American taxpayer for subsidies and guarantees on their foreign efforts in the future, if any efforts are made. They would also tend to reduce the growth in exports of American books, which is becoming an increasingly important source of foreign exchange earnings for the United States.

One American publisher has said:

"We are just beginning to learn how to distribute our books and other educational materials abroad. I fear that, if this particular provision of the new revenue bill is adopted, we may have to pull out of some of the so-called developed countries where it has begun to expand, and to abandon other expansion projects abroad.

"Our principal product is sets of books, but we also sell other books as well. We are learning how to sell these books by American methods abroad (including in countries where English is not the dominant language) and this means we sell sets of books on the installment plan with the purchasers having 2 years or more to pay. This immediately complicates our problem of financing. We deliver the sets of books when they are ordered, and we pay commissions and maintain our offices abroad, but we don't begin to show cash earnings on the sale

of a set until after most of the monthly payments have been made—not until the last few payments. This means we are faced with an expensive problem of financing. The only practicable way for us to handle this financing is to use the earnings of an established foreign subsidiary, before U.S. taxes, to finance the development of a newer subsidiary.

"From the point of view of the Treasury, of course, the amounts of money that would be involved in an exemption for educational and informational media is very small."

The remedy

The remedy here is relatively simple. In view of the special role American books are playing and can increasingly play abroad, in broad support of American foreign policy objectives, it is recommended that books and other media of communication which are deemed by the Secretary of the Treasury or his delegate to be educational, cultural, scientific, or informational should be exempted from those provisions of the pending bill which call for immediate taxation here of certain income of foreign subsidiaries. Because of the phraseology of the act, two amendments are felt to be necessary to achieve this end, and they are appended to this memorandum. These amendments would not only help to promote our foreign policy objectives but would contribute in a positive way to our balance-of-payments problem.

PROPOSED AMENDMENTS

In section 952 of the code (which is found in sec. 13 of the pending revenue bill) insert in (e)(2)(A) after the words "which is purchased," the following: "(exclusive of books, including textbooks, educational and scientific books and journals, and encyclopaedias, and exclusive of other media of communications which, under regulations prescribed by the Secretary or his delegate, are deemed to be educational, scientific, cultural or informational in nature)"

In section 13, insert in section 952(e), immediately after (6)(B), the following:

"(C) For purposes of sub-paragraph (A) and (B) dividends shall not constitute foreign base company income to the extent that such dividends under regulations prescribed by the Secretary or his delegate are properly chargeable to the earnings and profits which are excluded from the definition 'foreign base company sales income' under subsection (e)(2) in respect of books, including textbooks, educational and scientific books and journals, encyclopaedias or other media of communications which are deemed to be educational, scientific, cultural or informational in nature)"

In section 13 of the draft, insert in section 957, immediately after paragraph (c), the following:

"(d) CORPORATIONS ENGAGED IN PRODUCING OR SELLING BOOKS OR OTHER MEDIA OF COMMUNICATIONS WHICH ARE EDUCATIONAL, SCIENTIFIC, CULTURAL OR INFORMATIONAL IN NATURE.—For purposes of this subpart, the term "controlled foreign corporation" does not include any corporation with respect to which 80 percent or more of its gross income for the three-year period immediately preceding the close of the taxable year (or for such part of such period immediately preceding the close of such taxable year as may be applicable) was derived from the production or sale of books, including textbooks, educational and scientific books and journals, and encyclopaedias, and other media of communications which, under regulations prescribed by the Secretary or his delegate, are deemed to be educational, scientific, cultural or informational in nature. For purposes of determining income from the production or sale of such books and such other media of communications, dividends and interest from a corporation which is excluded from the definition of 'controlled foreign corporation' solely by reason of this subsection shall be deemed to be income from the production or sale of such books and such other media of communications."

CHICAGO, ILL., *June 20, 1962.*

HON. HARRY F. BYRD,
Chairman, Senate Finance Committee,
Old Senate Office Building, Washington, D.C.:

LIBBY, MCNEILL & LIBBY has been engaged in the production and marketing of canned foods for almost 100 years and is presentliy one of the world's largest exporters of a diversified line of canned and frozen foods with substantial

production facilities overseas and agents throughout the free world. We wish to voice our opposition to the enactment of H.R. 10650 and particularly with respect to section 13, which attempts to extend tax jurisdiction over the undistributed income of foreign subsidiaries. This is not only contrary to long-tablished tax principals and practice but, because it ignores proper legal entities, is constitutionally unsound. Foreign operating subsidiaries are established to maintain a competitive position in foreign markets and are not an alternative to the expansion of U.S. production for export. Repatriated earnings have far exceeded foreign investment. Foreign investment actually helps provide more jobs for Americans through increased exports; earnings and exports generated by foreign investment improve our balance-of-payments position; and the proposed taxation of undistributed earnings would have little effect on domestic investment.

We particularly endorse the views expressed before your committee by Dan Throop Smith, professor of finance, Harvard Graduate School of Business Administration, on April 27, 1962, as well as the statements by Hon. Thruston B. Morton before the Senate on March 29, 1962, on the subject of American investment abroad and that of Carl J. Gilbert, chairman, Committee for a National Trade Policy, inserted in the Congressional Record by Hon. Thomas B. Curtis in the House of Representatives on May 10, 1962. It is our considered view that the proposal in H.R. 10650 is utterly inconsistent with the concept expressed in H.R. 11970 designed to encourage freer world trade. We request that our views be made a part of the record of the committee and that it oppose the enactment of H.R. 10650.

LIBBY, MCNEILL & LIBBY,
ROBERT L. GIBSON, *President.*

PUERTO RICO ORGANICS INC.,
Arecibo, P.R., June 14, 1962.

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

HONORABLE GENTLEMEN: It is with the utmost urgency that our corporation wishes to add its voice to the countless others which have requested reconsideration of the proposed section 15 of the revenue bill of 1962.

Our corporation is precisely what the gentlemen from Congress had in mind when they created the Small Business Investment Act. It has been financed partly by the faith of a large number of local small investors and will be able to go forward with the aid of private capital supplied by Puerto Rico Capital Corp.

It is an industry which requires a considerable amount of technical know-how and at present all of its personnel are native Puerto Ricans. It is our belief that our corporation typifies the very essence of what the President and Congress meant by development within the Alliance for Progress; native investors together with native know-how forging ahead with the aid of private capital provided by a small business investment company.

There are countless others like us waiting first that push provided by SBI companies to flourish into self-supporting units of industry to provide employment and raise the standard of living of our community.

Puerto Rico is the showcase, the foremost example, that the United States has of what can be accomplished under our democratic system of free enterprise. It has raised its per capita income 600 percent in 20 years, it has done this primarily under a free enterprise system.

It would be a great pity and an unpardonable mistake to permit this unique example under our flag to flounder.

We respectfully urge that you use the well-known American commonsense and sense of justice recommending strenuously the necessary amendments to make it so that such corporations as small business investment companies not be treated as controlled foreign corporations in Puerto Rico.

Yours very truly,

TEODORO VEGA, *President.*

(Whereupon, at 5:10 p.m., the committee adjourned, subject to the call of the Chair.)

REVENUE ACT OF 1962

MONDAY, JULY 2, 1962

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

The committee met, pursuant to recess, at 10:05 a.m., in room 2221, New Senate Office Building, Senator Albert Gore presiding.

Present: Senators Gore, Douglas, Talmadge, Williams, and Bennett.

Also present: Elizabeth B. Springer, chief clerk.

Senator GORE. The committee will come to order.

The first witness is Mr. Albert Kornhauser, representing Controls Co. of America.

STATEMENT OF ALBERT E. KORNHAUSER, TREASURER OF CONTROLS CO. OF AMERICA

Mr. KORNHAUSER. Mr. Chairman, and members of the Senate Finance Committee, I am appearing on behalf of Controls Co. of America to comment on the proposed amendments by the Secretary of the Treasury to the tax bill, H.R. 10650.

I am Albert E. Kornhauser, treasurer of Controls Co. of America, manufacturers of controls and control systems for the aviation, missile, industrial automation, electronics, automotive, home appliance, refrigeration, air-conditioning, and heating industries. I appreciate the honor of being invited to appear before you to comment on the tax bill and the proposed amendments.

Controls Co. is a relatively small company compared with many American companies engaged in worldwide business. We do about $50 million worth of sales and have approximately 20 percent of our plant area and employees engaged in foreign operations.

Our international organization started with one plant in Holland in 1956, and now consists of the Dutch plant, which has been expanded three times to 70,000 square feet, a plant in France built in 1960, an English factory acquired in 1961, and two South American companies.

We direct our international activities from and operate through a base company located in Zug, Switzerland. We could not have obtained this business overseas from exports from the United States since our customers demand local sources of supply, nor could we have expanded our organization and facilities abroad without the tax advantages inherent in operating through a base company.

I would like to confine my comments to section 13 and the proposed amendments to this section. The amendments, in our opinion, do not make the bill more equitable for American companies in oversea business.

The bill would reduce the scope of operations of foreign-base companies and would further restrict the legitimate business of American companies abroad.

Specifically, we refer to the Treasury's proposed amendments to section 13 which extend the definition of foreign-base-company income to include service income derived in connection with the performance of technical, managerial, engineering, scientific, industrial, commercial, and other services.

This service income would be added to the other categories of foreign-base-company income, which include dividends, interest, rents, and royalties, as well as income derived from the sale of products outside of the base company country.

The proposed amendments by the Treasury, as well as many basic concepts given expression in this tax bill, deviate from our historical concepts of taxation and equity.

One of the cardinal principles of tax policy in effect since 1913 has been the limitation of the U.S. Government's power to tax only "realized" income. The principle of deferral of taxes until income is realized by corporate shareholders in America has been recognized as equitable by Government, industry, and the legal fraternity for years.

Most oversea investments of American companies have been made with the assumption of permanence of this concept. The attempt in this bill to extend the right of the U.S. Government to tax the income of foreign corporations may bring about, in addition to placing a burden on American taxpayers, serious problems of law, treaty obligations, American constitutionality, and in all probability carries the threat of retaliation by the foreign countries upon which our assumed extraterritorial tax power would impinge.

The basic problem, we think, is this. This country is faced with a balance-of-payments problem. Our Government is attempting to alter basic concepts of taxation of more than short-range value in an attempt to increase current income of the Treasury, instead of facing the real cause of the unfavorable balance of payments. Our balance-of-payments problem derives principally from our overcommitment for economic and military expenditures beyond the current financial ability of the United States.

In spite of the fact that the proposed section 13 is not as bad as the former section 13, it remains our feeling that the section is still unnecessarily harsh and would not be good legislation.

The Treasury claims that one of its purposes is to end certain "abuses" connected with the use of foreign-base companies.

The Treasury has at no time specifically listed what it considers to be these abuses, but we would gather they would include the following:

(1) The draining off of income from U.S. parent companies or other related taxpayers into foreign-base companies by means of artificial intercompany pricing;

(2) The compensation-free use of patents, trademarks, know-how, and other intangibles developed by the U.S. parent company or related taxpayers by the foreign-base company to earn royalties abroad;

(3) The use by foreign-base companies of parent company capital, facilities, experience, goodwill, and established trade relations to earn profits more properly attributable to such U.S. taxpayer; and

(4) The use of "paper" foreign-base companies, having little or no substance, for tax deferral purposes.

I would have no argument with the Treasury if suitable legislation were enacted to terminate the abuses of the type listed above, assuming for the moment that new legislation is, in fact, needed.

The difficulty is that the Treasury is not satisfied in limiting its objectives to the elimination of the above-listed abuses, but really wants to reach out and tax the profits of all controlled foreign corporations whether or not such profits have any connection whatsoever with the United States.

Just as nature abhors a vacuum, so the U.S. Treasury abhors untaxed income, and feels that it is its God-given duty to make sure that no dollar of income earned by any controlled foreign corporation escapes taxation either by the United States or by some foreign country.

Controls Co. does not condone, any more than the Government condones, the use of "tax havens" in sham operations devised for the sole purpose of diverting income and evading taxes.

However, we believe that the use of base companies in countries with tax rates lower than those in the United States serves a valid purpose to the American companies using them, and provides a substantial benefit to the U.S. Government.

If an American company cannot do business through a base company enjoying a relatively low rate of taxation compared with the U.S. 52-percent rate, the proposed tax legislation would not restrict the company's foreign competitors from enjoying these so-called privileges.

American companies have formidable competition in most of the markets in which they operate. Any advantage to a foreign competitor is at the same time a disadvantage to the American company.

For example, our competitor, the Holzer Co. of Meersburg, Germany, has a Swiss base and trading company which would be able to accumulate capital at a faster rate than Controls Co.

If the Holzer Co. and Controls Co. each have the same volume of sales and the same profit in Switzerland, Mr. Holzer will have approximately 85 percent of his Swiss profit available for further development of his business compared with 48 percent which Controls Co. would have if the present tax bill is accepted by the Senate.

Mr. Holzer is a very capable manufacturer who gives us all the competition we can handle already, without the advantage of having more capital available in the dynamic growing European market.

One of the most difficult aspects to understand in the proposed tax legislation is the attempt to force an equalization of foreign income tax rates as applied to American companies only, but not to their foreign competitors.

If this proposed tax bill becomes law so that there is no advantage to form a base company in a low tax country such as Switzerland, American companies will undoubtedly operate through corporations domiciled in industrial countries with the largest markets, like England, Germany, or France, which have income tax rates comparable to U.S. rates.

Since the U.S. parent can utilize a credit in most cases for foreign income taxes paid, the U.S. Government in these cases would obtain no tax income nor any consequential future right to taxes. We do not see why the U.S. Government would not consider it favorable to per-

mit U.S. companies to obtain income tax rates on foreign income lower than U.S. rates since the Government retains a deferred right to tax.

American companies investing overseas have demonstrated an ability to earn substantial profits and have returned to the U.S. parents dividends, interest, fees, and royalties many times their original investments.

In addition, their oversea organizations have been responsible for the sale of American manufactured goods, resulting in profits on which Federal income taxes are paid.

I believe the Controls Co.'s experience amply illustrates this point.

Since 1950 Controls Co. has invested approximately $576,000 in two foreign manufacturing operations in Canada and in Holland.

Through 1961 we received from these two companies approximately five times this amount in dividends less foreign taxes withheld, service charges and interest, and these companies have purchased over $5,250,000 of manufactured products from our American factories. The Federal income tax paid on dividends, service charges, and interest, and on the estimated profit on sales to these companies, amounted to approximately $883,000, or 1½ times the amount of the original investment.

If foreign income taxes had been lower, the U.S. Treasury would have collected more taxes.

It does not seem sensible to remove the incentive to American business to reduce its foreign tax bills. Most certainly the nations of the world which currently have lower tax rates than the United States if the proposed legislation were effected would retaliate by increasing their tax rates or withholding provisions, and thus nullify the advantage that the U.S. Treasury expects.

Since taxes abroad, like taxes here, have a tendency to remain in effect, once enacted, such a course of events would run to the permanent detriment of U.S. business and to the U.S. balance-of-payments positions.

The proposed amendments to section 13 would eliminate the right to defer taxes where base company profits from developed areas are used for investment in undeveloped areas.

It has been our policy to limit investment in the undeveloped areas to a minimum necessary only to insure the financial success of these operations. As there is a basic shortage of capital invested in companies in undeveloped countries, Controls Co.'s subsidiaries and affiliates do not have funds to pay dividends in any case, and in some cases the payment of interest or fees is restricted.

Because of inflation in most of the undeveloped countries it is often difficult to determine what is a "real profit." Consequently, it would be contrary to conservative accounting practice to to consider subsidiary book profits as income from these areas. Income can only be considered real when it is received by the U.S. parent.

We do not think that the Treasury's proposed amendments to sections 14, 15, 16, and 20 make H.R. 10650 more acceptable to U.S. industry or contribute toward solving the balance-of-payments problem.

We feel that it is in the best interests of the United States not only to permit U.S. companies to form foreign base companies, but it would be in the best interests of the United States to adopt the approach of

the Boggs bill, proposed in 1958 and 1959, and to permit U.S. companies to incorporate such foreign base companies domestically. Only by positively encouraging U.S. business to invest abroad by granting a complete deferral of U.S. tax on profits until they are repatriated to the United States can this country fully encourage the foreign investment needed to enable lesser developed countries to eliminate poverty.

We hope the Senate Finance Committee will consider the long-range interests of the American economy, business, and our world position and reject this proposed law which will stifle American business abroad.

Thank you very much.

Senator GORE. Mr. Kornhauser, how many employees do you have in your plant in Holland?

Mr. KORNHAUSER. We have approximately 460 employees in Holland.

Senator GORE. What was your—460?

Mr. KORNHAUSER. Yes, sir.

Senator GORE. What was your net profit in your Holland plants last year?

Mr. KORNHAUSER. It would be in the neighborhood of $400,000 to $500,000.

Senator GORE. What was your tax rate on that profit?

Mr. KORNHAUSER. 47 percent was the effective tax rate in Holland.

Senator GORE. How many employees do you have in your plant in Zug, Switzerland?

Mr. KORNHAUSER. Well, that is not a manufacturing plant. That is an administrative, sales and a technical service organization, and our employees there are between 25 and 50, I would guess about 35 at the present time.

Senator GORE. What is the highest salary paid there?

Mr. KORNHAUSER. The highest salary there would run around $20,000 per year.

Senator GORE. Around $40,000?

Mr. KORNHAUSER. No, sir; $20,000.

Senator GORE. What net profits did your Zug Corp. show?

Mr. KORNHAUSER. I don't have the figures with me, but it would be in the neighborhood of $300,000 to $400,000.

Senator GORE. So with your principal operation in Holland, where you have more than 10 times as many employees, your net profits are approximately equal.

Mr. KORNHAUSER. The Zug company, though, is supervising a group of people who are working for the company in Germany, where we have a separate corporation which does the sales and engineering work.

We have a company in France which is manufacturing, and we have a company in England so that all of these European companies which are separate corporations are supervised by the administrative and technical staff that operates out of Switzerland, so it is a bigger operation than the people that are directly located in the city of Zug would imply, and——

Senator GORE. You mean it is bigger financially?

Mr. KORNHAUSER. I beg your pardon?

Senator GORE. It is bigger financially?

Mr. KORNHAUSER. No, it is bigger in effect, and the handling of all of the financing in Europe is also handled in Zug.

Senator GORE. What was your effective tax rate in Zug?

Mr. KORNHAUSER. It is approximately 15 percent.

Senator GORE. You said in your statement that you had two companies in South America.

Where are they located?

Mr. KORNHAUSER. One is in São Paulo, Brazil.

The other one is in Buenos Aires, Argentina.

That is, they were both started in about the middle of 1959. They are not wholly owned. All of our European business is wholly owned by Controls Co.

In South America we have local partners, in Brazil, the Brazilians own 50 percent of the company, and in Argentina they own 49 percent.

Senator GORE. Your share is owned directly by Controls Corp.?

Mr. KORNHAUSER. Our share is owned by the Swiss company. The Swiss company in most cases owns the stock in our various foreign operations. The parent company owns the stock in the Dutch company because the Dutch company was incorporated prior to the Swiss company, otherwise we probably would put that all together.

Senator GORE. But your Swiss subsidiary at Zug owns both of your South American operations, also your France and German operations?

Mr. KORNHAUSER. That is correct, and the English.

Senator GORE. And in England?

Mr. KORNHAUSER. Yes.

Senator GORE. Does your Holland corporation have a contract with the Zug subsidiary?

Mr. KORNHAUSER. Yes.

The Zug subsidiary sells the product of the Holland plant outside of Holland; it is mostly in Europe, and they provide engineering, application engineering work and some technical design work on the products that are manufactured in Holland.

Senator GORE. Why would you locate at Zug instead of a more——

Mr. KORNHAUSER. Instead of where, sir?

Senator GORE. Instead of a place more accessible; Geneva, for example?

Mr. KORNHAUSER. Well, we had several reasons for that. We first picked out Switzerland for a number of reasons; it is right in the middle of our sales territory, and it had a stable history economically with good sound money, a good banking system politically so we didn't expect to have many problems there.

They had pretty good people so the employees we would be able to obtain there would be reasonably well qualified for the jobs that we would expect them to do.

Now, as to why we picked Zug compared with Geneva, it was due somewhat to the fact that Switzerland has been a booming country, and housing, office space, and that sort of thing was difficult to obtain in Geneva, or so we were informed at the time we started out, and we picked Zug, we were one of the early companies, as a matter of fact, that moved into Zug.

We have been very happy with that. It is only 30 miles from Zurich, so from a convenience standpoint it is quite satisfactory.

Senator GORE. Senator Douglas?

Senator DOUGLAS. Well, is the mountain scenery very good in Zug?

Mr. KORNHAUSER. Very nice.

Senator DOUGLAS. I take it, then, that it is the mountain scenery rather than the local rate which drew you to Zug?

Mr. KORNHAUSER. Well, I wouldn't say it is the mountain scenery; I think Switzerland is all very beautiful from a picturesque standpoint, but we picked Switzerland first as a country, and then it is a question somewhat of finding a suitable place within——

Senator DOUGLAS. Low tax rates had nothing to do with your going to Switzerland?

Mr. KORNHAUSER. The tax rate naturally is one of the most important——

Senator DOUGLAS. Why didn't you mention that in your reply to Senator Gore?

You mentioned everything but the low tax rates. I was struck at this, and so I thought I would bring in scenery.

Mr. KORNHAUSER. I am glad you brought that up. The tax rate that we were able to get in Zug was relatively favorable.

Now, not so much as at a couple of other places that were not so——

Senator DOUGLAS. I see you have given this matter some study. What would be the other places more favorable than Zug?

Mr. KORNHAUSER. I am not an expert on all the cantonal tax rates in Switzerland, but we—there are some, I think that have a lower——

Senator DOUGLAS. What about the tax rate in Glarus?

Mr. KORNHAUSER. I can't——

Senator DOUGLAS. Or Penza?

Mr. KORNHAUSER. I can't quote you——

Senator DOUGLAS. Or Zurich?

Mr. KORNHAUSER. Zurich runs a little higher than 15 percent.

Senator DOUGLAS. So it was worth while to go 30 miles outside of Zurich rather than in Zurich itself?

Mr. KORNHAUSER. Yes, it was.

Senator DOUGLAS. What about Geneva?

Mr. KORNHAUSER. Geneva, I think, runs a little higher than Zug.

Senator DOUGLAS. Do you think this has anything to do with the popularity of Zug as a site for American corporations overseas?

Mr. KORNHAUSER. I think it has a great deal to do with it, and as I mentioned in my testimony, I think that that is a favorable aspect of the location of a center of operations.

Senator DOUGLAS. In your statement you say:

> Controls Co. does not condone any more than the Government condones the use of tax havens and sham operations devised for the sole purpose of diverting income and evading taxes.

Do you think there are such tax havens?

Mr. KORNHAUSER. Well, I suppose there are.

Senator DOUGLAS. Zug is not one of them?

Mr. KORNHAUSER. We have, in Controls Co., a genuine operation which we use in Europe. Prior to the time we established our own sales organization we did business through sale representatives that were independent, and they paid this profit that we now make.

We changed over our whole setup some years back for more than just the tax reasons though. The business gets to be somewhat technical, and you have to provide the technical information in order to continue to have an important position in the markets which meant we had to have fully qualified trained people working for us in Europe,

and we have done that, we brought over about 15 engineers 3 years ago, trained them in the United States, and sent them back there so that the operation that we have is one in which we cover a good bit of ground, and the location of it in Zug happens to be a very good spot from the standpoint of the area in which we serve.

It could perhaps geographically be located in western or southern Germany. It would do just as well, perhaps, but from a tax standpoint, it is better to have it in Switzerland. There are a number of reasons why we would prefer to have it in Switzerland in any event.

Senator DOUGLAS. Mr. Kornhauser, what functions in addition to supervision of sales does the Zug corporation perform?

Does it do accounting work for your organization?

Mr. KORNHAUSER. Yes, it does.

Senator DOUGLAS. Does it place insurance?

Mr. KORNHAUSER. Yes.

Senator DOUGLAS. What other functions?

Mr. KORNHAUSER. Well, all of the financial in regard to obtaining credit, either short or long term. It does a certain amount of technical planning on new products. Market research is a function which is handled out of there. It is a fully staffed administrative organization.

Senator DOUGLAS. When you say you are in Zug, does this include salesmen paid out of the Zug's office?

Mr. KORNHAUSER. It includes some of them on the Zug payroll.

Senator DOUGLAS. How many are physically present in Zug?

Mr. KORNHAUSER. There would be about 30 people physically present in Zug. Some of them on Zug's payroll and live in cities outside of Zug. Some of them on the payrolls of other companies would be supervised by the Zug personnel.

For instance the German unit.

Senator DOUGLAS. Of course, you realize it is a very difficult problem to work out. It is very easy to milk a manufacturing company for these services performed by a company in a political jurisdiction where the tax rates are lower. It is very easy; that is one of the difficulties that we face.

Mr. KORNHAUSER. Yes, sir.

Senator DOUGLAS. You evidently think they are tax havens and you don't condone them, although you say that you are not using a tax haven.

Do you have any suggestions to us as to how we could reach these tax havens?

Mr. KORNHAUSER. Well, I know it is a difficult problem, and as I understand it, the question of defining what is a bona fide business organization that performs a service that is related to the income that is in connection with it is sometimes a difficult thing to judge, and I think it is primarily a question of determining whether the organization that is in a low tax country is performing the function or the service that is related to the income and whether the pricing is such——

Senator DOUGLAS. How would you help us to define it?

Mr. KORNHAUSER. Well, I think that the physical presence of the organization in the country and the fact that they are performing the service for which they are being paid will be a matter that can be tracked down when—if the service is being performed perhaps by

a company and the money is being diverted to perhaps a Swiss company, it can easily be determined by looking at the character for the organization in the low tax country such as Switzerland, and I would think that it would be possible to segregate the sham operation from the bona fide operations.

Senator DOUGLAS. What criteria or stigmata, I believe that is the word, would you lay down as to whether an operation is a sham operation or a bona fide operation?

Mr. KORNHAUSER. Well, if there is, the work is being done, we will say, by an organization in the United States, and the income is going to——

Senator DOUGLAS. Or another foreign country?

Mr. KORNHAUSER. Or another foreign country, I think that would be under our present definitions of what we seem to be looking for, a pretty good indication that the organization overseas is not earning the income or creating the sales.

Senator DOUGLAS. That is precisely what the administration is trying to get at in the redraft; namely, the distinction between so-called active functions of manufacturing which, as I understand it are exempt, and the auxiliary functions, I don't know whether they could be called tacit functions. But the administration is saying that the auxiliary functions of marketing, financing, and insurance should not be used as a pretext to get lower tax rates. That is precisely what the administration is seeking.

Would you lay down another test, the percentage of the employees overseas who are located in such a spot?

Mr. KORNHAUSER. Well, I think functions such as sales and marketing and financing are as bona fide functions as the manufacturing.

Senator DOUGLAS. The question is not about contracts with intermediate organizations, in your case the Dutch firm. Some get returns which are very much greater than the service rendered.

The fact, for instance, you make as much profits from these auxiliary operations as you do from manufacturing itself, although you employ only one-tenth as many employees, and so far as the physical location in Zug is concerned only one-fifteenth as many——

Mr. KORNHAUSER. I think it is quite normal in manufacturing sales; we sell only to other manufacturers. We don't do any retail business, where you would have a large number of employees per dollar of sales and you would naturally have a large number of employees per dollar of sales in the manufacturing operation itself.

But I think that the relationship is reasonably normal because when we had representatives who did these functions for us overseas, what we paid to them is just about in line with what we now receive ourselves, and of these various fees that we collect in Switzerland, we return two-thirds of them to the United States every year, one-third is kept over there for investment, and further development, so that I think the tax revenue that the Treasury picks up is pretty substantial.

Senator DOUGLAS. I have seen what purports to be photographs of relatively small office buildings in the capital of Zug, with some 30 or 40 nameplates of American corporations there.

Would you say that if you would have two or three nameplates to a small office building this would be an indication that they were coming there for purely nominal tax-haven purposes?

Mr. KORNHAUSER. It is pretty hard to say, to generalize like that. Perhaps some of them might very well be, and some of them, of course, might have only a limited function to be handled there.

Senator DOUGLAS. Have you been in Zug yourself?

Mr. KORNHAUSER. I have been there, yes.

Senator DOUGLAS. Is it true you will find a small building with many nameplates of American-owned corporations?

Mr. KORNHAUSER. Well, I think you would find the nameplates of many European companies as well as American on these doors.

Senator DOUGLAS. I understand, but I am talking about American.

Mr. KORNHAUSER. And I would think that would be natural, to have representatives who would carry out whatever limited functions they might have.

Senator DOUGLAS. Is it not true that from your knowledge of Zug, that the size of the companies which have their nameplates are out of all proportion to the minuteness of their office quarters or conversely that the smallness of their office quarters in Zug is relatively minute in comparison with the total business of a parent company?

Mr. KORNHAUSER. I don't think I am well enough acquainted with that problem in Zug to answer your question.

Senator DOUGLAS. As you walk up and down the streets of Zug, it has never occurred to you that some of these companies might be coming there for tax-haven purposes?

Mr. KORNHAUSER. Well, it certainly has occurred to me that they would go to Switzerland and I know that many of them have gone to Zug for the tax rate which is one of the considerations.

Senator DOUGLAS. Do you think it is wrong then that the Government should try to reach these tax havens?

Mr. KORNHAUSER. I think that the approach of taxing the income of the U.S. company in Switzerland, let's say, if the function that they are carrying on is a normal business function, yes, I think that is wrong, because the foreign competitor may have another company right in Zug, and business has been growing at a very great rate in Europe, much faster than here in the United States.

The need for capital, the need for putting money into engineering is very great in Europe, and if the money is cut off to the American company, why certainly these European companies who are very well qualified, and hard working, are going to get ahead.

In some cases, they do get ahead, and it is up to the American business to try to stay ahead. Once you have gotten a good foothold in a market, for instance, our own company, we started out in Europe——

Senator DOUGLAS. I don't want to interrupt you, Mr. Kornhauser——

Mr. KORNHAUSER. Yes, sir.

Senator DOUGLAS. In short you don't believe there should be any change in existing law?

Mr. KORNHAUSER. I think the existing law, if it is enforced properly, would be equitable to the American companies, and many of the abuses could be handled under the present law.

Senator DOUGLAS. And therefore, in order to reach these tax havens, you do not believe any change in existing law should be made?

Mr. KORNHAUSER. I don't think it is necessary, no, sir.

Senator DOUGLAS. Have your travels ever brought you to Nassau?

Mr. KORNHAUSER. Unfortunately not. They have a very nice climate but unfortunately I haven't been there.

Senator DOUGLAS. You prefer the bracing mountain scenery in Switzerland rather than the atmosphere in the near Tropics, is that correct?

Mr. KORNHAUSER. Well, it is a place where we happen to have a business operation and I have been there on business.

Unfortunately, I haven't had very much time to enjoy the bracing climate.

Senator DOUGLAS. Mr. Chairman, that is all.

Senator GORE. Senator Bennett?

Senator BENNETT. No questions.

Senator GORE. Thank you.

The next witness is Mr. David Watts.

STATEMENT OF DAVID WATTS, REPRESENTING A GROUP OF NEW YORK LAWYERS; ACCOMPANIED BY EDWIN COHEN

Mr. WATTS. Mr. Chairman, and members of the committee. Mr. Edwin Cohen, on my left, and I represent a group of 18 lawyers who have made a joint study of the provisions of the House bill and more recently of the Treasury draft.

The other members of this group are listed at the end of the memorandum which is being distributed to you.

Senator DOUGLAS. Do you represent the Association of the Bar of the City of New York?

Mr. WATTS. No, we are an informal group which got together as kind of a reaction to the shock of seeing the House bill.

Senator DOUGLAS. You are not in a state of coma?

Mr. WATTS. Still somewhat.

We have a lengthy statement about the provisions of sections 13 and 16 of the Treasury draft, and we would like to request that this statement be incorporated in the record.

Senator GORE. It is so voluminous that I will leave that decision to Senator Byrd, the chairman of the committee.

This is a 41-page document which will be quite expensive to print, so I should like to defer that decision to the chairman of the committee.

Mr. WATTS. Very well, sir.

Senator GORE. Are you retained or employed to make this presentation?

Mr. WATTS. We are not. To the best of my knowledge, not a member of this group has been paid for any of the time that has been spent in the discussions, as far as I know, not a word or phrase of this memorandum has been discussed with any client. As we stated in our prior testimony on the House bill, we do have clients that are engaged in foreign operations.

Senator GORE. You are not a registered lobbyist?

Mr. WATTS. We are not.

Senator GORE. You may proceed.

Mr. WATTS. We are here as citizens and lawyers who sincerely believe that we might perform a public service by presenting views based on our experience in this area.

Senator DOUGLAS. Mr. Chairman, I want to say this is very commendable. I always believe the right to petition which is embodied in the American Constitution should not only be practiced by lobbyists but by citizens.

Mr. WATTS. Thank you, Senator.

We have a brief summary of our views beginning on page 1 of the statement. I will not attempt to read more than a few paragraphs of the statement and make passing references to the balance.

Our summary begins at the bottom of page 1.

The new Treasury draft contains significant changes in the foreign income provisions of the bill as passed by the House. These changes are helpful in limiting the scope of the bill and in eliminating or ameliorating some of the technical and administrative problems and some of its unduly harsh effects. We recognize that much commendable work has gone into these revisions in a conscientious effort to improve the bill.

We therefore regret that we find ourselves compelled to express once again the view that, even as revised, the—

bill does not effectively distinguish between such (tax avoidance) devices and legitimate business operations conducted outside the United States—

and, further, that—

the foreign income provisions are unworkable, are unduly penal in their impact on the foreign business of U.S. persons, and would have many consequences that are clearly adverse to the interests of the United States.

As in the case of the House bill, merely reading the new draft will suffice to demonstrate its utter complexity. Even the most sophisticated become lost in the forest of its technicalities; its phraseology is vague at critical points; precedents for its construction and application are lacking because of the novelty of its concepts; and it seeks to resolve vital and difficult problems by the expedient of delegating authority to issue regulations.

Moreover, it still requires that U.S. shareholders obtain from abroad detailed historical and current information which must be prepared according to American accounting and tax concepts unknown to foreign accountants. We seriously question whether a law of such complexity could be applied and administered in an effective and reasonably evenhanded way.

The provisions are still unduly harsh in many respects in imposing burdens of taxation and compliance much more extensive than in the case of domestic operations, particularly as they affect individual shareholders of foreign corporations.

Although draft section 16, dealing with gain on sale of stock or liquidation of controlled foreign corporations, would limit the taxes payable by individual shareholders on the gain, no limitation of any kind has been placed upon current taxation of income to individual shareholders under draft section 13.

Further, no provision has yet been made to permit adjustment of or exemption for legitimate business arrangements established in reliance upon existing law, particularly with respect to present contractual commitments or indebtedness abroad which could not be met if heavy new taxes are to be imposed.

The provisions as amended still have numerous consequences that seem clearly undesirable. They impose upon U.S. persons doing busi-

ness abroad burdens which their vigorous foreign competitors do not bear. This is especially true because the new draft, like the House bill, taxes profits from certain foreign transactions considered to lead to possible reduction in foreign income taxes, though the transactions do not themselves involve U.S. taxes or taxpayers.

Under present economic conditions, it seems unwise indeed to shackle American business with a complex scheme of new taxes which cannot be imposed by Congress upon our foreign competitors and which in effect protects not the U.S. tax system but the tax systems of the countries of our competitors.

At pages 3 to 9 of our memorandum we discuss the problems of trying to make this draft a workable tax law. These problems are many and very difficult. They start because of the very involved techniques of the bill referred to on pages 3 and 4. They continue because of the extensive use of terms that are completely new to the tax law, and which leave many difficult problems unresolved. Some of these difficult new terms are set forth in a note on pages 5 and 6.

On page 6 we refer to what we have termed the "iceberg" nature of this bill. That is, only a part of this bill can be seen and known. Much of this bill leaves difficult problems either not referred to at all, or in other instances are handled by the expedient of saying that the Secretary or his delegate shall establish the substantive rules. On page 8 we refer to the many remaining very difficult technical problems.

The listing on pages 8 and 9 refers to matters that were dealt with in a prior memorandum by our group, and which have not yet been resolved in the Treasury draft. In addition, at this point I would like to refer to part 2 of our memorandum.

Senator BENNETT. May I interrupt you at this point to ask you to what memorandum these page designations refer?

Mr. WATTS. The memorandum refers to a memorandum that was filed on April 27 by our group, and the page designations refer to the report in the record of the hearings.

Senator BENNETT. Thank you.

Mr. WATTS. We have 28 pages——

Senator BENNETT. These are the House hearing?

Mr. WATTS. No, the Senate hearings. We appeared before this committee on April 27 with respect to the House bill. Our prior memorandum dealt with problems under the House bill, and was presented at the hearings held by this committee with respect to the House bill.

Senator BENNETT. That is fine.

Mr. WATTS. And the hearings that are identified are the hearings of this committee with respect to H.R. 10650. The date of our prior testimony was April 27.

These 28 pages of technical problems in part 2 of our present memorandum relate to just two sections of the Treasury draft of May 31. They are a sincere attempt by lawyers to try to deal with the serious matters remaining in this draft.

We have tried to avoid nitpicking. We have tried to raise only technical problems that we regard as creating very substantial difficulties for business that may have foreign investments.

Indeed, this bill has become so complicated that we have spent many hours individually and in group discussions, and we do not pretend to begin to understand how the draft of May 31 might operate.

As an illustration of how complex this bill has become, a group of us spent 45 minutes trying to figure out whether a particular section reference in the Treasury draft was or was not a typographical error, and we still don't know.

On pages 10 and 11 we refer to a policy which appears in the House bill, and which is perhaps expressed with even greater clarity in the most recent Treasury draft.

This involves the Treasury's concern about transactions that reduce foreign taxes. We think that very much of the technical difficulty, the very substantial problems of the Treasury draft, stem from this position of the Treasury that it is concerned not about our U.S. tax structure, not about transactions that involve U.S. taxpayers nor transactions that involve a source within the United States, but rather is concerned about the complex of foreign business organizations and transactions between foreign business organizations.

Indeed, some of the major complexities of the bill we think are directly attributable to this concept which we believe to be entirely wrong as a matter of tax principle.

We do not believe that we should be concerned in our tax structure with the provisions that may be made by American business to reduce their costs of operating abroad, when the operations in no sense involve a transaction with a U.S. person or any kind of activity that has a U.S. source.

Indeed, as an illustration of the degree of fantasy that this has led us to, section 954(d)(2) of the Treasury draft purports in a long sentence to create a whole new entity and to set forth in that sentence an entire system of taxation with respect to that entity.

This is the "branch" concept, which in the interests of time I will not read. None of us have the slightest idea of how this could possibly operate. We aren't clear whether one salesman under this provision constitutes a separate branch. If a salesman does constitute a branch, we don't have any idea how we determine what the income is that the bill seeks to tax as a consequence of having that salesman.

We believe that it is not possible to have a workable tax structure for the United States which involves the disregard of the separate entities of foreign corporations solely because of transactions that result in a reduction of foreign taxes. Even if it were, we are unable to understand the view that this is an important thing for the Congress to be concerned about.

We think that the important areas where this committee and this Congress should concern itself are matters that involve U.S. tax avoidance.

The only areas where we believe that such avoidance exists today are excessive accumulations and the area of intercompany pricing in tranactions involving U.S. taxpayers. We submit that pricing problems are primarily an administrative matter, which require a fact-by-fact and case-by-case approach, though we have no objections to legislation that deals with major abuses where U.S. taxpayers are involved.

For example, we have no objection to dealing specifically by legislation with a problem such as the reinsurance problem.

In addition, there are other major aspects of the bill to which we wish to call this committee's attention.

Pages 12 and 13 refer to what we regard as the very severe treatment of individual shareholders under bill section 13.

This treatment is particularly severe because individual shareholders are subject to ordinary income tax rates running up to 91 percent, so that a 91-percent tax might be imposed in circumstances where the income has not been received by the individual and may never be received, and imposed without benefit of any foreign tax credit, and imposed under circumstances where that individual may remain fully subject to foreign personal holding company provisions which are in no sense correlated with this bill even under the latest Treasury draft. Moreover, another provision of this bill would change the impact of the foreign personal holding company provisions, which now deal primarily with investment companies, so that the foreign personal holding company provisions would themselves have an impact on active business corporations.

Senator GORE. Mr. Watts, each person has been allotted 10 minutes. I am afraid your time is about up.

Do you have additional points you wish to make?

Mr. WATTS. May I then just briefly refer to the U.S. property concept which we have discussed on pages 13 and 14, and which we find very puzzling. Under this concept foreign corporations are encouraged to invest in Norwegian bonds rather than U.S. Treasury bills, for example, or are encouraged to invest in Royal Dutch stock rather than Standard Oil of New Jersey, without reference to whether these transactions involve affiliates of any such person.

We find the purposes of the U.S. property provisions impossible to understand. We do not think they begin to deal with any reasonable objectives, as, for example, trying to tax constructive dividends.

On page 14 we have a very brief conclusion which I would like to read.

In our view, the only important U.S. tax problems arising from the use of American-owned foreign corporations involve allocations of income and deductions in transactions with affiliated persons subject to U.S. taxes, and unwarranted, accomulations of earnings to avoid U.S. taxes on distributions to shareholders.

The provisions of the bill are not well designed to identify and deal with these or any other U.S. tax problems.

Moreover, the burden that would be imposed by the bill on our foreign business would be substantial. The concepts and techniques of the bill are so highly complex that we doubt that reasonable technical solutions for its defects can be devised.

In any event we are convinced that the bill could not be equitably and uniformly administered because it would be impossible for most revenue agents and taxpayers to understand and apply its provisions.

We therefore regretfully conclude that the foreign income provisions of the bill, even as revised by the Treasury draft, would have a seriously adverse effect on foreign operations of American business.

Senator GORE. Senator Bennett?

Senator BENNETT. No questions.

Senator GORE. Thank you, the committee appreciates your initiative, your exercise of the right to petition. You have brought a statement that is thoughtful and provocative.

Mr. WATTS. I would again like to urge that the committee consider reprinting the entire statement in the record.

We have a great many detailed matters that we think warrant the attention of the committee.

(The entire statement referred to follows:)

PROPOSED TAXATION OF FOREIGN INCOME UNDER H.R. 10650

COMMENTS ON TREASURY DEPARTMENT DRAFT OF STATUTORY LANGUAGE OF AMENDMENTS TO SECTIONS 13 AND 16 OF H.R. 10650

These comments reflect a joint study by a group of lawyers of the Treasury Department draft of amendments to H.R. 10650 contained in the committee print of May 31, 1962 A memorandum on the principal foreign income provisions of H.R. 10650 was submitted to the Committee on Finance by this group on April 27, 1962 (reprinted in hearings on H.R. 10650, pp. 3146–3200).

Our comments in this memorandum are limited to sections 13 and 16 of the bill as they would be amended by the Treasury draft. We have not considered bill section 15, relating to foreign investment companies. The draft amendments proposed to bill section 20, relating to returns of information, are helpful and we have not commented further on that section. The provisions of bill sections 5, 6, and 7, which were discussed in our prior memorandum, have not been dealt with in the Treasury draft.

Part I of this memorandum discusses sections 13 and 16 generally. Part II contains more detailed substantive and technical comments. This memorandum is not intended to be exhaustive. It has not been possible to identify and deal fully with all of the problems presented by the Treasury draft of sections 13 and 16 within the limited time available.

PART I. GENERAL STATEMENT

The new Treasury draft contains significant changes in the foreign income provisions of the bill as passed by the House. These changes are helpful in limiting the scope of the bill and in eliminating or ameliorating some of the technical and administrative problems and some of its unduly harsh effects. We recognize that much commendable work has gone into these revisions in a conscientious effort to improve the bill. We therefore regret that we find ourselves compelled to express once again the view that, even as revised, the "bill does not effectively distinguish between such [tax avoidance] devices and legitimate business operations conducted outside the United States" and, further, that "the foreign income provisions are unworkable, and unduly penal in their impact on the foreign business of U.S. persons, and would have many consequences that are clearly adverse to the interests of the United States."[1]

As in the case of the House bill, merely reading the new draft will suffice to demonstrate its utter complexity. Even the most sophisticated become lost in the forest of its technicalities: its phraseology is vague at critical points; precedents for its construction and application are lacking because of the novelty of its concepts; and it seeks to resolve vital and difficult problems by the expedient of delegating authority to issue regulations. Moreover, it still requires that U.S. shareholders obtain from abroad detailed historical and current information which must be prepared according to American accounting and tax concepts unknown to foreign accountants. We seriously question whether a law of such complexity could be applied and administered in an effective and reasonably even-handed way.

The provisions are still unduly harsh in many respects in imposing burdens of taxation and compliance much more intensive than in the case of domestic operations, particularly as they affect individual shareholders of foreign corporations. Although draft section 16, dealing with gain on sale of stock or liquidation of controlled foreign corporations, would limit the taxes payable by individual shareholders on the gain, no limitation of any kind has been placed upon current taxation of income to individual shareholders under draft section 13. Further, no provision has yet been made to permit adjustment of or exemption for legitimate business arrangements established in reliance upon existing

[1] See our prior statement, hearings on H.R. 10650, p. 3146.

law, particularly with respect to present contractual commitments or indebtedness abroad which could not be met if heavy new taxes are to be imposed.

The provisions as amended still have numerous consequences that seem clearly undesirable. They impose upon U.S. persons doing business abroad burdens which their vigorous foreign competitors do not bear. This is especially true because the new draft, like the House bill, taxes profits from certain foreign transactions considered to lead to possible reduction in foreign income taxes, though the transactions do not themselves involve U.S. taxes or taxpayers. Under present economic conditions, it seems unwise indeed to shackle American business with a complex scheme of new taxes which cannot be imposed by Congress upon our foreign competitors and which in effect protects not the U.S. tax system but the tax systems of the countries of our competitors.

WORKABILITY OF THE DRAFT

We do not believe that the provisions of the draft are workable, even though they represent an appreciable improvement over the bill as passed by the House. The basic approach of bill section 13 seems inherently so complex that amendments which leave intact its fundamentals will not suffice.

Complexities of the concepts and techniques of the bill.—Foreign business operations are necessarily complicated because of the wide variations in foreign statutes and administrative controls; in foreign methods of business organization, marketing, financing, and accounting; and in treaties among foreign countries and with the United States. Consequently, any approach to the problem of imposing taxes currently upon the income of foreign corporations from active foreign businesses necessarily presents many complications. Yet, in lieu of a clear and simple policy that might be superimposed upon this involved business and legal background, the bill [2] adopts a multiplicity of difficult new tax concepts and techniques.

The bill, in effect, disregards the separate entity of foreign corporations for certain purposes. In taxing shareholders of foreign corporations on undistributed income of active businesses, the bill adopts techniques that present a variety of difficult problems for which there is no meaningful precedent. [3] These techniques include:

(1) taxing U.S. shareholders of a foreign corporation as if they had received distributions of certain items of its gross income (reduced by allocable deductions) that are not in excess of earnings, without regard to whether or when the corporation pays dividends;

(2) "hopscotching," which in the case of a chain of foreign entities involves taxing U.S. shareholders of the parent foreign corporation as if they were owners of shares in each of the corporations further removed in the chain; and

(3) exempting from tax such shareholders (or certain identified successors) with respect to subsequent distributions of earnings previously taxed under the above concepts.

In addition to the difficulties inherent in computing the amount of income or earnings of a corporation that is not itself a U.S. taxpayer, the problems necessarily raised by the techniques used in the bill include, among others: deter-

---

[2] Except as otherwise stated, references in this memorandum to "the bill" refer to H.R. 10650 and assume the incorporation of the Treasury draft amendments of May 31, 1962, into the bill. Also, except as otherwise stated, section references refer to the Internal Revenue Code of 1954 as it would be amended if the Treasury draft were incorporated in the bill and the bill were enacted.

[3] The present foreign personal holding company provisions are not significantly relevant. These provisions have been important in preventing the establishment of closely held foreign corporations that are mere holding companies and in governing the intercorporate organization of closely held foreign businesses. However, our experience leads us to believe that taxes have seldom been imposed under these provisions. In the exceptional investment holding company case where the existing code provisions conceivably might apply, little difficulty arises in the computation of income or in the availability of income for dividend distributions. In contrast, bill section 13 introduces many new and complex income rules and would apply to active business operations and to foreign holding companies in a business structure where all funds may be actively employed in the foreign business. Moreover, the foreign personal holding company provisions accord a much greater recognition to the corporate entity because they apply only to the extent current earnings are not distributed, their limited scope and their tax avoidance context makes unnecessary any provision for subsequent offsetting tax-free distributions (except those resulting from the elimination of earnings and profits), and the imputing of income from subsidiaries of a foreign parent is only through application of foreign personal holding company rules to the foreign parent. (The foreign personal holding company provisions would themselves be extended to active business operations if the greatly modified income test of bill section 7 were adopted.)

mining stockholders' shares of undistributed income where there are different classes of stocks with different dividend rates and preferences; resolving inconsistent determinations made by revenue agents or courts with respect to the same corporation in cases involving different shareholders; allowing for offsetting losses of the same or affiliated foreign corporations; limiting the impact of the tax burden on shareholders who are individuals; and adjusting the treatment of subsequent distributions to account for previously taxed undistributed income. The adjustments for previously taxed undistributed income include a variety of difficulties incident to "hopscotching," changes in stock ownership, and the computation of foreign tax credits. The foreign tax credit problems are further complicated by the payment of foreign taxes withheld at the source when there is an actual distribution of earnings that had previously been taxed to U.S. shareholders.

The bill multiplies the problem of taxing undistributed income by its dependence upon many new and involved classifications of gross income, and separate allocations to each such class of expenses, losses of the same or affiliated foreign corporations, other deductions, and foreign income taxes. With respect to all of these calculations, each U.S. shareholder having a 10-percent stock interest would be entitled to be heard separately.

Introduction of new terminology.—In addition to the complications necessarily resulting from the involved concepts and techniques of the bill, the difficulties in understanding and applying the bill are increased by the fact that most of the many terms used would be entirely new to the tax law and are to a very large extent vague.

Some idea of the complexity of the provisions of the bill can be obtained by simply noting the number and nature of the entirely new terms that would be added to the Internal Revenue Code by bill section 13 alone, even after the significant improvements of the draft amendments.[4]

In addition, there are numerous definitions and formulas in bill section 13 that are related to the new terms. Many of these involve imprecise words such

---

[4] Although many of these terms may at first appear clear and precise, further consideration discloses that each may present substantial difficulty in application. The new terms include:
"Controlled foreign corporation."
"United States shareholder."
"Subpart F income" and "pro rata share" thereof.
"Less developed country."
"Less developed country corporation."
"Qualified investments in less developed country corporation."
"Previously excluded subpart F income withdrawn from investment in less developed country corporations" and "pro rata share" thereof.
"United States property."
"Increase in earnings invested in United States property" and "pro rata share" thereof.
"Income derived from the insurance of United States risks."
"Insurance or annuity contract in connection with property or liability arising out of activity in, or in connection with the lives or health of residents of, the United States."
"Arrangement whereby another corporation receives a substantially equal amount of premiums or other coisideration in respect of any reinsurance or the issuing of any insurance or annuity contract in connection with property or liability arising out of activity in, or in connection with the lives or health of residents of, the United States."
"Foreign base company income"
"Foreign base company sales income."
"Foreign base company services income."
"Related person with respect to the controlled foreign corporation."
"Rents, royalties, and similar amounts received from a related person for the use of, or the privilege of using, property within the country under the laws of which the controlled foreign corporation is created or organized."
"The property which is purchased [or sold] is manufactured, produced, grown, or extracted outside the country under the laws of which the controlled foreign corporation is created or organized."
"Sold for", or "purchased for" "use, consumption, or disposition outside such foreign country."
"The carrying on of activities * * * has substantially the same effect as if such branch or similar establishment were a wholly owned subsidiary corporation deriving such income"
"Performance or furnishing of technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial, or like services."
"Property used in such trades or businesses and located in less developed countries."
"Deposits with persons carrying on the banking business, located in less developed countries."
"Deposits with persons carrying on the banking business, located in the United States."
"Investment which is required because of restrictions imposed by a less developed country."
"Area within the Sino-Soviet bloc."
"Property located in the United States which is purchased in the United States for export to, or use in, foreign countries."
"Secret formula or process."
"Obligation of a United States person arising in connection with the sale of property if the amount of such obligation outstanding at no time during the taxable year exceeds

as "substantial part," "the effect of substantial reduction," "substantially similar to," and "similar property right." It requires no oracle to predict that if enacted a principal effect of the bill would be costly administrative controversy and litigation for years to come.

Dependence of the provisions on substantive rules to be developed by regulations.—Many major questions as to doubtful technical soundness, inequitable application and administrative unworkability lie below the surface of the bill. As suggested by the foregoing discussion, the bill involves an extraordinary number of difficult problems of interpretation. In addition to the general authority that the Treasury has to issue interpretive regulations, bill section 13 alone contains 16 express grants of authority to the Secretary or his delegate to develop the substantive rules by regulations.[5] Yet even this extensive delegation of rulemaking power leaves important substantive problems that are not covered by either statutory rules or express delegation of administrative authority.[6]

Such broad delegation by Congress of the power to develop substantive rules of taxation raises serious difficulties quite apart from the general question of legislative policy. Where legislative draftsmen have been unable to produce guiding principles that are clear, technically satisfactory, and administratively workable, it should not be assumed that even the ablest draftsmen of regulations can solve the myriad of problems in presently unexplored areas.

An important question also arises as to when taxpayers will be given some idea of the nature of the law that, beginning in 1963, would govern their operations. In a number of important areas final regulations have not yet been issued with respect to the Internal Revenue Code adopted by Congress nearly 8 years ago. A statute with material gaps in its terms that are to be filled in by administrative action after its effective date may be just as inequitably retroactive as if the introduction and enactment of the bill itself had occurred on the date of such administrative action. And, of course, no matter how relevant to a meaningful discussion of the bill, it is impossible to discuss here the propriety and effect of these presently nonexistent regulations.

Among the broadest delegation provisions of the bill is section 962(a). This section provides for the determination of earnings and profits, which controls the amount of income subject to tax, "according to rules substantially similar to those applicable to domestic corporations, under regulations prescribed by the Secretary or his delegate." These rules would have to correlate subpart F with most of the other provisions of the Internal Revenue Code in the context of the special techniques for taxing to various shareholders foreign adjusted gross income whether or not distributed. This correlation involves many difficult problems, including questions of inconsistent positions of shareholders, determining the persons who have the power to make (and the timing and procedures for making) essential tax elections,[7] and further related questions that arise upon transfers of stock to or from either a foreign shareholder or another U.S. shareholder.

---

the amount which would be ordinary and necessary to carry on the trade or business of both the other party to the sale transaction and the United States person had the sale been made between unrelated persons."

"Any aircraft, railroad rolling stock, vessel, motor vehicle, or container used in the transportation of persons or property in foreign commerce and used predominantly outside the United States."

[5] See secs. 952(d), 953(d)(5), 954(b) (5) and (6), 954(d)(2), 955(b)(3), 955(c)(1), 957(c), 959 (a) and (b), 960(a)(1), 961 (a) and (b), 962 (a), (b), and (c). In addition, the right to the exemption under sec. 954(b)(4) must be "established to the satisfaction of the Secretary or his delegate," and sec. 955(c)(2) grants authority to the President of the United States to designate "less-developed countries" by Executive order.

[6] E.g., the determination of the "pro rata share" of undistributed income that is taxable to various types and classes of preference stock.

[7] In addition to questions involving a choice of basic accounting periods and methods, the elections that determine the amount of income and of earnings and profits include those relating to reserves for bad debts (sec. 166), depreciation (sec. 167 and 179), amortization of facilities (secs. 168 and 169), year of deduction for charitable contributions (sec. 170), amortizable bond premium (sec. 171), circulation expenditures (sec. 173), research and experimental expenditures (sec. 174), soil and water conservation expenditures (sec. 175), trademark and trade name expenditures (sec. 177), expenditures for fertilizer (sec. 180), organizational expenditures (sec. 248), intangible drilling and developing costs (sec. 263), capitalization of carrying charges (sec. 266), installment sales (sec. 453), obligations issued at a discount (sec. 454), prepaid subscription income (sec 455), prepaid dues income (sec. 456), accrual of real property taxes (sec. 461), last-in, first-out inventories (sec. 472), exploration expenditures (sec 615), development expenditures (sec. 616), cutting of timber (sec. 631), discharge of indebtedness (sec. 108 and 1017), involuntary conversions (sec. 1033), and blocked foreign income (Mim. 6475, 1950–1 C. B. 50). Moreover, sec. 367, relating to nontaxable exchanges in the case of foreign corporations, raises a problem comparable to an election, since the taxability of an exchange (e.g., the complete liquidation of a wholly owned subsidiary) may depend upon whether a ruling is obtained prior to the exchange.

Existence of important technical problems.—The draft amendments leave many important technical problems unsolved, and in a number of instances create new technical difficulties. Many of these problems are discussed in part II of this memorandum under the relevant section headings.

As an illustration of the difficulties in resolving the complications of the bill, it may be noted that the following problems relating to bill sections 13 and 16, which were referred to in our memorandum of April 27, 1962, have either not been dealt with at all in the draft, or have not adequately been resolved (page references refer to the pertinent references in the hearings on H.R. 10650, which reprints our prior memorandum):

Determination of shareholders and attribution of ownership (pp. 3148, 3185–3187).
Determination of subpart F income (p. 3151).
Determination of earnings and profits (pp. 3151–3153).
Determination of amount of investment in property (p. 3152).
Necessity of maintaining separate accounts for different shares and shareholders (p. 3153).
Lack of adequate consolidation of income and loss among corporations and years (pp. 3155, 3177).
Inappropriate treatment of intercompany transactions (p. 3157).
Taxation of deemed distribution as ordinary income but deduction of losses only on disposition and then as capital losses (p. 3158).
Inadequate correlation of section 13 with foreign personal holding company provisions and possibility of double tax (pp. 3175, 3176, 3179, 3191–3194).
Discriminatory treatment of noncorporate shareholder (p. 3158).
Disallowance of foreign tax credit to noncorporate shareholder (pp. 3159, 3189).
Relief from tax of income subject to prior debt or other commitments (p. 3161).
Lack of provisions permitting tax-free readjustment of corporate structures (p. 3163).
Determination of "pro rata share" (p. 3176).
Failure to reduce income for distributions to non-U.S. shareholders (p. 3176).
Double taxation of income under bill sections 13 and 16 (p. 3176).
Difficulty of allocating expenses to items of income (p. 3180).
Inappropriate effect of liabilities and methods of financing upon determination of investment in property (pp. 3181, 3182).
Taxation of income "owned" by other persons (p. 3186).
Use of attribution rules to tax income but not to secure foreign tax credit (p. 3189).
Failure to correlate foreign tax credit with "gross-up," with resulting double taxation (p. 3190).
Failure to permit successors to secure benefit of increase in section 904 limitation (p. 3191).
Application of bill to corporations not controlled after December 31, 1962 (p. 3196).
Creation of unwarranted presumption re earnings and profits (p. 3197).

TRANSACTIONS THAT REDUCE FOREIGN TAXES

The bill would impose taxes on U.S. shareholders whose foreign corporations engage in transactions that reduce foreign taxes, even though those transactions do not evade or avoid U.S. taxes or themselves have any conceivable adverse effect on the revenues of the United States. (Indeed, any reduction in foreign taxes increases funds available for distributions subject to U.S. tax and decreases offsetting foreign tax credits on such distributions.) Taxing income which has not actually been received and taxing it though it may never actually be received is a severe penalty.[8]

Congress must provide adequate rules or administrative authority to protect the U.S. revenues from sham devices that reduce taxes on income from U.S. sources. However, the bill would tax a person who owns an interest in a corporation which engages in a transaction designed to minimize taxes payable to a foreign nation in a manner permitted by the laws of that nation and customarily employed by its citizens and corporations. Thus it would "protect" the revenue of foreign nations beyond their own desires. These nations are

[8] It is especially severe because there is no provision in the bill for a refund if there are losses which occur after the tax is imposed, even though these losses wipe out the hypothetical income which has been taxed and make it certain that the taxpayer will never get that income.

sovereign and it is fair to assume that they and not we are best equipped to determine in what way and to what extent their revenues should be protected. The United States may cooperate with them in the revision of their laws and administration, or may negotiate with them treaties which would bring their citizens and ours under comparable rules. But we believe that the effect of the bill in penalizing our own citizens and corporations for transactions which reduce foreign taxes in a manner permitted by foreign laws and administration is wrong in principle. Its effect would be to impose substantial disadvantages on the foreign enterprises of U.S. citizens and corporations.

> Example:—A is a Belgian corporation owned 75 percent by U.S. shareholders and 25 percent by Belgian nationals. B is a Belgian corporation owned 100 percent by Belgian nationals. The two companies are in competition manufacturing agricultural chemicals in Belgium for use in the Middle East. A and B each sells its products to its Swiss subsidiary at cost plus 5 percent. The Swiss subsidiaries resell the chemicals and invest their profits (after relatively low Swiss taxes) in needed expansion of inventories and in providing financing for customers.
>
> Under the bill, the Swiss selling subsidiary of A is a "controlled foreign corporation." Its profits are "foreign base company income" and the U.S. shareholders of A would be taxed on 75 percent of these profits as dividend income. The shareholders of B would not be subject to similar tax.

The net effect would be that the foreign enterprise owned by Americans must operate under a tax system which is much more burdensome than that under which its foreign-owned competitor operates. A substantial part of the earnings of the American-owned business could not be used for the requirements of the business but would have to be distributed for payment of the shareholders' taxes.

We do not believe that the penalty for reducing foreign taxes can be justified on the ground that U.S. business activities will be promoted by discouraging foreign enterprises. As we stated in our previous memorandum, our experience with businessmen who are planning foreign operations indicates that they seldom really have a choice between establishing a business outside the United States on the one hand and, on the other hand, establishing the same business within the United States (or expanding an existing business so that it can export abroad).

Our experience leads us to conclude that American business generally establishes enterprises abroad only when the practical alternative is to let a foreign market be exploited by foreigners.

The avoidance of U.S. taxes through foreign corporations can and should be dealt with. However, the bill should not impose a U.S. tax based on foreign tax results. We believe, therefore, that the income of a foreign corporation should not be subjected to the rules of subpart F except to the extent that—

> (*a*) The corporation is used to reduce taxable income from U.S. sources by transactions involving an affiliated U.S. person which enable that person to understate the gross income it earns or to claim deductions to which it would not otherwise be entitled; or
>
> (*b*) The foreign corporation accumulates funds beyond the reasonable present and anticipated needs of its business in order to avoid the U.S. tax which would be imposed on its shareholders were its profits distributed.

Surely there can be no need or justification for putting foreign enterprises owned by U.S. shareholders at a competitive disadvantage merely because they are conducted so as to reduce their foreign tax burdens.

INEQUITABLE TREATMENT OF NONCORPORATE SHAREHOLDERS UNDER BILL SECTION 13

Section 13 of the bill taxes income earned by a controlled foreign corporation to an individual (or to an estate or trust) at individual income tax rates ranging up to 91 percent. No credit for foreign taxes paid by the corporation is available to him.

As we pointed out in our original memorandum, this treatment would impose severe hardships and would certainly not be equal to the tax treatment afforded U.S. stockholders of domestic corporations (hearings on H.R. 10650, p. 3158). If the business which produced the income were conducted by a foreign branch of a U.S. corporation owned by the individual, the income would be taxed only at the corporate rate, less foreign tax credits, unless it were actually distributed. The income remaining after corporate taxes could be plowed back into the business of a U.S. corporation, and no individual income tax would be payable until his stock would be sold or the company liquidated. Even then the tax would be at capital gains rates.

If undistributed income of a foreign corporation is to be taxed to a U.S. shareholder, we believe that it should not in any event be taxed more severely than undistributed income of a domestic corporation. The amendments to section 16 of the bill (which relates to gain on the sale or exchange of a foreign corporation stock) proposed by the Treasury recognize the need for more equitable treatment in this respect when an individual disposes of his stock, but no relief whatever for shareholders who are individuals has been provided under bill section 13. The unfair results of section 13 of the bill as applied to individual shareholders were illustrated in examples 6 and 7 of our prior memorandum, which continue to be applicable (hearings on H.R. 10650, p. 3160).

The inequitable position in which an individual shareholder of a controlled foreign corporation is put under the bill is made even more troublesome as a result of the lack of correlation between bill section 13 and the foreign personal holding company provisions. The draft retains unchanged the proposed amendment of section 551(b) of the code, which amendment is designed to prevent taxation of individual shareholders on the same income under both the foreign personal holding company provisions and bill section 13. As pointed out in our previous memorandum (hearings on H.R. 10650, pp. 3176, 3179, 3191–3194) the amendment is technically defective and unworkable. This is especially disturbing in view of the greatly enlarged scope of the foreign personal holding company provisions under bill section 7. Moreover, in view of the differences in calculations of income taxed under foreign personal holding company provisions and under those of bill section 13, individual stockholders would be subjected to the administrative burdens of making calculations under both provisions and would be liable for income tax under those provisions that impose the higher tax.

THE CONCEPT OF "U.S. PROPERTY"

The amendments of May 31 include in section 956 a definition of "U.S. property," the acquisition of which results in the imposition of a tax on shareholders under subpart F. Presumably, section 956 reflects a view that a purchase of "U.S. property" by a controlled foreign corporation should be treated as the equivalent of an actual distribution of earnings or that the purchase evidences an improper accumulation.

These provisions do not appear well directed toward the problems of either "constructive" dividends or improper accumulations. The exceptions to the definition of "U.S. property" should in any event be expanded to include any property reasonably necessary to the trade or business of the corporation acquiring it. For example, it would certainly seem preferable for a foreign corporation making temporary investments of working capital to be permitted to purchase U.S. Treasury bills, rather than encouraged to purchase foreign short-term obligations. Similarly, if a foreign corporation is employed to accumulate funds unnecessarily and avoid U.S. income tax on U.S. shareholders, the effect of section 956 is to encourage the corporation to purchase foreign investment securities rather than U.S. investment securities. In such case, section 956 does not strike at the accumulation: it simply encourages the retention of funds offshore with presumably adverse effects on our balance of payments.

CONCLUSION

In our view, the only important U.S. tax problems arising from the use of American-owned foreign corporations involve (*a*) allocations of income and deductions in transactions with affiliated persons subject to U.S. taxes, and (*b*) unwarranted accumulations of earnings to avoid U.S. taxes on distributions to shareholders.

The provisions of the bill are not well designed to identify and deal with these or any other U.S. tax problems. Moreover, the burden that would be imposed by the bill on our foreign business would be substantial. The concepts and techniques of the bill are so highly complex that we doubt that reasonable technical solutions for its defects can be devised. In any event, we are convinced that the bill could not be equitably and uniformly administered because it would be impossible for most revenue agents and taxpayers to understand and apply its provisions.

We therefore regretfully conclude that the foreign income provisions of the bill, even as revised by the Treasury draft, would have a seriously adverse effect on foreign operations of American business.

PART II. TECHNICAL DISCUSSION OF SECTIONS 13 AND 16 OF THE TREASURY DRAFT

The following is a brief discussion of certain problems and technical deficiencies believed to exist in sections 13 and 16.

BILL SECTION 13. CONTROLLED FOREIGN CORPORATIONS

Amounts included in gross income of U.S. shareholders (sec. 951)

Section 951(a)(1).—This section sets forth the amounts to be included in the gross income of persons who are "U.S. shareholders" (i.e. 10 percent shareholders) of a controlled foreign corporation.

The draft does not do anything toward defining what is the pro rata share of a U.S. shareholder who holds noncumulative preferred stock of a controlled foreign corporation or who holds the common stock of a controlled foreign corporation which is subordinate to an issue of cumulative preferred stock upon which no dividend is declared during the year in question or which is in arrears.

If A sells stock of a controlled foreign corporation to B, earnings and profits of the year of sale may be taxed to A under section 1248(b), and taxed again to B as subpart F income for the year. This point was raised in our earlier memorandum but is not corrected by the draft (hearings, p. 3196).

As in the House bill, it remains doubtful whether the amount includible in gross income of a U.S. corporate shareholder under this section is treated as a dividend for personal holding company purposes.

It may not be entirely clear under this section whether in order to be taxed a person must be a 10-percent shareholder on the last day of the taxable year, or whether it is enough that the person owning stock on the last day shall have been a 10-percent shareholder on any day of the taxable year.

Section 951(a)(2).—The pro rata amount taxable to a U.S. shareholder is reduced only by distributions to some other U.S. person during the taxable year as a dividend on the particular stock in question. This point was covered in our earlier memorandum (hearings, p. 3176). It would seem that any distributions during the year on a stock should reduce the pro rata shares of tainted items allocable to a U.S. person who hold that stock at the critical date. Furthermore, the result of the provisions in their present form could be to tax two U.S. persons on the same income.

> Example: X, a U.S. corporation, owns P, a Panamanian subsidary which owns S, a Brazilian corporation. P sells all the stock of S to A, a U.S. citizen, under arrangements by which current income to the date of sale is paid out to P as a dividend. The S dividend will be taxed to X as subpart F income and the earnings of S (already taxed to X) will be taxed again to A if they are subpart F income.

Section 951(a) (3) and (4).—Unlike section 951(a)(2), dealing with subpart F income, there is no reduction of either the pro rata share of previously excluded subpart F income withdrawn from investment or the pro rata share of investment in U.S. property by reason of distributions received by other persons during such year as a dividend. Section 951(a)(1) should specifically provide that all income taxable under that section should be reduced by distributions during the year (and, as noted above, by other amounts treated as dividends under sec. 1248) in lieu of the more limited provision of section 951(a)(2), which is applicable only to subpart F income.

Sections 951(a)(2), 951(a)(3) and 951(a)(4).—These provisions of the bill apparently are intended to deal with a case in which a foreign corporation is a "controlled foreign corporation" during part of the year but is not during the remainder of the year. (See comment under sec 957(a) below.) In order to limit the amount taxable to U.S. shareholders as subpart F income in such a case, these provisions reduce the amount otherwise taxable as subpart F income to a fraction of the total. This fraction is the same as the fraction of the year during which the foreign corporation was "controlled." This rule would not produce a correct result when control of a foreign corporation shifts between foreigners and U.S. shareholders during the year and the company's subpart F income is not realized proportionately during the two periods.

> Example: X corporation is a foreign corporation on a calendar taxable year. On January 1 it is owned entirely by U.S. shareholders. Between January 1 and June 30 X has no subpart F income. On June 30 the U.S. shareholders sell their interests in X to a group of nonresident aliens. Be-

tween July 1 and December 31 X has subpart F income. Under section 951(a)(2) half of this subpart F income is taxable to the former U.S. shareholders.

Provision should be made permitting U.S. shareholders who acquire or sell control of a foreign corporation to be treated as though the taxable year of the foreign corporation had commenced or terminated at the date of acquisition or sale.

Subpart F income defined (sec. 952)

Section 952(b).—The wording is identical with section 952(a)(2) of the House bill. This section excludes from subpart F income the income derived from sources within the United States of a foreign corporation engaged in trade or business in the United States. Where a foreign corporation is not engaged in trade or business within the United States and receives fixed or determinable periodic income from U.S. sources, within the meaning of section 881(a), then it would appear that a tax would still be imposed upon the foreign corporation under section 881(a) and a second tax might be imposed upon its U.S. shareholders under proposed section 951. A possible approach to the problem of imposing a second tax on section 881(a) income might be to provide a deduction from the gross amount of such income equal to twice the amount of U.S. tax paid thereon. This would reduce the amount of such income taxable under subpart F by excluding such part thereof as in effect might be considered to have already borne a U.S. tax at a 50-percent rate.

Section 952(c).—This is a new section which is apparently intended to meet the criticism that the House bill contains no provisions with respect to allowance of losses. Section 952(c) permits the carry-forward of post-1962 losses of a controlled foreign corporation against its subsequent earnings. It makes no provision for the carryback of losses. Thus where a controlled foreign corporation is initially successful but ultimately incurs a loss (as in the case of expropriation by foreign governments), the U.S. shareholders would be required to pay a tax at ordinary income rates with respect to the undistributed income of the profitable years without receiving the benefit of any carryback with respect to the subsequent year in which such income was ultimately lost.

Section 952(c) is technically deficient. Under this section, the subpart F income of any controlled corporation may not exceed the earnings and profits of the corporation for the current year reduced by the amount by which (1) the sum of the deficits in earnings and profits for prior years beginning after December 31, 1962, exceeds (2) an amount equal to the "earnings and profits described in section 959(c)(3)" accumulated for taxable years beginning after December 31, 1962 (including the current year). Presumably under this section "earnings and profits described in section 959(c)(3)" means earnings and profits which are not taxed under section 951. When there are earnings and profits in the current year which are not taxed under section 951, this provision does not work as intended.

> Example: In 1963 a corporation has a deficit in earnings and profits of $400,000. In 1964 the corporation has earnings and profits of $400,000, consisting of subpart F income of $300,000 and other income of $100,000. Since the deficit in 1963 is just equal to the earnings in 1964, it would be expected that no amount would be taxable in 1964. Under the limitation set forth in section 952(c), the limitation on subpart F income in 1964 would be determined as follows: the earnings and profits for the current year of $400,000 would be reduced by (1) the deficit for 1963 of $400,000 minus (2) the nonsubpart F income in 1964 of $100,000, that is, $300,000 ($400,000—$100,000); therefore, subpart F income of $100,000 would be taxed even though the deficit in 1963 was equal to the entire earnings and profits of 1964.

This anomalous result would be corrected if section 952(c)(2) merely provided for the deficits of prior years to be reduced by an amount equal to the earnings and profits described in section 959(c)(3) accumulated for prior taxable years beginning after December 31, 1962. This would eliminate the double counting of earnings and profits of the current year.

It should also be noted that the section does not permit the carry forward of losses incurred prior to 1963.

The reference in subparagraph (2) of this section to accumulated earnings and profits of the type described in section 959(c)(3) should explicitly provide that such earnings should be reduced by distributions that are not excluded from gross income under section 959. It may not be clear that the word "accumulated" by itself accomplishes this result.

In the last sentence of the section, it should also be made clear that the deficit will be excluded only if it was previously taken into account in computing subpart F income; one way of accomplishing this would be to add the words "and thereby reduce subpart F income" to the end of the sentence.

Section 952(d).—This is another new subsection dealing with losses. It permits losses within a single chain of controlled foreign corporations to be applied against earnings of other foreign corporations within the same chain, "in such manner as the Secretary or his delegate shall prescribe by regulations." Among the problems which the regulations would have to face would be questions of prorating as between shareholders having preferred and common stock or having varying interests during the year or having varying interests in the various corporate links in the chain of corporations; prorating as between foreign corporations which came under U.S. control at different times during the year; and resolving competing interests of shareholders with respect to the carry forward of losses within a single corporate entity (under sec. 952(c)) or attribution of the losses to another corporation in the chain (under sec. 952(d)). It is questionable whether substantive problems of this magnitude should be or can be delegated to the Secretary's discretion without legislative guidelines.

It seems unfair to impose a tax on U.S. shareholders of the parent with respect to undistributed income from a submember of the chain, without giving the taxpayer any indication of the manner in which losses are to be attributed within the chain. The essential drafting difficulty here stems from the statutory device of attributing to the U.S. shareholder directly the undistributed income of a foreign subsidiary in which the U.S. shareholder owns no shares. It would appear preferable to adopt either the system of hypothetical distributions upward in the chain (the "link" system) which is used in existing section 555(b) with respect to foreign personal holding companies, or to provide a method under which the U.S. taxpayers would be given the election, subject to suitable safeguards, to determine the income of all the foreign corporations in a chain or in an affiliated group on a consolidated basis similar to the one available to domestic corporations. If this "hopscotching" method is adhered to, it would be desirable to enlarge section 952(d) so as to (i) permit attribution of losses between affiliates as well as between members of a single chain, (ii) make it clear that losses so applied may be carried forward under section 952(c), and (iii) establish standards for the Secretary to follow.

Foreign base company income (sec. 954)

Section 954(b)(1).—This new section would exclude from foreign base company income "dividends and interest" received from certain qualified investments in less developed country corporations, providing such dividends and interest do not exceed the increase in such investments for the taxable year. If the purpose is to permit earnings from an investment from one less developed country to be withdrawn for reinvestment in another less developed country, then the subsection should not be limited to dividends and interest but should extend to all subpart F income received from a less developed country, such as royalties, gains from the sale of the stock of a less developed country corporation, foreign base company sales income, or foreign base company service income.

Section 954(b)(3).—This paragraph, which is similar to section 952(e)(6) of the House bill, imposes a special rule where the foreign base company income is less than 20 percent, or more than 80 percent of gross income. The interrelation between sections 954(b)(3), 954(b)(1), and 955(a)(1)(A) should be clarified. As presently worded, it is not certain whether interest and dividends from certain less developed country investments which qualify for exclusion under section 954(b)(1), are included in the numerator in applying the percentage tests of section 954(b)(3).

Section 954(b)(4).—This new paragraph provides an exception for any item of income of a controlled foreign corporation if the Secretary is satisfied that "the creation or organization [of the corporation] receiving such item under the laws of the foreign country" of incorporation does not have the effect of "substantial reduction" of income, war profits, excess profits, or "similiar taxes."

Section 954(b)(4) represents an attempt to limit the complex provisions of the proposed statute to cases of tax avoidance. As discussed in part I, it is suggested that this provision should be amended so that the reference to reduction of taxes applies only to U.S. taxes. Whatever the decision on this question of policy may be, this section should be technically clarified in a number of respects. The taxpayer should have the right to establish his right to the excep-

tion by the preponderance of the evidence instead of leaving the determination entirely to the discretion of the Secretary. In addition, the section should be clarified so as to refer to the transaction giving rise to the income, rather than the "creation or organization" of the corporation.

Section 954(b)(5).—Our earlier memorandum (hearings, p. 3180) pointed out some of the difficulties which would be involved in determining which deductions would be "properly allocable" in determining foreign base company income. The present draft would give the Secretary authority to promulgate regulations to determine the allocation of "deductions" to four different types of tainted income. This is another instance in which the statute seeks to sidestep difficult problems by delegating their solution to the Secretary. It would seem preferable to face these problems from the outset, in order to help ascertain whether the statute would be workable in practice. In particular, it should be made clear that any excess of expenses, losses, and deductions allocable to one category of subpart F income over the income in that category should be charged against other categories of subpart F income. Merely allowing such excesses to reduce earnings and profits will not suffice, since they may be absorbed by earnings from sources which do not constitute subpart F income.

Section 954(b)(5) should be clarified so as to refer to "expenses" and "losses" as well as "deductions" (as is done in sec. 953(b)(5) with respect to certain insurance income), and to permit the various elections as to depreciation, etc., of the kind available to domestic corporations (as appears to be intended in sec. 962(a) with respect to determination of earnings and profits).

Section 954(c)(2).—As in the case of section 952(e)(3) of the House bill, this section would include all rents in foreign base company income without regard to whether they constitute more than 50 percent of gross income, subject to the exceptions of sections 954(c)(3) and 954(c)(4)(B) (see below). These exceptions are responsive in part to our original comments (hearings, pp. 3179–3180), but do not deal at all with the problem of rents which have been "locked in" to cover debt or commitments of a foreign corporation. One way to handle the "lock-in" problem generally would be to expand new section 962(b) (blocked foreign income) to include restrictions or limitations imposed under loan agreements or other commitments necessary for the business.

Consideration should also be given to the desirability of excluding rent where it constitutes the principal income of the foreign corporation, as is done with respect to personal holding companies under the 50-percent limitation of present section 543(a)(7). As pointed out in our earlier memorandum (hearings, pp. 3179–3180), if the purpose of removing the 50-percent limitation is to prevent rental income from sheltering other foreign base company income, this could be accomplished simply by excluding rental income from "gross income" for the purposes of the computation in section 954(b)(3).

Section 954(c)(3).—This is a new paragraph which excludes dividends, interest, rents, and royalties from foreign base company income if they are both (A) "derived in" the active conduct of a business, and (B) not received from a related person. The listed items of income may be received in connection with, or as an ordinary incident to, a manufacturing or other operating business, but it is not clear that the phrase "derived in" would cover these cases. Moreover, the exception from the exclusion under (B) should be limited to the case where the related person in a U.S. person. A transfer of items between related persons in connection with an active foreign business should not be the occasion for imposing a U.S. tax unless it involves the shunting of income from, or increasing the deductions of, a U.S. person.

Section 954(c)(4).—This is a new paragraph which excludes dividends, interest, rents, and royalties from foreign base company income if received from a related person under certain described circumstances. In the case of dividends and interest, the payor must be organized under the laws of the same country as the payee and, in addition, the payor must have substantial assets used in its business in such country. In the case of rents, royalties, and "similar amounts" the payor must be paying for the use of property located in the country in which the recipient corporation is organized. It is assumed that the theory behind the exclusion is that under the laws of most foreign countries the payment of the item under the circumstances described will not result in a reduction of foreign taxes. As stated above, it does not seem desirable to use the avoidance of foreign taxes as an occasion for imposing U.S. taxes; it would be preferable to disregard foreign-to-foreign intercompany transactions entirely.

Special provisions should be made for property of the type which is necessarily used within or between two or more countries, such as ships or planes. The ref-

erence to a corporation "created or organized" under the laws of a particular country should be expanded to include a corporation treated as a resident under such laws.

Section 954(d)(1).—This section defines foreign base sales income in terms similar to section 952(e)(2) of the House bill. It would deprive U.S.-controlled foreign corporations of the benefits of using a sales subsidiary or affiliate which is incorporated outside the country from which it buys or to which it sells. This is apparently intended to make it difficult for U.S.-controlled business conducted abroad to minimize foreign taxes, even though such benefits are freely available to their foreign competitors. Our objections to the imposition of these unilateral competitive disadvantages are set forth in detail in our earlier memorandum (hearings, pp. 3163–3164, 3179) and in part I of this memorandum.

Section 954(d)(1) differs from its predecessor section in one significant respect: it eliminates the separate 20-percent test for foreign base company sales income, which would have at least afforded protection where such income is relatively minor as compared with the rest of a corporation's business. It may be that the elimination of this important exclusion is an oversight, since it is not mentioned in the Treasury's explanation of changes.

It should be noted that, as in the case of the House bill, no specific provision has been made for the case where the foreign sales subsidiary manufactures, processes, or assembles products made from raw materials or parts acquired from a related person. The House committee report indicates that the provision is not intended to extend to the case where "appreciable value" was "added" to the product by the sales subsidiary (H. Rept. 1447, p. 62).[9] This concept appears nowhere in the language of either the House bill or the Treasury draft. It would seem inadvisable to leave substantive matters of this importance for definition by the committee reports alone.

Section 954(d)(2).—This is a new section. It provides that in "situations in which the carrying on of activities * * * through a branch or similar establishment outside the country of incorporation of the controlled foreign corporation has substantially the same effect as if such branch or similar establishment were a wholly owned subsidiary corporation deriving such income," then, under regulations to be prescribed, the income attributable to the "carrying on of such activities" is to be treated as income derived by a wholly owned subsidiary and shall constitute foreign base company sales income of the controlled foreign corporation.

The entire provision is vague and uncertain in the extreme. Its application and operation are so uncertain that comment upon the provision is most difficult.

Many foreign countries do not tax corporations organized under their laws with respect to income attributable to branches located in other countries. The Treasury may regard operation under laws of this type as a method of avoiding foreign taxes which this provision is intended to penalize. If so, this would represent an extreme instance of the Treasury's concern regarding the payment of foreign taxes which are not required by the countries involved. In such cases it would appear that section 954(d)(2) might well lead those countries not taxing branch income to impose a "soak-up" tax on U.S. controlled corporations organized under their laws, but not on their foreign competitors.

This provision, if it were to remain in the bill, would create innumerable problems. For example, should the "branch" be treated as a corporation which has been organized under the laws of the country in which the putative parent is organized, or in which the branch is actually located, or elsewhere? How would it be possible at one and the same time to treat the income of the branch as "income derived by a wholly owned subsidiary" and as constituting foreign base company sales income of the putative parent? What part of the income of the branch is to be so treated?

Section 954(d)(3).—This new section contains a definition of "related person," which substantially expands the language of the last sentence in section 952(e)(2) of the House bill. In determining stock ownership, the new section incorporates the rules of direct and indirect ownership of section 958(a) and the attribution rules of section 958(b). In view of the incorporation of the rules of section 958, it is confusing for section 954(d)(3) to refer again to "ownership, directly or indirectly."

---

[9] The technical portion of the House committee report states that the test is whether the corporation "substantially transforms the parts or materials, so that, in effect, the final product is not the property purchased" (p. A94).

Section 954(e).—This new section defines "foreign base company services income" as meaning any income derived "in connection with" the performing or furnishing of "technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial or like services" which are performed for a related person "for or in connection with business activities carried on by such related person outside the country under the laws of which the controlled foreign corporation is created or organized." The meaning and scope of this new section is obscure. For example, it is not clear whether the section covers services performed (for a related person) outside the country of incorporation of the corporation rendering the service, or whether it refers to services performed anywhere in connection with business carried on by the related person outside such country of incorporation. It is also not clear what kind of business enterprises would be included under such broad terms as "managerial," "industrial," "commercial," and the "like," or whether income derived "in connection" with such services for a related person would include compensation received from an unrelated third party.

The language of section 954(e) seems broad enough to encompass marketing companies and sales agencies of the kind described in section 954(d)(1). If an item of income should fall under both section 954(e) and 954(d)(1), then under section 954(b)(6) the allocation of the item would be determined by regulations to be prescribed. This adds still another element of uncertainty to the statute, since the exceptions set forth in section 954(d)(1) are not the same as those in section 954(e).

Withdrawal of previously excluded subpart F income from qualified investment (sec. 955)

Under the provisions of sections 954(b)(1) and 954(f) a controlled foreign corporation can exclude from subpart F income certain dividends and interest received from less-developed countries and reinvested in those countries. When the investment is withdraw, sections 955 and 951(a)(1)(A)(ii) would tax the previously excluded income to U.S. shareholders as a new category of income, called "previously excluded subpart F income withdrawn from investment in less-developed country corporations for such year." The technique of creating a new category of income (rather than treating the withdrawal as subpart F income in the year of withdrawal) results in serious complexities and incongruities.

Section 955(a)(1).—It is not clear under this section whether interest and dividends would be considered to have been excluded from foreign base company income under section 954(b)(1) (and therefore potentially taxable under sec. 955) if they were received in a year in which there was no foreign base company income because all of the foreign base company income (including such dividends and interest) was less than 20 percent of the gross income of the controlled foreign corporation.

The word "foreign" is omitted after the word "controlled" in the second line of this provision in the committee print.

Section 955(a)(2).—This section defines a decrease in qualified investments, and limits the amount of such decrease to "the sum of the earnings and profits for the taxable year and the earnings and profits accumulated for prior taxable years beginning after December 31, 1962."

Under the quoted language it is entirely unclear whether a deficit existing at the beginning of the taxable year may be applied to reduce or eliminate earnings and profits of that year. Moreover, even if a deficit may be so applied, there seems to be no reason why its treatment under section 955(a)(2) should differ from its treatment under section 952(c). The latter section expressly provides that subpart F income is to be taxed only to the extent of untaxed earnings and profits less prior deficits. Section 955(a)(2), however, would seem to permit the taxation of section 955 withdrawals if there are any accumulated earnings and profits, whether or not they have been taxed.

> Example: In 1963 corporation X (wholly owned by U.S. shareholders) has $300,000 of subpart F income and $300,000 of dividends and interest excluded from subpart F income under section 954(b)(1). In 1964 X has a $300,000 operating loss. In 1965 X has neither current earnings and profits nor a current loss, and withdraws from iinvestment the $300,000 previously excluded from subpart F income. Since X has accumulated earnings and profits of $300,000 ($600,000 from 1963 less the $300,000 loss of 1964), the withdrawal would be taxed under section 955(a)(2). Thus, taxes have

been imposed on $600,000 of income, even though X's accumulated earnings and profits through the year of withdrawal were only $300,000.

The incongruity of the rules provided by section 955(a)(2) is illustrated by the different result which would occur were the tax-free distribution made prior to the year of section 955 withdrawal.

Example: Same facts are in the preceding example, except that in 1964 X distributes $300,000 to its U.S. shareholders. The distribution is tax free under section 959, but results in a reduction of earnings and profits. The section 955 withdrawal in 1965 is likewise tax free, because there are no accumulated earnings or profits at the beginning of 1965.

Under section 955(a)(2), the amount of any decrease in qualified investments is to be adjusted by eliminating decreases resulting from net losses on qualified investments which are disposed of during the taxable year. It is not clear whether an investment which has become worthless during the taxable year (and which would thereby contribute to the decrease in qualified investments) has been disposed of for the purposes of the above adjustment. Section 955(a)(2) should be revised to clarify this point.

Section 955(a)(3).—This section purports to define pro rata share of amount withdrawn. The definition says only that a person's pro rata share is his pro rata share. It contributes nothing toward resolving this important question. See our comments under section 951(a)(1) above.

Section 955(c)(1)(B).—This section requires that 80 percent or more in value of the assets of a less developed country corporation consist of certain assets. These assets include "property used in such trades or businesses and located in less developed countries". It is not clear that accounts receivable from customers located in countries outside less developed countries are "property" located in less developed countries, even though the receivables grew out of a trade or business conducted in a less developed country.

Section 955(c)(1)(C).—There seems to be no reason for requiring that a less developed country corporation be incorporated under the laws of such a country if it meets the other tests of section 955(c)(1).

Investment of Earnings in U.S. Property (Section 956)

Section 956(a)(1).—In defining the amount of earnings invested in U.S. property, this section limits such amount to the extent it would have "constituted a dividend (determined after the application of sec. 955(a)) if it had been distributed". We could have thought the reference would be to section 959(a) rather than section 955(a), so that an investment in U.S. property would not be taxed if it could only be made out of earnings available for tax-free distribution under section 959.

The reference to "property held, directly or indirectly" is obscure and should be clarified.

Section 956(a)(2).—This section deals with the "pro rata share" of an increase in the earnings of a controlled foreign corporation invested in U.S. property. As we have observed earlier, the term "pro rata share" requires clarification. The section would tax an increase in investment in U.S. property even though attributable to earnings and profits accumulated before January 1, 1963. This represents a marked change from the parallel provisions of sections 953 of the House bill, which limited the tax to earnings and profits accumulated after December 31, 1962. In this important respect it seems clear that section 956 is not "with technical changes, substantially the same" as the parallel provisions of the House bill, notwithstanding the Treasury comment to this effect at page 2 of its explanation.

Section 956(b)(1).—This section defines U.S. property as tangible property located in the United States, stock of a domestic corporation, or an obligation of a U.S. person, if acquired after December 31, 1962. If the purpose of section 956 is to impose a tax with respect to U.S. investments which are tantamount to dividends by reason of benefits conferred upon related U.S. persons, then the section should apply only to such investments. On the other hand, if the purpose of section 956 is to strike at investments which evidence unreasonable accumulations, then there would seem to be no reason to limit it to U.S. property or to apply it to investments made in connection with the business of a controlled foreign corporation.

The reference to property "acquired after" December 31, 1962 is not clear. For example, if securities held prior to December 31, 1962, are exchanged in a tax-free reorganization, it is not clear when the securities resulting from the refunding transaction have been "acquired".

It should also be noted that the restriction of the definition to property acquired after December 31, 1962, would bar replacement of existing U.S. investments upon their maturity or sale after December 31, 1962. As a result, the statute would tend to force capital out of the United States as well as to bar its flow into the United States. The advisability of these provisions seems highly doubtful in the light of our balance of payments problem.

Section 956(b)(2)(A).—This section would exclude from the definition of "U.S. property" any "money, or deposits with persons carrying on the banking business, located in the United States." In view of the phrasing, it would appear that the deposits, as well as the money, must be "located" in the United States. This would raise substantial doubts with respect to the potential taxability of deposits made with a foreign branch of a U.S. bank, even though there would be no question if the deposit had been made at the home office of the U.S. bank. This result was probably unintended. It is suggested, accordingly, that section 956(b)(2)(A) be worded to read as follows:

"(A) money, or deposits with or obligations, pledges and guarantees of persons carrying on the banking business;".

Section 956(b)(2)(C).—This is an exception which is apparently intended to permit sales to U.S. persons on usual credit terms. The wording of the exception is singularly awkward and gives rise to numerous questions of construction. In particular, it is not clear whether the exception would apply in the case of a sale made to an unrelated person.

An exception should be provided for any obligation arising in the ordinary course of business. In the absence of such an exception, obligations arising from the performance of services for a U.S. person or obligations for rentals due under leases to U.S. persons would be treated as if they were investments in U.S. property under section 956(b)(1)(C), even though the services were performed or the rental property was located entirely outside the United States.

Section 956(c).—This section states that a controlled foreign corporation shall be considered "as holding an obligation of a U.S. person if it is a pledgor or guarantor of such obligation." It is assumed that the world "it" refers to the controlled foreign corporation, but this is not clear. If this assumption is correct, the section would prevent a tax haven company, for example, from guaranteeing a loan by a foreign bank to the tax haven company's U.S. parent based on funds of the tax haven corporation accumulated in the foreign bank. If such is the intent, this should be made clear by deleting the word "it" and substituting in its place the words "the controlled foreign corporation." This was the thrust of the original section 953(b)(4).

If the word "it" were to be construed to refer to "U.S. person," it is believed that it would raise very serious unintended problems. For example, it is a common banking practice abroad for a bank to guarantee obligations of various kinds between its customers. A number of these transactions would be exempted under section 956(b)(2)(C). Many other similar problems arise in connection with sales of property and if the guarantee of a foreign branch of a U.S. bank in such transactions would convert the obligation guaranteed into U.S. property, it would not only put the bank branch at a competitive disadvantage but would raise difficult problems for its customers who were controlled foreign corporations.

Controlled foreign corporations (sec. 957)

Section 957(a).—The bill as passed by the House also presented substantial difficulties in determining the facts necessary for identification of a controlled foreign corporation. The incidence of these problems has been substantially reduced under the draft by the proposed limitation on attribution through corporations and by the disregard for purposes of the definition, of U.S. persons whose owned or attributed stock interests are less than 10 percent. However, serious problems could still arise for a minority shareholder who must determine whether the number of remaining shares held by or attributed to U.S. persons is such as to place the corporation in the category of a "controlled foreign corporation." Even though only 10 percent shareholders (actual or attributed) are counted for this purpose, the counting may be complicated or impossible because of registration of the remaining stock in numbered accounts or "street" names, the use of bearer shares, the difficulties of applying the attribution rules, and the fact that "control" might exist on only one day in the year.

Moreover, despite the 10 percent limitation it is still possible for situations to arise in which a corporation will be treated as "controlled" by U.S. persons although it is in fact controlled by foreigners.

> *Example:* A U.S. publicly held corporation owns 40 percent of the stock of foreign corporation X. The remaining 60 percent of X stock is owned by a foreign corporation which is owned by foreigners except that 20 percent of its stock is owned by an American. X is deemed to be a "controlled foreign corporation" under sections 957 and 958, although Americans do not have effective control.

As drafted, a foreign corporation would seem to be a "controlled foreign corporation" for the entire taxable year if the ownership test is met on any one day. This is inconsistent with sections 951(a)(2), 951(a)(3), and 951(a)(4) where a U.S. shareholder is taxed only with respect to the portion of the year that the foreign corporation is a "controlled foreign corporation." This section should specifically provide that a foreign corporation is a "controlled foreign corporation" only during the period in which the ownership test is met.

Section 957(c).—The other basic change in what constitutes a controlled foreign corporation is in the exclusion of certain corporations organized in U.S. possessions. This is a desirable change. The parenthetical reference in sections 957(c)(1) and 957(c)(2) seems unnecessary.

Rules for determining stock ownership (sec. 958)

Section 958(a).—Under section 958(a), a U.S. person is treated as owner not only of stock he actually owns, but also of stock he indirectly owns through a foreign corporation, foreign partnership, foreign trust, or foreign estate. This section has been made applicable not only for the purpose of taxing U.S. persons (as the corresponding provision in the House bill was) but also for the purpose of determining whether a U.S. person is a "U.S. shareholder" and whether a corporation is a "controlled foreign corporation." No reason has been given or is apparent for making this change.

Section 958(b).—This is the same as former section 955(b) of the House bill except for the change embodied in section 958(b)(4). The latter section narrows the attribution of stock ownership through a corporation to a situation where the stockholder owns 10 percent or more of the stock directly or indirectly. Unfortunately, a similar limitation has not been introduced into section 958(a). Since sections 958(a) and 958(b) serve the same statutory purposes (determining who is a "U.S. shareholder" and determining if a foreign corporation is "controlled"), the failure to include the 10-percent limitation in section 958(a) largely negatives the change made in section 958(b). For this reason, section 958(a) should be restricted to its original purpose. Except for the foregoing change, the problems are the same as those discussed in our previous comments (hearings at pp. 3186–3187).

Exclusion from gross income of previously taxed earnings and profits (sec. 959)

Section 959.—This section is identical to section 956 of the House bill except for the occasional substitution of the word "shareholder" for "person," and the major difficulties continue to be the same.

Whether a distribution of earnings or an investment of earnings in U.S. property results in the realization of taxable income by a person subject to Federal income taxation will depend upon whether such earnings were previously included in the taxable income of a "U.S. shareholder" who owned the shares now owned by the person whose income tax liability is in issue. Shares which are otherwise identical may therefore have different tax attributes depending upon how they were previously owned. If the purposes of section 959 are to be served, administrative problems of almost insuperable complexity will be encountered, especially in tracing and identifying shares of a public corporation which may be registered in street name and purchased and sold through brokers.

> Example: A, a U.S. citizen, acquires one one-hundredth of 1 percent of the stock of X, a foreign corporation. The value of his investment is about $10,000. X company has acquired over a number of years control of several foreign corporations owning rental property in various foreign countries. X acquired the stocks of its subsidiaries from other foreign corporations, from U.S. corporations, from trustees and executors of estates here and abroad, etc. Subsidiaries of X sell properties (realizing no net gain), and distribute the proceeds to X. Then X distributes a dividend of $1,000 to A.

To the extent that the rental income of the underlying companies was taxed to U.S. persons in previous years through the stock which X has acquired, A should receive his $1,000 tax free under section 959(a) when the rule of section

958(a) is taken into account. However, it may be prohibitively expensive for A to examine the past shareholdings of the companies now underlying X (and the shareholdings of the companies of which they were once subsidiaries).

Moreover, there may be no reason for the management of X to provide A with information or assist him in securing it. X may not be a "controlled foreign corporation." A and other U.S. shareholders taken together may have a very small fractional interest in X. Their problems would not stem from the status of X as a "controlled foreign corporation," but from the fact that they receive cash and the fact that some of the subsidiaries of X were at one time or other controlled foreign corporations whose income was taxed to U.S. citizens and is now being taxed again.

In the case described, a revenue agent faced with the statute, the lack of proof and A's cash receipt would have to include in A's gross income the $1,000 cash distribution by X. Despite the elaborate technical machinery of section 959, the same income could, in practice, be taxed twice.

Section 959(b) excludes previously taxed earnings from gross income "for purposes of the application of section 951(a)" when distributed through a chain of ownership through other controlled foreign corporations. Such distributions should also be excluded from gross income for the purposes of section 551 of the Internal Revenue Code. Absent such an exclusion, distributions of previously taxed income through a chain of foreign corporations may be taxed again as foreign personal holding company income.

Special rules for foreign tax credit (sec. 960)

Section 960.—Section 957 of the House bill, providing special rules for the foreign tax credit, has been renumbered as section 960 of the Treasury draft. There have been no changes. Thus all the problems noted and analyzed in the report of this group and other groups remain. Some of these criticisms are listed below without extensive comment.

Under section 960, no credit for foreign taxes is available to individual U.S. stockholders in controlled foreign corporations.

Attribution rules are used to compute income elsewhere in subpart F, but are not used to determine eligibility for the foreign tax credit in section 960.

Section 960(a)(3) should be correlated with the gross-up provisions of the bill, for otherwise a domestic parent may be required to include income of a controlled foreign corporation in its gross income twice in order to obtain a foreign tax credit.

It is not clear whether section 960(a)(4) is intended to mean that inclusions in gross income are not ordinarily to be considered as dividends.

Section 960(b) should be extended to apply to successors in interest and provision for prior year limit should be made.

Section 960(b)(2)(A) should be clarified so as to include appropriate amounts grossed-up in determining the amount of increase in the section 904 limitation.

Section 960(b)(2) should be modified to take into account in the year of distribution, in addition, to the increase in the section 904 limitation for the year of taxability, the carryovers, and carrybacks resulting from such limitation for the year of taxability.

Section 960(b)(2) will require keeping prior years open for long periods of time, for purposes of that section, since the section 904 limitation in the year of distribution will be determined in the light of that limitation in the year of taxability.

Section 960(b)(4).—This provision does not yield the correct result in cases such as the following:

> Example: Under section 951(a) the 1963 income of A corporation (a foreign corporation) is taxed to X corporation, a U.S. corporation. In 1964 X corporation receives a tax-free distribution from A corporation. In 1964 X corporation also realizes taxable foreign income from source B. X corporation increases its section 904 limitation under section 960(b) (1) and (2) After doing so, X has the following items for 1964:

U.S. income tax liability	$1,000
Foreign tax credit under sec. 901 arising from source B income after applying sec. 904	500
Increase in limitation under sec. 960(b) arising from tax-free distribution by A corporation	700

The statute is intended to permit X to employ the $700 increase in its credit limitation under section 960(b) so as to eliminate its net liability of $500 for

1964 and also claim a $200 "refund." The statute, however, does not operate because the $700 increase in the section 904 limitation which arises under section 960(b) does not exceed the tax of $1,000 imposed for 1964. The statute should read:

"* * * the tax imposed by this chapter for such year reduced by any credits allowable under any provisions of this chapter other than credits arising out of or allocable to the increase in the limitation airsing under section 960(b),".

Adjustments to basis (sec. 961)

This section provides for increases in basis of stock of a controlled foreign corporation by amounts included in gross income under section 951(a). It is submitted that the basis increase provisions does not go far enough.

> Example: X, a U.S. citizen, owns all the stock of P, a Panama corporation, which owns all the stock of S, a Swiss corporation. S has subpart F income charged to X under section 951. Under section 961(a) the basis of the P stock is increased, but not the basis of the S stock in the hands of P. A sale of S stock by P would thus increase the earnings and profits of P and the increase could form the base for further taxes (for example under sec. 956) imposed upon X, essentially stemming from the same income already taxed.

It is submitted that the basis of the S stock in the hands of P should also be increased under these circumstances.

Miscellaneous provisions (sec. 962)

Section 962(a).—This section provides that earnings and profits of a foreign corporation are to be computed for purposes of subpart F according to rules "substantially similar" to those applicable to domestic corporations, under regulations to be prescribed by the Secretary or his delegate. This section leaves unanswered specific questions with respect to elections, accounting methods, and fiscal periods affecting the computation of earnings and profits.

Section 962(b).—This section provides that under regulations to be prescribed "no part of the earnings and profits of a controlled foreign corporation for any taxable year shall be included in earnings and profits for purposes of sections 952, 955, and 956" if it is established that such part could not be distributed because of currency or other restrictions or limitations.

We presume that this section is intended to prevent the inclusion of blocked income in the taxable income of a U.S. shareholder of a controlled foreign corporation. It will not always accomplish this purpose.

> Example: A controlled foreign corporation has $300,000 of operating income from country A which is not blocked and $300,000 of subpart F income from country B which is blocked. Section 962(b) excludes the blocked income from earnings and profits. Section 951(a)(1)(A)(i) and section 952(c) require the U.S. shareholder to include in his taxable income the amount of subpart F income not in excess of earnings and profits of the taxable year. Subpart F income is $300,000 and earnings and profits are likewise $300,000. The shareholder would be required to include $300,000 in his taxable income.

The result in the foregoing example was presumably not intended and the section should be redrafted. Moreover, it would appear imperative that blocked income be completely excluded from all calculations of gross income, earnings and profits and taxes paid until it is unblocked. Otherwise the 20–80 ratio of section 954(b)(3) and the operation of the foreign tax credit provisions would be materially distorted.

It is hoped that the committee report will state that it is not intended that this section require the taxation of earnings and profits which technically can be distributed but only at a substantial loss due to foreign exchange laws and restrictions.

Technical and clerical amendments

Bill section 13(b).—This section is the same as section 13(b) of the House bill. This section was intended to relieve the stockholders of foreign personal holding companies from imposition of a second tax under section 551 with respect to any subpart F income on which they will be taxed under section 951. In our memorandum of April 27, we pointed out that this section was technically deficient and failed to accomplish its purpose (hearings, pp. 3191–3194). The failure to

correct these deficiencies is particularly troublesome because the scope of the foreign personal holding company provisions has been broadened by bill section 7.

BILL SECTION 16. GAIN FROM CERTAIN SALES OR EXCHANGES OF STOCK IN CERTAIN FOREIGN CORPORATIONS

Section 1248.—This section provides that gain recognized from sales or exchanges of stock in a foreign corporation (including redemptions of stock or liquidating distributions treated as exchanges under sec. 302 or 331) will be treated as dividends to the extent of an allocable part of the earnings and profits accumulated by such corporation after December 31, 1962. The section applies only to gain realized by a stockholder who has owned (by applying certain rules of constructive ownership) 10 percent or more of a corporation's total voting stock at any time during a 5-year period ending on the date of sale or exchange when the foreign corporation was a "controlled foreign corporation."

The Treasury draft makes the application of bill section 16 more equitable in the following important respects: (*a*) by providing similar treatment for gains whether derived from sales of stock or liquidations; (*b*) by limiting the earnings and profits which will be taken into account in all cases to those accumulated after December 31, 1962; and (*c*) by limiting the amount of tax which is payable by individuals generally to the lesser of the amount that would have been payable if a domestic corporation had been used for the foreign operations or the amount that would have been payable if the earnings had been distributed yearly as earned.

Section 1248(a)(2).—This paragraph limits the application of section 1248 to a person who has owned a 10-percent stock interest in a controlled foreign corporation during a 5-year period ending on the date of the sale or exchange. The section should not apply unless the 10-percent stock interest is held after December 31, 1962. Accordingly, the word "during" in the fifth line of the paragraph should be deleted and the words "after December 31, 1962, and within" should be inserted in lieu thereof.

Presumably, the reference in section 1248(a)(2) to section 955(b) should be a reference to section 958(b) and the reference to section 954 should be a reference to section 957.

Section 1248(b).—This section treats as a dividend (rather than as capital gain) a portion of the gain recognized on the sale or exchange of stock of a controlled foreign corporation. If the taxpayer is a corporation, the portion of gain which is taxed as a dividend under section 1248(b) would not reduce accumulated taxable income under section 535(b)(6) nor undistributed personal holding company income under section 545(b)(5), even though the stock was held for more than 6 months. Section 1248 does not appear intended to extend the impact of the accumulated earnings or personal holding company taxes. We suggest that treatment as a dividend under this section should be limited so that such treatment would not apply for the purposes of section 535(b)(6) or section 545(b)(5).

Section 1248(c)(1).—This paragraph provides a limitation on the amount of U.S. taxes payable by individuals under a formula designed generally to determine the amount of U.S. taxes that would have been payable if the corporation had been a domestic corporation. It is recommended that the taxes taken into account under subparagraph (A)(ii) should be limited to those taxes which are in the aggregate not in excess of a 52-percent tax rate (i.e., to an amount of tax that is not in excess of 52 percent of the sum of clause (i) and (ii) of subparagraph (A)). Otherwise, the application of this section to situations where the effectve foreign tax rate is greater than 52 percent would be unclear. The reason is that the amount computed under subparagraph (A) is reduced by the amount referred to in subparagraph (B). If that reduction is interpreted to permit a negative figure, the effective tax on a stockholder under section 1248 may be less than if the section was not applicable at all; however, if a negative figure is not recognized, so that there is no deduction from the amount computed under subparagraph (C) then the tax computed under these provisions would seem too high in the case where a foreign tax rate is higher than 52 percent. For example, assume that a foreign corporation had gross income of $100 and paid foreign taxes of $60, leaving $40 in accumulated earnings and profits to be taken into account under section 1248. The amount of the tax computed under the limitation of this section would be either $4 or $12 (assuming the applicability of the 25 percent alternate capital gains tax), depending upon which of the fore-

going interpretations is followed. It would seem, however, that this section is intended in such circumstances to provide a limitation of the amount of tax to $10.

As now written, this provision allows no credit for U.S. taxes paid by a foreign corporation even though it is engaged in trade or business only in the United States, and pays a full 52 percent Federal tax on all of its income. That this is merely an inadvertence is suggested by section 952(b), which excludes from subpart F income any income of such a foreign corporation that is subject to full U.S. tax. Moreover, consistent with the apparent purpose of the provision, a credit should also be allowed for U.S. taxes paid by a foreign corporation even though it is not engaged in trade or business in the United States. Subparagraph (A)(ii) should also include a credit for any foreign taxes of any foreign sibsidiary that would have been "deemed paid" if a foreign tax credit were computed under section 902(b). Accordingly, it is recommended that the words "(including the amount of any foreign taxes paid by any foreign subsidiary that would have been taken into account under section 902(b) if the taxpayer were a domestic corporation computing a foreign tax credit under section 902) or to the United States" be added in the third line immediately after the words "any foreign country."

Section 1248(c)(2).—This section should be conformed to other provisions of the code by changing it to provide that the Secretary or his delegate will prescribe the adjustments for losses and distributions by regulations.

Section 1248(d)(2).—This section provides for the exemption from the application of section 1248 of the earnings and profits of a foreign corporation attributable to the sale of property (as defined in sec. 337(b)) within a 12-month period ending on the date of the liquidation of the foreign corporation. If earnings and profits for purposes of section 1248 are to be computed generally in accordance with the rules applicable to domestic corporations, section 1248 should so provide (compare sec. 962(a), which is inadequate, but at least refers to the problem for purposes of subpart F). In such case, this section would seem at best unnecessary and at worst confusing in view of the fact that the limitations of section 337(c) are not adopted. If earnings and profits are to be computed under some different set of rules or standards, guidance as to those rules and standards should be provided in section 1248.

Section 1248(d)(3)(C)(iii).—The word "not" appears to have been inadvertently omitted before the words "more than 6 months."

Section 1248(d)(3)(D).—This section provides for an exemption from the treatment provided by section 1248 in the case of gain with respect to the sale or exchange of stock of a "less developed country corporation," provided the stock has been owned by the taxpayer for a continuous period of at least 10 years ending on the date on which the gain is recognized and the corporation has qualified as a less developed country corporation during the entire 10-year period. In its present form, this application of the exemption is not reasonably predictable and it therefore will not be a significant factor in encouraging investment in less developed countries.

The continued classification of a foreign corporation as a less developed country corporation is outside the control of the taxpayer and is not assured because of political uncertainties. If significant encouragement is to be provided for investment in less developed countries, all earnings accumulated during any period when a corporation qualifies as a less developed country corporation should be excluded in determining the amount taxable as a dividend under section 1248. At the very least, the 10-year period of qualification of the corporation as a less developed country corporation should be substantially reduced and a credit should be allowed for the period of time of the investment prior to the establishment of the classification of a "less developed country corporation" under the statute. Under the provision in its present form, no benefit could be obtained from the exemption prior to 1973.

Similar objections apply to the requirement of a shareholder's holding period. As mentioned above, the exemption provided by this section will not apply unless the taxpayer has owned the stock in the less developed country corporation for a continuous period of at least 10 years, and, if the taxpayer is a corporation, the exemption will not apply unless no stockholder owning 10 percent or more of the taxpayer's stock has transferred such stock within such 10-year period other than by bequest or intestate succession. There would appear to be no reason for such a holding period requirement since, regardless of a transfer of the stock, the investment in the less developed country continues, and a transfer of the stock has no identifiable U.S. tax avoidance

consequences that should affect the tax treatment of the stock in the hands of the transferee. If, however, there must be a taxpayer holding period as a condition to this exemption, it would be essential to provide exemptions to cover termination of the investment based on changes in conditions or other circumstances outside the shareholder's control, such as expropriation or elimination of the country of incorporation from the category of less developed countries. Also, the words "the whole of such continuous period," which appear twice in this section, should be replaced by the words "such 10-year period." Under the present form of this section, the taxpayer's holding period must have coincided with the entire continuous period of qualification of the corporation as a less developed country corporation even though such period is much longer than 10 years.

Section 1248(e).—As noted in our memorandum of April 27, 1962, this provision places a special burden of proof on the taxpayer to establish the amount of earnings and profits, and provides that he shall be penalized for failure to meet this burden by having his entire gain taxed as a dividend. The determination of earnings and profits of a foreign corporation involves numerous criteria which have not yet been determined by the Secretary. The application of these criteria, once established, will be difficult. In view of this difficulty, the ordinary burden of meeting the presumption that the Commissioner's findings on a tax matter are correct seems all that can reasonably be required. Therefore, this section should be deleted.

The following persons have participated in the preparation of these comments, and respectfully submit them for consideration:

M. Bernard Aidinoff, 48 Wall Street, New York, N.Y.
John P. Carroll, Jr., One Chase Manhattan Plaza, New York, N.Y.
Norris Darrell, 48 Wall Street, New York, N.Y.
Charles C. MacLean, Jr., 40 Wall Street, New York, N.Y.
Robert H. Preiskel, 120 Broadway, New York, N.Y.
David E. Watts, 40 Wall Street, New York, N.Y.
Bliss Ansnes, 20 Broad Street, New York, N.Y.
Edwin S. Cohen, 26 Broadway, New York, N.Y.
Henry W. de Kosmian, One Chase Manhattan Plaza, New York, N.Y.
Robert J. McDonald, 48 Wall Street, New York, N.Y.
Sidney I. Roberts, 405 Lexington Avenue, New York, N.Y.
Paul R. Weltchek, 20 Exchange Place, New York, N.Y.
John Baity, One Chase Manhattan Plaza, New York, N.Y.
John F. Costelloe, 25 Broadway, New York, N.Y.
Hans J. Frank, 120 Broadway, New York, N.Y.
William A. Patty, 20 Exchange Place New York, N.Y.
David Simon, 26 Broadway, New York, N.Y.
Edward J. P. Zimmerman, One Chase Manhattan Plaza, New York, N.Y.

Senator GORE. The next witness is Mr. Kenneth C. Royall.

Mr. ROYALL, do you come to exercise the right of petition as a private citizen or as a registered lobbyist?

STATEMENT OF KENNETH C. ROYALL, PHARMACEUTICAL MANUFACTURERS ASSOCIATION

Mr. ROYALL. Fortunately, I am employed.

Senator GORE. Are you registered as a lobbyist?

Mr. ROYALL. I am.

Senator GORE. What is your retainer by Pharmaceutical Manufacturers Association?

Mr. ROYALL. It hasn't been yet determined.

Senator GORE. You are not regularly on retainer?

Mr. ROYALL. Not regularly on retainer, no, sir. Employed for this particular service. We represent this particular group.

Senator GORE. You may proceed.

Mr. ROYALL. Mr. Chairman, I appeared before this committee on May 2 on behalf of the Pharmaceutical Manufacturers Association for whom I now appear.

I am a member of the law firm of Royall, Koegel & Rogers of New York and Washington.

In accordance, with the directions which your committee has given, I will discuss only section 13. I do so without waiving our position in any way on the other sections which I discussed before.

You have an amplified statement and I just want to emphasize a few points that are in it.

The present proposed amendments do offer some improvement along the lines of suggestions that had been previously made but they still fail to correct many important deficiencies in the bill.

One recent change by the Treasury purports to provide, to quote their words, more "equitable application of the taxing mechanism," and that relates to the matter of losses.

The suggestion is on its fact incomplete and insufficient. While it permits losses to be carried forward, it does not permit them to be carried back.

The allowance of both carryback and carryover would be more equitable and more appropriate and more consistent with precedent.

Again, in substituting new provisions relating to patents the Treasury has indeed, in our opinion, provided for both confusion and discrimination. The amendments do not, as they should, clearly eliminate the imputing of income.

Any possibility of this should certainly be entirely removed and not partially and in a doubtful manner as it now appears from this draft.

Aside from that, the present proposals tax as ordinary income any gain realized by American parent in the sale of a patent to or for an exchange with its controlled foreign subsidiary.

This transaction, in the case of a domestic subsidiary, would result in a capital gain. This law would make it ordinary income. That would clearly work an injustice between the two.

This proposed discrimination against foreign subsidiaries is startling at this time particularly because the Secretary of the Treasury has specifically testified that equality in the tax treatment of similar groups of taxpayers is one of the most fundamental of guiding principles in American income taxation.

We merely ask for that equality here.

Again, we note that the proposed amendments would not tax as much of the unrepatriated income of foreign subsidiaries as was suggested by the earlier version. However, a large segment of that undistributed income would still remain taxable under the amendments.

This would place a serious continuing competitive disadvantage on the members of this association doing business abroad.

This competitive disadvantage would inevitably reduce our members favorable balance of payments from their foreign business. It would also materially decrease domestic employment in the production of items for oversea markets. This was pointed out in my earlier appearance before this committee, and is still the fact under this changed law.

Section 13 of the original bill enlarged the definition of tax haven to include not only U.S. tax avoidance, but also so-called deferral of U.S. income tax to a later year. The latter is bad enough. Now the

Treasury seeks by a provision of section 954 to further extend that definition to include legitimate minimization of foreign taxes.

This expanded definition is almost beyond belief. We can understand and we favor the genuine concern of this Government in preventing the avoidance of U.S. income taxes.

But we just cannot fathom the concern of this Government to prevent the now proper minimization of income taxes imposed by foreign countries. Certainly there can be no justification for deliberately seeking to hurt foreign subsidiaries of American companies when foreign competitors of those companies are not similarly affected.

That is just what this present proposal would do. It deprives American business operating abroad of the opportunity available to its foreign competitors in legitimate methods of minimizing, not evading or avoiding, but minimizing foreign taxes. It will inevitably result in such a severe competitive disadvantage to American business abroad that the effects will be serious.

In time American business will lose, sometimes all, sometimes in part, their markets in foreign countries, and certainly that is not what the proposal is designed to do.

Subsidization of foreign business at the expense of the United States is a form of additional foreign aid, and the effect is an unjustified tax baldly taken from American business.

Perhaps, the most shocking feature of the present proposed bill is the number of delegations of authority to the Secretary of the Treasury, or to his delegate, to prescribe regulations.

In the first place, until these regulations have been finally issued it will be impossible to determine just what the law and the regulations are or to know how to proceed under them.

Secondly, this is no proper way to answer the questions and meet the objections raised by this committee and by the business element—to say we will just regulate—and not giving any indication of what the regulation would be.

This proposal is not legislation really. It is a request for a delegation of legislative authority with practically no limits or definition.

It is a step toward government by ukase, which is as foreign as any theory can be to our American system and to the Congress.

There has been a lot of talk recently about lack of confidence on the part of businessmen, lack of confidence in the Government and in the Congress.

I am not speaking personally because I am still a supporter of the administration. But I do realize that this type of legislation can lead to confusion and fear, and I would think at this particular time with the lack of confidence that does exist in so many, it would be most ill advised to add on a drastic program such as this legislation would require.

This bill can certainly do nothing to bolster business confidence, particularly in the case of businesses which operate abroad.

Its passage might well create or increase lack of confidence.

There is another, and it seems to me, perhaps the most important, practical reason, regardless of ideology and theory that we have. The administration has formally announced that it will propose to the Congress in 1963 a comprehensive revision of the entire Revenue Code. To make changes such as are suggested here, changes that are not only controversial but are exceedingly doubtful, when a general

revision is in immediate sight would seem to be nothing short of absurdity.

We hope the legislation will not be passed in this form and at this time.

(The statement referred to follows:)

TESTIMONY OF KENNETH C. ROYALL FOR PHARMACEUTICAL MANUFACTURERS ASSOCIATION

I am Kenneth C. Royall, of the law firm of Royall, Koegel & Rogers, New York, N.Y. I previously appeared before this committee on May 2, 1962, on behalf of the Pharmaceutical Manufacturers Association in opposition to sections 6, 11, and 13 of the Revenue Act of 1962, as passed by the House of Representatives.

Although these hearings are specifically limited to the Treasury Department's proposed amendments to certain sections of the House bill, I wish to make it clear that our association remains opposed to those sections as well as to the other provisions of the bill to which I made reference in my previous testimony.

As to the matter before us today, first note that the Secretary of the Treasury in his transmittal letter of May 31, 1962, to the chairman of this committee, states that the proposed amendments embody "technical improvements in the application and mechanics" of the bill as passed by the House and present a "more limited tax-haven approach" should the committee prefer it.[1] While the proposed amendments do offer improvements in line with some of the previous suggestions of witnesses appearing before this committee, such improvements fail to correct other important deficiencies of the House bill.

Take, for example, the alleged "technical improvement" relating to the utilization of the losses of a controlled foreign corporation. While this suggestion purports to provide a more "equitable application of the taxing mechanism,"[2] it is patently incomplete. It permits losses to be carried forward to future years, but unlike the treatment afforded net operating losses by our present Revenue Code,[3] it does not permit them to be carried back.[4] The allowance of both a carryback and carryover would be an appropriate, and more "equitable" solution.

Again, in excising those provisions of the House bill relating to patents and substituting the present proposed section 1249, the Treasury has compounded both discrimination and confusion. It might appear from a casual reading that income from a license would only be allocated, and not imputed, and that, under this amendment at least, the capital contribution of a patent to a foreign subsidiary would not produce income to the parent. However, the Secretary, in his testimony before this committee, has given the clear indication that the Treasury proposes to impute income in such situations.[5] All possibility of this latter interpretation should be removed.

Furthermore, section 1249 proposes to tax as ordinary income any gain realized by an American parent from the sale of a patent to—or an exchange with—its controlled foreign subsidiary.[6] Such transactions should, of course, result in capital gain, as would similar transactions with a domestic subsidiary. This proposed unwarranted discrimination against foreign subsidiaries is all the more startling when it is recalled that the Secretary has testified that "equality in the tax treatment of similar groups of taxpayers" is "[o]ne of the most fundamental of the guiding principles in American income taxation."[7]

It is true that the proposed amendments do, in some cases, adopt, in the words of the Treasury, a "more limited tax-haven approach." No longer are the undistributed manufacturing earnings of a controlled foreign subsidiary to be taxable to its American parent. However, a sufficient amount of sales and service income would remain taxable to place the members of this association doing business abroad under a serious continuing competitive disadvantage with foreign business. This inevitably would reduce the very favorable balance of payments for our members from their foreign business, as well as decrease domestic

---

[1] Committee on Finance, U.S. Senate, draft of statutory language, with accompanying explanation of amendments proposed by the Secretary of the Treasury on May 10, 1962, to secs. 13, 15, 16, and 20 of H.R. 10650, p. III (May 31, 1962).

[2] Ibid., p. 4

[3] IRC, 1954, sec 172

[4] Ibid., sec. 952(c), p 7.

[5] Hearings before the Senate Committee on Finance on H.R. 10650, pt. 10, p. 4253 (May 10, 1962).

[6] Amendments, op. cit., sec. 1249(a), pp. 22–23.

[7] Hearings, op cit., pt 1, p. 177 (Apr. 2, 1962).

employment by our members of labor for oversea markets. This was pointed out in my earlier appearance before this committee.[8]

The bill, as passed by the House, adopted the Treasury's novel and startling approach to the entire problem of tax havens. Until this bill, a "tax haven" situation was generally understood by industry—and, I might add, by the Government—to mean only a situation where by the use of a foreign entity an American taxpayer avoided American income tax entirely, or at least converted an American ordinary income tax into an American long-term capital gains tax. In other words, until this bill, "tax haven" meant real "U.S. tax avoidance."

Section 13 of the bill, as passed by the House, enlarged this definition to include not only avoidance, but the "deferral" of U.S. income tax to a later year.

The Treasury has now injected a provision which would, in effect, increase instead of decrease this burden on American industry. It has proposed an amendment which would grant an exception from the taxes imposed by section 13 where it can be demonstrated that the foreign subsidiary is "not availed of to reduce taxes" [9] including foreign taxes. This provision broadens the definition of "tax haven" to include the situation where an American taxpayer by normal and accepted means uses a foreign entity to minimize foreign income tax.[10]

This expanded definition is beyond belief. We can understand the genuine concern this Government would have in preventing the avoidance of U.S. income taxes, but we cannot fathom the concern of this Government to prevent the minimization of the income taxes imposed by foreign countries. So far as we know, this is the first time Congress has been asked to pass a law to protect foreign revenues. Can you conceive of the same being done by any of the nations which are so fiercely competing with us?

There are other valid criticisms of the proposed amendments. They go even further than increasing the revenue of foreign countries from existing tax laws. Indeed, they are an invitation to these countries to alter their own tax laws to increase their revenues at the expense of the U.S. Government.

Assume an American-controlled subsidiary incorporated in country X but conducting a sales operation in country Y. Assume further that the country of its incorporation imposes little or no tax on its extraterritorial sales activity. This legislation invites the host country to raise its tax rates on U.S.-controlled subsidiaries to, for example, 40 percent and say to such corporation: "Be thankful for the increase—it is unlikely that the U.S. Internal Revenue Service can successfully maintain that you incorporated here to "effect * * * [a] substantial reduction of income * * * taxes. Consequently, since your parent won't be taxed on your income by the United States at 52 percent, our increase, in reality, is saving you 12 percent." This additional tax collection would not only result in an immediate increase in the revenue of the foreign country, but the increased burden on American-controlled subsidiaries would eventually result in such severe competitive disadvantages to them that in time they would lose their markets to local industry. Such subsidization of foreign industry at the expense both of the Government [11] and citizens of the United States is a form of additional foreign aid and should be recognized as such.

Perhaps the most shocking feature of the "technical improvements" to section 13 of the bill is the fact that they contain no less than 16 delegations of authority to the Secretary or his delegate to prescribe regulations. Not until these regulations have been finally issued will it be possible to determine precisely just what the law is. In this fashion the Treasury has sought to postpone answering the questions and meeting the objections raised by the members of this committee and the witnesses appearing before it. This is not a request for legislation; it is a request for a delegation of the legislative power. It is a step toward government by ukase.

Finally, the Treasury estimate of the revenue to be collected under these provisions as passed by the House was $85 million.[12] Under the recent suggestions, or what is called a more limited tax-haven approach, the Treasury would have to make a smaller estimate. Certainly it would be only a fraction of 1 percent of our annual budget. With the inescapable complications of administration it may be at least doubtful (or worse) whether the revenue produced will pay the costs of collection and enforcement. When this committee also considers

[8] Hearings, op. cit., pt. 8, pp. 3689–3690 (May 2, 1962).
[9] Amendments, op. cit., sec. 954(b)(4), p. 9.
[10] Testimony of Hon. Douglas Dillon, hearings, op. cit., pt. 10, p. 4254 (May 10, 1962).
[11] The Treasury would lose because the profits of the subsidiary would be sharply reduced and the ultimate taxable dividend to the parent would likewise be reduced.
[12] Hearings, op. cit., pt. 1, p. 106 (Apr. 2, 1962).

the heavy financial burden these provisions will place upon American industry doing business overseas, the novelty of the concepts which underlie these provisions, and the serious competitive disadvantage which will result, we hope the committee will decide to reject the entire bill.

As an addendum I want to express one thought. I am not in any sense an expert on the stock market. However, I have seen suggestions to the effect that lack of "confidence" may have played a part in the confusion that now seems to exist in many quarters. I just wonder whether, considering the current conditions of the stock market, it would not be most ill advised to enact a bill which will certainly do nothing to bolster investor confidence in the future of American business enterprises operating abroad and which may itself weaken confidence.

There is another sound reason for rejecting the bill at this time. The administration has announced that it will propose to the Congress in 1963 a comprehensive revision of the entire Internal Revenue Code. To make the highly controversial changes which have been here discussed at this time and then to begin with a general revision in 6 months would seem the height of absurdity.

Senator GORE. Senator Douglas?

Senator DOUGLAS. Mr. Royall, you have had a distinguished career both in Government and in the private practice of law, public affairs, and we are very glad to have you as a witness.

I wondered if you would state the companies which are members of of the Pharmaceutical Association which you represent, not the small companies, but the big companies?

Mr. ROYALL. There are quite a large number, and I don't believe I have the complete list but I will be glad to furnish it.

If I name part of them and didn't name the others it might put me in a bad light. I can give you a number of names but I would prefer to give you all the names.

Senator DOUGLAS. With the understanding that they are not conclusive, yes, if you would.

Mr. ROYALL. I say I prefer to give you all of them instead of just a few.

Senator DOUGLAS. Is the Merck Co.——

Mr. ROYALL. What is that?

Senator DOUGLAS. Is the Merck Co. a member of the Pharmaceutical Association?

Mr. ROYALL. Yes, it is.

Senator DOUGLAS. Is the Pfizer Co. a member?

Mr. ROYALL. Yes, sir.

Senator DOUGLAS. Is Eli Lilly Co.?

Mr. ROYALL. Yes, sir.

Senator DOUGLAS. That may jog your memory, can you remember now some of the others?

Mr. ROYALL. Sure, I can remember those, and Bristol Myers, Warner Lambert, and quite a few others.

I would rather give you the entire list and put it in the record.

Senator DOUGLAS. Bristol Myers, Lambert.

Tell me is the Government-owned General Aniline Dye a pharmaceutical company or not?

Mr. ROYALL. I don't think they are on this list.

Senator DOUGLAS. So those five?

Mr. ROYALL. There are more than that, Senator, and I would have to give them to you.

(The following was later received for the record:)

MEMBERS OF THE PHARMACEUTICAL MANUFACTURERS ASSOCIATION

Abbott Laboratories, 14th Street and Sheridan Road, North Chicago, Ill.
Agricultural Division, American Cyanamid Co., Post Office Box 400, Princeton, N.J.
Alcon Laboratories, Inc., Post Office Box 1959, 6201 South Freeway, Fort Worth, Tex.
Ames Co., Inc., 819 McNaughton Avenue, Elkhart, Ind.
Armour Pharmaceutical Co., 3020 Prudential Plaza, Chicago, Ill.
Arnar-Stone Laboratories, Inc., 225 East Prospect Avenue, Mount Prospect, Ill.
B. F. Ascher & Co., Inc., Post Office Box 827, 5100 East 59th Street, Kansas City, Mo.
Ayerst Laboratories, division of American Home Products Corp., 685 Third Avenue, New York, N.Y.
J. T. Baker Chemical Co., North Broad Street, Phillipsburg, N.J.
Baltimore Biological Laboratory, Inc., division of Becton, Dickinson & Co., 2201 Aisquith Street, Baltimore, Md.
Barnes-Hind Laboratories, Inc., 895 Kifer Road, Sunnyvale, Calif.
Barry Laboratories, Inc., 9100 Kercheval, Detroit, Mich.
Baxter Laboratories, Inc., 6301 Lincoln Avenue, Morton Grove, Ill.
Don Baxter, Inc., 1015 Grandview Avenue, Glendale, Calif.
The Blue Line Chemical Co., 302 South Broadway, St. Louis, Mo.
Bowman, Inc., 965 Cleveland Avenue, Northwest Canton, Ohio
Boyle & Co., 6855 East Gage Avenue, Bell Gardens, Calif.
Brayten Pharmaceutical Co., 1715 West 38th Street, Chattanooga, Tenn.
Breon Laboratories, Inc., 1450 Broadway, New York, N.Y.
Brewer & Co., Inc., 67 Union Street, Worcester, Mass.
Bristol Laboratories, division of Bristol-Myers Co., Post Office Box 657, Syracuse, N.Y.
Brunswick Laboratories, Inc., 8671 Vincennes Avenue, Chicago, Ill.
Buffington's, Inc., 8 Sudbury Street, Worcester, Mass.
The C. M. Bundy Co., 329 Perry Street, Cincinnati, Ohio
Burroughs Wellcome & Co. (U.S.A.), Inc., No. 1 Scarsdale Road, Tuckahoe, N.Y.
Garisulphoil Co., 2917 Swiss Avenue, Dallas, Tex.
G. W. Carnrick Co., 115 Park Avenue, Summit, N.J.
The Central Pharmacal Co., 116–128 East Third Street, Seymour, Ind.
Chatham Pharmaceuticals, Inc., 901 Broad Street, Newark, N.J.
Chicago Pharmacal Co., 5547 North Ravenswood Avenue, Chicago, Ill.
Ciba Pharmaceutical Co., 556 Morris Avenue, Summit, N.J.
Cole Chemical Co., 3715–31 Laclede Avenue, St. Louis, Mo.
Commercial Solvents Corp., 260 Madison Avenue, New York, N.Y.
Crookes-Barnes Laboratories, Inc., Fairfield Road, Wayne, N.J.
Cutter Laboratories, Fourth and Parker Streets, Berkeley, Calif.
Dade Reagents, Inc., 1851 Delaware Parkway, Miami, Fla.
Davies, Rose & Co., Ltd., 22 Thayer Street, Boston, Mass.
The De Pree Co., 130 Central Avenue, Holland, Mich.
Difco Laboratories, 920 Henry Street, Detroit, Mich.
Distillation Products Industries, division of Eastman Kodak Co., 755 Ridge Road West, Rochester, N.Y.
Dorsey Laboratories, division of the Wander Co., 200 North 15th Street, Lincoln, Nebr.
S. F. Durst & Co., Inc., 5317 North Third Street, Philadelphia, Pa.
Endo Laboratories, Inc., 84–40 101st Street, Richmond Hill, N.Y.
Ethicon, Inc., Somerville, N.J.
Ferndale Laboratories, division of Ferndale Surgical, Inc., 780 West Eight Mile Road, Ferndale, Mich.
Fine Chemicals Department, Lederle Laboratories Division, American Cyanamid Co., Pearl River, N.Y.
First Texas Pharmaceutical, 1810 North Lamar, Dallas, Tex.
C. B. Fleet Co., Inc., 921–927 Commerce Street, Lynchburg, Va.
Flint, Eaton & Co., division of Baxter Laboratories, Inc., 300 East Main Street, Decatur Ill.
E. Fougera & Co., Inc., Post Office Box 73, Cantiague Road, Hicksville, Long Island, N.Y.
Geigy Pharmaceuticals, division of Geigy Chemical Corp., Post Office Box 430, Yonkers, N.Y.

Haack Laboratories, Inc., 1415 Southwest Harbor Drive, Portland, Oreg.
The G. F. Harvey Co., Inc., 11 East 26th Street, New York, N.Y.
Heyden Newport Chemical Corp., 342 Madison Avenue, New York, N.Y.
Hobart Laboratories, Inc., 900 North Franklin Street, Chicago, Ill.
Hoffmann-La Roche, Inc., 340 Kingsland Street, Nutley, N.J.
Hollister-Stier Laboratories, 107 South Division Street, Spokane, Wash.
Hyland Laboratories, 4501 Colorado Boulevard, Los Angeles, Calif.
Hynson, Westcott & Dunning Inc., Charles and Chase Streets, Baltimore, Md.
Irwin, Neisler & Co., Box 1110, 434 North Morgan Street, Decatur, Ill.
Ives-Cameron Co., division of American Home Products Corp., 685 Third Avenue, New York, N.Y.
Johnson & Johnson, George Street, New Brunswick, N.J.
Kinney & Co., Inc., 1013 Fourteenth Street, Columbus, Ind.
Knoll Pharmaceutical Co., 377 Crane Street, Orange, N.J.
Kremers-Urban Co., 141 West Vine Street, Milwaukee, Wis.
Lafayette Pharmacal, Inc., 522–524–526 North Earl Avenue, Lafayette, Ind.
Lakeside Laboratories, Inc., 1707 East North Avenue, Milwaukee, Wis.
Lederle Laboratories, division of American Cyanamid Co., Pearl River, N.Y.
Thos. Leeming & Co., Inc., 155 East 44th Street, New York, N.Y.
Eli Lilly & Co., 740 South Alabama Street, Indianapolis, Ind.
Lloyd Bros., Inc., 4527 Reading Road, Cincinnati, Ohio
Lloyd, Dabney & Westerfield, Inc., 3941 Brotherton Road, Cincinnati, Ohio
Magnus, Mabee & Reynard, Inc., 16 Desbrosses Street, New York, N.Y.
Mallard, Inc., 3021 Wabash Avenue, Detroit, Mich.
Mallinckrodt Chemical Works, 3600 North Second Street, St. Louis, Mo.
The S. E. Massengill Co., 513–29 Fifth Street, Bristol, Tenn.
McNeil Laboratories, Inc., Camp Hill Road, Fort Washington, Pa.
Mead Johnson & Co., 2404 Pennsylvania Avenue, Evansville, Ind.
The Medical Arts Supply Co., Inc., 706–08–10 Fourth Avenue, Huntington, W. Va.
Merck & Co., Inc., 126 Lincoln Avenue, Rahway, N.J.
Merck Chemical Division, division of Merck & Co., Inc., 126 Lincoln Avenue, Rahway, N.J.
Merck Sharp & Dohme, division of Merck & Co., Inc., West Point, Pa.
The Wm. S. Merrell Co., division of Richardson-Merrell, Inc., Cincinnati, Ohio.
The National Drug Co., division of Richardson-Merrell, Inc., 4663–85 Stenton Avenue, Philadelphia, Pa.
Nion Corp., 1001 North McCadden Place, Los Angeles, Calif.
Norden Laboratories, Inc., 227 North Ninth Street, Lincoln, Nebr.
The Norwich Pharmacal Co., 17 Eaton Avenue, Norwich, N.Y.
The P. J. Noyes Co., 51 Main Street, Lancaster, N.H.
Organon, Inc., 375 Mount Pleasant Avenue, West Orange, N.J.
Ortho Pharmaceutical Corp., Raritan, N.J.
Parke, Davis & Co., Post Office Box 118, R. P. Annex, Jos. Campau at the River, Detroit, Mich.
S. B. Penick & Co., 100 Church Street, New York, N.Y.
Chas. Pfizer & Co., Inc., 235 East 42d Street, New York, N.Y.
Philips Roxane, Inc., 330 Oak Street, Columbus, Ohio.
Pitman-Moore Co., division of the Dow Chemical Co., 1200 Madison Avenue Post Office Box 1656, Indianapolis, Ind.
Wm. P. Poythress & Co., Inc., 16 North 22d Street, Richmond, Va.
The Purdue Frederick Co., 135 Christopher Street, New York, N.Y.
Rexall Drug Co., division of Rexall Drug & Chemical Co., 8480 Beverly Boulevard, Los Angeles, Calif.
Riker Laboratories, Inc., 19901 Nordhoff Street, Northridge, Calif.
A. H. Robins Co., Inc., 1407 Cummings Drive, Richmond, Va.
William H. Rorer, Inc., 500 Virginia Drive, Fort Washington, Pa.
Rowell Laboratories, Baudette, Minn.
Rystan Co., 7 North MacQuesten Parkway, Mount Vernon, N.Y.
Sandoz Pharmaceuticals, division of Sandoz, Inc., Route No. 10, Hanover, N.J.
R. P. Scherer Corp., 9425 Grinnell Avenue, Detroit, Mich.
Schering Corp., 60 Orange Street, Bloomfield, N.J.
Schieffelin & Co., pharamaceutical laboratories division, 28 Cooper Square, New York, N.Y.
The Schuemann-Jones Co., 2134 East Ninth Street, Cleveland, Ohio
G. D. Searle & Co., Post Office Box 5110, Chicago, Ill.
Sherman Laboratories, 5031 Grandy Avenue, Detroit, Mich.
Smith Kline & French Laboratories, 1500 Spring Garden Street, Philadelphia, Pa.
Smith, Miller & Patch, Inc., 902 Broadway, New York, N.Y.

E. R. Squibb & Sons, division of Olin Mathieson Chemical Corp., 745 Fifth Avenue, New York, N.Y.
Standard Pharmacal Co., 847 West Jackson Boulevard, Chicago, Ill.
G. S. Stoddard & Co., Inc., 295–303 Lafayette Street, New York, N.Y.
Strasenburgh Laboratories, division of Wallace & Tiernan Inc., Post Office Box 1710, 755 Jefferson Roard, Rochester, N.Y.
Strong Cobb Arner Inc., 2917 East 79th Street, Cleveland, Ohio
The Stuart Co., division of Atlas Chemical Industries, Inc., 3360 East Foothill Boulevard, Pasadena, Calif.
Davis & Geck, American Cyanamid Co., Danbury, Conn.
Sutliff & Case Co., Inc., 201 Spring Street, Peoria, Ill.
Texas Pharmacal Co., Post Office Box 1659, 307 East Josephine Street, San Antonio, Tex.
The Tilden Co., division of Textron Pharmaceuticals, Inc., New Lebanon, N.Y.
The Upjohn Co., 7000 Portage Roard, Kalamazoo, Mich.
U.S. Vitamin & Pharmaceutical Corp., 800 Second Avenue, New York, N.Y.
The Vale Chemical Co., Inc., 1201 Liberty Street, Allentown, Pa.
VanPelt & Brown, Inc., 1322 East Main Street, Richmond, Va.
Walker, Corp. & Co., Inc., Post Office Drawer 1320, Syracuse, N.Y.
Walker Laboratories, Inc., No. 1 Bradford Road, Mount Vernon, N.Y.
Wallace Laboratories, division of Carter Products, Inc., Half Acre Road, Cranbury, N.J.
Wallerstein Co., division of Baxter Laboratories, Inc., Wallerstein Square, Mariners Harbor, Staten Island, N.Y.
Wampole Laboratories, division of Denver Chemical Manufacturing Co., 35 Commerce Roard, Stamford, Conn.
Warner-Chilcott Laboratories, division of Warner-Lambert Pharmaceutical Co., 201 Tabor Road, Morris Plains, N.J.
The Warren-Teed Products Co., 582 West Goodale Street, Columbus, Ohio
White Laboratories, Inc., Galloping Hill Road, Kenilworth, N.J.
Whittier Laboratories, Inc., 2101 Dempster Street, Evanston, Ill.
The Wilson Laboratories, division of Wilson & Co., Inc., 3221 South Western Boulevard, Chicago, Ill.
Winthrop Laboratories, 1450 Broadway, New York, N.Y.
Wyeth Laboratories, division of American Home Products Corp., Post Office Box 8299, Philadelphia, Pa.
The Zemmer Co., Inc., 231 Hulton Road, Oakmont, Pa.

Senator DOUGLAS. Do any of these companies have foreign subsidiaries?

Mr. ROYALL. Yes, sir.

Senator DOUGLAS. Do any of these companies have a Nassau subsidiary?

Mr. ROYALL. Not that I know of, sir. I could not tell you the individual subsidiaries of the various companies; I am not that familiar with them.

Senator DOUGLAS. Do any of them have a Panama subsidiary?

Mr. ROYALL. I would not know, sir.

Senator DOUGLAS. Does the Pfizer Co. have a Pfizer subsidiary?

Mr. ROYALL. I say I don't know where their subsidiaries are but if want to ask questions, Senator, on the theory that they have them in Switzerland or Panama or Nassau, I will be glad to let you take that assumption and answer anything that you desire to ask me.

Senator DOUGLAS. Well, it is very hard to conduct this questioning if you do not know the facts concerning the companies which you are representing. Do you know whether any of these companies have subsidiaries to which patent rights have been assigned so far as American production is concerned?

Mr. ROYALL. I didn't understand your question, sir.

Senator DOUGLAS. Do any of these companies have foreign subsidiaries to which patent rights have been assigned on American production?

Mr. ROYALL. Well, I am not sure that they do and I don't know which.

Senator DOUGLAS. Well, in these cases, if the subsidiary was located in a country where taxes were either extremely low or nonexistent, such as Panama or the Bahamas, wouldn't this amount to a diversion of income from the United States which would be taxed at 52 percent to an area where the rate of taxation would be very low?

Mr. ROYALL. Would you let me answer that——

Senator DOUGLAS. Here is a case of where the tax haven does not reduce the tax which another foreign government will get, but where it would directly reduce the taxes which would otherwise be paid to the United States?

Mr. ROYALL. Well, the point is, when you say otherwise would be paid to the United States, of course, you have got to a large extent to surmise because the various factual conditions which determines that.

Now, on this general question, I think the principle to be remembered is that if we are going to have foreign business, if we are going to do any business through foreign subsidiaries, that subsidiary must not be discriminated against in favor of a foreign company or subsidiary in that same location.

Otherwise, we will necessarily lose those subsidiaries and lose their ability to do business because we have got to be competitive.

In other words, the test should be, must be, whether this subsidiary, American subsidiary overseas, is treated the same as the foreigner is, and that should be the only test.

Now, you have got a separate problem and that is the evasion of American taxation. I do not think there is anyone, Senator, who does and I don't know anyone who should, want to encourage that. But as long as the funds are used for legitimate business purposes there should be no penalty on them.

Senator DOUGLAS. Mr. Royall, you are talking in hypotheticals, and——

Mr. ROYALL. Well, I don't think so.

Senator DOUGLAS. It seems to be difficult to get at the facts.

Mr. ROYALL. What fact do you want, Senator.

Senator DOUGLAS. Facts connected with some of the companies which you represent. So forgive me if I speak for a minute about hypothetical cases.

Suppose we have a subsidiary of an American drug company located either in Panama or in Nassau to which the patent rights of the American company are sold for a nominal consideration, say a hundred dollars, or say a thousand dollars, and this subsidiary located in Nassau or Panama, then proceeds to charge the parent company an amount for the use of the patent which has been previously delegated to it, and also collects the amounts which the parent company gets from smaller companies which may use the patent, and thus instead of paying 52 percent as would be true under the American system, either pays nothing or a very small rate upon this patent income.

Do you regard that as a legitimate tax haven or as a legitimate practice?

Mr. ROYALL. Well, my answer to that—is that the full question, sir?

Senator DOUGLAS. Well, it is the present question. It is not the complete question, but it is the present one.

Mr. ROYALL. I hope it is not the last one, but I just wanted to be sure that one was finished.

My point there is that they should have exactly the same treatment as any other foreign subsidiary in Panama, whatever it is.

If they don't they can't live.

Senator DOUGLAS. Even though the business which is done is almost entirely in the United States?

Mr. ROYALL. Well, I do not believe that we are destined to fix the tax systems of every place in the world any more than they have the right or can claim to fix ours.

We are dealing with business, which is a practical thing, and a business cannot operate in Panama, an American subsidiary cannot operate in Panama, unless it can compete with other people operating in Panama.

Senator DOUGLAS. Now, wait a minute. I am not speaking of a manufacturing business of this company in Panama. I am simply confining myself for the moment to the assignment of payment rights so that with a very small force of one or two men, this subsidiary can collect sums from the parent company for use of the patent which has been conveyed to it originally from the parent company on goods manufactured and sold inside the United States.

Mr. ROYALL. Well, of course, when you say "manufactured" and confine it to that, that doesn't answer the question of the right to compete, because manufacturing is only one element in the conduct of business.

Senator DOUGLAS. I understand.

Mr. ROYALL. Sales, know-how. That is all.

Senator DOUGLAS. Go ahead, please.

Mr. ROYALL. Those were the illustrations and, therefore, you have got to have the tax system in that country the same for the United States and other foreign competitors whether it relates to manufacturing, services, sales, or anything else.

Senator DOUGLAS. I take it then that you would not regard this as an illegitimate diversion, or an improper diversion of income from the American company to the foreign-owned subsidiary.

Mr. ROYALL. As I understand your facts, I would not. But I could conceive that if the purpose was solely to evade and if the services performed were not necessary in competing and conducting of business it might well be something that should be forbidden. But your question did not imply that.

Senator DOUGLAS. Not even if the patents were originally sold by the parent company A, to the subsidiary B for a nominal sum, and then subsidiary B turned around and charged the parent company A very large amounts for the use of the patent which was originally conveyed?

Mr. ROYALL. If the parent company gave the patent, it would amount to a contribution of capital, which is perfectly legitimate, and if it gave the foreign subsidiary the patent, then the more income that the parent company could get out of the subsidiary, the better it is for the United States. And that is what I think you are trying to do, get as much back here as you want to, not to restrict it.

Senator DOUGLAS. Well, I have chosen perhaps the clearest example, namely, conveying the legal title to a patent to a company in a foreign country. I suppose then that you would say that to an even greater

degree if this foreign subsidiary put on its payroll the salesmen inside the United States, and then charged a very high commission which yielded large profits to the parent company you would say this was not an illegitimate practice or the use of a tax haven to avoid American taxes?

Mr. ROYALL. Well, anything they paid to the parent company as dividends, for example, or for services, would be caught by the tax in the United States?

Senator DOUGLAS. Yes, but, of course, the reinvested capital would not be reinvested capital overseas.

Mr. ROYALL. As I understand it, your case doesn't give the facts on the reinvested capital or I have misunderstood you?

Senator DOUGLAS. We are dealing at arm's length with each other because we are discussing hypothetical cases and it is somewhat hard to get at the circumstances of each and every individual company where we have partial information on some of them.

May I ask this, Mr. Royall——

Mr. ROYALL. May I say this a minute, Senator?

I don't want you to feel too badly about me not knowing about individual companies.

As a matter of fact, it would be utterly impossible for an attorney, particularly employed to represent a considerable group of companies to know the specific facts, and there is no reason I should know them.

Senator DOUGLAS. I am not saying that you should.

Mr. ROYALL. No, sir.

Senator DOUGLAS. I simply am saying this makes it very difficult to conduct a meaty dialog at this session when we have to deal with hypotheticals.

I would like to ask your opinion on the taxation of American citizens abroad.

Do you have an objection to the administration's proposal on taxation of individual incomes of American citizens abroad?

Mr. ROYALL. As a matter of fact, Senator, I personally have long felt in that situation there has been some improper escape of American taxation. I am not familiar enough with the facts on that. I have never made any study of it, never had any occasion to study it, but I am confident that is a field that needs attention.

Now, the remedy I would be unable to give you.

Senator DOUGLAS. I am very glad to hear you say that.

Did you notice the tables that the Treasury produced and which are printed in volume 1 of the hearings on individuals with incomes over $50,000 abroad who have declared they were permanent residents and, therefore, escaped all American taxation?

Mr. ROYALL. No, sir, I didn't but I knew that a situation of that type existed but I didn't see the Treasury report.

Senator DOUGLAS. I think since you are a public-spirited citizen you might be interested in that table.

Mr. ROYALL. I will be delighted to look at it.

Senator DOUGLAS. It shows, for instance, two citizens who declared they were permanent residents abroad and resided in Switzerland who in a given year each had incomes of approximately $1,100,000, a husband and wife—obviously a husband and wife, the total income therefore was $2,200,000. They paid no American taxes, and resided in a canton in Switzerland with extremely low income taxes.

Mr. ROYALL. Senator, I would like to say that I agree 100 percent with anything that is done to prevent evasion of taxes as such or where that is the necessary result of it. Subject only to this: We are living in a world of business. Our country is dependent on it in many ways. I do not want us in the enthusiasm of correcting a real evil, to go over the line and hurt American business. I don't want us to go to the stage where we can't do business abroad in competition with other people who are doing business abroad.

I believe that in the long run that this gives perhaps the best chance for the stability of our Government, the balance of payments, and continued prosperity.

This trade bill which has just passed is a great thing. I would say one other thing, I believe in many respects that this bill now pending before this committee, if passed as it is, will neutralize a great deal of the benefit that the trade bill will produce.

Senator DOUGLAS. Of course, every measure which brings in more tax revenue to the Government diminishes the income of specific individuals, and therefore, it can always be argued that any tax measure hurts the taxpayers. But we are faced with a very difficult financial situation and the injustices in the present tax system, are breeding, I think, an increasing dislike for the payment of taxes and it is extraordinary that the integrity of the American taxpayer has held up as long as it has. But many honest people see individuals and corporations who in their judgment are escaping their just burden of taxes. This places a great strain on them and they say, "Why can't we get out of it, too?" and I think our tax system is beginning to break down just as the system of taxation under the Roman Republic and Empire broke down, and the system under the French regime broke down and, therefore, those of us who are trying to reform the tax system don't desire to heap unjust burdens on anyone but we feel we must introduce a greater degree of equity into the tax system if it is to be preserved and if the immediate fiscal problems of the Government are to be met. At every point where we turn to there is objection.

Mr. ROYALL. I agree with that but don't kill the cow and still expect milk.

Senator DOUGLAS. Well, all right.

That is all, Mr. Chairman. No further questions.

Senator GORE. Thank you, Mr. Royall.

Mr. ROYALL. Thank you.

Senator GORE. The next witness is Mr. Leon O. Stock.

STATEMENT OF LEON O. STOCK, PEAT, MARWICK, MITCHELL & CO.

Mr. STOCK. Mr. Chairman and members of the committee, my name is Leon Stock.

Senator GORE. Are you an official of the company, or are you a lawyer.

Mr. STOCK. I am a member of an international accounting firm, Peat, Marwick & Mitchell.

Senator BENNETT. Is this a partnership?

Mr. STOCK. Yes, sir.

Senator GORE. Are you employed specifically to present this testimony?

Mr. STOCK. No, sir. I appear on behalf of no client; just on behalf of our own firm.

Senator GORE. Thank you.

Mr. STOCK. The tax philosophy reflected in section 13 of the bill and those of us who oppose it, have been on collision course now for more than a year. Unless a meeting of the minds is reached, the resulting impact on business and on our country, in my opinion, will be tragic.

I have reference specifically to the foreign manufacturing company and its trading affiliate, and in that connection, as I read the draft amendments, the foreign manufacturing subsidiary would be relieved of the need to justify the retention of its profits. That, apparently, is intended to be a concession and, in my own judgment, it is a concession without significance.

Witness after witness has appeared before this committee and has pointed out that European tax rates, the areas in which foreign manufacturing plants are generally erected, all have tax burdens that substantially approximate the U.S. burden, and in some instances are greater.

That being the case, it is perfectly obvious that attempting to impute the income of a foreign manufacturing affiliate to the U.S. shareholder would produce little or no tax. Therefore, relieving that type of company of the need to justify the retention of its profits actually accomplishes nothing, and it is discouraging that it has taken over a year to reach a meeting of the minds on this point.

It should have been recognized right from the start, as we in practice did, that U.S. companies that go to Germany, France, England, and other economically developed countries, are not going there to reduce taxes, or to secure any undue tax advantages. They were going there solely for business purposes, to penetrate an expanding market.

We are told that while that may be true, the utilization of a base company in Switzerland to purchase the output of the affiliated manufacturing company in Europe for resale in the Common Market has the effect of reducing the European tax, and that instead of paying say a 51-percent tax in West Germany on the total profit, through the utilization of Switzerland, the overall effective tax is reduced to say 30 percent.

Therefore, it is claimed, an undue tax advantage is being enjoyed by American business overseas. For this reason, the draft amendment would place greater restrictions on the base company in the sense that it would not be given the privilege of reinvestments. Its income would be imputed to the U.S. shareholder.

No one can deny that the utilization of Switzerland does serve to reduce the European tax. But that is European taxation and not U.S. taxation. If anything, it merely serves in due course to enhance the U.S. tax. If reducing the European tax is improper, one would expect the European tax authorities to claim so.

European taxation is a matter for consideration by the foreign governments whose taxes are being reduced, and they show no inclination to outlaw the foreign-base company. There have been some implications raised during the course of these hearings that the European governments would be very happy to see section 13 enacted, that is, to see the base company eliminated.

I wonder just how accurate that is, looking at the draft amendments and finding that a branch would be treated as though it were a separate entity.

For example, if, in lieu of having a Dutch manufacturing company, which pays tax at 47 percent, selling its output to a Swiss sister company which might pay Swiss tax at rate of 10 percent, the Dutch company established a branch in Switzerland, the branch under the draft amendment would be given the same U.S. tax treatment as though it were a subsidiary.

That makes me pause and wonder why the need for such legislation; and the answer therefore becomes obvious. It is because the Dutch Government will treat the branch in Switzerland in the same fashion as a subsidiary.

If European governments are so terribly unhappy with the Swiss based companies, why do they not withhold favorable tax treatment to an unincorporated branch in Switzerland?

Gentlemen, I do not have the official answer. However, I do know that some European governments do provide such treatment, and will continue to do, and apparently our Treasury Department is aware of that fact.

It has been suggested that except for the Swiss trading company we would not have American companies going to Europe and establishing manufacturing plants in these high-tax-rate countries. I suggest that nothing could be further from the truth; that the Swiss company is not the motivation for the European manufacturing company. On the contrary, the Swiss company is set up solely and primarily to reduce the tax of the foreign manufacturing company whose existence is attributable solely to business considerations. It is the European company which gives rise to the Swiss company, not the reverse.

If tax motivation, that is, if the favorable tax possibilities abroad represented an important factor in reaching a decision as to whether to stay home or go abroad, then I submit for consideration one question: Why aren't more American companies going to Ireland where they can get a 10-year exemption for manufacturing, a 22-year exemption in the Shannon Airport area? Why aren't more Americans going to the southern part of Italy where they can get favorable tax treatment? If tax motivation is so important, why do they select the more industrialized countries where tax rates approximate or exceed our rates? The answer, of course, is obvious. Business considerations, not related to taxation determine where a plant is to be established.

If we are going to look askance at the reduction of European taxation, with the approval of European governments, what are we going to do about Northern Ireland which gives no tax concession but makes available financial grants of 40 percent of equipment costs? Are we going to propose a tax on that as well? I think we had better.

More recently, countries like Australia have granted tax concessions to increase exports. Austrailian companies are permitted to deduct 200 percent of every dollar spent in promoting foreign exports.

Canada has recently adopted tax concession legislation. What are we going to do with American companies that see fit for business reasons to manufacture in those countries and as a consequence receive the benefit of these tax concessions? Do we propose to negate these

concessions and thus create competitive inequality for our oversea operations?

Senator GORE. What do you propose?

Mr. STOCK. I propose that we take a more constructive approach. Permit controlled foreign corporations to any and all local tax beenfits available to foreign competitors. Do not make their position any more difficult than it already is.

We certainly have as much wealth, as much strength as any European country, and if, in their judgment, they think they can encourage and expand trade by tax concessions rather than punitive measures, then perhaps we should also be thinking affirmatively rather than negatively?

Senator GORE. Do you think we should do that, too?

Mr. STOCK. Perhaps, although at the moment it would seem premature. But I might add this, Mr. Chairman, a great deal has been said about the Bahamian companies, about the resulting diversion of U.S. income, which is somewhat different than the European situation.

I suggest that the growth of the Bahamian companies might have had its origin in the position taken by the Treasury to the effect that Western Hemisphere trade status under the code was and is not available unless the domestic company maintains an installation outside the United States.

I suggest that this contention contributed to the Bahamian situation.

Senator GORE. Are you favorable to the Bahamian situation?

Mr. STOCK. Not entirely, no. I am certainly not favorable to the sham. I would rule the sham out in summary fashion. As a matter of fact, I would consider very seriously criminal penalties for those establishing shams from here on out.

We are today in a position where the public knows or should know that a name place cannot be put on a wall in the Bahamas and thereby divert U.S. income legitimately. However, that was not the case 4 or 5 years ago.

For many years we sat back and we did nothing about these shams. We then came to the realization that they had to be stopped. Our public has now been educated to this fact, and I submit that anyone who goes out and establishes a sham today is inviting a fraud charge.

To conclude, Mr. Chairman, and members of the committee, I think that any foreign company controlled by Americans ought to be given every opportunity ot expand. However, I do not believe that any controlled company abroad should be permitted to take its profits and place them under the "mattress" in order to avoid U.S. taxes to its shareholders.

I think that companies accumulating abroad to prevent the imposition of U.S. tax should have their income imputed to the U.S. shareholder.

I also agree with the provision in the bill that will deny capital gain treatment on liquidation of a foreign company. This will discourage many offshore sales companies, particularly those organized by individuals.

Now, that is going to knock out many of these Bahamian and Panamanian companies established by individuals on the thin side.

If they cannot see a capital gain by collapsing these companies 5 or 6 years later, they are not going to be encouraged to go into those areas because tax deferment is not what they are looking for.

Now, perhaps, we ought to consider an international treaty under which all economically developed countries would agree to rule out and outlaw the base company.

I do not have any objections, I do not think anyone does. All we are asking for is equality, equality with our foreign competitors.

Thank you.

Senator GORE. Senator Douglas?

Senator DOUGLAS. No questions.

Senator GORE. Senator Bennett?

Senator BENNETT. No questions.

Senator GORE. Thank you, sir.

The next witness is Mr. Edward Rustigan.

Mr. Rustigan, are you appearing as a citizen or a lobbyist?

STATEMENT OF EDWARD C. RUSTIGAN, ATTORNEY, ON BEHALF OF BRUNSWICK CORP.

Mr. RUSTIGAN. I am appearing on behalf of Brunswick Corp.

Senator GORE. As a citizen?

Mr. RUSTIGAN. On behalf of Brunswick Corp., located in Chicago.

Senator GORE. Are you an official of the company?

Mr. RUSTIGAN. No, I am not. I am a partner in the firm of Mayer, Friedlich, Spiess, Tierney, Brown & Platt, who are the regular counsel for the company.

Senator GORE. Are you registered as a lobbyist?

Mr. RUSTIGAN. I am not. I am merely testifying on this bill. I have not done any lobbying.

Senator GORE. Have you considered the requirements of the law?

Mr. RUSTIGAN. I understood that one can testify on behalf of a company without registering. If I am incorrect, sir, I will register.

Senator GORE. I will not undertake to interpret the law.

What is your fee for representing the company in this case?

Mr. RUSTIGAN. No special fee has been fixed since we are regular counsel and fix our charges based upon the total work done for the company over the year.

Senator GORE. You have a regular retainer?

Mr. RUSTIGAN. Actually no retainer is paid in advance. It depends entirely on the amount of work which is done.

Senator GORE. Thank you. You may proceed.

Mr. RUSTIGAN. Mr. Chairman and members of the committee, I am Edward C. Rustigan, a partner in the Chicago law firm of Mayer, Friedlich, Spiess, Tierney, Brown & Platt. I appreciate this opportunity to testify, on behalf of Brunswick Corp., on the Treasury's recommendations for revising section 13 of the tax revision bill as passed by the House.

Brunswick Corp. is engaged in an intensive program to develop foreign markets for bowling equipment and the many other sporting and nonsporting products produced by the company. While Brunswick is seeking to open markets throughout the world, it is concentrating its principal effort in Europe. Local companies have been formed in most of the European countries to deal with the numerous aspects of a sales operation which can only be handled effectively by a local office.

In selling its products abroad Brunswick faces a variety of substantial and important general marketing problems common to all the foreign countries in which the company is doing business. Brunswick is selling in a multinational market and is confronted by marketing problems which cut across national lines.

The effective way to cope with marketing problems which are common to a number of foreign countries is through a central company. It would be impractical and inefficient for the various local companies to carry out most of these common marketing functions. Moreover, it would be impractical and inefficient to try to direct these functions from the home office of the company in Chicago, far removed from the countries where the business is being conducted. It is for this reason that Brunswick, and many other companies doing business abroad, have established central companies to deal with marketing problems common to their activities in a number of countries.

Brunswick feels that such companies are essential components in foreign business structures and that they should be taxed in the same manner as manufacturing or any other genuine business activity. Under the proposed Treasury bill, however, all such central companies would be classified as tax haven operations and their income would be taxed currently to their parent American corporations, even though they are performing genuine business functions.

MANY CENTRAL COMPANIES PERFORM GENUINE BUSINESS FUNCTIONS—THEY ARE NOT TAX HAVEN DEVICES

Brunswick has two central companies which were established to perform the variety of common marketing functions which cut across national lines. These central companies, which would be considered tax haven companies under the Treasury's proposed legislation, were formed wholly apart from tax considerations.

Together the central companies have a substantial staff which performs important functions, such as marketing, bowling center construction, management of Brunswick-owned bowling centers, and accounting and financial reporting. These are problem areas which cut across national boundaries and which must be carried on through a central company to avoid costly and inefficient duplication of effort.

For example, bowling center construction is managed by a group of highly skilled specialists, primarily construction engineers and architects, who are responsible for the building of Brunswick-owned bowling centers throughout the European and Mediterranean marketing area. This group also renders advice and technical aid to customers who are going into the bowling business, and provides continuing technical advice after the bowling establishments are in operation.

The staff concerned with the management of Brunswick-owned bowling centers is another good example of a business function which must be carried on through a central company to avoid costly and inefficient duplication of effort. This function will increase in importance as the company develops a complete network of bowling centers in the European and Mediterranean marketing areas. Under the proposed legislation, much of the income derived by the central company from these essential business activities, and by other central companies in similar circumstances, would be classified as foreign base

company service income and currently taxed to the parent American company.

Another major central company function is marketing. This encompasses such diverse activities as the study of marketing areas, development of programs for the introduction of Brunswick products in new areas, management supervision over installation and service of products, and training of marketing and sales staffs of the various subsidiary sales companies. The marketing staff is also responsible for maintaining quality standards and controls for certain products which are purchased from unrelated sources abroad. In some cases products are purchased from foreign licensees producing products according to Brunswick specifications. The market staff is responsible for negotiating these licenses. The proposed legislation would tax the income derived from these and other essential sales activities as foreign base company sales income when they are conducted through a central company solely in the interests of efficiency.

Still another major function of Brunswick's central company is the programing and close supervision of expansion into new areas. These activities will require capital, particularly in connection with the construction of Brunswick-owned bowling centers. Naturally it is more efficient for central companies in this position to accumulate investment capital for such expansion through dividends received from their subsidiaries. Under the Treasury bill this type of central company, which performs a real business function and is not merely a capital gathering holding company, would be taxed on the dividends derived from related companies incorporated in other countries.

SUBSIDIARIES OF CENTRAL COMPANY ARE IN SUBSTANCE DIVISIONS

For a company like Brunswick the central company is the indispensable heart of the foreign business structure. It would be completely impractical to duplicate the growing specialized staff stationed overseas, now numbering about 100, for each of the subsidiaries of the central company. Thus, the central company is not a paper entity formed simply as a tax planning device to reduce the overall taxes imposed on Brunswick's foreign operations abroad.

The various wholly owned subsidiaries formed to operate in particular countries are in a very real sense subordinate divisions. Very probably they would be operated simply as divisions of the central company were it not for several wholly nontax problems which made it desirable to incorporate them. The use of subsidiaries simplifies such problems as: (1) Obtaining local licenses, particularly for manufacturing; (2) obtaining import licenses; (3) obtaining Government subsidies; (4) establishing accounting procedures; (5) owning real estate; and (6) improving customer acceptance.

The Treasury's bill would leave untouched a central company which found it practical to operate in many foreign countries through divisions rather than subsidiaries. This would be so even through the central company which is operating through divisions, in fact operates exactly the same as it would through subsidiaries. The Treasury bill would require that an American corporation forego the advantages of incorporation in each country, and operate instead through divisions of its central company, if it wants to compete on an equal basis with many foreign manufacturers and with those American companies having a divisional structure.

THE BILL WILL NOT ACCOMPLISH ITS PRINCIPAL OBJECTIVE

We have tried to show that many central companies are vital for the effective conduct of business abroad, and not tax-haven operations conducted primarily for the taxes they will save. Brunswick believes that tax legislation which will hamper the effective operation of such companies should be enacted only if it is clearly shown that it is essential to achieve an important goal, and that it will in fact accomplish the desired results.

One of the Treasury's major arguments is that if the income tax burden is made neutral between investment in the United States and investment abroad many goods which are manufactured abroad for the foreign market would be manufactured in this country for export, thereby improving our balance-of-payments position. In the light of its experience Brunswick has serious doubts whether the bill will accomplish this purpose. Quite the contrary, Brunswick fears that the bill would hamper the efforts of American business to penetrate foreign markets against the competition of foreign producers, with the result that American business will receive a smaller share of the important foreign market.

The most important bowling product by far is the automatic pinsetter, and the next most costly component of a bowling installation is the lane itself. Every effort must be made to keep the manufacturing costs of these principal components as low as possible. Brunswick strongly feels that any significant increase in costs will greatly reduce the market for bowling abroad. Proprietors of bowling establishments in foreign countries are already charging prices which are generally equal to or in excess of those for bowling in this country.

The automatic pinsetter is a substantial machine, which, packed for export, weighs approximately 2,500 pounds. Naturally, there are distinct advantages in manufacturing any bulky or heavy product close to its market. The pinsetter is a machine made up of thousands of parts. It is essential to have a convenient and reliable local source of replacement parts, and these parts can be best produced by the company which manufactures the pinsetters.

In the light of such considerations Brunswick arranged to have pinsetters for the European market manufactured for it by an entirely unrelated German company located in Berlin. This arrangement has proved quite advantageous in terms of manufacturing costs for the reasons described above, and for a number of other reasons. Similar reasons led Brunswick to establish a subsidiary in Ireland which manufactures bowling lanes for the European market. Incidentally, the same factors of shipping costs and convenience prevent European-made pinsetters from being imported into the United States. Brunswick makes pinsetters for the American market in Muskegon, Mich.

BILL WOULD CREATE COMPETITIVE DISADVANTAGE FOR AMERICAN BUSINESS

In view of these considerations the legislation will not affect Brunswick's present program of manufacturing abroad. However, Brunswick believes that the bill would handicap it in competition with foreign producers so that it will receive a smaller share of the foreign market. The principal manufacturing countries of the

world, including the United Kingdom, Germany, France, Italy, Japan, Belgium, Canada, the Netherlands, and Sweden, do not tax the unremitted profits of foreign subsidiaries controlled by their citizens, residents, or domestic corporations.

None of these countries has legislation inhibiting the use of so-called tax haven companies. Moreover, a number of countries grant additional and important tax advantages to foreign source income. For example, Sweden and the Netherlands exempt income of a domestic corporation earned through an autonomous foreign branch, and Germany, Belgium, Italy, and Sweden tax such foreign branch income at reduced rates. The United Kingdom, through its oversea trading company legislation, allows a domestic corporation to be free of tax from foreign source income. Germany permits tax reduction for domestic corporations operating in less developed areas even though such income is not earned through an autonomous foreign branch; it also may reduce the usual tax on dividends from subsidiaries operating in such areas. Japan allows up to an 80-percent exemption for export income. Canada, the Netherlands, and Switzerland exempt dividends from controlled foreign corporations from any corporate income tax liability, and Belgium, Germany, and Italy tax such dividend income at reduced rates. In addition, by recent legislation, Germany grants a domestic corporation a deduction in computing its income in an amount equal to one-third of certain foreign investments in less developed areas. However, this deduction must be returned to income over a 5-year period commencing the third year after the deduction is taken.

It seems clear to Brunswick that the Treasury bill would place American companies at a disadvantage in competing with foreign manufacturers located in these countries. Even though income taxes are imposed only on profits they affect the capacity to compete for business. The manufacturer who is subject to lower income tax rates can use the retained profits for expansion, or reduce his prices to some extent, and thereby obtain a larger share of the market than his competitor. We believe that the experience with cooperatives and other tax favored institutions illustrates the point.

Brunswick is now selling a variety of products abroad which it manufactures in the United States. Any weakening of the position of Brunswick abroad by reason of legislation which places it at a disadvantage in competing with foreign manufacturers will result in the loss of some of this foreign business now satisfied with products manufactured in the United States. I have in mind export business in golf clubs, boats, school supplies, et cetera. Thus, enactment of the bill would in fact have an immediate adverse effect on exports by Brunswick. Of even greater concern to Brunswick is the long-range impact of the bill on American business abroad. If a foreign manufacturer is permitted to gain a secure foothold in a newly developing oversea market it will thereafter be extremely difficult for the American manufacturer to penetrate the market.

ALTERNATIVE APPROACHES

We fully appreciate that there are instances where central companies are in fact pure holding companies which do not perform genuine business functions. Unfortunately this type of operation widely

publicized in newspapers and magazines, casts discredit on the legitimate central company. We believe that if legislation is to be enacted in this area it must, in the interest of American business, distinguish between sham and legitimate central companies. Other countries have drawn such distinctions, for example, through legislation which favors oversea trading corporations.

Another approach which some have suggested as a means to control abuses in this area is to extend the tax now imposed on domestic corporations improperly accumulating surplus to controlled foreign corporations. This would insure that the advantages of tax deferral cannot be claimed by controlled foreign corporations, and particularly holding companies which do not perform genuine business functions, if they do not use their earnings in proper business activity.

Senator GORE. Thank you, sir.

The next and last witness is Mr. Robert J. Landolt, Financial Executives Institute.

STATEMENT OF ROBERT J. LANDOLT, COMMITTEE ON TAXATION, FINANCIAL EXECUTIVES INSTITUTE; ACCOMPANIED BY WILLIAM N. KALL

Mr. LANDOLT. Mr. Chairman, I would like to present an associate and fellow member of the Committee on Federal Taxation of the Financial Executives Institute, Mr. William N. Kall.

Senator GORE. The committee is pleased to have you.

Mr. LANDOLT. My name is Robert J. Landolt. I represent the Committee on Federal Taxation of the Financial Executives Institute. This organization until recently has operated under the name of Controllers Institute of America. It is the same body with a new name and is composed of over 5,000 members representing substantial corporations engaged in every aspect of business in the United States, many of such businesses having substantial foreign operations. It is the duty of our members in general to keep the accounting records, to analyze them for operational purposes, and to prepare Federal tax returns and handle their audits. Hence the complexities added to the Internal Revenue Code are of serious importance to our members.

We have heretofore testified and we believe every accounting organization which has testified before the Committee on Ways and Means and this committee has stated that the accounting requirements of sections 13, 16, and 20 are such as to be in practice impossible of accomplishment, particularly when viewed in the light of less than 100 percent share ownership.

We have other objections to H.R. 10650. Some of these have been covered in our testimony beginning on page 715 of the printed hearings on April 3, 4, and 5, 1962. Here, however, we are addressing ourselves principally to the accounting and recordkeeping problems of the May 31 revisions.

We respectfully suggest that in writing the proposed provisions for the taxation of foreign income, enough attention has not been given to the practical problems of the less than 100 percent owner. Indeed, the problems become progressively and geometrically more difficult as the taxpayer's percentage of ownership in the controlled foreign corporation decreases.

There are several reasons for this which are apparent to those who are acquainted with conditions in foreign countries. This condition prevails in all foreign countries except the United Kingdom and Canada. In general, the standards and requirements of accounting in all foreign countries except the two above mentioned are far below the standards and requirements in the United States and for internal revenue purposes. Even if the personnel were available the problem of keeping them fully informed of the requirements of accounting in accordance with the U.S. Internal Revenue Code are simply insuperable for less than 100-percent owned subsidiaries. The language differences alone are of tremendous importance. Where there is less than 100-percent ownership by U.S. interests the foreign partners will not accept the added cost of accounting required by the proposed law.

It should be borne in mind that the kind of accounting required by proposed subsection 954(d) of section 13 is not even required in the United States. This accounting problem is most serious for all percentages of ownership. This subsection, which refers to foreign base company sales income, requires profit and loss analysis of each sale or transaction involving a related corporation. Such sales run into the thousands, and hundreds of thousands in many cases, and there would be required a daily sales analysis broken down by departments and products within a department. The amount of accounting work required would be simply fantastic. When the great differences in accounting for costs prevalent in the United States are realized, some aspects of the problems can be appreciated.

At this point I would like to interpolate an added remark. As one example, every purchase by item must be analyzed to determine if from a related person, and then further determined if to be used, consumed or disposed of outside the country in which the U.S.-owned foreign corporation is located.

We protest this requirement as costly beyond all imagination, and probably regardless of cost impossible to comply with.

Every purchaser of any item could be required to certify as to its end use consumption or disposition.

Where sales are made to a distributor, jobber, or retailer they, in turn, would have to analyze their sales and possibly require their customers to do likewise to determine if such sales are subject to this provision of the proposed law. We submit that this is an astounding requirement.

If the spirit of this proposal is to receive favorable consideration by this committee, then we suggest that it should be sufficient to account only for sales where shipments are known to be destined outside the country in which the U.S.-owned subsidiary is domiciled.

The fact that the Internal Revenue Service recognizes some of these accounting problems is evidenced by three new subsections which have been added to this most recent draft.

Subsection 962(c) requires the U.S. shareholder to "maintain such records and accounts as may be prescribed by such regulations as necessary to carry out the provisions of this subpart."

Subsection 959(a) requires proof by the shareholder of his right to exclude earnings which have been previously taxed.

Subsection 1248(e) of proposed section 16 requires the taxpayer to

"establish the amount of the earnings and profits of the foreign corporation to be taken into account" on pain of having all gain considered a dividend.

In the case of investment of earnings in U.S. property under section 956 it would appear that all earnings and profits of the controlled foreign corporation since 1913 must be capable of a proof to the satisfaction of the Secretary to escape full taxation as a dividend.

It seems to us that these new requirements for the U.S. taxpayer to maintain records in the United States satisfactory to the Internal Revenue Service not only places an impossible burden upon the less than 100-percent shareholder but also indicates very plainly that the Internal Revenue Service realizes that it cannot audit the accounts of foreign corporations.

We submit that it should be a rule of general application that the taxing authority should tax no business that it cannot audit. It is obvious that where the original books cannot be compared with whatever records may be presented in this country, there are wide open areas for the encouragement of deceit and fraud.

Perhaps at this time it may be well to speculate upon the cost to the U.S. Government of these accounting requirements. In all cases the accounting requirements under the U.S. Internal Revenue Code will be different from what is required in the foreign country. In most cases, that is, except in English-speaking countries, the accounting records will be so sadly inadequate that it will be necessary to impose a new and complete accounting system so that the U.S. taxpayer will be able to file its own U.S. tax return. This will refer to the instances where it is possible, that is, in case of practical 100-percent ownership. It will be essential to send U.S.-trained personnel and keep them in the foreign location for long periods of time. The cost of sending this personnel and keeping them there will be costs attributable to filing of the tax return of the U.S. person and will be deductible as a cost in the United States. In many cases it will be necessary for the U.S. person to conduct and operate the complete accounting system for the controlled foreign corporation, all of which will be a cost of preparing the U.S. tax return of the U.S. person. And this will be so whether there is any U.S. taxable income attributable to the U.S. person or not.

As above indicated, it will also be necessary to analyze the accounts of the controlled foreign corporation for all years back to 1913 and to keep a current record for all foreign corporations that possibly may become or were controlled foreign corporations.

These remarks do not by any means exhaust the complications involved in this basically unsound endeavor to tax A upon B's income.

We should like at this point to comment on some of the specific inequities which have been presented by the redraft of May 31, 1962. In several cases it is provided that records, evidence, and valuations be developed and presented to the satisfaction of the Secretary or his delegate. We respectfully suggest that this is an unfortunate and unfair requirement by a Government of free citizens.

While provisions for the carryover of losses (proposed sec. 952(c)) and the consolidation of foreign earnings (sec. 952(d)) are most desirable, they present interesting and amazing accounting problems. In the first place it can be asked, What is the statute of limitations with respect to foreign corporations? With respect to the carryover

it seems to apply even though in other years affected the particular foreign corporation was not a controlled foreign corporation and whether or not a particular stockholder was stockholder in the year of loss.

With respect to the consolidation of foreign earnings, there is substantial uncertainty as to how this provision would work if control shifted during a taxable year and in other situations. This presents the fact that where any stock in a controlled foreign corporation is to be sold at any time in the future, it must carry a dossier of past years' tax results of itself and any other corporation that the particular stockholder had any 10 percent or greater ownership in, and the value of the share will depend upon earnings which may have been deemed to be dividends and losses of this corporation and other corporations which may be related in one way or another, all of which facts may still be open to audit adjustment for many years and all dependent upon when the statute of limitations might run.

Necessarily any attempt to tax one person upon another's income must involve great complications unless it is to be completely arbitrary inaction. The most compelling evidence of how arbitrary this action must be is evidenced by the new provisions, above referred to, where the taxpayer must prove to the Commissioner the facts with respect to nontaxability in records maintained in the United States or else he will be taxed on everything. This is unfair, it is arbitrary, and it will engender increasing disrespect for the tax system in the United States both at home and abroad.

While no change was made in this area by the May 31 draft, we should like to protest against the definition of "control" in section 951(a), that is, that 1 day's control provides the basis for taxation and all of the strenuous reporting required. We respectfully submit that if 30 days' control in any year were required—and I should mention we are talking of 30 full days of control—the most that could escape taxation would be 59 days in 2 consecutive year periods. This slight alleviation would be most helpful and would save substantial amounts of money in analysis as to whether a particular foreign corporation was controlled for an immaterial time during any year.

With respect to foreign base company sales income, arbitrary lines of demarcation are set up so that if trading is done across national boundary lines it becomes foreign base sales income. This has at least two very bad results:

(1) It distorts present methods of operation and will cause increased costs of doing business by requiring operations within specific foreign countries, whereas our foreign competition can operate within the Common Market and across national lines without encountering the onerous accounting and tax problems here sought to be forced upon American business.

(2) This requirement that operations be within national boundaries also makes it easy for foreign governments to do what Uruguay has already done in their tax law, that is, provide that if another foreign country benefits by the low taxes in Uruguay, then the Uruguyan tax will be increased so as to lap up what the other foreign country might otherwise receive in taxes.

Incidentally, this can be expected from all foreign countries so that there will be no net revenue to the Government but there will be greatly added costs of doing business and accounting which will be charged against the U.S. sources of revenue.

We should also like to protest new paragraph (2) of proposed section 954(d) wherein the Commissioner is given the power to determine that a branch of a foreign corporation operating in another country shall be considered as if it is another controlled foreign corporation, thus setting up opportunities for distorting the integrated operations of a corporation and making taxable income where there is none at present and creating foreign base company sales income out of intercompany transactions.

It is provided in proposed section 954(b)(4) that if it is established to the satisfaction of the Secretary that the creation or organization of the controlled foreign corporation "does not have the effect of substantial reduction of income or war profits, excess profits or similar taxes," then such controlled foreign corporation may escape the rack of section 13. It is not plain from this statement whose taxes are to be analyzed, that is, whether it is to be the taxes of the United States or whether it is to be the taxes of the foreign countries. Perhaps it means both, but in any case the particular wording indicates that the taxes discussed are those which have been commonly considered those taxes which may be credited against U.S. Federal income tax. This is an unfair standard because in most foreign countries the local income taxes, the turnover taxes, and the excise taxes are substantially greater than are in effect in the United States, but must be considered in operating a business as costs of doing business, just as are income taxes. Thus in most of the countries on the continent of Europe and in several in South America, the total taxes amount to as much as those in the United States, but the particular taxes named in paragraph (4), above referred to, are one-half to two-thirds of the Federal income tax on corporations in the United States.

We should also like to protest against the empirical standard of 5 years' duration which is attached to the validity of debt under section 955(b)(1). In many instances in foreign operations it is advisable to have great flexibility, particularly in raw material operations, otherwise large amounts of initial expenditures are forever tied up in an operation which has completed its purpose. Thus the standard should be bona fide debt rather than with any minimum maturity.

Finally we should like to point out that with respect to proposed section 20, there is still entirely too much reporting required for any sensible requirements. For example, the necessity of reporting the name of each new director where there is no change in beneficial ownership will, as we have before stated, result in hundreds of thousands of pieces of paper flowing into the Internal Revenue Service without any meaning whatsoever. This will be added cost of doing business and is completely unjustified. In addition the presentation of balance sheets and profit and loss statements is equally unnecessary in view of the stringent and far-reaching reporting requirements proposed by section 13.

Thank you, sir.

Senator GORE. Thank you.

The committee will stand adjourned until 10 tomorrow.

(Whereupon, at 12:25 p.m., the committee adjourned, to reconvene at 10 a.m., Tuesday, July 3, 1962.)

REVENUE ACT OF 1962

TUESDAY, JULY 3, 1962

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

The committee met, pursuant to recess, at 10:20 a.m., in room 2221, New Senate Office Building, Senator Harry F. Byrd (chairman) presiding.

Present: Senators Byrd, Kerr, McCarthy, Williams, and Curtis.

Also present: Elizabeth B. Springer, chief clerk.

The CHAIRMAN. The committee will come to order.

The first witness is Mr. Ellsworth G. Alvord, United States Council of the International Chamber of Commerce.

STATEMENT OF FRED W. PEEL, MEMBER OF THE COMMITTEE ON TAXATION OF THE UNITED STATES COUNCIL OF THE INTERNATIONAL CHAMBER OF COMMERCE

Mr. PEEL. Mr. Chairman, Mr. Alvord will be unable to appear today because of illness, and I am substituting for him. My name is Fred W. Peel.

I am also a member of the firm of Alvord & Alvord and a member of the Committee on Taxation of the United States Council.

The United States Council of the International Chamber of Commerce appreciates having this opportunity to present its views on the amendments to H.R. 10650 which have been proposed by the Secretary of the Treasury.

The comments of the United States Council will be confined to the Secretary's proposals with respect to section 13 of the bill.

The Treasury amendments do not remove the United States Council's fundamental objections to section 13. In fact, on balance a number of American firms feel that section 13 revised as proposed by the Treasury would be worse than it was in the form in which it passed the House.

The amendments proposed by the Secretary to section 13 of H.R. 10650 are, in some respects, improvements over the bill in the form in which it passed the House of Representatives. Specifically, section 13 would be improved by the Secretary's proposal in the following respects:

1. Income from operating business in the more developed countries would not be taxed regardless of whether or not the income from these operations is reinvested in the same business.

2. A limited exemption from section 13 would be provided for corporations organized and operating in U.S. possessions. While

there does not appear to be any good reason why corporations in other parts of the world—particularly the less developed countries—should not be treated as well as corporations in the U.S. possessions, we approve the proposal to exempt some of these corporations from section 13 as a step in the right direction.

3. Some types of dividends, interest, rents, and royalties received in the course of active business operations would be exempted.

4. The special provision for the taxation of income and imputed income from patents and copyrights would be eliminated.

5. Greater recognition would be given to losses incurred by controlled foreign corporations.

6. Section 13 would be limited to 10 percent shareholders and only 10 percent shareholders would be taken into account in determining whether or not a foreign corporation is a controlled corporation.

A number of the Secretary's proposals would make section 13 even worse than the provision contained in the bill which passed the House. The following provisions are of particular importance in this respect:

1. All subpart F income derived from developed countries would be taxed even though it is reinvested in less developed countries.

2. Subpart F income from the less developed countries which is eligible for deferral through reinvestment in such countries would be limited to dividend and interest income.

3. Dividend and interest income from less developed countries would be eligible for deferral only if reinvested in other corporations, thus barring reinvestment in business operations conducted by the controlled foreign corporation itself in less developed countries.

4. Income from the performance of services for related persons would be treated as foreign base company income.

5. Certain commissions would be treated as foreign base company sales income.

6. Branches of foreign corporations would be treated as though they were separate subsidiary corporations, in some cases, for purposes of determining foreign base company sales income.

7. Amounts invested in the United States by controlled foreign corporations would be taxed to the extent of earnings and profits accumulated since 1913, instead of to the extent of those accumulated after 1962 as provided in the House bill.

It is apparent from its latest recommendations that the Treasury still takes the position that it is wrong for U.S.-owned foreign corporations to save foreign taxes. Section 13, revised as proposed by the Secretary, would not be limited to the prevention of avoidance of U.S. tax on income from U.S. sources. In fact, its principal application would be to transactions between foreign corporations with respect to income from foreign sources.

The new Treasury proposals would continue, and in some respects even extend, the tax penalties imposed by section 13 on trading corporations set up to do business in several countries. As in the House bill, this would be true even for trading corporations operating in common market areas such as the European Common Market.

A single foreign corporation is frequently used to sell products in several countries because this is cheaper and more efficient than setting up separate selling subsidiaries in each foreign country. For many small- or medium-sized American firms the cost of setting up and

staffing a separate selling corporation in each foreign country would be prohibitive. However, section 13, if amended as proposed by the Secretary, would still impose a U.S. tax penalty on the failure to create a number of costly local affiliates, each to sell in its country of incorporation.

It is illogical to make the national boundaries between foreign countries a decisive factor in applying U.S. income tax. To do so flies in the face of economic reality. A developed country such as Canada may support a separate affiliate, but the sum total of operations within all the several governmental units of the Latin American free trade zone, for example, would dictate only one affiliate if the decision is made on business grounds rather than to avoid U.S. tax consequences.

This distinction between trading in the country of incorporation and trading in a wider economic trading area is all the more difficult to understand in view of the fixed policy of our Government to abet and encourage the development of common market areas in other parts of the world, so that businesses owned by the nationals of other countries can gain the benefits of trading outside their borders.

Under the Treasury proposals, section 13 would continue to label legitimate business operations as tax haven operations and penalize them accordingly. This would be done without regard to the many reasons having nothing to do with taxes which dictate the use of separate operating foreign subsidiaries owned by a foreign holding company, or serviced by a centrally located foreign corporation, or which dictate that trade in one foreign country be conducted by a corporation organized under the laws of another foreign country.

For example, a foreign corporation may be used to market goods in another country to save the cost of local incorporation, or perhaps to prevent the proceeds from these sales from being subjected to burdensome currency controls. In some cases a corporation organized under local law may be undesirable because the foreign country requires that a specified percentage of the stock of local corporations must be owned by nationals.

It is unfortunate that the tax haven label has been attached indiscriminately to corporations receiving interest, dividends, rents, and royalties, or doing business in more than one foreign country. Tax policies should not be influenced by labels. Attaching good labels and bad labels merely makes it more difficult to analyze the real issues intelligently.

So-called tax haven corporations are being used by American business abroad. They are being used legally and properly. To the extent that there has been improper use, it can be corrected. But let us not smash the whole basis of our foreign enterprises in an attempt to make this correction.

The proposed revision of section 13 contains a hodgepodge of restrictive requirements. The numerous instances in which the draft of proposed legislative language leaves problems to be solved by regulations to be issued by the Secretary points up the complexities in what the Secretary is proposing. It is difficult to see precisely what is supposed to be bad tax haven conduct. Is it bad to deal with related persons? Or perhaps it is bad to deal with unrelated persons (see proposed sec. 954(c)(4)). Is it wrong to attempt to save taxes of foreign countries, which ultimately increases U.S. tax revenues? Is it wrong for a corporation to do business outside its country of in-

corporation? Surely this is an archaic idea—contradicted by the last 100 years of development in the use of corporations.

Is it wrong for a corporation to buy from, or sell to, related corporations? It is difficult to understand why a tax penalty should be imposed on the use of a foreign subsidiary to buy products manufactured in the United States by its parent corporation for resale throughout the world, while this penalty is not imposed on a foreign subsidiary which manufactures abroad—often because of national requirements—instead of buying from its U.S. parent.

The proposed definition of foreign base company income is largely keyed to transactions with related persons. Thus, section 13 would discourage American firms from selling U.S.-produced goods abroad through foreign trading subsidiaries. This is in flat contradiction to the original objective announced by Secretary Dillon of attempting to improve the U.S. balance of payments. Also, one wonders whether the representatives of American labor fully appreciate what the latest Treasury proposals for section 13 would do.

The accounting requirements which would be imposed by section 13 would be so burdensome and so costly as to amount to a substantial deterrent to competing in foreign markets, entirely aside from the substantive tax burdens which would be imposed. In spite of all the evidence which has been presented in the past year, the Treasury still does not appear willing to give recognition to the tremendous differences in accounting principles and practices between the United States and foreign countries.

Accounting in nearly all foreign countries differs markedly from what we are accustomed to here. The principles governing the establishment of reserves, for example, are drastically different. In the case of wholly owned foreign subsidiaries, it would be necessary to recruit staffs of American accountants and send them abroad to duplicate the present accounting work in order to conform it to American tax principles. And it is not merely the taxpayers who will have to increase their accounting staffs—the Internal Revenue Service will have to do the same. In the case of foreign corporations in which there is substantial foreign ownership, it is questionable whether U.S. shareholders will even be permitted to apply American accounting principles.

Basing the imposition of U.S. tax on whether business is done inside or outside the country of incorporation of the controlled foreign corporation would raise a host of problems. Are transactions with colonies of the country of incorporation treated as being outside the country of incorporation? In the case of a federation of countries or semi-independent colonies, such as the British West Indies Federation, is the federation considered the country or is each member of the federation considered a separate country? Suppose the European Common Market becomes a political unit in a few years as well as an economic unit? If internationally incorporated companies are authorized for the European Common Market (and this is under consideration), what would be their country of incorporation? What is the country of incorporation of a company organized to do business in a colony if the colony subsequently becomes an independent country? Suppose a portion of a country secedes and becomes independent, as Syria has done?

SECTION-BY-SECTION COMMENTS

Section 951(a)(2): A U.S. shareholder would be taxed on a pro rata share of earnings of a controlled foreign corporation for the year without diminution for dividends previously paid during the year on the same shares of stock while the stock was held by persons who would not meet the definition of a U.S. person. In other words, a U.S. shareholder would be taxed on income earned during the year and paid out as dividends to the preceding owner of the stock. This unreasonable burden would effectively prevent the purchase of stock in foreign corporations from foreigners in most cases.

Section 951(a)(2)(A): A U.S. shareholder who owns common stock in a controlled foreign corporation at the end of the year would be taxed on a pro rata share of all of the subpart F income from the year, even though these earnings or a part of them have already been distributed during the year as dividends on preferred stock. Thus the provision would produce a double tax on earnings of controlled foreign corporations which pay dividends on preferred stock.

Section 951(a)(2)(A): In a situation in which a sale of stock in a foreign corporation by a U.S. shareholder during the year causes the foreign corporation to cease being a controlled foreign corporation, the U.S. shareholder would be taxed on a share of the earnings calculated for the entire year, even though the foreign corporation may have had no income during the period it was controlled. The taxation of the U.S. shareholder would also be complicated if exchange rates for the currency in which the foreign corporation earned its profits fluctuated during the year after the U.S. shareholder disposed of his stock.

Section 952(d): This provision recognizes, but hardly solves, the problem of taxing a U.S. shareholder on income earned by one foreign corporation while other foreign corporations owned by the same shareholders are operating at a loss. The provision does not provide any guarantee that the losses will be used to offset the income of other controlled foreign corporations. The provision amounts to little more than a promise that the Treasury will prescribe regulations to take these losses into account to the extent it considers it proper to do so.

Section 954(b)(1): Under the Treasury proposals only dividend and interest income from corporations in less developed countries could be reinvested in less developed country corporations without tax. There does not appear to be any logical reason for limiting this provision to interest and dividends so as to exclude other types of foreign base company income such as rents and royalties, so-called foreign base company sales income, or income from the performance of services.

Section 954(b)(1): Under the Treasury proposals a controlled foreign corporation could not reduce its foreign base company income by reinvesting income in its own business operations in less developed countries, even though investment of this income in the stock or securities of another corporation engaged in precisely the same activities would qualify. This limitation is utterly illogical. It can only be explained by a desire to cause a proliferation of separate foreign subsidiaries.

Section 954(b)(4): This exception for controlled foreign corporations not availed of to reduce taxes is likely to be largely illusory. In the first place, the exception may be used only if the taxpayer's case is "established to the satisfaction of the Secretary or his delegate."

This means there would be virtually no court review of the Revenue Service's decisions under the provision.

Furthermore, the standard provided in the provision is far from clear. The test is whether creation of the controlled foreign corporation has the effect of substantially reducing income taxes. It is not clear what effect a deferral of taxes would have. It is not clear whether the provision means a reduction of U.S. income taxes or of foreign income taxes. If the exception applies unless the effect of the controlled foreign corporation is to reduce U.S. taxes, then it could be very valuable. However, if the exception is not meant to apply if the effect of the controlled foreign corporation is to reduce foreign taxes, it is unlikely to be of much significance.

Some taxpayers have obtained rulings under section 367 for tax-free exchange treatment of transactions involving the transfer of assets to controlled foreign corporations on the basis of representations that the purpose of the transfer was to effect a reduction in foreign taxes. These taxpayers have rulings that it is not improper to reduce foreign taxes. If a reduction in foreign taxes would make a controlled foreign corporation ineligible for the section 954(b)(4) exception, the effect would be to repudiate these rulings.

The meaning of the provision is further confused by coupling the creation of the controlled foreign corporation (which may have occurred years ago) with the current effect on taxes. Suppose the creation of the foreign corporation did not reduce taxes at that time but that subsequent changes in the tax laws or in the operations of the corporation resulted in a reduction of taxes.

Section 954(c)(2): This provision should treat all rents as foreign personal holding company income, even though they amount to more than 50 percent of the foreign corporation's gross income. The same provision was contained in the House-passed bill. Rents received by closely held corporations are not treated as foreign personal holding company income for purposes of the foreign personal holding company tax if the rents amount to more than 50 percent of gross income, and there is no apparent reason why treatment of rental income should be harsher under section 13 then it is for foreign personal holding companies.

Section 954(d)(2): This provision purports to apply the rules proposed for foreign base company sales income to income derived by branches of controlled foreign corporations located in other countries. The provision is inexplicable—either as to its effect or as to the policy which motivated the Secretary to propose it. In fact, sales activities of a controlled foreign corporation conducted through a branch in another foreign country would meet the definition of "foreign base company income" without the application of this paragraph. The only apparent purpose of the provision would perhaps be to cover situations in which the controlled foreign corporation did not deal with related persons but merely dealt with itself. If that is the purpose of the provision, then it would presumably apply only to income generated by the branch from sales outside the country in which the branch is located. The provision would apply where carrying on activities through the branch "has substantially the same effect" as if the branch were a wholly owned subsidiary. "Substantially the same effect" on what?

The paragraph provides that in such a case the income of the branch is to be treated as income derived by a wholly owned subsidiary of the controlled foreign corporation—the provision is silent as to where this constructive subsidiary is deemed to be incorporated. If this is to be the effect of the paragraph, query whether the income of the branch should not constitute dividend income to the controlled foreign corporation instead of foreign base company sales income, as the paragraph would provide.

Section 954(d)(3): The definition of a "related person" is silent as to the situation in which a person controls a foreign corporation for only part of the year. Query whether transactions by a foreign corporation with a person before or after the period of that person's control over it are transacted with a related person.

Section 954(e): This subsection would include income from the performance of services in foreign base company income. The provision is phrased so broadly that it could be interpreted as requiring an allocation of part of the selling price of virtually all items sold to related parties "in connection with" business carried on outside the country of incorporation.

Section 955(a): The mechanics of this subsection for measuring withdrawals of investments from less developed country corporations are such that all subsequent investments in such corporation would be automatically locked in if proposed section 954(b)(1) has ever been availed of. Regardless of how much additional investment is made in subsequent years, the first dollar of net investment withdrawal from less developed country corporations would be treated as a withdrawal of the earlier investment to which section 954(b)(1) applied.

Section 955(c)(1) and section 957(c): In both of these sections provision is made for determining the source of income under regulations to be prescribed by the Secretary or his delegate. No standard is provided for the Secretary's guidance in writing these source rules. The purpose of the provisions is puzzling, since the code already contains statutory provisions governing the source of income, and these code provisions have been supplemented for years by extensive regulations. Perhaps this provision for the determination of source rules by regulations is designed to circumvent the source of income rules presently in the code. If this is the intention, the Treasury proposals should state it frankly and should reveal the criteria which the Secretary plans to use in writing these new source rules.

Section 955(c)(2): The language of this provision permitting possessions to be treated as separate countries may not be broad enough. For example, Greenland, a part of Denmark, should be considered a less developed country within the intent of section 13, but it is questionable whether it is covered by the language of this paragraph. Possibly of even greater practical significance is the criterion of place of incorporation or organization. Taking Greenland again as an example, even if this territory is considered a less developed country, an operation conducted in Greenland is apt to be carried on by a corporation organized under the laws of Denmark. Accordingly, no more protection is given for the operation in the less developed country than would be the case if the venture were based in Copenhagen.

This situation is apt to be found frequently in the British Commonwealth where operations in some of the smaller territories are carried

on by United Kingdom corporations. This difficulty would be cured if a less developed country corporation was defined to include a corporation operating in a less developed country but organized in a politically related foreign country. This problem runs through section 954 as well as section 955; for example, in section 954(c) (4) (A) reference is made to dividends and interest received from a related person organized under the laws of the same foreign country.

Section 959(a): The provision for proof of the identity of stock interests traced through successive owners in order to qualify for exclusion of previously taxed earnings will present fantastic administrative problems. Long sheets of paper will have to be attached to every stock certificate where there are changes in stockownership. In each case where a stockholder is taxed on a presumed dividend which is not paid, there must be a paper evidencing that tax attached to the share of stock.

Section 960(a)(1): The foreign tax credit proposed to be allowed to U.S. shareholders when they are taxed on the income earned by controlled foreign corporations would contain limitations which are inconsistent with the assumption upon which the Treasury's proposals are based. If U.S. shareholders are to be taxed as though they had received directly the income of their controlled foreign corporations, they should be allowed foreign tax credit on the same assumption. Under the Treasury's proposals, however, a U.S. corporate shareholder would be eligible for foreign tax credit for taxes paid by a controlled foreign corporation only if it owns at least 10 percent of the voting stock directly. Individual U.S. shareholders would not be eligible for any credit for foreign income taxes paid by a controlled foreign corporation.

Furthermore, neither individuals nor corporations would be allowed credit against the U.S. tax on earnings of controlled foreign corporations which are not actually paid out as dividends for the foreign taxes which will be withheld when the earnings are subsequently distributed. Failure to allow credit for these dividend taxes when the income is taxed to U.S. shareholders has the effect of an interest-free loan of this amount by the U.S. shareholders to the U.S. Government until the dividends are paid and the foreign tax on them is allowed as a credit.

Section 962(b): Under the Treasury proposals, U.S. shareholders would be taxed on blocked foreign income unless they can establish to the satisfaction of the Secretary or his delegate that the income could not have been distributed to them. The requirement that the taxpayer must satisfy the Treasury or the Revenue Service is much stricter than the present treatment of taxpayers who earn blocked foreign income directly—either the present treatment under the general rules of law or under the provisions of Mim. 6475, 1950–51, C.B., page 50.

Blocked income can arise in a number of ways. Sometimes it is necessary to get advance approval for foreign exchange transactions and approval may be months or years in coming. Sometimes remittances may be made abroad to pay for goods, but not to pay dividends. Some countries require the creation and retention of a reserve fund out out of profits. On occasion, distributions are blocked until the taxes owed the foreign country for the year have been settled. In other cases no dividends may be paid until after the close of the year.

If the proposed section 962(b) is to be meaningful, it should state flatly—as the Secretary's explanation does—that—

tax will not be payable in situations in which the presence of blocked income means that earnings of a controlled foreign corporation could not be distributed to U.S. shareholders.

Section 1249: This new provision would tax gain on sale of patents, copyrights, and similar properties to a controlled foreign corporation as ordinary income. This provision does not appear to be within the objectives of the bill. There is no basis for this discriminatory treatment of gain on transactions with a controlled foreign corporation, as contrasted with capital gain treatment or gain from sale of the same rights to an unrelated foreign corporation or to a related or unrelated domestic corporation.

CONCLUSION

Section 13, as it passed the House or as revised by the Secretary's proposals, would have the immediate effect of decreasing the U.S. shareholders' share of business abroad, forcing withdrawal of American businessmen to our shores and leaving the field to their foreign competitors. The overall tendency would be toward economic isolationism. A secondary result would be that individual investors in the United States would increase their investments in foreign-controlled corporations.

The basic theory behind section 13 is wrong, and the U.S. council is fundamentally opposed to it in principle. Our basic objections are spelled out in our April 25 statement before the Senate Committee on Finance.

Even as proposed to be revised by the Secretary, section 13 is not the right answer. It is still not directed at the real problem of correcting abuses in the tax haven area, which should be corrected. The problem needs much more study before imposing any drastic tax penalties.

Mr. Chairman, the director of research of the U.S. council, Dr. Smith, has been working on an analysis of exhibit 3 of Secretary Dillon's original statement before the committee, which explained the effect on the balance of payments of these proposals.

This is not in completed form yet, but he has every hope of having it completed within the next few days, and I would like to have permission to submit this for the record by next Monday.

It will run about 15 pages with two or three tables.

The CHAIRMAN. In other words, you propose to compare, to analyze, the last recommendations of the Secretary as compared with the first; is that it?

Mr. PEEL. No, sir; to analyze and criticize his analysis of the effect on the balance of payments. We feel that there were serious errors in the models that were prepared by the Treasury Department.

The CHAIRMAN. Whatever comments you have, we will be glad to have.

Mr. PEEL. Thank you, Senator.

The CHAIRMAN. Thank you very much.

(The following was later received for the record:)

A Critical Appraisal of the Treasury's Analysis of the Balance-of-Payments Effects of H.R. 10650

Prepared for the Committee on Taxation by Wm. J. J. Smith, Director of Research, U.S. Council of the International Chamber of Commerce

Secretary Dillon, in his earlier appearance before this committee, defended the proposed elimination of tax deferral on foreign subsidiary earnings on the grounds (*a*) that it would increase the level of domestic investment and national income and (*b*) that it would substantially improve the U.S. balance of payments without weakening the competitive position of U.S. enterprise abroad. This latter contention, particularly, has been a point of major controversy in the course of the hearings of the past year in respect to the Treasury's tax proposals.

The basic question for legislative decision is whether the proposed elimination of tax deferral as provided in the bill section 13 would bring any substantial short-run reduction in the international payments deficit and whether its long-term effects would be substantially adverse to the balance of payments.

Statement of the Treasury's position

Secretary Dillon has assured this committee that the elimination of the deferral privilege would in fact make a substantial contribution in reducing the deficit, and suggests that these beneficial effects may reasonably be expected to continue for at least 10 to 15 years as evidenced in his statement that "the immediate balance of payments drain of new investment in the industrialized countries is not made up for at least 10 to 15 years." His assurances concerning the beneficial effects that may be expected from the provisions of section 13 are based on the projective model set forth in exhibit III attached to his statement. This model undertakes an analysis of the relations between (*a*) the outflow of direct-investment capital particularly to manufacturing subsidiaries in Canada and West Europe and (*b*) the receipts generated by such capital outflows. These related receipts consist of exports to manufacturing subsidiaries, dividend remittances, and other receipts (such as royalties, management fees, etc.).

In this analysis, the Treasury contends specifically that the elimination of the deferral privilege would reduce the outflow of capital and accelerate the repatriation of foreign earnings, and that these combined effects would improve the balance of payments for the period indicated by the Secretary.

The Treasury's contentions, however, are not supported by sufficient evidence. All parties to the present controversy recognize that the available data do not permit precise quantitative measurements. The Treasury's model, however, is fundamentally defective in other respects. It is based on dubious assumptions and an inadequate treatment of available data, and does not support the conclusions the Treasury has drawn from it. The Secretary's assurances, therefore, are not warranted even on his own assumptions.

The total impact of tax deferral and nondeferral on the basis of the Treasury's assumptions

Table I is designed to show, in the terms of the Treasury's analysis, what the total impact would have been on the balance of payments if the deferral privilege had been completely eliminated in respect to the manufacturing subsidiaries in Canada and West Europe at the beginning of 1960. This table takes the actual value of the direct-investment capital in such operations outstanding on the 1960 base date, and shows what the results would have been on the basis of the same assumptions and the application of the same ratios as those developed in the Treasury's analysis and used in exhibit III to show the relevant balance-of-payments effects. These assumptions include the following:

(1) The data refer only to the operations of such manufacturing subsidiaries, and the differential results for the balance of payments are attributable to the complete elimination of the deferral privilege with respect to such operations. In both exhibit III and this memorandum, therefore, the various exceptions and qualifications provided in section 13 and those provided in the Secretary's recent proposed amendments to the section are disregarded.

(2) Under existing tax provisions the new capital outflow to such enterprises is assumed to increase by 10 percent a year. The elimination of the deferral privilege, however, would (by assumption) reduce the year-to-year outflow by 10 percent.

(3) Total annual earnings are assumed to run at a constant 14.7 percent of the value of the total investment outstanding at the beginning of the year (end of the preceding year). According to these assumptions, the elimination of tax deferral would not alter this ratio, but it would alter the proportions in which earnings are reinvested abroad and remitted as income to this country. Thus, it is assumed that the ratio of reinvested earnings to total earnings would drop from about 54.6 to 45.4 percent (implying a drop from 8 to 6.7 percent in the ratio of reinvested earnings to total capital outstanding at the beginning of the year). Equivalent offsetting increases would occur in the corresponding ratios for dividend payments. These ratio changes constitute the "switch effect" in the Treasury's analysis.

(4) The foregoing ratios are the same as those used in exhibit III, tables A5 and A7, but differ from those used in table A6. For some unexplained reason, in this latter table, the Treasury assumed an arbitrary earnings ratio of 12 percent and somewhat different ratios for the distribution of earnings between reinvestment and dividend payments. These three tables therefore contain inconsistent data and thus fail to show even indirectly the total quantitative effect attributable to the elimination of deferral within the framework of the Treasury's model.

(5) The net export ratio is taken at 8 percent of total investment and the ratio for other receipts is 2.3 percent.

(6) These ratios imply that with deferral total receipts from manufacturing subsidiaries, as reflected in the balance of payments, would amount to 17 percent of total capital outstanding, and that this ratio would rise to 18.3 percent with the elimination of deferral.

Thus, table I shows what the differential effects would have been on the international payments position if the nondeferral provisions had been enacted at the beginning of 1960 and if the most favorable assumptions of the Treasury are fully conceded. The most striking fact is the insignificant, almost negligible benefit for the international payments position. The maximum gain of $135 million in 1960 compares with an actual deficit of about $3.9 billion that year, a hypothetical improvement of 3.5 percent. The results suggest that during the first 2 or 3 years the maximum benefit would amount to less than $130 million a year, while the gain for the annual payments over the entire period of improvement would be virtually negligible (amounting to substantially less than $100 million annually). Furthermore, the period over which the beneficial effects could be considered more than negligible would cover only 4 or 5 years, about a half or a third as long as the Treasury suggests.

Moreover, the differential gain in receipts would continue for only 5 years. Thereafter, the sharply retarded growth of capital would cause a loss of receipts in spite of the accelerated repatriation of foreign earnings. While the reduced outflow of new capital would bring small net improvements another 2 or 3 years, the entire cumulative gain would amount to little more than 15 percent of the actual 1960 deficit alone, and this total gain would be wiped out by the subsequent losses in less than 5 years.

These facts alone are sufficient to show that the provisions of section 13 cannot be justified as a method for reducing the international payments deficit. Even on the most favorable assumptions, the gains are clearly too small and uncertain to warrant the enactment of these provisions. If the problem of the deficit were to become so urgent during the next 2 or 3 years as to justify harsh measures affecting the investment activities of U.S. enterprise abroad, some other method must be found.

This conclusion stands even more clearly in the light of the losses that would be incurred. If we take a period of loss equal to the period of gain in net inflows as shown in table I, the elimination of deferral would cause, on balance, a loss of $1.6 billion in net inflows and a loss of $8.6 billion in foreign capital assets held by the Canadian and West European manufacturing subsidiaries of U.S. owners. Furthermore, such losses would result primarily from the reduction in foreign earnings available for reinvestment. Thus, over a 15-year period as shown in table I, nondeferral would bring a 26 percent loss in capital accumulated from reinvestment as compared with the 10-percent reduction in capital flowing from this country. Nondeferral tax provisions, therefore, would have relatively more adverse impact on reinvestment. Retained earnings over time are one important source of capital for generating net payments to this country and for building the position of U.S. enterprise abroad without exercising any direct short-term drain on the U.S. balance of payments.

Several conclusions may be drawn from the foregoing analysis. The Treasury tax proposals even on its own analysis would not substantially or significantly reduce the international payments deficit, and even the possible short-run gains would be so small that they must be considered as substantially uncertain and speculative. Over time, the proposals would adversely affect the balance of payment, would weaken and reduce absolutely and relatively the market position of American-owned enterprises abroad and thereby reduce the income and foreign assets of American owners, would probably reduce the market for U.S. exports and reduce the taxable income base for the Treasury.

The relation of the capital outflow to the inflow of receipts

The Treasury's analysis is in large part premised on the argument that the current outflows of capital are not related to the current inflows of export and income receipts. Thus, Secretary Dillon, in attacking the testimony presented by representatives of the business community and other witnesses who have opposed the elimination of tax deferral, argued before this committee that "the two types of flows being compared—the outflow of new capital and the dividend and export receipts for a given year or period—are not related one to another. The dividends, and most of the export receipts, of 1 year or period have been generated by investment over many years prior to the current year or period; that portion of the inflows which has been generated by past investment, then, should not be considered when we are evaluating the employment and balance of payments effects of current outflows."

On the basis of this argument, the Treasury thus contends that the time pattern of receipts from direct investments abroad must be specifically related to the corresponding outflows of capital by which they are generated. Such a procedure is carried over to tables A5 and A7 where the Treasury shows the consequences specifically imputable to a given capital outflow or given changes in outflow during a given period of years. As applied in table A5 dealing with the actual outflow of capital during 1952–60, the procedure is to start not with the total capital outstanding, but rather to take the capital outflow in the base year and then to measure the cumulative increments to capital generated by the capital outflows in the base year and in the succeeding years. Receipts are then computed from the given ratios as applied to the total accumulated capital and netted against the corresponding outflows.

The Treasury's argument and procedure in constructing these tables seem faulty in several respects:

(1) The Treasury's contention that current outflows of capital are independent of the current inflows of receipts is stated much too broadly (even as slightly qualified in the text of exhibit III). Surely the Treasury experts do not mean to deny that total investment during a period is influenced by business expectations concerning the prospective changes in levels of business activity and corporate earnings in response to cyclical, long-term growth, and other factors. Such expectations are themselves always influenced in some measure by recent ("current") profit behavior. Receipts from direct investments abroad are determined in major part by the rate of current earnings abroad and by the proportions of such earnings that are reinvested. Clearly the amount of reinvestment in large part directly determines both the income receipts and the current outflow of capital from U.S. sources during a given period. Such investment and income responses thus reflect the same basic factors affecting the prospective levels of business activity.

(2) Furthermore, the Treasury's criticism of the arguments presented by business and other opponents of section 13 seems in part to have missed the point. These witnesses have not meant to argue that the capital which flows from this country this year will yield an excess of net receipts for this year. What they have argued is that the growth of direct-investment capital has on balance had a favorable effect on the balance of payments and that this effect comes in major part from the flow of reinvestment capital abroad (the flow that would be the most adversely affected by the section 13 provisions). No one means to deny that a considerable lag may occur between the outflow of capital and the total export and income receipts specifically imputable to such outflows.

(3) It may be useful and appropriate for some problems to compute (as the Treasury does) annual increments to capital and annual incremental changes in receipts specifically attributable to such capital growth. It is not appropriate,

however, in respect to the issues involved in the present controversy, to exclude the annual reinvestment increments from computations such as those made in exhibit III, table A5. As indicated below and in table II, the results of this table would be reversed on the Treasury's assumptions if allowance is made for such reinvestment additions to capital.

The Treasury analysis of the investment process

The foregoing comments would perhaps be unimportant if it were not for the fact that the Treasury's contentions concerning the balance-of-payments effects of capital growth abroad are based upon an incomplete analysis.

(1) *The effects of current capital outflows as shown in exhibit III, table A5.*—In this table the Treasury applies its basic ratios to the actual capital outflows during 1952–60, in order to show the time pattern of increments to capital in relation to the time pattern of receipts earned by the additional capital.

While it is not entirely clear what this table is designed to prove, it clearly does not touch the basic issue as to whether the growth of capital during the past 8 or 10 years has on balance contributed to the international payments deficit. In table A5, the Treasury starts with the initial 1952 capital outflow and then computes (a) increments to capital (including the subsequent annual outflows and the reinvestments of earnings imputable to the prior additions) and (b) the incremental receipts. The 8-year cumulative balance between these incremental flows shows a substantial deficit.

If the Treasury had started, however, with the total capital outstanding and then computed the total increments to capital and total increments to receipts, the results would be reversed (as shown in table II). On this basis, the total incremental reinvestments would have brought an annual surplus of receipts every year and a cumulative 8-year surplus of about $850 million as compared with the Treasury's deficit of $1.8 billion. The basic results would not be changed substantially even if the 1952 outflow of $127 million is included without any allowance for 1952 earnings.

This weakness in the Treasury's analysis is fundamental in view of the contention of the business representatives that tax deferral has not operated as a substantial "subsidy" inducing domestic capital to go abroad but rather that it has permitted to a larger degree the financing of capital growth with foreign earnings, and this growth has yielded a rising stream of net receipts for this country.

(2) *The assumption of the increase in the capital outflow.*—The assumption that the capital outflow will continue to expand at a constant annual rate of 10 percent is made without regard to many of the important underlying factors. This assumption merely projects roughly the 1952–60 average rate. At no point does the Treasury give attention to the fact that this period has been one of an exceptionally rapid buildup of capital in response to several factors: (a) the rebuilding of the West European economies; (b) the growth of the Common Market and free trade areas; (c) the rising levels of output and income in the industrial economies; (d) the prospects of the external tariff affecting U.S. exports; (e) the need to establish coordinated production and distribution systems to defend and expand U.S. market positions here and abroad (including the markets for U.S. exports); (f) the fact that costs are more favorable for some foreign operations; and (g) finally the effects of exchange convertibility in liberating capital movements.

It does not seem to be responsible procedure, moreover, to assume a constant independent outflow rate based on the past several years and to project this rate for one or two decades.

(3) *Sources of investment funds.*—In this same connection, given its assumption of an independent capital outflow rate, the Treasury then makes the growth of capital depend on the constant ratios in which earnings are distributed. No attention is given to the available data on the sources and uses of funds, and no allowance is made for the evidence that as direct-investment enterprises become successfully established and earnings accrue, future growth is likely to be financed increasingly from foreign earnings and foreign external sources (especially for working capital).

This defect is especially evident in table A6 designed to show the "switch effect." There the Treasury assumes a 10 percent annual growth rate not only for the capital outflow but also for the total stock of capital attributable to such outflows. The result gives a grossly distorted pattern of capital growth, as the annual outflow of capital, according to this table, exceeds the annual reinvestments for a very long period. By contrast, however, the actual data show that for the manufacturing subsidiaries in West Europe and Canada, reinvestments during the 1952–60 period constituted more than 60 percent of the total combined growth financed by reinvestment and direct-investment outflows.

(4) This distortion in the investment pattern is carried over to table A7 which shows the "deterrent effect." As noted above, the pattern is further distorted by the Treasury's unexplained change in the rate of return and thus in the ratio of reinvestment to total capital. Exhibit III has no table showing the total net impact which, according to the Treasury's model (or several models), the elimination of tax deferral would have on the payments balance.

The Treasury's assumptions concerted the earnings and receipt ratios

Some of the objections made above to the Treasury's treatment of the investment process apply in similar terms to its ratios of earnings and receipts. These objections include: (a) the failure to take account of or explain its handling of past data; (b) the failure to allow for the major structural changes in economic institutions during the recent past and to distinguish between the effects of primarily cyclical factors and long-term growth conditions: (c) the failure to make explicit its assumption concerning long-term growth trends here and abroad. These are basic requirements for any such long-term projective model.

Much testimony has been given concerning these ratios, and not much is likely to be gained from additional detailed criticism. But some additional comments supporting the general objections may emphasize the fact that the model is not very useful for making long-term projections.

(1) The earnings ratio is based on the 1956–60 data for Canada and West Europe as shown in table A2. These lower average ratios (weighted by the relative capital outflows), although below the corresponding 1953–56 and 1953–60 averages, are presumably taken without regard to the basic institutional, foreign-exchange, and monetary changes particularly in West Europe during these years and without regard to recent diverse business-cycle movements in Canada and West Europe.

(2) Substantially the same comments apply to the dividend ratio, as evidenced in part by the Treasury's failure to allow for possible trend and other changes shown by the data and to make appropriate adjustments for the fact that this was a period of relatively sharp increase in investments abroad.

(3) The treatment of the net export factor is particularly unsatisfactory. This 2-year average is used to make roughly a two-decade projection, and is computed without regard to the diverse cyclical and other factors here and abroad affecting export and import fluctuations during the 1959–60 period. The absurdity of this procedure is particularly evident in the case of West Europe where, on the basis of 1959 data, the ratio would be a negative figure. Many expert witnesses have criticized this ratio also in respect to what is excluded (such as the products manufactured by the parent and sold by the foreign subsidiary without commission and the sales through trading subsidiaries which are made possible by the operations of a related manufacturing subsidiary abroad.) A more basic analytic objection is the fact that this ratio makes net exports a function entirely of outstanding investments without regard to any assumption concerning the trends in industrial production and national income here and abroad.

(4) This last objection above suggests the general weakness running through the model particularly if it is intended to be useful for making projections. What would be required as a starting point would be an explicit statement of some reasonable assumptions for industrial countries concerning trends in industrial production, gross national product, business investment, world trade, and monetary stability here and abroad.

By contrast, the Treasury resolutely assumes a constant rate of increase in the annual outflow of direct-investment capital to manufacturing subsidiaries in Canada and West Europe. It then chooses a few ratios from recent data to determine prospective receipts from such operations.

The basic contribution of the Treasury analysis

While the Treasury's analysis may not be very useful as a projective model, it does show that the elimination of tax deferral would, at most, bring a small short run but uncertain gain for the balance of payments (a gain almost de minimis relative to the payments deficit in recent years) and that this gain would turn into losses which would thereafter grow at an accelerating rate. In the meantime, U.S. subsidiaries abroad will have a heavier tax burden than their foreign rivals. The reduced rate of capital growth abroad would result from and lead to further reductions in the present and future cash flows abroad and thereby decline in the market position of U.S. enterprise abroad.

The Treasury suggests several solutions to this last problem:

(1) The subsidiary could reduce its dividends to U.S. shareholders by the amount of the increase in current tax liabilities. This solution, however, would defeat the gain in receipts from the "switch effect," and would also imply a shift of the increased tax burden to the U.S. parent.

(2) The subsidiary may borrow the funds. In this case, the increased interest cost would directly reduce the competitive position of the subsidiaries relative to their foreign rivals and reduce the earnings ratio used to compare the distribution of earnings under the deferral and nondeferral conditions. Furthermore, if the borrowed funds were from U.S. sources, the loan may defeat the "deterrent effect" with no improvement in the balance of payments, and may, in fact, cause a rise in the deficit.

TABLE I.—*A comparison of the balance-of-payments effects in deferral and nondeferral situations on the basis of the Treasury's exhibit III assumptions as applied to total capital of manufacturing subsidiaries in Canada and West Europe at the beginning of 1960*

[Millions of dollars]

	1959	1960	1961	1962	1963	1964	1965	1966	1967	1968	1969
Deferral:											
Capital outflow	370	407	448	493	542	596	656	721	793	873	960
Reinvestment, 8 percent	447	599	679	770	871	984	1,110	1,251	1,409	1,585	1,782
Capital outstanding end of year	7,485	8,491	9,618	10,880	12,292	13,872	15,637	17,609	19,811	22,269	25,010
Receipts, 17 percent		1,273	1,444	1,635	1,850	2,090	2,358	2,658	2,994	3,368	3,786
Nondeferral:											
Capital outflow	370	366	403	443	488	536	590	649	714	785	864
Reinvestment, 6.7 percent	447	502	560	624	696	775	863	960	1,068	1,187	1,320
Capital outstanding	7,485	8,353	9,316	10,383	11,566	12,877	14,330	15,939	17,721	19,694	21,877
Receipts, 18.3 percent		1,370	1,529	1,705	1,900	2,117	2,357	2,622	2,917	3,243	3,604
Balance with deferral		866	996	1,143	1,308	1,494	1,703	1,937	2,200	2,495	2,826
Balance without deferral		1,004	1,126	1,262	1,413	1,580	1,767	1,973	2,203	2,458	2,740
Gain or loss		+138	+130	+119	+105	+87	+64	+36	+3	−38	−86

	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980
Deferral:											
Capital outflow	1,056	1,163	1,278	1,406	1,546	1,701	1,871	2,058	2,264	2,490	2,739
Reinvestment, 8 percent	2,001	2,245	2,518	2,822	3,160	3,536	3,955	4,422	4,940	5,516	6,157
Capital outstanding (end of year)	28,067	31,474	35,270	39,497	44,203	49,440	55,266	61,745	68,949	76,955	85,851
Receipts, 17 percent	4,252	4,771	5,351	5,996	6,715	7,515	8,405	9,395	10,497	11,721	13,082
Nondeferral											
Capital outflow	950	1,045	1,150	1,265	1,392	1,531	1,684	1,852	2,037	2,241	2,465
Reinvestment, 6.7 percent	1,466	1,628	1,807	2,005	2,224	2,466	2,734	3,030	3,357	3,718	4,118
Capital outstanding	24,293	26,966	29,923	33,193	36,808	40,805	45,223	50,105	55,499	61,459	68,042
Receipts, 18.3 percent	4,004	4,446	4,935	5,476	6,074	6,736	7,467	8,276	9,169	10,156	11,247
Balance with deferral	3,196	3,610	4,073	4,590	5,108	5,814	6,534	7,337	8,233	9,231	10,343
Balance without deferral	3,053	3,400	3,785	4,211	4,683	5,205	5,784	6,424	7,132	7,915	8,782
Gain or loss	−143	−210	−288	−380	−486	−609	−750	−914	−1,101	−1,316	−1,562

The percentage ratios refer to total capital outstanding at the end of the preceding year. See the text for the assumption upon which these ratios are based. The total capital outstanding at the end of 1959 is the actual amount shown in exhibit III, table A1 for manufacturing subsidiaries in Canada and West Europe.

Details may not add to totals, due to rounding.

TABLE II.—*The growth of foreign capital and earnings generated by total annual investments*

[Millions of dollars]

	1952	1953	1954	1955	1956	1957	1958	1959	1960	Total
Growth with capital outflow:										
1. Capital outflow	127	20	72	90	184	304	164	370	638	1,969
2. Reinvestment	244	274	298	327	361	404	461	511	581	3,461
3. Capital outstanding	3,428	3,722	4,092	4,509	5,054	5,762	6,387	7,268	8,487	
4. Receipts		583	633	696	767	859	980	1,086	1,236	6,840
Growth without capital outflow:										
5. Reinvestment generated by pre-1952 capital	244	264	285	308	333	359	388	419	453	3,053
6. Total capital values (end of year)	3,301	3,565	3,850	4,158	4,491	4,850	5,238	5,657	6,110	
7. Cumulative increments	244	508	793	1,101	1,434	1,793	2,181	2,600	3,053	
8. Reinvestment receipts		42	86	135	187	244	305	371	442	1,812
9. New capital outflow receipts		22	27	41	60	96	155	195	274	870
10. Total receipts (line 8 plus line 9)		64	115	176	247	340	460	566	716	2,684
11. Balance (line 10 less line 1)		+44	+43	+86	+63	+36	+296	+196	+78	+842

NOTES.—(*a*) Data refer to manufacturing subsidiaries in Canada and West Europe. (*b*) Lines 1–4 show the total growth in capital on the basis of the actual capital outflows as shown in exhibit III, table A1 and on the basis of the Treasury's ratios assumed for earnings and receipts under present deferral conditions as shown in table A5. Capital outstanding at the end of 1952 is actual value (*c*) Lines 5–8 show what the growth would have been on the Treasury's assumptions if there had been no outflow of new capital from the United States. The reinvestment figures in line 5 thus reflect the growth of capital from earnings generated by pre-1952 capital. The figure of $244 million is estimated from the Treasury's ratios. Thus $264 million for 1953 is 8 percent of the 1952 total line 6 and 108 percent of $244 million. (*d*) The difference between line 2 and line 5 is the reinvestment of earnings imputable to the outflows of line 1. (*e*) The receipts in line 9 are those computed in the Treasury's table A5. (*f*) Details may not add to totals due to rounding.

The CHAIRMAN. The next witness is Mr. Walter A. Slowinski, of the Chamber of Commerce of the United States.

Take a seat, sir, and proceed.

STATEMENT OF WALTER A. SLOWINSKI, MEMBER OF THE COMMITTEE ON TAXATION OF THE CHAMBER OF COMMERCE OF THE UNITED STATES

Mr. SLOWINSKI. Mr. Chairman, Senator Curtis, I am Walter A. Slowinski, of Washington, D.C., a member of the law firm of Baker, McKenzie & Hightower. I am appearing for the Chamber of Commerce of the United States as a member of its committee on taxation.

On April 3, 1962, the chamber testified before this committee on H.R. 10650. At that time we stated that although the chamber is as interested as the Congress in removing any possibilities for tax avoidance in foreign operations by U.S. companies or shareholders, it was clear the provisions of section 13 are so drafted as to discourage further business investment abroad even in less-developed countries.

We emphasized the fact that to the extent the Treasury Department is interested in abolishing so-called tax havens, however they may be defined, it can do so through provisions similar to those now in section 6 of H.R. 10650, coupled with the presently effective provisions of section 482 covering allocation of income between related taxpayers. Even under present law, the Internal Revenue Service, to our knowledge, has not lost a single section 482 allocation case involving substantial tax avoidance in foreign operations.

In addition, section 20 of H.R. 10650 broadens the Treasury's "discovery" powers to obtain new enforcement information on oversea transactions.

The May 10 and 11 oral and written presentations of the Secretary of the Treasury, and the newly revised Treasury legislative proposals of May 31, 1962, make it clear such new proposals are not merely directed against so-called tax havens, but are so drafted as to prevent U.S.-controlled foreign-owned corporations from competing on equal terms with foreign-owned corporations on foreign soil.

The President has said he does not wish to "penalize legitimate private investment abroad." However, these new Treasury proposals would tie the hands of U.S. corporations by complex, artificial, uncertain, and complicated legislation without in any way imposing on foreign competitors the same geographical and technical rules and prohibitions.

The May 31, 1962, Treasury proposals would still present the unconstitutional specter of taxing income which has not yet been received. This basic and major change in U.S. taxing policy should not be undertaken under any guise of establishing "neutrality" between U.S. corporations which invest abroad and those which stay at home and do not choose to risk their assets in worldwide competition with foreign companies under the laws of many governments.

Even if the basic policy change were to be considered by this committee, the chamber respectfully submits that the May 31, 1962, Treasury proposals are hastily drafted stopgap measures which leave many of the serious technical issues unresolved. In major difficult areas of this legislative proposal, the Treasury resorts to administrative discretion by the constant assurance that the answers will be

worked out "under regulations prescribed by the Secretary or his delegate." If the needed answers cannot be devised and placed into the statute now, what assurance does American oversea business have that years of uncertainty will not transpired before the Treasury is able to devise such answers and publish them in regulations having the force of law which will not be subject to court review or appeal?

The new Treasury version of section 13 has also the same major infirmity as the version it replaces; the new proposals simply cannot work unless U.S. Internal Revenue Service agents audit every controlled foreign corporation within the ambit of the law. It is a fact that the Internal Revenue Service is not staffed, and cannot be in the foreseeable future, to perform tax audits in every non-Iron Curtain country of the world. Nor is it conceivable that in the foreseeable future Revenue agents can acquire the necessary competence in foreign tax systems, foreign accounting practices, and foreign languages, to carry out such audits. These are basic, inescapable facts which just cannot be shrugged off.

A number of major tax policy areas are delegated by the Treasury draft to the Treasury for the formulation of the basic rules—not the administrative rules. We submit, for example, that the Senate Finance Committee will not wish to withdraw from its tax-writing responsibilities and assign to the Secretary of the Treasury such crucial questions as whether income is earned within or without a less developed country, Puerto Rico, the Virgin Islands, or possessions of the United States.

The Congress has stated clearly for more than 40 years what it considers to be income from sources within the United States or from sources without the United States. These source rules have been confirmed by the courts in leading decisions over many years, although the Treasury continues to fight these source of income decisions whenever the court's interpretation leads to a lesser tax.

However, under its proposals, the Treasury would now have the same authority to abandon these source rules insofar as Puerto Rico, American Samoa, U.S. possessions and all less developed countries are concerned so that new source rules could be promulgated by Treasury Department fiat. The tests or standards to be employed have not yet been determined, nor has the Senate Finance Committee been advised how they would be applied. It is this type of uncertainty in the new Treasury proposals which creates serious concern in the minds of bona fide private investors planning new or expanded facilities in less developed countries, or in Puerto Rico, the Virgin Islands, or U.S. possessions.

On a similar objection, section 862(a)(3) of the Internal Revenue Code has for more than 40 years provided that income from personal services performed outside the United States shall be treated as income from sources without the United States. This rule, confirmed by the courts, would now be ignored by the Treasury in its proposal to inject a new concept of "foreign base company services income" which would attract a U.S. tax under certain conditions even though all services were performed abroad. This type of unrealistic approach to the taxation of foreign-earned income likewise creates doubts and concern among business taxpayers.

This committee also will not wish to delegate to the Secretary of the Treasury the responsibilities of determining what constitutes

earnings and profits in foreign operations or in deciding how complicated questions of blocked income shall be resolved. All of these problems and others are glossed over in the May 1 Treasury draft as unimportant administrative details, but they are crucial to U.S. private investors who must now decide whether they shall withdraw from foreign operations if this legislation makes them noncompetitive with foreign-owned corporations.

The Treasury has now recommended deletion of its earlier approach in the proposed section 959(a)(1)(B) which would have included as "subpart F income" all income from U.S. patents, copyrights, and exclusive formulas and processes. The Secretary orally indicated before this committee that the pressure of drafting the bill quickly in its final few days before the House Ways and Means Committee had resulted in technical problems which now prompted his suggestion that the provision be deleted. However, his proposed alternative recommendation in this case is equally unworkable. He suggested the imposition of a tax at 52 percent (corporate tax and surtax for U.S. corporations) on the full value of technology of U.S. origin at the time it is originally transferred to a controlled foreign corporation. He also orally urged a "somewhat longer statute of limitations" on assessments to permit a retrospective valuation of such technology at some future time.

Although the Treasury's recommendation is in very broad terms, an example of how the new proposal might work in the area of our Alliance for Progress seems to be as follows:

If a U.S. corporation transfers a new Brazilian patent to its controlled Brazilian subsidiary, it would have to estimate in advance the fair market value of the Brazilian patent since it was never exploited abroad before. If such fair market valuation is determined by the U.S. corporation to be $100,000, it, the U.S. corporation, must pay $52,000 in U.S. tax before beginning to exploit this Brazilian patent through its subsidiary. If the Brazilian patent project is a failure, perhaps (if time permits) a claim for refund of the $52,000 tax, based on retrospective valuation, could be filed by the U.S. taxpayer. However, if the Brazilian patent project is a success, then a U.S. Internal Revenue Service agent would assert a substantial tax deficiency (with interest retroactive to the date of the tranfer) against the U.S. corporation based on a new valuation at any time during the "somewhat longer statute of limitations," the term of which has not yet been prescribed by the Treasury.

The new Treasury proposal would not only levy this new tax under the proposed section 1249 on the sale or exchange of patents, inventions, models, designs, copyrights, secret formulas, secret processes, or "other similar property rights," but it would also then tax currently any royalties collected by the Brazilian subsidiary from the licensing of these same rights.

There is also ground for the broadest speculation under this new proposal as to what may now happen to the advance rulings procedures under section 367 under which such Brazilian patents may, under present law, be exchanged for controlling stock of the Brazilian subsidiary in a section 351 reorganization. In similar situations under present law, a favorable ruling would be granted by the Internal Revenue Service if the taxpayer shows a business purpose for the transaction and proves that avoidance of Federal income taxes is not

one of the principal purposes of the transaction. With a Brazilian corporate tax rate of approximately 30 percent, plus a 25 percent withholding tax in Brazil on dividends paid to a U.S. corporation, no U.S. tax is being avoided because of the operation of the foreign tax credit provisions.

More troublesome under the new Treasury proposal is the question of how the U.S. foreign tax credit provisions will apply with regard to Brazilian taxes paid by the subsidiary in later years and how such Brazilian taxes will be able to offset in any way the large U.S. tax paid earlier under the new section 1249 by the U.S. corporation on the initial transfer of the Brazilian patent.

The Treasury's proposal in essence seems to be to evaluate all the future earnings potential of the foreign patent and tax the estimated value fully in the United States before even the first brick is laid in the factory abroad needed to exploit such patent even in a less developed country.

The Treasury is understood to have informally assured taxpayers that the new May 31 provisions will now permit a U.S. company to manufacture abroad through a foreign subsidiary without being subject to the provisions of section 13. However, this is precisely the business function most companies wish to retain in the United States—and it is vitally important to keeping U.S. employment as high as possible. Many witnesses before this committee, including Dow Chemical, Minnesota Mining, Abbott Laboratories, Harnischfeger, Clark Equipment, and others, clearly testified that a substantial part of their total work force (some as high as 25 percent) is dependent on foreign trade for its domestic livelihood. Obviously, it is desirable that tax policy not discourage efforts of such companies to retain as much manufacturing in the United States as possible.

Just as no man is an "island," so there are few, if any, international businesses which can afford the luxury of conducting abroad a single function such as manufacturing. Companies competing in the world market must develop the entire range of the profitmaking spectrum to succeed. They must survey new markets; conduct sales promotion; warehouse, sell and distribute; provide credit financing for customers; license subcontractors or third parties; conduct research and development in foreign countries; provide technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial or like services and receive interest, dividends or royalties from anyone who has utilized the services or resources of such companies. To limit strictly in our U.S. tax law what those U.S. owned corporations engaged in international trade may or may not do is to impose tax limitations on foreign commerce never before proposed by any major commercial nation and never contemplated by the congressional drafters of our income tax system nor by our courts in their interpretation of the 16th amendment.

Such drastic change of taxation policy to experiment with a theory of "neutrality" of investment should not be undertaken by the Congress. In this one proposed tax law, entirely regulatory in purpose, the Treasury seeks (1) to control such tax avoidance as may exist; (2) to establish an entirely new policy of taxing legitimate U.S. business overseas, and (3) to use the Federal income tax law as a regulatory statute to control the balance of payments. These differing objectives should not be mixed into one provision of tax law such as section 13.

The CHAIRMAN. Thank you very much.

Are there any questions?

Senator CURTIS. Mr. Slowinski, I have always had a very high regard for your ability and standing as a tax lawyer, and I want to ask you a couple of questions.

I have no desire to mislead by oversimplifying. On the other hand, there are some very basic principles involved in this tax of income earned abroad that I think we should remember.

In the past, if income was earned in the United States subject to the jurisdiction of the United States, it was taxed here.

That is correct; is it not?

Mr. SLOWINSKI. Yes, sir.

Senator CURTIS. If it was earned outside the jurisdiction of the United States, it was not taxed until brought here, until returned here; is that not correct?

Mr. SLOWINSKI. If it was earned outside the United States by a foreign corporation?

Senator CURTIS. Yes.

Mr. SLOWINSKI. It was not taxed until the earnings were remitted to the U.S. stockholders.

Senator CURTIS. Yes.

Now, the original Treasury proposal violated both of those concepts; did it not?

Mr. SLOWINSKI. Yes, sir.

Senator CURTIS. And it would tax income of the U.S.-owned foreign corporation, the income earned abroad, before it was ever returned to the United States; is that right?

Mr. SLOWINSKI. Yes, sir.

Senator CURTIS. And that raises a jurisdictional departure, or that would bring about a jurisdictional departure that no major nation has ever followed; is that right?

Mr. SLOWINSKI. Yes, sir.

Senator CURTIS. And it also raises a possible constitutional question. In your opinion, do you think that is true?

Mr. SLOWINSKI. Yes, sir.

Senator CURTIS. Now have these basic objections been overcome in the Treasury's new proposals as interpreted by their oral statements here before this committee?

Mr. SLOWINSKI. No. Senator, not at all.

Senator CURTIS. I think that is all, Mr. Chairman.

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

The next witness is Dr. Emilio Collado, of the Standard Oil Co. of New Jersey.

Take a seat. We are glad to have you, sir.

STATEMENT OF DR. EMILIO COLLADO, VICE PRESIDENT AND DIRECTOR OF STANDARD OIL CO. OF NEW JERSEY

Mr. COLLADO. Mr. Chairman, my name is Emilio G. Collado. I am a vice president and director of Standard Oil Co. of New Jersey.

My prepared statement which I am now filing is short. My oral comments will be even shorter.

We awaited with great interest Treasury's proposal for revision of section 13. We had hoped it would reflect the constructive criticism

of the House provision developed by your committee and the many witnesses who testified before you. Unfortunately, we find the new section 13 is susceptible to most of the same criticisms as the old.

We are concerned, too, not only by the direct tax consequences of the Treasury proposal, but also by the misunderstanding being created by the Treasury's attack on private investment abroad. In April we submitted an extensive statement to your committee explaining why we believe that section 13 strikes at our national interest and why the arguments advanced by the Treasury on the balance of payments and neutrality are invalid. Our April 24 statement demonstrates that American foreign business operations help rather than harm our balance-of-payments position and that this is true from both a short-range and a long-range point of view. It also indicates that this attack on American business operations abroad cannot be justified on the basis of tax neutrality. It shows, moreover, that the Treasury proposal is without precedent in any other country.

In my statement for the record today I have stated in greater detail what I believe to be wrong with the revised section 13. I have shown that, in an effort to get at some poorly defined abuses, the section would do great harm to business operations abroad.

The provisions of the revised draft that would hit hardest at international companies are, first, those which would tax certain sales and services income as tax haven income merely because a foreign corporation does business with a related person; and, second, the entirely new provision which would permit the Treasury to treat a branch business conducted by a foreign corporation in a second country as if such business were a passive portfolio investment. The section seems to be based on the unjustifiable premise that any transaction with a related person must be an abuse. The result is that the revised section 13 would make it considerably more difficult to do business abroad and particularly in underdeveloped countries. Since about 70 percent of the oil we sell is produced abroad and moves in international trade abroad before the final sale, we are disturbed by this apparent effort to penalize those who do not confine their foreign operations to tight little individual country compartments.

In my statement for the record, I have also referred to several other examples which illustrate how Treasury's new section 13 could disturb the operations of my company. The statement proposes several essential modifications of section 13 of H.R. 10650 which should be made if it is decided to retain this section in the bill. These changes are aimed at removing legitimate foreign business operations from the application of the section.

However, I strongly believe that no convincing justification has been put forward for enactment of section 13 of H.R. 10650. We do not condone abuses but we are convinced that the real abuses can be eliminated with the assistance of the more extensive reporting requirements recently enacted and by forceful application of existing law. Abuses through manipulation of prices charged between related persons for U.S. exports or imports are identifiable. So are sham foreign corporations engaged in passive investment abroad. But, certainly, it is not an abuse, as Treasury claims, to minimize income taxes paid to foreign governments by use of appropriate corporate organizations for business operations abroad. Increasing foreign

82190—62—pt. 11——27

profits accruing to U.S. shareholders, whether by improved operations or by better organization, benefits rather than harms the U.S. economy and the Federal revenue. On the other hand, enactment of section 13, even if revised as proposed by Treasury, would harm foreign business operations which have no flavor of tax abuse and would be in direct conflict with the Alliance for Progress since it would, in particular, harm legitimate business operations in the underdeveloped countries.

(The prepared statement referred to is as follows:)

STATEMENT BY EMILIO G. COLLADO, VICE PRESIDENT AND DIRECTOR, STANDARD OIL CO. OF NEW JERSEY, ON AMENDMENTS TO SECTION 13 OF H.R. 10650

In the judgment of Standard Oil Co. of New Jersey, the provisions of section 13 of H.R. 10650 whether or not amended as proposed by the Treasury draft language of May 31, 1962, would prove harmful to the economic future of the United States and would conflict with efforts of government and business to increase U.S. foreign trade. Enactment of these provisions would weaken rather than strengthen our balance-of-payments position, make our tax system discriminatory rather than neutral, and would deliver opportunities to our foreign competitors. Our statement of April 24 to this committee (p. 3232 to 3275 of pt. 7 of printed hearings before the Senate Finance Committee on H.R. 10650) gives our reasons for reaching these conclusions, and they are also applicable to Treasury's May 31 substitute for section 13.

Our April statement also covers in detail the unintended consequences that would result from enacting the foreign tax credit amendment recommended by the Secretary of the Treasury for the first time on April 2. (See pp. 103 and 104 of pt. 1 of the printed hearings.) This proposal would also be harmful and could prejudice the efforts of our affiliates in Venezuela and in other areas to aid the industrialization and quicken the economic development through participation in local enterprises in those areas. It is hoped that the committee will find that the proposed tax credit change is unnecessary but if one is to be made, the implementing language should be modified to limit application to short-term investments as intended by the Treasury and as evidenced by testimony of the Secretary before this committee on May 10. (See pp. 4259 and 4260 of pt. 10 of printed hearings.)

While the May 31 Treasury draft does not contain revised language to conform with this testimony in relation to the foreign tax credit, it does propose a complete substitute for section 13. This substitute would go beyond the removal of the true tax-haven abuses to harm legitimate American enterprises operating abroad. Such legitimate investments strengthen our economy and contribute favorably to the U.S. balance-of-payments position. Yet they would be discouraged. For example, the proposed section 13 would in some circumstances increase the effective tax burden on the income derived by an operating subsidiary abroad if such company—

1. Operated throughout a region, developed or underdeveloped, and sold products in various countries—even though neither the sales nor the purchases were made in the United States;
2. Chose to expand its operations into another country, developed or underdeveloped;
3. Chartered ships to a related person;
4. Were incorporated in a developed country but conducted active operations in an underdeveloped country;
5. Rendered services to a related person, in a developed or underdeveloped country;
6. Operated in a country that devalued its currency, developed or underdeveloped; or
7. Needed to acquire a patent, copyright, formula or process from a related U.S. person.

All of these forms of normal business activities, and others, would be hit—unnecessarily hit—by the proposed section 13.

The May 31 draft of section 13 would place unjustifiable emphasis on confining business activities of a foreign corporation solely to the country of incorporation. It would treat as tax-haven income the earnings from almost any business activity with a related person by expanding the foreign base company sales provision of the House version, by treating business investments in operations in third countries as if they were passive-portfolio investments, and by adding a new provision to tax income from services rendered to related persons. Attach-

ment I contains several examples of how the Treasury redraft of section 13 would affect the operations of Standard Oil Co. (New Jersey).

An international company, such as Jersey Standard, to avoid classification of certain business earnings as tax-haven income, would have to—

1. Reorganize extensively long-established operations abroad at costs which might involve prohibitive local or even U.S. taxes;
2. Increase current operating costs by being required to maintain unnecessary and costly local companies in each country in which it operates;
3. Be continually reorganizing as new nations emerge or achieve independence, or as country boundaries change; and
4. Exercise constant vigilance to see to it that the flow of its international trade is diverted to these narrow channels.

Even though the Treasury has advocated tax legislation that would favor investments in the less developed areas, the revised section 13 would make it even more difficult than would section 13 of H.R. 10650 to invest in the less developed areas. Actually, in our view, there is no justification for any distinction based on the economic status of a country. In our business the refining and marketing investments in the developed areas make possible our investments and earnings in the developing countries. We are sure this is true of many other industries. Because of the interdependence of one function or location of an international business on other functions and locations, any attempt to confine reinvestment of earnings to a single country or area of the world can only result in imposing unnecessary penalties on international business.

Our recommendation, therefore, is that section 13 of H.R. 10650 or its proposed revision be held over for further serious study. We agree that there have been abuses which should be eliminated, but we believe this can be done by enforcing existing law and without adding to our tax law the complexities and inequities inherent in section 13. Abuses through manipulation of prices charged between related persons for U.S. exports or imports are identifiable. So are sham foreign corporations engaged primarily in passive investment abroad. But, certainly, it is not an abuse, as Treasury claims it is, to minimize foreign income taxes by use of appropriate corporate organizations for business operations abroad. Increasing foreign profits accruing to U.S. shareholders, whether by improved operations or by better organization, benefits rather that harms the U.S. economy and the Federal revenue.

A period of study would give an opportunity to test the conclusion of many expert witnesses that the real abuses are in truth prohibited by existing tax law and so could be eliminated by more forceful application of such existing law in the light of more extensive reporting requirements recently enacted. If some additional legislation is considered indispensable, it would be possible to enact an allocation formula for use by the Treasury in dealing with borderline cases in the pricing of U.S. exports and imports. This is the purpose of section 6 of H.R. 10650.

Many legally competent witnesses have pointed out that there are serious doubts as to the constitutionality of section 13-type proposals to tax one person on the income of another. There is also a question whether such provisions could be applied to subsidiaries in many of the 21 countries with which the United States now has tax treaties without renegotiation of the treaties involved. Our legal advisers believe that these doubts are real and constitute serious obstacles to any section 13, including the Treasury revision of May 31, becoming fully effective. In any event, for years after enactment business decisions must be clouded with uncertainty as to the tax consequences of future operations abroad.

If, nevertheless, a section 13 is to be enacted, attachment II lists some of the principal modifications that should be made.

Our conclusion is that section 13 as revised by Treasury should be rejected, even though it would make some improvements in section 13 of H.R. 10650. Certainly elimination of the antidiversification rule is highly desirable, and certain other changes suggested would be helpful. But, as mentioned above, the new draft would also introduce new concepts which would increase the inequities and complexity of section 13. It would add considerably to the difficulties of doing business abroad. In our case, this would be particularly true of our operations and plans for expansion in the less developed countries. Our international operations in the developed countries would also be made more difficult. American business would be denied legitimate opportunities to reduce foreign taxes, and thus the result could be less rather than more revenue to the U.S. Treasury. The Treasury's task of enforcement would be made more rather than less difficult by new complexities. Most importantly of all, the proposed section 13 would

harm foreign business operations which have no flavor of tax abuse. The section would, in particular, harm legitimate operations in underdeveloped countries.

ATTACHMENT I

HOW THE MODIFICATION OF SECTION 13 OF H.R. 10650 IN THE TREASURY DRAFT (MAY 31, 1962) COULD AFFECT THE OPERATIONS OF STANDARD OIL CO. (NEW JERSEY)

1. We are expanding our fertilizer business in the underdeveloped areas of the world, particularly in South America. Under section 13, as revised, if we used one corporation to conduct this fertilizer business throughout a given region in Central or South America, it could be classed as a tax-haven operation. If a foreign holding company were to establish a separate company in each less developed country, involving substantial additional operating costs, no tax-haven operation would be involved as long as the holding company reinvested dividends in its subsidiary companies. This is a substantial change from the House-passed section 13 which would have permitted reinvestment of operating income in less developed countries.
2. If one of our foreign subsidiaries suffered losses through expropriation, confiscation or catastrophic accident after profitable years in which it had undistributed subpart F income which incurred U.S. income tax, the losses would not be allowed as deductions to recover such tax.
3. Our foreign-flag tankers which are owned by foreign affiliates are frequently chartered to other foreign affiliates. The Treasury draft might be construed to classify some of this income as tax-haven income.
4. Profits and interest received by a foreign affiliate from supply contracts would be treated as tax-haven income if received from an affiliate incorporated in a different country.
5. For good historical reasons, our United Kingdom affiliate conducts its operations in Ireland through a wholly owned Irish subsidiary. Dividends from the Irish company would be considered tax-haven income even though the operations in the United Kingdom and Ireland are both parts of a single, integrated active business.
6. If an operating foreign affiliate entered directly into the chemical business in another country, the income therefrom would be treated as foreign base company sales income.
7. The producing and refining income of a long-established Canadian incorporated affiliate generated in less developed countries wuold be tax-haven income.
8. Jersey could be taxed under section 13 if a foreign affiliate had local currency earnings in a given year equivalent to $100 classified as subpart F income. If, in a subsequent year, the affiliate had the same amount of income in local currency but equivalent to only $60 because of devaluation, and then distributed the income of both years, we would receive $120 but would have been required to report taxable U.S. income of $160.

ATTACHMENT II

SUGGESTED MODIFICATIONS OF SECTION 13 OF H.R. 10650

If section 13 is to be enacted, it should be modified as outlined below. It is reiterated that passage of section 13 even in such modified form is not recommended.

1. No attempt should be made to apply U.S. tax currently to any income of a foreign subsidiary reinvested in an active business anywhere outside the United States.
2. The provisions relating to income from international sales or services should be eliminated since any abuses in this field could be dealt with under section 482 of the Internal Revenue Code, fortified, if necessary, as called for by section 6 of the bill.
3. The provisions relating to income from use of patents, processes, or similar property rights developed in the United States should be deleted since any abuses in this area can also be handled under section 482 of the Internal Revenue Code and without the necessity of enacting the proposal in the May 31 Treasury redraft of section 13, to tax certain capital gains as ordinary income.

4. Income from rents, royalties, dividends, and interest directly related to the active conduct of a trade or business or received from an operating subsidiary should be excluded from passive or foreign base company income.

5. There should be a complete exclusion from the provisions of section 13 where a specified percentage, say 50 percent, of a U.S. person's earnings attributed to foreign sources is currently includible in U.S. taxable income either as dividends from foreign corporations or as earnings of foreign branches of U.S. companies.

The CHAIRMAN. Thank you very much.

Senator Curtis?

Senator CURTIS. Have you been in consultation with the Treasury on the proposed substitute for section 13?

Mr. COLLADO. We have been in consultation with the Treasury on an amendment to section 13 which would be what you might call a nonapplication clause under certain circumstances.

We also talked with the Treasury very extensively about each aspect of section 13, giving them extensive indication of how it would affect our particular business.

Senator CURTIS. Could you just briefly, because we have a long list of witnesses and a heavy schedule here, tell us what is your amendment aimed at?

What is this proposed discussion you have had with the Treasury concerning the proposed amendment to section 13? What would that do?

Mr. COLLADO. Senator, we really have had two discussions. One would be in detailed amendments to section 13 to eliminate those proposals which we have spelled out in attachment 2 of the document before you, and they are all written out on the last page of the document you have.

Senator CURTIS. The document attached?

Mr. COLLADO. Yes.

Basically, our proposals here would be to exempt from the application of section 13 any current active operations outside of the United States.

Senator CURTIS. Then what would it cover?

Mr. COLLADO. Section 13, if it were to be provided, I think would continue to include only those transactions of passive investment, as the Treasury talks of it, as contrasted with active investment.

The abuses through pricing are covered elsewhere in existing section 482 and in section 6 of the bill. It would be a limited amount left in section 13.

But our strong view is that the legitimate foreign operations of a company like our own should not be attacked by further tax legislation at all. We do not see any reason for that.

Now, I think you perhaps had in mind the other question that we have also been discussing with the Treasury, which is that if there is to be a section 13, which we would hope there would not be, there should be a provision that would set up some form of test so that if you return in earnings, dividends and the like an adequate amount of your foreign earnings you would exempt from section 13.

We have had rather extensive conversations on this issue with Treasury going back many months, and, more particularly, in the last few weeks, and I think that may be what you are referring to.

Senator CURTIS. That is all, Mr. Chairman.

The CHAIRMAN. Thank you very much, sir.

The next witness is Mr. Stanley Ruttenberg of the AFL-CIO. Take a seat, sir, and proceed.

STATEMENT OF STANLEY H. RUTTENBERG, DIRECTOR OF RESEARCH, AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS

Mr. RUTTENBERG. Mr. Chairman and Senator Kerr, I have a longer statement which I would like to have included in the record, and if I might just in a brief few minutes summarize it for the benefit of the committee.

It seems to me, in looking at the overall issue of section 13, to which I shall restrict most of my comments this morning, one loses sight of the overall objective which lies behind this provision, which lies behind the whole concept of the removal of tax deferral on income earned overseas by foreign subsidiaries.

The proposal is made not to stop the flow of capital or private capital out of the United States.

It is not designed to prevent companies from operating overseas. It is designed to remove the tax differential as a factor which enters into decisions to invest or not to invest.

There are, it seems to those of us in the labor movement looking at this problem, three major arguments advanced against the elimination of complete tax deferral.

I might say, Mr. Chairman, that we support not the proposal made by the Treasury and the Secretary of the Treasury in late May to amend section 13, but, on the contrary, we support the position taken by the Secretary in his testimony before this committee on April 2 and the position which the President of the United States has taken in discussing the question of taxation of income earned overseas. We are for the complete termination of deferral of taxes overseas, whether earned through sham tax haven corporations or what others would call legitimate tax havens overseas, as well as income earned overseas by manufacturing subsidiaries of American corporations.

There are three basic arguments which are advanced against the complete deferral of tax income earned overseas, and these are:

(1) That it conflicts with our Trade Expansion Act;

(2) That it would unfavorably affect our balance of payments; and

(3) American corporations must operate overseas in order to retain a share of their business or they would lose it to foreign corporations.

Let me deal with each of these three points very briefly. I deal with them in considerably greater detail in the statement which has been inserted into the record.

The first issue is that it conflicts with our Trade Expansion Act. At the outset, I think one ought to look very carefully at exhibit 3, presented by the Secretary of the Treasury in his testimony on the 2d of April before this committee. I might point out that there has not been any refutation of the conclusions in exhibit 3.

They are, namely, that if an American corporation invests a dollar in a developed country overseas, it produces a net export effect on the United States of 4 cents, but a dollar invested in a less developed country, in Latin America, Asia, Africa, etc., would produce a net export effect of 40 cents.

This is a 10 to 1 ratio, and the concept of this bill is to continue tax deferral for income earned in less developed countries but remove the tax deferral for income earned in developed countries.

The second point is that it would adversely affect our balance-of-payments situation. In the first place, one has to look at this problem not in terms of the dividends returned to the United States on the basis of outstanding private investments that have been invested over many years. We must look specifically at what is the current year's relationship of the outflow of capital to the return on that capital, which is invested that year, and not on the capital which is invested over a period of 30 or 40 years, because our balance of payments was not a serious problem 10, 15, or 20 years ago.

It was not a serious problem until the last 3 or 4 years, and therefore, one ought to look at the capital outflow in relation to the return of investment on that capital in relation to the year-by-year situation.

For example, the Treasury has pointed out that if one looks at the new private capital which flowed out of the United States between 1952 and 1960 to Canada and Western Europe and compares it against the inflow resulting from that capital investment, one finds that the dollars flowing out exceeded the amount of the return over this 8-year period by $1.1 billion.

This shows up as an unfavorable balance of payments situation with a net outflow of capital instead of a net inflow.

Thirdly, it is argued that if we do not invest, if American corporations are not permitted to invest overseas, a foreign company will take over the business and fill the market demand for the product because those U.S. companies could not export from the United States.

They must get into the indigenous countries where the markets are or in countries overseas so that they can compete for third markets from production facilities in Germany or in the Common Market or in Great Britain, as contrasted to production for third market products from the United States.

I think, in looking at this, one has to examine the problem of whether the United States can actually compete overseas, and I think we have been quite successfully competing from U.S. based, manufacturing facilities with operations overseas in example after example.

One of the best examples is the Underwood Typewriter Corp., recently purchased by the Olivetti Co. of Italy, which is operating in Hartford, Conn. They are exporting American-made typewriters instead of going overseas to produce typewriters to compete in the world market.

We can compete.

And then I think we must also consider that if the U.S. company does lose the business to a foreign company operated by, or whose ownership is not American, that no great harm is done to the United States by this. As a matter of fact, considerable help may be done to the United States by permitting certain of the oversea

countries to have earnings from their exports which they need to resolve their balance-of-payments problems.

For example, I question the validity of our trying to absorb too large a part of the world export market in the face of the serious balance-of-payments problems which countries like Japan and Great Britain and others actually have.

So that it seems to me that no great harm is done to the United States if business sometimes is lost to a foreign corporation, particularly if U.S. companies lose it because they are not operating in the oversea developed country because they no longer enjoy a tax windfall.

But if they operate in the less-developed countries, they would continue to have tax deferral.

Having very briefly and hastily gone through these three points, Mr. Chairman, I want to conclude with two general statements:

(1) We feel very strongly that the present tax bill before this committee must include, as it is reported from this committee, a section dealing with the taxation of foreign income, namely, of the type of section 13 of the bill, but improved in line with the basic suggestions which we made in our testimony on April 2, and with which we are still in agreement, namely, that much of the problems, such as the antidiversification problem of income earned by manufacturing subsidiaries in developed countries, would be eliminated if we move completely to the concept of complete elimination of deferral of taxation, complete deferral of income earned overseas.

And, therefore, we feel very strongly that a provision eliminating this tax deferral must be contained in any tax reform bill which is reported by this committee.

(2) Might I conclude with a general comment about those who argue that there is an inconsistency between the Trade Expansion Act, which has recently been passed by the House and will soon be considered by this committee, and this tax provision, namely, the section 13 of H.R. 10650.

I must say that the AFL–CIO does not think there is any fundamental or even slight inconsistency between these two bills. The Trade Expansion Act would be further helped and promoted by a sound approach to the problem of the taxation of foreign income, and our whole concept of supporting the Trade Expansion Act has been based upon the notion that, hopefully the United States would close the loopholes which now exist with respect to deferred income earned overseas by American corporations.

Thank you very much.

(The complete prepared statement of Mr. Stanley H. Ruttenberg is as follows:)

STATEMENT OF STANLEY H. RUTTENBERG, DIRECTOR OF RESEARCH, AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS ON THE REVENUE ACT OF 1962

In its statement before this committee on April 4, 1962, the AFL–CIO said:

"We urge the complete termination of all special tax exemptions and deferral privileges now enjoyed by Americans living abroad and businesses operating overseas, except in the case of income earned in less-developed countries."

We hold to this position today. In fact, evidence presented to this committee on April 2 by Secretary Dillon, after our own statement had been prepared, has further strengthened our conviction on this matter. Our position, in effect,

supports the proposals of the President made in April 1961 and reaffirmed by Secretary Dillon in April 1962.

We unalterably oppose any effort to compromise these proposals and we urge the committee to reject any amendment which would do so.

I will address myself specifically to section 13 of the proposed act dealing with taxation of controlled foreign corporations because of the time limitation and the importance we particularly attach to that section.

It is our view that action by this committee which does anything less than completely eliminate tax deferral on the earnings of all American-owned foreign subsidiaries (except in less-developed countries) will endanger the vital interests of this country and, particularly, the welfare of its workers.

Enactment of restrictions on the operations of tax havens, even if broadly defined, will not be sufficient. The time has come to end all tax privileges which induce American firms to favor investment overseas in preference to investment at home and thereby discourage job creation and economic growth in the United States.

Spokesmen for those who seek to maintain special tax windfalls for income earned overseas naturally must argue that these special priviliges advance the national well-being. Yet, none of their claims stand up against the carefully documented and tightly reasoned testimony Secretary Dillon presented to this committee on April 2. On the contrary, existence of these tax benefits is harmful to most Americans and does direct injury to our national economy.

It is alleged, for example, that capital investment overseas, which is now increasing at the rate of about $5 billion annually and is largely financed by reinvestment of oversea earnings untaxed by the United States, increases employment opportunities for American workers. This is supposed to occur because U.S.-owned foreign subsidiaries buy machinery, components and raw materials made in the United States.

Actually, oversea investment is destroying job opportunities at home, and Secretary Dillon's counterarguments leave no room for doubt. By statistically checking the impact of a dollar of new investment in manufacturing in Europe, the area where U.S. capital outlays are now soaring, he gives the lie to the job-creation legend. When the exports these investments induce are balanced against sales by foreign subsidiaries to the United States, only 4 cents' worth of net exports from the United States was found to result from each dollar invested in Europe.

Put another way, if an American dollar now stimulated to go to or to stay in Europe because of tax deferral privileges can be encouraged to stay home by removal of the privilege, and anything more than 4 cents of that dollar is then invested at home, employment and income in this country are benefited.

But this isn't all. Even this calculation ignores the factor of "displaced U.S. exports," exports we might have been making to the European countries where the subsidiaries are now located and sales to third-country markets, but which are lost to production here at home because of substitute sales by U.S.-owned foreign subsidiaries.

Although no one can precisely measure this displacement effect on U.S. exports and U.S. jobs, it is substantial. According to the Secretary, if even only a little over 1 percent of the sales of U.S. subsidiaries in Europe displaces exports that would have come from the United States, "the net export impact of U.S. investment in Europe is completely wiped out." Since the displacement incontestably is far greater, it is apparent that the jobs of thousands of Americans are being wiped out.

After his painstaking examination of the consequences of U.S. investment in both Europe and Canada, the Secretary concludes that "elimination of tax deferral in those areas would almost inevitably have a favorable effect on income, employment and growth here at home."

On the other hand, according to Secretary Dillon's findings, we get a very different picture of the effect of U.S. manufacturing investment in the less-developed countries. Because alternative sources of supply are very limited in these areas, a U.S. dollar invested in them produces a 40 cents "net export" gain, a factor 10 times more favorable to employment at home than investment in Europe. It is precisely in these areas that U.S. tax deferral would continue under the President's proposals.

The Secretary, in addition, has effectively refuted the assertion that oversea investment is helping to mitigate the current balance-of-payments problem. The opposite is the case, and only a statistical sleight-of-hand gives the appearance of validity to this assertion.

Opposition spokesmen have simply taken a recent year and added together profits returned from the foreign subsidiaries of particular U.S. corporations and U.S. exports to these subsidiaries. Then they have subtracted new investment dollars sent to these subsidiaries from the United States. The resulting balance shows a net favorable cash inflow to this country, they maintain.

Actually, in this kind of comparison the dollar inflows and outflows are not properly related to each other. As the Secretary notes, "the dividends and U.S. export receipts (inflows) of 1 year or period, have been generated by investments (outflows over many years prior to the current year or period; that portion of the inflows that has been generated by past investment, then, has nothing whatsoever to do with the outflow of the current year or period in question."

In its effort to obtain the actual facts, the Treasury carefully isolated the new capital outflow to Canada and Western Europe for the period 1952 to 1960 and checked it against inflows related to that period. It found that dollars going out of the United States exceeded those coming in by $1.1 billion.

While, ultimately, U.S.-owned foreign subsidiaries inevitable will reduce their rate of capital expansion, the trend now is in the opposite direction and currently worsens our balance-of-payments problem.

By ending all tax deferral on foreign earnings as the President proposes, tax-induced oversea investment (except in the less-developed areas) would end. As a consequence, according to Secretary Dillon, there would be "a net favorable effect of $200 to $400 million in the early years following the new legislation." Indeed, this would go far toward ending the payments deficit crisis.

On the other hand, because the net export gain for the United States from manufacturing investment in less developed countries is 10 times greater than from industrially advanced countries, increased investment in such areas aids the United States with respect to our balance-of-payments problem. And it is in these areas alone that the administration proposes to continue to encourage investment through continued tax deferral.

Finally, the opposition argues that ending tax deferral on oversea earnings would cause American business to lose profitmaking opportunities abroad to investors from other countries.

It is evident, however, that the American people are now being asked to pay too high a price in behalf of this private profitmaking opportunity overseas. Continuing the artificial tax inducement of investment in prosperous industrialized countries abroad, no matter how profitable for a few, no longer can be rationally justified in the face of:

(1) The consequent reduction of employment opportunities for Americans at home. It is sheer folly to continue to sanction U.S. tax subsidies which entice American dollars to go and to remain overseas by making foreign investment more attractive than investment here at home.

(2) The adverse current impact of this tax-induced foreign investment growth upon the international balance-of-payments position of the United States.

(3) The continued loss by the Treasury of millions of dollars of sorely needed revenue as a consequence of tax deferral, a revenue loss which the taxes of Americans who work and invest at home have to make up.

What is more, it is worth pondering whether continued tax encouragement which leads to more and more billions of dollars' worth of American ownership of plants and facilities in other lands truly is in our own long-range political interest. Apart from the frequent need for the investment of private "seed" money and the granting of long-term repayable loans, constantly mounting absentee ownership creates attitudes that are not always conducive to friendly relations between sovereign states.

Finally, it should be recalled that other friendly nations often have need to increase their oversea sales because of their own frequently urgent balance-of-payments problems. To crowd them out of world markets—particularly with U.S. sales based on the production of U.S. subsidiaries abroad—can be a dangerous policy both in terms of their long-range interests and our own.

It may be argued by some that profitable investment opportunities in the United States simply are not sufficient in relation to the current cash accumulations of American corporations available for investment. Indeed, the spendable yearly cash flow to American companies—made up of undistributed profits and depreciation set-asides—has soared from $30 billion in 1953 to about $54 billion this year. Meanwhile, in recent years the total investment in new plant and equipment in the United States has grown very little.

It is our view, however, that investment opportunities here at home are abundant if they are eagerly sought and if profit expectations are held within

reasonable bounds. If the yearly cash flow of American corporations is truly too great to be reinvested within the United States, it would seem that other alternatives than exporting these surplus dollars abroad should suggest themselves to those who write our fiscal legislation.

In conclusion, the AFL–CIO continues to support the view of the President and of Secretary Dillon that deferral of taxation of the income of controlled corporations—all corporations except in less developed areas—should now be ended. As a consequence, we oppose the proposal which emanates from the House of Representatives that tax deferral be allowed if the profits of an oversea subsidiary are invested in itself. Furthermore, for us the problem of definition of "antidiversification" does not exist because we reject as inimical to the welfare of American workers and to the entire Nation any further tax deferral for any reason whatsoever.

We also note in the Secretary's transmittal letter accompanying the committee print of May 31 that draft amendments to section 13 have now been prepared "as an iad to the committee if it prefers the more limited tax-haven approach." We emphatically oppose this draft amendment and every other amendment that in any way compromises the stated administration objective to end all preferential tax treatment on income earned abroad, and we hope this committee will support our view. Indeed, our position with respect to the entire bill ultimately will be heavily influenced by your action on this section.

Finally, we must take note of the rumor that some who now enjoy special advantages because of tax deferral have threatened to withdraw support for the Trade Expansion Act if these oversea tax privileges are now ended.

If this rumor is correct, it amounts to a shocking declaration of war by a few American corporations with oversea interests, against the welfare of their fellow citizens and particularly against America's wage and salary earners.

The AFL–CIO has supported the Trade Expansion Act, not to lessen investment in the United States and liquidate job opportunities for Americans, but to expand them. At the same time we oppose continued tax inducements to expand American investments overseas for many reasons affecting the national welfare, including the fact that these tax windfalls stultify investment growth and employment opportunities in the United States.

It now appears, on the other hand, that some American firms with expanding oversea production seek to maintain their special U.S. tax windfalls as a means of financing their growing oversea operations and concurrently seek lower tariffs through the Trade Adjustment Act so that more of their mounting oversea production can be shipped back home.

We are confident that it will be abundantly clear to this committee as it weighs its decision on section 13—in terms of the stimulation of job opportunities and economic growth here at home, the balance-of-payments problem, and tax equity and revenue needs—where the interests of the American people truly lie.

With respect to other ways in which U.S. businesses and individuals enjoy tax preference if their income is earned abroad instead of at home, we hold to the position, stated in our testimony of April 4, that they must end. We support the position of the President, endorsed by the House in H.R. 10650, that credits for foreign tax paid against U.S. taxes must not be permitted to reduce the effective U.S. tax rate below 52 percent. We support the President's request—not concurred in the House—that all tax exemption for U.S. citizens who reside abroad (except in less developed countries) be ended. We support the provisions of H.R. 10650 with respect to the tax treatment of earnings of U.S. citizens from foreign investment companies and from the sale of stock of foreign corporations, and the elimination of exclusion of real property located overseas from the U.S. estate tax base.

Senator Kerr. Thank you very much, Mr. Ruttenberg.

Senator Curtis. Mr. Ruttenberg, what is your definition of a "tax haven"?

Mr. Ruttenberg. Senator Curtis, there are all types of tax havens, and in discussing this problem with various people, various businessmen, for example, some of whom have appeared before the committee this morning, they say:

"We are against tax havens. We want to get rid of the abuses of tax havens."

But when you pin them down as to what they mean by "tax havens," everybody has a different notion and a different concept as to what it is.

Senator CURTIS. What is yours?

Mr. RUTTENBERG. I would say a "tax haven" is that type of a corporation, a sales facility operating overseas, selling the bulk of or receiving the bulk of its income from the sale of goods outside of the territory in which it is incorporated.

For example, a U.S. company exporting from the United States but operating through a few bookkeepers that sit over in Panama City is strictly a sham, offshore, tax-haven corporation.

No products flow through Panama. Nothing is sold in Panama. As a matter of fact, the only thing that flows in Panama are invoices, and the goods flow from the United States to areas overseas.

This is strictly a tax haven and one referred to as a sham.

The second——

Senator CURTIS. If that sales corporation is a foreign corporation, and we will assume it is owned by a parent corporation in the United States, suppose the parent corporation pays a full domestic tax on its earnings.

It is your contention that they should also pay taxes on the subsidiary that they own on the income earned abroad before it is brought back here?

Mr. RUTTENBERG. Yes.

It is my contention that the income assigned or allocated to the Panamanian tax-haven, sham corporation should be subject to U.S. tax.

Senator CURTIS. Are all foreign subsidiaries, sales or marketing corporations, are all of them shams?

Mr. RUTTENBERG. As I started to say, Senator, I would describe three different types of tax havens, one which we have discussed, the Panamanian sham type. That is clearly a sham.

Senator CURTIS. Are all marketing corporations set up in Panama shams?

Mr. RUTTENBERG. Well, you know, all of them—it would be my judgment that it is a rare exception, if it is not, but, in any case, we should not really take Panama exclusively because it applies in the entire Caribbean area, to Liechtenstein, it applies in part to Switzerland and other parts of the world where the corporation tax rate is low.

Most of them, the overwhelming majority, if not the total, of them, are sham corporations.

But, in addition, there are the manufacturing facilities of American companies, say in Germany, in Great Britain, or in France that sell their manufactured products, in the main, outside of the country in which it is produced. Instead of selling it through the manufacturing subsidiary in Germany or in Great Britain, they incorporate a sales corporation in Liechtenstein or in Monaco or in Switzerland and, therefore, accrue the profit not to the German manufacturing subsidiary, where they would have to pay the German tax which is very close to the U.S. tax, but they accrue the tax to the sales corporation incorporated in Switzerland or in Liechtenstein where the tax is relatively little.

This I would also consider a tax haven.

Senator CURTIS. How is that in relation to the U.S. tax in the illustration you have cited? If they produce their product in Germany, according to your statement of a hypothetical case, if they marketed it in Germany, the German tax would be substantially or near what the U.S. tax would be.

Now, you say that they create a sales corporation in Liechtenstein because the tax is less there. Have they in reality avoided a German tax or an American?

Mr. RUTTENBERG. They have avoided both a German and an American tax because a corporation owned overseas by Americans, but incorporated on foreign soil in a foreign country, should not escape U.S. taxation.

I think we have cleared this issue up in terms of the Foreign Personal Holding Company Act which has been declared constitutional and the issue is not a constitutional one.

Senator CURTIS. What is the tax rate in Germany?

Mr. RUTTENBERG. The tax rate in Germany is either 50 or 51 percent, in that general neighborhood.

Senator CURTIS. All right.

Now, according to your hypothetical case, they set up in Liechtenstein or some place to collect profits, according to your statement of the hypothetical case, that were actually made in Germany?

Mr. RUTTENBERG. Made on the products produced in Germany.

Senator CURTIS. It is a German tax?

Senator KERR. With sales headquarters in Liechtenstein and the stock is sold in——

Senator CURTIS. And not the U.S. tax; is that correct?

Senator KERR. Would the Senator yield?

Senator CURTIS. Yes.

Senator KERR. He is talking about a situation where the manufacturing plant is in Germany, the sales in Liechtenstein, and the markets in France.

Mr. RUTTENBERG. Or the market might be in Africa or any place.

Senator CURTIS. How does that avoid the U.S. tax and where do we have any jurisdiction?

Mr. RUTTENBERG. Because, in the first place, this bill, H.R. 10650, does, as it was passed by the other body, include a provision which says that income earned by a manufacturing subsidiary such as the German one that does not operate through the Swiss or Liechtenstein sales facility, but actually sells in Germany, is to be subject to U.S. tax unless it does one of two things—

(1) Invest the income derived in a less developed country; or

(2) Invest it in itself.

So that the concept of taxing the differential between the U.S. rate and the German rate has been accepted by the bill as it is now before this committee.

Senator CURTIS. The existing law, is that money were earned in Germany, transmitted here, and the credit for the foreign tax paid would be 51 percent against a 52 percent tax rate, so it would be 1 percent?

Mr. RUTTENBERG. Except that the gross, which is also contained in 10650, I hope will continue to go through, which will make the rate effectively 52 instead of something else.

Senator CURTIS. If that German company sells throughout Europe and there is a separate corporation that handles the sale, that involves the question of the German revenue rather than the U.S. revenue, is that not right?

Mr. RUTTENBERG. Only to the extent of the German tax of 50 or 51 percent, but not to the extent of the rest of the tax which should be paid by the foreign subsidiary owned by the American company.

It is to this issue that, you see, they not only avoid the entire German tax, and a very small portion of the U.S. tax, by selling through Switzerland, but they——

Senator CURTIS. You talk about a holding company and that sort of thing.

I think it is clearly the intent of the law that if income is really earned in the United States under the American flag, you cannot transfer your pocketbook some place else and establish an artificial jurisdiction and avoid the tax.

That would be clearly a tax haven.

But we are asked in this particular bill to extend our jurisdiction and tax income that is not earned in the United States and before it gets here.

Do you support that?

Mr. RUTTENBERG. Yes, I support that, Senator, because, actually, if one looks at existing law, the U.S. Congress has accepted the notion of taxing income earned overseas by an American entity, by an American individual in the Foreign Personal Holding Company Act.

That is not a new concept in American tax law. It goes way back.

Senator CURTIS. I think it is.

Mr. RUTTENBERG. Well, the Congress accepted this years ago, sir.

Senator CURTIS. I think not.

I think the statement that no major commercial nation has taxed income earned by a foreign subsidiary before it is brought in has never been extended by any country.

Now, what is your definition of exporting jobs?

Mr. RUTTENBERG. Well, I could give you specific examples of this, of course.

An American company closes down its American facility, opens up a factory overseas and produces not only for the oversea market but for the American market as well and reexports back to the United States.

This is very definitely an export of an American job, Senator.

Senator CURTIS. In other words, you would adhere to the definition you have set forth in your article in Business Horizons of a year ago?

Mr. RUTTENBERG. Yes, I would, in the University of Indiana magazine; yes.

Senator CURTIS. Yes.

You said the definition of exporting a job as invented here refers to American companies' foreign production of goods designed for sale in the American market?

Mr. RUTTENBERG. That is only one aspect of it, of course, Senator Curtis.

If frequently, for example, an American company could produce in the United States for export to either the Common Market or to a third country, but, instead, closes its American facility and goes overseas on the hypothetical argument that it must establish a production facility overseas in order to continue to have that share of the market,

I say I think that is hypothetical in most instances, and that would very definitely be an export of American jobs, even though the output of the oversea factory does not come back to the United States.

It takes the place of a former U.S. export, Senator.

Senator CURTIS. You are aware of the fact, of the American oversea production, only a small portion comes back to the United States?

Mr. RUTTENBERG. Oh, yes.

Senator CURTIS. And would you not also agree that that can be reached in another manner through tariff and trade legislation?

Mr. RUTTENBERG. I do not think it ought to be reached through tariff and trade legislation.

Senator CURTIS. I did not ask you that. I asked you if you would not agree that it could be?

Mr. RUTTENBERG. Oh, it could be if we wanted to move to a protectionist position on foreign trade.

But I think what is involved here is not the stopping of the exporting of American jobs or not the stopping of the exporting of American capital.

What is involved in this bill, section 13, as amended, as suggested by the amendments by various parties, is to remove as a factor which enters into the decisionmaking process of a corporation the issue of a deferral of a differential in taxes.

This is the issue.

It is not that jobs, all jobs, should stay in the United States and all capital should stay here. This is not the argument.

Senator CURTIS. I am disturbed—I will admit, percentagewise, it is a small amount—I am disturbed over the exporting of jobs in the sense that a factory once existing here goes abroad to supply the American market.

I very definitely think that that should be taken into account in writing the tariff and trade laws. There used to be a jeweled watch factory in Lincoln, Nebr., that at one time employed 2,000 people.

It is now in Japan, providing watches for the American market.

That has nothing to do with the Treasury's proposal here under section 13, and it will not remedy that situation at all.

Mr. RUTTENBERG. Except that the Treasury proposal does get at that by indirection.

Senator CURTIS. It will not do any good.

Mr. RUTTENBERG. By saying that the income earned by that Japanese corporation, whether it is from the sale of products on the American market, the Japanese market, the Burmese or the Indian market, will be subject to U.S. tax immediately upon being earned.

Senator CURTIS. It will mean that the investors find it more profitable to buy stock in a foreign corporation where the parent corporation is a foreign one rather than to establish a business abroad.

Mr. RUTTENBERG. That is an outflow of U.S. dollars which is an unfavorable aspect in our balance-of-payments problem.

Senator CURTIS. That is what this would encourage.

Mr. RUTTENBERG. It would discourage, just the contrary, Senator.

Senator CURTIS. No, no, I think not.

I think if American businesses cannot establish subsidiary corporations abroad, that there will be American capital that will flow into Belgium, Swiss, German, English corporations, and so on.

Mr. RUTTENBERG. Yes, but income derived from, the dividends derived from the purchase of those——

Senator CURTIS. When it is transmitted.

Mr. RUTTENBERG. When it is transmitted, it would be subject to the U.S. tax.

Senator CURTIS. Yes, and that is the law with respect to American corporations, is it not?

Mr. RUTTENBERG. At the moment.

Senator CURTIS. Yes.

Mr. RUTTENBERG. The present law, yes.

Senator CURTIS. Yes.

Mr. RUTTENBERG. Yes.

Senator CURTIS. Now, considerable evidence has been compiled in this record by companies as to the number of jobs created in the United States by supplying their foreign subsidiary corporations with equipment, raw materials, and other things.

Would you supply for the record the number of members of AFL–CIO whose jobs are created by this business, how many of your members are employed by reason of American parent corporations supplying oversea subsidiary corporations?

Mr. RUTTENBERG. Supplying their oversea manufacturing facility?

Senator CURTIS. All types.

Mr. RUTTENBERG. With component parts?

Senator CURTIS. Sales organization and everything.

Mr. RUTTENBERG. It would be very difficult for us. We do not have such figures, Senator. We could only make an approximation.

Senator CURTIS. There have been quite a few companies here that have given testimony about it, and I wondered if that involved any of your people.

Mr. RUTTENBERG. There is, of course, the third type of so-called tax haven, which I started to describe two of them and we discussed them, the Panamanian type and the German-Swiss type.

The third type would be where all of the production is in the United States. The products are exported overseas, but instead of being done through bookkeeping operations in Panama, are handled through a worldwide sales and services organization that has facilities selling and servicing in Asia, in Africa, Australia, New Zealand, and elsewhere around the world, but who for tax purposes coordinate the sales facility incorporated in, let us say, Switzerland or some other country for tax purposes.

This is a third type of tax-haven corporation.

Senator CURTIS. We have other witnesses to hear, and I do not want to prolong this, but the Treasury has power now to see to it that there is not an improper allocation of the earnings in this company to the earnings of the foreign subsidiary that make their money from sales.

Mr. RUTTENBERG. Senator, if the Treasury and Internal Revenue Service had that authority, it seems to me there would be no reason to have a new proposed allocation formula in the present bill, H.R. 10650, but there is a new allocation formula in that bill precisely for the purpose that it has not been possible to adequately enforce the allocation of income between the oversea sales company and the U.S. corporation, and this is what needs to be closed up, and this is why we need further legislation.

Senator CURTIS. But that is section 6; is it not?

Mr. RUTTENBERG. That is section 6 of the bill, and I say this is another part of it. This is another part of the whole problem.

But you do not resolve the issue of tax deferral by the new allocation formula of section 6.

It helps. It is essential and we need it, but it is not sufficient to do the job.

Senator CURTIS. Now, do you think income that, in truth and in fact, is earned outside the United States by an American-owned foreign subsidiary corporation should be taxed in the United States before the income is sent back?

I am talking about the situation where the foreign subsidiary, in truth and in fact, does earn its income outside the United States.

Mr. RUTTENBERG. I do unquestionably and unequivocally, senator.

Senator CURTIS. Senator McCarthy, do you have any questions?

Senator MCCARTHY. No, I do not think I will ask any questions.

Senator CURTIS. You may take over the chairmanship and call the next witness.

Mr. RUTTENBERG. Thank you very much.

Senator CURTIS. Thank you very much.

Senator MCCARTHY. Mr. Max Goldman?

STATEMENT OF MAX GOLDMAN, ATTORNEY, ACCOMPANIED BY RAYMOND O'NEILL, ATTORNEY

Mr. GOLDMAN. Mr. Chairman and honorable members of the Senate Finance Committee, my name is Max Goldman. I am an attorney and have been a resident of Puerto Rico for over 10 years. The gentleman with me is Mr. Raymond O'Neill, who is also an attorney in San Juan. My associates in this presentation are Mr. O'Neill, Manuel Vallecillo, Robert M. Baker, and Paul Kelberg. We are not here in representation of any particular clients, and we believe that the questions on which we desire to be heard are of vital importance to all Puerto Rico corporations, as well as any we may happen to represent in our respective law practices.

Our concern is with sections 13, 15, and 16 of the bill. Section 16 will require no separate discussion since its application depends on whether a corporation is a "controlled foreign corporation" within section 13.

With respect to section 13, our basic position is that the exclusion from the definition of "foreign controlled corporation" with respect to Puerto Rico contained in section 957(c) as now proposed by the Treasury, is unduly narrow, particularly in the light of the statement of policy of Secretary Dillon of May 10, 1962; that it entails possible income and estate tax consequences to Puerto Rico residents which ought not to be overlooked; and that it unnecessarily creates serious problems for all Puerto Rico corporations.

With respect to section 15, which deals with foreign investment companies, our basic position is that there is no sound reason of policy why a small business investment company organized under the laws of Puerto Rico and licensed by the Small Business Administration under the Small Business Investment Act, which specifically provides for the licensing of SBIC's in Puerto Rico, should be treated as a "foreign investment company." Moreover, the possibility of the use of the pattern of the small business investment company as a vehicle

for private participation in international development programs should not be prejudiced by such treatment.

Our specific grounds for concern as to section 13 are as follows:

With respect to Puerto Rico corporations engaged in the conduct of trade or business activities which do not constitute manufacturing, processing, or operation of hotels under the proposed section 957(c), we do not understand why such corporations have been excluded from the scope of the exception of the proposed section 957(c), in view of the statement of Secretary Dillon of May 10, 1962, and the language of the general description of this section in the "Explanation of Amendments Recommended by the Treasury Department to Section 13 of H.R. 10650."

In his statement of May 10, 1962, before this committee, Secretary Dillon said:

> I would recommend, however, that such corporations not be treated as controlled foreign corporations, since the possessions of the United States, principally Puerto Rico and the Virgin Islands, are not truly foreign areas and present special problems under U.S. tax law which can best be handled outside of the context of the treatment of controlled foreign corporations.

The "Explanation of Amendments Recommended by the Treasury Department," in the section entitled "Major Changes From Section 13 of H.R. 10650," comments on the proposed section 957(c), as amended, as follows:

> 11. Elimination of coverage of corporations in the Commonwealth of Puerto Rico and the Virgin Islands. The draft leaves these corporations subject to the rules of existing law with, however, provision to insure that such corporations will not be availed of for tax haven activities.

In view of these statements which appear to be clear and unequivocal in their meaning and intent, we cannot understand why the language of section 957(c) has been so narrowly drawn as to exclude from its remedial scope Puerto Rico corporations engaged in such activities as the rendition, within Puerto Rico, of transportation or communication services, construction, wholesale and retail sales, or the conduct of service establishments, such as restaurants, laundries, and similar establishments. We do not understand that the derivation of income from nonmanufacturing activities otherwise constituting the active conduct of a trade or business are, per se, tax haven activities. Moreover, when we consider the large number of Puerto Rico corporations, controlled by local residents of Puerto Rico, and engaged in purely local activities, the stated explanation for the limited scope of section 957(c) becomes even less understandable.

Stockholders of such Puerto Rico corporations have up to now enjoyed the same capital gain treatment on liquidation as is enjoyed by stockholders of U.S. domestic corporations carrying on activities in Puerto Rico in compliance with the requirements of section 931 of the U.S. Internal Revenue Code. However, if section 957(c) is enacted in its present form, the stockholders of the Puerto Rico corporation would be subject to the onerous provisions of section 16, even if none of the income of the corporation constitutes "subpart F income." If, contrary to the statement of Secretary Dillon, the "controlled foreign corporation" approach is appropriate in any particular Puerto Rico corporation situations, the application should be on the basis of a more refined approach than a wholesale slaughter of the innocents.

There are possibly unintended Federal income tax consequences for the Puerto Rico resident stockholders of Puerto Rico corporations which are not covered by section 957(c). Under existing law, the income of such a person derived from Puerto Rico sources (which would normally include distributions of a Puerto Rico corporation) is excluded from Federal gross income under section 933 of the U.S. Internal Revenue Code. However, since critical provisions of sections 13 and 16 of the bill require "U.S. shareholders" and "U.S. persons" (both of which include U.S. citizens who are residents of Puerto Rico and most residents of Puerto Rico are U.S. citizens) to include certain items in gross income in terms which are contradictory to the provision of section 933, the serious question of implied repeal in part of section 933 is presented.

Moreover, it is no answer to say that existing corporations which are not covered by section 957(c) may apply for rulings under section 367 and reorganize as section 931 domestic corporations, doing business principally in Puerto Rico.

It must be kept in mind, when we are speaking of Puerto Rico corporations, we are dealing substantially not only with manufacturing corporations, we are dealing with the restaurants, retail service establishments, and other types of business, which I am sure the Treasury and this committee have no concern to deal with under this bill.

Wholly aside from the expense and burden, particularly on small corporations, of securing such rulings, there is a serious estate tax problem involved in the ownership of stock of a corporation organized in one of the States, by a U.S. citizen domiciled in Puerto Rico who was born in continental United States. Due to technical provisions of the U.S. estate tax and the Puerto Rico inheritance tax laws, double estate taxation of the shares of a section 931 corporation owned by such a person at death could be a very real possibility. It is clear that no Federal estate tax credit would be available for the Puerto Rico inheritance tax paid, and that is because the situs of the property would be the place of incorporation, and the Puerto Rico statute is at best doubtful on the allowance of a credit against the Puerto Rico tax for the Federal tax paid, again because of the situs of the stock at the place of incorporation.

Thus, the Puerto Rico domiciliary who was not born in Puerto Rico and who wishes to engage in one of the activities not covered by section 957(c), has the unenviable choice of a Puerto Rico controlled foreign corporation or a section 931 corporation and possible estate tax disaster.

Section 957(c) creates serious uncertainties even for the Puerto Rico corporations engaged in the manufacturing and processing and hotel operating activities which afford grounds for exclusion under the proposed section. There is language in section 957(c) to the effect that the activities described therein and the source of income derived from such activities shall be defined and determined in accordance with regulations to be promulgated by the Treasury. We understand the Treasury's concern that it should have adequate powers to deal with oversea activities which are not bona fide—we believe they have such powers under the allocation rules as they now stand and as amended in the bill—but we submit that it is wholly unnecessary to upset long-settled and carefully considered regulations and precedents. No good reason exists for depriving Puerto Rico corporations of the

guidance of existing regulations and precedents, particularly with respect to the crucial matter of source of income. In opening the way for an entirely new body of regulations and interpretations on this subject, the bill, in its efforts to build a wall against tax haven activities, would also make the ground around it a morass of quicksand on which enterprises engaged in legitimate activities could no longer move with security.

We submit that a section 957(c) drafted to conform as nearly as possible with the applicable provisions of section 931 would implement Secretary Dillon's statement of policy in the most effective and least onerous manner.

In connection with section 15, which deals with foreign investment companies, it remains only to explain why a small business investment company cannot readily be utilized for the type of activities which would make an investment company a tax haven of any significance. Under the Small Business Investment Act of 1958 and the Small Business Act, the definition of a small business in which a small business investment company may invest effectively prevents a small business investment company from making investments in companies of substantial size, the securities of which are readily traded in U.S. and international stock markets. The investment purposes of such a small business investment company generally relate to financial assistance in the establishment of entirely new risk ventures or making available financing to existing small businesses. By law and regulation, a small business investment company is limited to the making of loans of a duration of not less than 5 years. The public policy underlying the Small Business Investment Act with respect to making more readily available sources of financing for small businesses is applicable with special force in Puerto Rico.

Furthermore, the possible utilization of the small business investment company device as a means of participation in the development of Latin American countries under the Alliance for Progress merits careful consideration. It would be most unwise to classify as a "foreign investment company," and lump in with investment companies engaged primarily in holding and trading in marketable securities such a vehicle for assistance to small businesses and for foreign development efforts.

Thank you.

Senator CURTIS. Your criticisms are of the language, what it does, are directed against the latest revision of the Treasury?

Mr. GOLDMAN. Yes, sir.

This statement is particularly directed to the revision as presented in the document entitled, "Explanation of Amendments Recommended by the Treasury Department."

Senator McCARTHY. I have no questions.

(The supplemental statement of Mr. Goldman follows:)

COMMENTS WITH RESPECT TO SECTIONS 13, 15, AND 16 OF H.R. 10650

This memorandum of comments results from a joint study of sections 13, 15, and 16 of H.R. 10650 as revised by the Treasury Department (herein called the "bill"), and is submitted as an addendum to the testimony of Max Goldman, of San Juan, P.R. before the Senate Finance Committee on July 3, 1962. The signatories hereto are attorneys having corporate and individual clients in Puerto Rico.

This memorandum is divided into 5 parts:

Part I describes the existing Federal income tax law applicable to commercial activity in Puerto Rico;

Part II discusses circumstances and events leading up to the draft of section 957(c);

Part III deals with the foreseeable impact of draft section 957(c) upon the shareholders of Puerto Rican corporations;

Part IV contains suggested amendatory language, and reasons therefor; and

Part V discusses the effect of section 15 of the bill on certain small business investment companies.

PART I. PRESENT LAW

Under existing law, U.S. investors intending to establish a business in Puerto Rico may enjoy substantially same tax treatment whether they organize a corporation under the laws of one of the States of the United States or a corporation under the laws of Puerto Rico.

(1) Both types of corporations may be exempt from U.S. tax on income from Puerto Rican sources. Under the code, income from Puerto Rican sources is income from sources outside the United States. A corporation organized under the laws of one of the States of the United States may exclude from its U.S. gross income, under section 931 of the code, all income from sources outside the United States, if it derives 80 percent or more of its gross income from sources within a possession of the United States and 50 percent or more of such income from the "active conduct of a trade or business" within such a possession, Puerto Rico being classified as a possession for such determination. Similarly a Puerto Rican corporation is exempt from U.S. tax on its Puerto Rican source income since it is technically a foreign corporation and foreign corporations are not taxed on income from sources outside the United States.

(2) The tests under the present law for determining source of income are exactly the same whether the corporation is organized under the laws of one of the States (and qualified under section 931) or whether the corporation is organized under the laws of Puerto Rico. Under regulation § 1.931(b)(1)(ii) reference is made to section 861, et seq. of the code for guidance in determining source of income. To the extent that it would be necessary to determine source of income of a Puerto Rico corporation, section 861 et seq. would also be applicable.

(3) The gain from the sale or exchange of shares is accorded the same tax treatment, whether the corporation is a U.S. 931 corporation or a Puerto Rico corporation, except in the case of the liquidation of a subsidiary.

(4) The only substantial difference which a U.S. investor may encounter relates to the privilege of tax-free liquidation. A corporation organized under the laws of one of the States would be permitted to liquidate tax-free into its parent company. Such a privilege would be accorded a Puerto Rico corporation only if a prior ruling were obtained from the Secretary of the Treasury to the effect that the exchange of properties would not have as one of its principal purposes the avoidance of Federal income taxes.

PART II. THE REVENUE BILL OF 1962 AND PUERTO RICO

Section 13 of the bill as passed by the House of Representatives described a new class of corporation under the Federal tax law called controlled foreign corporation. The corporation must be foreign (i.e., not organized under the laws of one of the States or a territory) and more than 50 percent of the voting stock owned by "United States persons." Section 13 did not specifically provide for corporations organized under the laws of Puerto Rico, however, leaving such corporations within the classification of "controlled foreign" if they met the tests of stockownership.

The policy considerations prompting the Treasury Department's request for the legislation contained in sections 13 and 16 of the bill do not apply to corporations organized under the laws of Puerto Rico for the following reasons:

(1) Such corporations have not been used as tax haven devices. Two years ago the Governor of Puerto Rico vetoed a proposal which would have permitted Puerto Rico corporations to pay a nominal Puerto Rico income tax on their off-island income, and Puerto Rico has maintained a corporation income tax with a rate structure sufficiently high to make Puerto Rico corporations unattractive as tax haven vehicles.

(2) The fact that Puerto Rico is within the dollar area removes it entirely from any considerations relating to the balance-of-payments problem.

(3) The designation of Puerto Rico as "foreign" is inaccurate. Puerto Rico is within the U.S. tariff system, is subject to the coastwise shipping laws (which has the effect of increasing freight rates beyond the rates which foreign countries must pay) and is subject to the minimum wage laws of the United States, with special provisions deemed by Congress to be suitable for Puerto Rico.

It was undoubtedly these considerations which prompted the Secretary of the Treasury to make the following statement before this committee in the course of his testimony on May 10, 1962:

"*Nonapplicability to possessions of the United States.*—All corporations not incorporated under the laws of the United States are treated as foreign corporations for purposes of the Internal Revenue Code. As a consequence, corporations incorporated under the laws of possessions of the United States technically might be classified and treated as controlled foreign corporations under the present language of the bill. I would recommend, however, that such corporations not be treated as controlled foreign corporations, since the possessions of the United States, principally Puerto Rico and the Virgin Islands, are not truly foreign areas and present special problems under U.S. tax law which can best be handled outside of the context of the treatment of controlled foreign corporations."

For the reasons stated in part III hereof, it is the opinion of the undersigned that the Treasury Department's proposed amendment to section 13 of the bill does not implement the policy enunciated by Secretary Dillon.

PART III. SECTION 957(C)

The Treasury's draft amendment to implement Secretary Dillon's above-quoted statement is contained in section 957(c). The test provided therein for exclusion of corporations organized under the laws of the possessions is the 80 and 50 percent of gross income rules of section 931 except that section 957(c), unlike section 931, limits the exclusion to "trades or businesses constituting the manufacture or processing of goods, wares, merchandise or other tangible personal property; the processing of agricultural or horticultural products or commodities (including but not limited to livestock, poultry, or fur-bearing animals); the catching or taking of any kind of fish or the mining or extraction of natural resources, or any manufacturing or processing of any products or commodities obtained from such activities; or the ownership or operation of hotels."

The draft amendment also provides for the promulgation of regulations to define such activities, and further provides that source of income shall be determined without regard to section 931 and that regulations shall likewise be promulgated on this subject.

The explanatory text accompanying the Treasury's draft states the following in paragraph 11 under the title "Major Changes From Section 13 of H.R. 10650":

"*Elimination of coverage of corporations in the Commonwealth of Puerto Rico and the Virgin Islands.*—The draft leaves these corporations subject to the rules of existing law with, however, provision to insure that such corporations will not be availed of for tax haven activities."

It is not entirely clear what the feared tax haven activities might be, since, as stated above, corporations organized under the laws of Puerto Rico at least have never been useful for this purpose. It is clear, however, that the draft definitely does not leave many corporations organized in the possessions subject to the rules of existing law, since it does not extend the exclusion to corporations in at least the following industries: wholesale and retail sales for consumption in the possessions, construction, communications, transportation, entertainment and professional services.

The net result of the above-described distinctions which the Treasury has suggested is best described by several examples:

(1) X corporation is wholly owned by a U.S. citizen, resident of New York, and is organized under the laws of Puerto Rico. It engages only in the business of overland transportation of raw materials from dockside in San Juan to manufacturing facilities in Puerto Rico. X is a controlled foreign corporation and any gain realized by the shareholder of X upon disposition of his shares and attributable to earnings accumulated after December 31, 1962, will be taxed at ordinary income tax rates.

Y corporation is wholly owned by a U.S. citizen, resident of New York, and is organized under the laws of Puerto Rico. Y operates one of the manufacturing facilities to which X corporation delivers raw materials. Assuming Y corpora-

tion could meet the 80 and 50 percent source of income tests described in section 957(c), it would not be considered a controlled foreign corporation, since it is engaged in manufacturing. The gain realized by its shareholder upon disposition of his shares would presumably be taxed at capital gains rates, including any gain attributable to earnings accumulated since December 31, 1962.

The reason for the difference in tax treatment of the shareholders of X and Y corporations is not apparent.

(2) X corporation is organized under the laws of Puerto Rico and is wholly owned by a U.S. citizen, resident of Florida. X is engaged in the laundry business only in Puerto Rico. X is a controlled foreign corporation and gain realized by its shareholder upon disposition of his shares and attributable to earnings accumulated since December 31, 1962, will be taxed at ordinary income tax rates.

Y corporation is organized under the laws of Delaware and is wholly owned by a U.S. citizen, resident of Delaware. Y is also engaged in the laundry business only in Puerto Rico. The gain realized by the shareholder of Y upon the disposition of his shares will presumably be taxed at capital gains rates, including gain attributable to earnings accumulated after December 31, 1962.

Assuming Y was able to meet the 80 and 50 percent source of income tests described in section 931, neither X nor Y will pay a U.S. income tax on their current earnings. The reason for differing tax treatment of the shareholders of X and Y corporations upon disposition of their shares is not apparent.

(3) X and Y corporations are wholly owned manufacturing subsidiaries of two U.S. corporations producing competing products. X is incorporated under the laws of Puerto Rico, Y under the laws of Delaware. Each sells its manufactured product to its parent company retaining a manufacturing profit in the subsidiary. Title to goods and risk of loss are transferred in San Juan. Under existing rules, Y would probably meet the 80 and 50 percent source of income requirements described in section 931. It is not clear under the Treasury's draft of section 957(c) whether the source of X's income would be considered to be Puerto Rico, since the tax jurisprudence under section 931 is apparently intended to be disregarded and new regulations written to make this determination.

The overall impact of the above-described possible differences in tax treatment depending on place of incorporation or type of business activity would be a mass of inconsistency in the law and utter confusion in the Puerto Rico investment community. Why a Delaware corporation should be able to do in Puerto Rico what a Puerto Rico corporation cannot without tax penalty to its shareholders is unexplained. Similarly unexplained is the distinction being drawn before Puerto Rico corporations engaged in certain business activities and those engaged in others. The Treasury statement that "the draft leaves [Puerto Rico] corporations subject to the rules of existing law with, however, provision to insure that such corporations will not be availed of for tax haven activities" does not explain the difference, unless it is the theory of the Treasury that the services, construction, and merchandising industries are per se tax haven activities.

In addition, the Treasury proposal that it be empowered to rewrite by regulations some 40 years of tax jurisprudence on the subject of source of income leaves even those Puerto Rico corporations which are apparently covered by section 957(c) in doubt. There has been no suggestion by the Treasury of proposed guidelines, nor has there been any exposition by or on behalf of the Treasury to explain the need for this extraordinary request, except the invocation of the phrase "tax haven." We understand the Treasury's concern that it should have adequate powers to deal with oversea activities which are not bona fide, but we submit that it is wholly unnecessary to upset long-settled and carefully considered regulations and precedents. No good reason exists for depriving Puerto Rico corporations of the guidance of existing regulations and precedents, particularly with respect to the crucial matter of source of income. In opening the way for an entirely new body of regulations and interpretations on this subject, the bill, in its efforts to build a wall against tax haven activities, would also make the ground around it a morass of quicksand on which enterprises engaged in legitimate activities could no longer move with security.

The difficulties caused by section 957(c) are by no means confined to Puerto Rico corporations controlled by U.S. citizens nonresident in Puerto Rico. Section 9(h) of the bill defines "U.S. person" as including U.S. citizens, irrespective of residence. Virtually all residents of Puerto Rico are U.S. citizens and hence "U.S. persons" within the meaning of the bill. Thus, the concept of "controlled foreign corporation" will be applicable to virtually all Puerto Rico corporations,

however locally confined their activities, including such enterprises as restaurants, furniture stores, and other such service and retail or wholesale establishments, when carried on in the corporate form. Only in the event that the provisions of section 933 continue to be fully applicable to bona fide residents of Puerto Rico who are stockholders of Puerto Rico corporations would the disabilities attached to ownership of stock in a controlled foreign corporatin not be visited upon stockholders of such purely local Puerto Rico enterprises. However, in view of language in sections 951(a) and 1248 (a) and (b) with respect to inclusion in gross income of U.S. persons, which appears to clash with the language of section 933 that there "shall not be included in gross income" income derived from sources in Puerto Rico, uncertainty is compounded for the bona fide resident of Puerto Rico who is in control of a Puerto Rico corporation.

Moreover, it is no answer to say that existing corporations which are not covered by section 957(c) may apply for rulings under section 367 and reorganize as section 931 corporations. Wholly aside from the expense and burden, particularly on small corporations, of securing such rulings, there is a serious estate tax problem involved in the ownership of stock of a corporation organized in one of the States, by a U.S. citizen domiciled in Puerto Rico who was born in continental United States.

Under section 2208 of the Internal Revenue Code, such an individual is considered a citizen of the United States for Federal estate tax purposes, and taxable under the law by virtue of such citizenship. As a domiciliary of Puerto Rico, however, his estate is also fully taxable in Puerto Rico. It is clear under section 2014 of the code that no foreign tax credit would be allowed against the U.S. estate tax for taxes paid to Puerto Rico on stock of a U.S. corporation, since the stock would be deemed to have a situs in the United States for this purpose and not in Puerto Rico. (Reg. sec. 20.2014–1(a)(3).)

Generally Puerto Rico would permit a credit for the Federal estate tax paid, but section 5(a) of the Puerto Rico Inheritance Tax Act which affords the credit states: "*Provided further*, That if such a tax is imposed by reason of the donor [deceased] having a taxable status within the jurisdiction, said credit shall be allowed only if such jurisdiction does not tax transfers made by residents of Puerto Rico or grants a corresponding tax credit in such cases."

It is at best doubtful that a credit would be permitted under this language, since the United States does tax transfers made by Puerto Rico resident in the case suggested, and does not grant a corresponding credit in such case.

PART IV. AMENDATORY LANGUAGE AND REASONS THEREFOR

In his statement before the committee on May 10 of this year, Secretary Dillon recognized that the question of the tax treatment of commerce within the possessions should not be considered within the context of a foreign tax reform bill. Nonetheless, Treasury's draft section 957(c) has the effect of including certain substantial categories of Puerto Rican commerce in the classification of controlled foreign corporations. It is the position of the undersigned that if differences of tax treatment of varying types of industry or commerce in the possessions are to be written into the Federal tax law this should be done only after public hearings and public testimony in support of the reasons for drawing such distinctions. The Treasury's brief explanation of section 957(c) is of no practical assistance in divining the applicable criteria. In fact the explanation does not reflect awareness of the distinctions which have been drawn.

We respectfully suggest that section 957(c) be amended to read in accordance with the following language which is substantially the statutory formula found in section 931. Adoption of this amendment will preserve the status quo until such time as a proper study of the question of Federal taxation of the possessions may be undertaken and will at the same time guarantee that only those corporations organized in the possessions and deriving the requisite amount of their income from the active conduct of a trade or business therein will be in a position to avail themselves of the benefits of the exemption.

"(c) Corporations Organized in United States Possessions. The term 'controlled foreign corporation' does not include any foreign corporation which is created or organized in a possession of the United States if

"(i) 80 percent or more of the gross income of such corporation for the 3-year period immediately preceding the close of the taxable year (or for such part of such period immediately preceding the close of such taxable year as may be applicable) was derived from sources within a possession of the United States; and

"(ii) 50 percent or more of the gross income of such corporation for such period or such part thereof was derived from the active conduct of a trade or business within a possession of the United States."

PART V. EFFECT OF SECTION 15 ON SMALL BUSINESS INVESTMENT COMPANIES

In recent years there have been organized under the laws of the possessions, particularly Puerto Rico and the Virgin Islands, companies licensed by the Small Business Administration as small business investment companies. The sole function of these companies is to provide equity capital and make loans to "small business concerns" as defined in the Small Business Investment Act, 15 U.S.C.A. §§ 684 and 685. Such a company may not acquire any type of equity security or make any loans if the purpose thereof is to furnish small business concerns with financing for a period of less than 5 years. It is obvious enough that a company subject to such limitations is a very different enterprise from an investment company accumulating a portfolio of marketable U.S. or foreign securities.

Although corporations organized under the laws of possessions are technically foreign for tax purposes, it is of importance to note that the definition of the word "State" for purposes of the Small Business Investment Act includes Puerto Rico as well as the Virgin Islands. 15 U.S.C.A. § 662(4). The public policy underlying the Small Business Investment Act is applicable with special force to such areas as Puerto Rico and the Virgin Islands, with their pressing needs of industrial development and of sources of financing for such development.

In view of the limitations and safeguards provided by the Small Business Investment Act with respect to small business investment companies, no good reason exists for treating such a company as a foreign investment company. It is recommended that the proposed section 1246(b) be amended to exclude small business investment companies organized under the laws of the possessions and licensed under the Small Business Investment Act of 1958, as amended, from the definition of "foreign investment company."

ROBERT M. BAKER, Esq.
MAX GOLDMAN, Esq.
PAUL R. KELBERG, Esq.
RAYMOND C. O'NEILL, Esq.
MANUEL I. VALLECILLO, Esq.

Senator McCARTHY. Thank you, sir. Our next witness is Mr. Tyrone Gillespie, Dow Chemical Co. Have a seat, Mr. Gillespie.

STATEMENT OF TYRONE GILLESPIE, ASSISTANT TO THE PRESIDENT, THE DOW CHEMICAL CO.

Mr. GILLESPIE. Mr. Chairman, on May 2 of this year we were accorded the privilege of testifying before this committee with respect to the provisions of H.R. 10650 as they affect foreign source income.

Since that date, due to the tremendous effort of this committee in developing so much information before legislating on the complex law, many latent inequities appeared. As a result, the Treasury has suggested changes which relieve a few of the many burdens imposed by the bill. We can agree with the Secretary of the Treasury in his statement of May 10, 1962, before this committee when he stated: "These changes seem to us to be clearly called for. Undoubtedly, further discussion in executive sessions will reveal other ways in which this bill can be improved."

As the bill has proceeded down the road, pitfalls have appeared. It is expected that even more will be found as the bill progresses further.

We are anxious to be constructive, but as strong as is our desire to be constructive, we must subscribe to the statement of Prof. Dan Throop

Smith of Harvard, when on June 20, 1962, he pointed out clearly to this committee that the basic concept of this proposed legislation is inequitable and an aberration in our whole tax policy.

To accept as law this bill, even as amended, there must be acceptance of the principle that a stockholder may be taxed on a gain in net worth in a Corporation in which he holds stock before the gain is paid in the form of dividends and further that such taxes will be calculated on a different basis than the earnings appear in the books of account. This is a revolutionary concept and the institution of an extremely dangerous precedent.

Furthermore, the need to do so at this time is not apparent, for the President and Secretary Dillon have recently publicly announced that they will urge the Congress to enact a basic revision of the existing Internal Revenue Code in 1963 to reduce tax rates for individuals and corporations without any substantial revenue loss. The revised code would also become effective on January 1, 1963. If the 88th Congress enacts the President's recommendation to revise the code and the 87th Congress enacts H.R. 10650, section 962(a) of this bill would require new regulations conforming to the new code. Both proposed laws and implementing regulations would become effective on the same date, namely January 1, 1963. Consequently, postponement of the pending legislation relative to the taxation of foreign source income would not result in any loss of revenue nor more rapidly correct any of the alleged abuses because the proposed effective dates would be identical.

It would be hoped that the new code would by definition of the areas of concern to the Treasury enable effective enforcement, without establishing a new concept of taxation which will jeopardize the competitive position of American business abroad.

The proposed amendments are extremely vague. There are over 15 instances where the language would delegate authority to the Secretary to enact regulations to effect broad definitions and principles of application without clear guidelines. For example, the definition of "records," "accounts," "earnings," "profits," "basis of a United States shareholder's stock in a controlled foreign corporation," and whether earnings and profits are "blocked" are all left to determination by the Secretary.

It seems likely that in exercising this discretionary and delegated authority, the Secretary would endeavor to support the position he advocated before this committee on May 10, when he said:

> We remain convinced that our basic proposal for the general elimination of deferral for operations in developed countries would be the most equitable and appropriate policy.[1]

When questioned by Senator Curtis as to what a tax haven company is, Secretary Dillon replied:

> What we have done is not to define a tax haven company specifically, but to define in effect a tax haven transaction. For example, a tax haven transaction is one where a company incorporated in country A purchases from country B and resells in country C.
>
> So in this situation there have to be three countries involved and the use of the words "tax haven company" is just a short description of companies which operate in this way. We do not have a definition of a company as a tax haven company.[2]

---

[1] Revenue Act of 1962, hearings before the Committee on Finance, U.S. Senate, 87th Cong., 2d sess., H R. 10650, p. 4252.

[2] Ibid., p. 4309.

Now, this definition encompasses most of the import-export business of the world.

How then is business to proceed under this nebulous concept which would interfere with normal trading patterns?

For the benefit of the committee we will mention briefly some of the problems still unresolved which makes the proposed legislation unworkable, even if one overrode our basic objection that the concept of taxation of increases in net worth is inequitable:

1. Section 13 would apply the principle of punitive taxation of increases in net worth under the Treasury amendment even if only two foreign countries are involved in a single transaction. In other words, the tax haven concept is extended under these amendments to areas not encompassed in the House bill (sec. 954(d)(2)).

2. The exclusion does not extend to taxation on profits or earnings that are "blocked" in a chain of corporations beyond their first tier (sec. 962(b)).

3. All stockholders of foreign corporations would be required to keep records of their holdings and those of other U.S. shareholders and the value of such holdings on a daily basis (sec. 951(a)(1)).

4. There has been no recognition of the virtually unsolvable problem of bearer shares and nominee ownership in determining control.

5. There is discrimination in that the proposal favors sale of know-how and patents to unrelated companies rather than providing some advantages to the inventor and/or owner. Domestically, such sales are capital gains; abroad they are treated as ordinary income (sec. 1249).

6. The provisions of the amendments relating to qualified investments in less developed country corporations are discriminatory in three ways:

(*a*) There is a requirement for daily computation of owned assets and their source in such foreign susbidiary (sec. 955(c)(1)(B)).

(*b*) There is provision which discriminates against sales or trading to any appreciable extent (more than 19 percent) between a less-developed country and a developed country (sec. 955(c)(1)(A)).

(*c*) The decision as to whether the country is developed or less developed is delegated to the President without criteria (sec. 955(c)(2)). Whether there has been compliance and determination as to the source of income has been delegated to the Secretary of the Treasury without criteria (sec. 955(c)(1)).

7. The suggested amendments fail to specify the basis of capital investment in a less-developed country for any tax computation.

8. The Secretary at his discretion may give credit for foreign taxes after allowances for incentives against U.S. taxes; however, the effect of section 960 is negated by section 962(a) which requires consolidation in compliance with rules applicable to domestic corporations. They do not encompass deductions allowed under section 960. This is a fundamental conflict which can only be resolved by the unguided decision of the Treasury which may well result in taxation in excess of U.S. rates on domestic companies.

9. Provision is made for a "special rule where foreign base company income is less than 20 percent or more than 80 percent of gross income." What about the amounts in between? It is likely that between the two figures proration is intended, but there is no language to support such a view (sec. 954(b)(3)).

To sum up, we reiterate that the sections of H.R. 10650, even as modified by the Secretary's recent proposals, applying to foreign source income, appear to be founded in hastily put together, inequitable, and dangerous concepts. Although the Secretary in his appearance before this committee on April 2 endorsed the provision of the House bill, on May 10 he testified to the effect that:

A great deal of concern has been expressed by witnesses regarding the provisions of section 13 of the bill. Substantial modifications of this section are called for.[1]

Undoubtedly, with adequate time, the Secretary and the committee may agree that even further modifications are necessary. We have endeavored to develop some of the areas requiring new language in our testimony. The present language is vague and almost every section is delegated to the Secretary for interpretation, and law-abiding business people will find it almost impossible to comply with the law. Abuse is not characteristic of American business at home or overseas. Provisions to prevent tax evasion can be incorporated in the new tax code. We are hopeful that such abuses may be clearly identified and dealt with individually rather than using the shotgun approach of damaging the normal method of doing business.

In conclusion, we would ask the committee to consider carefully the implications of establishing the new, strange, and dangerous precedent of taxing stockholders on increases in net worth of corporations before the profits are distributed as dividends.

Senator McCARTHY. Thank you very much, Mr. Gillespie.

Our next witness is Mr. Weiss, of the Harnischfeger Corp. Will you identify yourself for the record, Mr. Weiss?

STATEMENT OF A. H. WEISS, TAX MANAGER, HARNISCHFEGER CORP.

Mr. WEISS. My name is Alvin Weiss. I am tax manager of Harnischfeger Corp., of Milwaukee, Wis., which company has previously been identified in testimony before this committee on May 2, 1962. We are an old, well-established manufacturer of heavy construction, mining, and industrial machinery and equipment with a sizable U.S. payroll and with important oversea manufacturing operations, many of which involve foreign investment in countries presently indicated to be both developed and underdeveloped as defined by revised section 13.

This section of the proposed tax bill must be deleted. It discriminates against much foreign business activity. It artificially and arbitrarily attempts to channel foreign investment without regard for sound economic principles, which in our opinion is not a proper function of tax legislation. It will tend to lessen our exports and hence have a negative effect on our balance of payments as we so testified earlier. It is just very poor and unnecessary legislation.

While section 13, as amended, is somewhat less onerous than the previous proposal, it still remains basically inequitable, complex, and for all practical purposes unworkable. I have discussed these provisions with a number of tax attorneys and accountants knowledgeable

[1] Ibid., p. 4252

in this field and I have found no one who has been able to furnish me a clear interpretation of section 13 and its proposed amendments.

It is no wonder that the drafters of these amendments have time after time included in many of the subsections the phrase "under regulations prescribed by the Secretary or his delegate." I am certain the Congress of the United States does not want to abdicate its tax-law-writing prerogatives to "regulations prescribed by the Secretary or his delegate."

One amendment purports to simplify the problem of imputing income from U.S. developed patents, copyrights, et cetera. Here, again, special rules are invoked against U.S. foreign trade; when a patent is sold to a controlled foreign corporation the asset is no longer a capital asset or property described in section 1231. Not only is this discrimination invoked against foreign operations, but it is also proposed by Secretary Dillon in his May 10 statement that a somewhat longer statute of limitations could be provided to insure that the valuation of the patent at the time of transfer is a fair one.

ffl8hpp'nat:g

One of the reasons given in support of the proposed tax legislation was to effect tax neutrality as between domestic operations and foreign operations. Where is the so-called neutrality in taxation when one set of U.S. tax rules and rates are employed in the taxation of domestic operations and another set of rules and rates for foreign operations?

A further proposal has been suggested by the Treasury involving royalties where the patent is licensed rather than sold. Such royalties attributable to the patent would be currently taxable to the U.S. stockholders of the controlled foreign corporation regardless of whether technical services were performed abroad under such license. Here we have a lack of awareness or disregard of how many foreign license arrangements are actually made.

For example, the considerations involved on the part of the licensor and licensee can be, and most times are, varied and complex. The duties of the licensor in order to earn its fees might include all, a part, or combination of the following:

(1) Sell or aid in the sale of the products directly or through its own foreign distributors and dealers;

(2) Furnish technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial, or like services; and

(3) Grant the rights to manufacture, use, and sell under certain patents, et cetera.

Considering all these factors, how much is to be imputed as income from patents? The use of the patents might be a very insignificant, or might be a material part of the fees received from the licensee.

In addition, the definition of just what "royalty" income is, differs from country to country and the United States, yet the proposed legislation takes none of these factors into account in determining "neutrality."

Under the proposed section 954(b)(4) there appears to be an exemption from foreign base company income for foreign corporations not availed of to reduce taxes, where "it is established to the satisfaction of the Secretary or his delegate with respect to such item, that the creation or organization of the controlled foreign corporation

receiving such items, under the laws of the foreign country in which it is incorporated, does not have the effect of substantial reduction of income, war profits, excess profits or similar taxes." Here again the Treasury draft is very ambiguous.

Does this mean reduction of foreign taxes or U.S. taxes? If it is foreign taxes, what possible concern is it to the U.S. Treasury except possibly to promote the collection of more taxes by foreign countries at the eventual expense of the U.S. Treasury. Furthermore, how can the U.S. Treasury possibly know whether a particular method of operation in a foreign country is primarily for avoidance of foreign taxes or primarily for commercial and business purposes. If it is U.S. taxes which are referred to, the term "avoidance" is not applicable.

The major issue in this whole controversy is whether the United States should reverse its fundamental tax policy since 1913 and tax U.S. citizens on income they have not or may never receive, leaving out the possibility that such drastic change is unconstitutional. The philosophy seems to be that if a controlled foreign corporation pays less foreign income taxes than it would pay if such income were currently subject to U.S. income, such income is somehow "tainted." The fact that foreign countries, as a general rule, rely very much less on income taxes than does the United States seems to have been given no consideration, and certainly no consideration for foreign tax credits applicable to U.S. income taxes.

In view of the Treasury's complaint that it has difficulty under present U.S. tax law in detecting U.S. tax avoidance, it now proposes to add to its problems by attempting to determine if tax avoidance exists under foreign tax laws throughout the world. It seems unbelievable that we are deliberately encouraging foreign governments to increase the taxation of U.S. business done abroad. Whether by design or accident, this is exactly what the Treasury proposals will do.

Some publicity has been given to the statement that section 13 has been substantially liberalized inasmuch as a company operating abroad with only manufacturing facilities would not be affected. A careful study of the draft language does not support this inference.

For example, if a company desired to sell into the Common Market it could do so safely only by creating manufacturing affiliates in each country it wished to do business.

Even if, for the moment, we concede that a fair degree of liberality has now been enacted in section 13 in favor of controlled manufacturing affiliates; those taxpayers who may for good commercial and economic reasons develop foreign manufacturing through foreign license arrangements are discriminated against. The decision to manufacture abroad whether through a manufacturing license arrangement with an already successfully established foreign manufacturer or whether to create from scratch an entirely new manufacturing enterprise is a practical business judgment taking into account many economic, business, and financial factors. What might be feasible for one type of product in one part of the world might be entirely uneconomic under a differing set of circumstances.

What is so magic or more legitimate about a bricks and mortar 100 percent owned manufacturing activity in a foreign country as against a manufacturing activity under license or technical service agreement

to fully utilize unused capacity which already exists in that country by virtue of previous investments of others? Is the first brick and mortar investment any more legitimate or valuable in the economic scheme of the country than the second? Will it help develop a so-called underdeveloped country any faster? Should a company invest several million dollars for a plant in a foreign country so that it can technically qualify as a manufacturing organization when it could accomplish the same or better results through a licensing arrangement with a much smaller or even no cash capital investment? Certainly it should not, unless it is forced to artificially and uneconomically by improper tax legislation.

As a very minimum, license fees and/or technical service fees earned by foreign subsidiaries from unrelated parties should be equated on the same basis as now provided for direct manufacturing, and should be exempt from punitive, and possibly unconstitutional, taxation as proposed in section 13. This is not to suggest any degree of approval of section 13. Even if the sole activity of the controlled foreign subsidiary is from trading income, commissions, or service fees from its parent (which, by the way, is not the case in our operation) there is no equitable justification for taxing such earnings currently if such fees are at arm's length. It seems that the Treasury is attempting to solve its section 482 problems by taxing all such income rather than by disallowing a deduction to the parent for any excess payments which might be made.

The enactment of section 13, for example, would seriously handicap our company's foreign trade at a time when, along with others, it is facing increasing foreign competition not only from the free world and the European Common Market, but also from countries behind the Iron Curtain. At the present time our foreign subsidiary has firm contractual capital commitments in developed and underdeveloped countries. In one specific situation it has a firm contractual obligation to invest in a substantial equity participation within the next few years which would be in excess of its foreign subsidiary's entire retained earnings from all sources and far in excess of its present current assets available for working capital and investment.

This is one important obligation it will be required to meet whether section 13 is enacted or not. If section 13 is enacted this obligation will in all probability have to be met by borrowings or further investment by the parent in its foreign subsidiary thereby utilizing capital which could be otherwise employed in its domestic operations. Other tentative commitments involving more risk, especially in less-developed countries, will in all probability be abandoned.

In order for the parent to continue to export an increasing amount of domestically produced products it must depend on the strong worldwide distribution system developed by its foreign subsidiary. The foreign subsidiary, to maintain and increase its distribution system, must be able to insure its dealers and distributors a full line of products to sell. This means that in some areas certain products must be manufactured abroad to insure a full competitive line for its distribution system.

That this program has been successful in increasing Harnischfeger's export of domestically produced products is clear from the record as indicated in our previous testimony.

There is no question in our minds that the enactment of punitive and discriminatory taxation of foreign source income will only serve to diminish the Harnischfeger Corp.'s participation in worldwide trade to the detriment of its employees, its stockholders, and to the U.S. tax revenue.

We, therefore, urge this committee to reject section 13, especially in view of the administration's announced consideration of a general and drastic tax reform bill next year.

Senator McCARTHY. Thank you, Mr. Weiss. Do you think that we could come up with a satisfactory formula for taxing oversea profits next year?

Mr. WEISS. I certainly think it should be considered in the context of an overall tax revision bill, and I think, in view of the testimony that has been given over a substantial period of time, that this requires much further study.

Senator McCARTHY. Do you think there is any need for any significant changes in existing law with regard to the taxation of corporations?

Mr. WEISS. No, I do not.

Senator McCARTHY. So that you wouldn't expect us to come up with anything very successful next year in this general area?

Mr. WEISS. No, I would not.

Senator McCARTHY. Is it your opinion that in view of the changing pattern of trade, the development of the Common Market and so on, that it might be well to withhold action in this field until we get some clear indication of how world patterns of trade and commerce begin to adjust to that factor?

Mr. WEISS. That is particularly true right now, in view of the world situation and the passage of the foreign trade bill—that we should be very, very careful at this time not to take hasty action that might destroy or at least hurt the foreign business of U.S. corporations. It is too serious a thing, and, once it is done, you cannot easily roll back the damage that would be done.

Senator McCARTHY. I don't know what the countries are in which you have invested. Are you investing in Common Market countries at the present time?

Mr. WEISS. No.

Senator McCARTHY. Are you making any investments——

Mr. WEISS. We have a licensee arrangement within the Common Market.

Senator McCARTHY. Where are your manufacturing establishments for the most part; in what countries?

Mr. WEISS. Manufacturing or licensing?

Senator McCARTHY. Well, you talk some about having some manufacturing establishments.

Mr. WEISS. We have a jointly owned manufacturing operation in Australia. We have a licensee arrangement with no equity participation in Germany, in India. We are working toward a partcipation in another developed country of the world which I don't want to state at this time, and which involves a considerable sum of money.

Senator McCARTHY. Have you intensified your efforts to secure licensing arrangements and agreements because of and since the Common Market has begun to develop as a reality?

Mr. WEISS. Yes.

Senator McCARTHY. What were the reasons for that, Mr. Weiss?

Mr. WEISS. Well, there are, of course, two reasons. One is trade restrictions of the various countries and, second, where the facilities of countries in the Common Market have now developed to a point where competitively there are certain products and certain models we cannot produce at home and sell abroad, and in those cases and only in those cases have we established licensees.

Senator McCARTHY. Do you anticipate greater difficulty in reaching those markets after the Common Market is firmed up than you now have?

Mr. WEISS. We expect the difficulties to continue to increase.

Senator McCARTHY. As the Common Market becomes more firmly established?

Mr. WEISS. That is correct.

Senator McCARTHY. What are the principal competitive advantages you have as a result of being inside the market over what you now have, or are likely to have?

Mr. WEISS. Harnishchfeger Corp. manufactures quite a wide line of products. Its foreign subsidiary has developed good dealers and distributors. These dealers and distributors must have products that they can sell competitively.

If they have a full line of products, we are more able to sell our American-produced products to these dealers and distributors, and in those cases where products can't be manufactured here and economically shipped abroad, they are manufactured abroad. In that way we promote the sale of our domestically produced products and, as presented in our previous statement, our export sales of domestically produced products has substantially increased during the period our foreign licensees have been producing some of our equipment.

We have had very striking results along that line. Our increase in exports is substantially over that of our industries' index of exports—much higher.

Senator McCARTHY. Do you attempt to borrow any money overseas for the financing of new developments here or expansion of existing plant and facilities?

Mr. WEISS. We expect we may have to because I don't believe we will be able to earn a sufficient amount of money to take care of the commitments that we do have or commitments we are working on.

Of course, as you understand, some negotiations don't finally end up as a contract, but we have firm commitments that for the near and foreseeable future—the next 3 or 4 years—will require every bit of earnings the foreign subsidiary could possibly earn. At that time we may have to borrow money abroad.

Senator McCARTHY. Thank you.

Mr. Eppert, of the Greater Detroit Board of Commerce.

STATEMENT OF RAY R. EPPERT, ON BEHALF OF GREATER DETROIT BOARD OF COMMERCE

Mr. EPPERT. Mr. Chairman, my name is Ray R. Eppert, and I am president of Burroughs Corp. I am testifying today on behalf of the Greater Detroit Board of Commerce—a nonprofit organization incorporated under the laws of the State of Michigan.

Our statement pertains to section 13 and the amendments proposed by the Secretary of the Treasury on May 10.

The amendments would not correct the fundamental weakness of the bill. It is our opinion that enactment of this legislation in any of the forms which have been presented to date would materially decrease the competitive effectiveness of American business in the world market.

It seems very clear that any action taken which would weaken that competitive position and prevent a maximum penetration of the world market would severely damage our domestic economy and adversely affect our balance-of-payments position.

Even a status quo in our present oversea position could create a serious problem. As we move toward freer trade it is increasingly important that we strengthen, not weaken, the worldwide competitive ability of American business.

In order to preserve the most efficient operating format, section 13 as proposed would provide an incentive for American business to take a minority ownership position in foreign operations overseas. This certainly would not help the United States to maintain a maximum current account trade surplus and to achieve the maximum dividend remittances as a direct capital inflow. Reducing American equity would mean that the results of U.S. effort abroad would be divided between the United States and the particular foreign country involved. The negative effect on our balance of payments could be very substantial.

On July 21, 1961, the staff of the Joint Committee on Internal Revenue Taxation submitted to your committee a report on the tax effects of conducting foreign business through foreign corporations. Appendix B of this report is a statement by the Secretary of the Treasury before the Committee on Ways and Means relating to the elimination of the tax-deferral principle which has been in effect for almost 50 years.

The Secretary's statement indicated that, if section 13 were enacted, the net result for the United States of eliminating the deferral principle on legitimate foreign earnings and the successful closing of any tax haven sham operations would, potentially, improve our balance-of-payments position as much as $390 million per year.

That statement assumes the actions proposed in section 13 could be taken without weakening legitimate American business overseas or our competitive position. We think that is an incorrect assumption.

In the first place, if foreign dividends are forced before they should be remitted, it would inhibit American operations in the world market. Unless the needed capital is sent back by the parent companies to foreign subsidiaries, the U.S. competitive position would deteriorate and our balance-of-payments position would worsen.

The Secretary mentioned a maximum potential of $390 million per year. That is a very small amount in the aggregate involved in our balance of payment. Total U.S. receipts from abroad in 1961 were $30.2 billion. In 1960 they were $28.1 billion and in 1959 $25.5 billion.

It is our belief that the imposition of new punitive rules on oversea operations would seriously affect the forward progress American business is making in the world market. Instead of a potential $390 million credit to our balance of payments we think the actual result would be a very large debit.

Instead of the Government imposing handicaps which our competitors in the world market do not have, we think American business should be encouraged in every practicable way to fight for an adequate slice of the rapidly growing world economic pie. Success in this objective is essential for the U.S. economy.

The Treasury amendments which offer certain very minor allowable reinvestment of earnings prohibit this reinvestment right for any new American oversea business which starts after December 31, 1962, and also bars those now there who have not operated for 5 years. It seems very strange that legislation which discriminates between new and old American foreign subsidiaries should be proposed. In effect, the Treasury is asking the Congress to create a monopoly for one segment of American business insofar as the reinvestment provision is concerned. American firms now in the world market do not want any preference over other American firms. They just want to be competitive with foreign enterprises.

Taxing foreign earnings of a bona fide business operation, not remitted as dividends, and any restraints on the reinvestment of legitimate retained earnings anywhere, whether in developed or underdeveloped areas, would, in our opinion, militate against the best interests of the United States.

We believe section 13, either with or without the proposed amendments, would—

1. Greatly weaken the competitive position of American business versus foreign-owned business in the world market.
2. Seriously reduce the rate of new private investments abroad through lower availability of foreign-earned income for reinvestment, or produce an unfavorable effect on the U.S. balance of payments if the rate of foreign investment is maintained.
3. Eliminate the incentive for American companies to organize oversea operations so as to have—
   (*a*) The lowest tax base abroad;
   (*b*) The largest amount of retained earnings for reinvestment and remittance to the United States; and
   (*c*) The lowest foreign tax credit as earnings are remitted to the United States, thus maximizing taxes for the U.S. Treasury.
4. Reduce our favorable export surplus.
5. Reduce domestic employment and retard future job growth.
6. Require even larger expenditures of U.S. funds for foreign economic aid to offset the reduced rate of private investment, thus creating a still further adverse effect on the balance of payments generated by Government aid programs.

For these reasons we strongly recommend that section 13 be eliminated. Section 6, which deals unrealistically with allocation of foreign profits, should also be rejected because, even if section 13 is dropped, section 6 would permit imposing negatives which would militate against the U.S. competitive position overseas and therefore place an added burden on our balance of payments.

We are not here just to criticize the proposed bill. We think criticism imposes a responsibility to offer constructive recommendations which will attack the real problems which are—

1. The maintenance of the maximum number of jobs in the United States.

2. Encourage holding the level of oversea operations to the essential minimum necessary to obtain a satisfactory American competitive position and an adequate penetration of the world market.

3. Hold in the United States, on intercompany transactions, a proper profit legitimately subject to a current U.S. tax.

4. Maximize the contribution of American business overseas to our balance of payments.

We have two suggestions which we think would contribute greatly to the solution of our basic economic problems and which would strengthen our international fiscal position.

Suggestion No. 1 pertains to export pricing. A fair and reasonable profit should be contained in the transfer price of the total transactions between the U.S. parent company and its foreign subsidiaries. This insures a taxable profit resident in the United States, subject to current tax. Exports in total might normally be expected to produce a profit margin ratio after tax, which would approximate the aftertax ratio the parent company realizes from its domestic operations on similar products or materials. The profit markup on an export would of course be based only on the cost elements involved within the United States. This transfer price might vary depending on the competitive situation in a particular market.

Approaching the problem on the basis of the aggregate of all exports, with recognition and acceptance of special operating problems, would eliminate any attempted malpractice of exporting currently taxable profit outside the jurisdiction of the United States.

Individual transfer pricing must be designed to achieve a successful business result in each market of the free world. Flexibility is essential in meeting the competitive problem in each oversea market.

If an excessively high transfer price is used, it could defeat the tariff agreements which the United States must shortly be prepared to negotiate. For example, if the United States secured a reduction in tariffs for exports on a certain category of products from 15 to 10 percent, an excessively high transfer price could nullify the tariff concession, because the lesser rate on a higher landed cost could mean a higher total cost to the foreign subsidiary and a noncompetitive price in the market. The result would be to weaken the subsidiary's market position and reduce the contribution to the future balance-of-payments position of the United States.

A program involving transfer pricing requires no changes in the present Internal Revenue Code. It achieves the legitimate tax objective and eliminates any implied tax imperialism by the United States through extraterritorial encroachment.

Suggestion No. 2 involves achieving the maximum export surplus for the United States. We feel that exports to all free world markets should be most aggressively promoted and that more U.S. firms should be encouraged to enter the world market, many more.

We believe a tax incentive on the profit held in the United States on exports would insure the maximum competitive effort in the world market and the greatest possible contribution to our balance-of-payments position.

The rapidly developing world market is the greatest economic frontier and challenge the United States has ever faced, and the development of this frontier requires a two-pronged attack—direct

exports, and oversea direct investments and operations to generate added exports and income.

Our future balance-of-payments position and the world status of the dollar as a reserve currency will, in very large measure, be determined by just one thing—the competitive position of American business in all markets of the free world.

The continued maintenance of that competitive position is our most urgent economic problem.

Senator McCARTHY. Thank you very much. Mr. Eppert, have you had any experience yourself with the program involving transfer price and determination of profits at that point? Has Internal Revenue tax entered your transfers on the basis of this coordination?

Mr. EPPERT. Mr. Chairman, I think it is well known that Internal Revenue today in their examinations are checking very carefully on transfer pricing of exports; particularly where foreign subsidiaries are involved and you are not shipping direct to a customer. The answer is yes, a very careful check is being made. I can say that with certainty.

While we are on that subject I would like to make a point about taxes on exports. Possibly this has been brought out in previous testimony.

Is it clear that not even the Internal Revenue Department or the Treasury or the exporter knows how many times a U.S. tax has been paid on an export? Let me explain.

First of all, the exporter who is making the shipment is taxed on the profit that he is taking in the current year in which the shipment is made. I will come back to that in a minute.

If the exporter has suppliers each one and sometimes they run into dozens and dozens in a single product, each of those suppliers is paying a tax on his portion that went into the final configuration of product. The supplier himself doesn't even know he is paying a tax on an export. There is no way of knowing how many times a current tax is assessed on a given export.

Is it also clear that where we are shipping an export to a foreign subsidiary, we are prepaying U.S. tax? If the shipment goes into inventory in the subsidiary, it is merely a capital asset over there; and has not created revenue on which earnings will be computed. Therefore the profit taken on the shipment and held resident in the United States created a prepayment of tax in the current year before customer revenue was realized.

Senator McCARTHY. My inquiry was concerned with the difficulty of administering this provision. It must be difficult under existing law.

Mr. EPPERT. Existing law? You mean transfer pricing?

Senator McCARTHY. Yes. You have given an example of that.

Mr. EPPERT. I think it is not, Mr. Chairman, and I believe Internal Revenue would certify to that belief.

What we have attempted to offer here is a transfer pricing yardstick that we believe no one could legitimately quarrel with.

In other words, if exports in total are giving approximately the same ratio of return on the cost involved as the parent company is getting in its domestic operation, do we have only legitimate right to expect more when we are sending it abroad to participate in probably the biggest marketing battle in the United States has ever had to face?

I think we have offered a pretty good yardstick, and that no one could quarrel very much with it.

Senator McCARTHY. I suppose you could argue either way.

Mr. EPPERT. Yes.

Senator McCARTHY. It is a question of deciding between yardsticks. The second suggestion really involves an export subsidy in a sense, a subsidy out of taxes, is it not?

Mr. EPPERT. Yes, it does. This proposed tax bill started over a year ago, in April to be exact, and then in Ways and Means extensive hearings in June 1961.

There has been a lot of reporting on the bill, what it is, what it would do to inhibit business operations, and so forth.

I think this proposed legislation has done a lot of harm, because it has discouraged a lot of companies that should be getting into the world market and fast. We can be certain they are not enthusiastically marching forward until they know what the rules are going to be.

Mr. Chairman, we need many, many more American businesses overseas. We don't go overseas because we have a choice of doing it there or doing it here.

Any businessman, just through commonsense, is going to maximize the use of one set of assets, and when you go beyond one situs of operation, there is a legitimate reason for it.

Let me explain by citing the case of my own company, the Burroughs Corp. Historically we have operated overseas since before the turn of the century. We had a plant in Britain in 1897. Most of our present corporate format was created, at least in an embryo form—I am speaking of our various foreign subsidiaries—prior to 1910.

The income tax didn't come in until 1913, and therefore we certainly didn't go overseas because of an income tax.

I was interested in the questions that were asked this morning about an export of jobs. It can be documented and proven in case after case after case that operations overseas supplement and make more jobs here.

Now back to the specific case of the Burroughs Corp.

As I said, historically we operated overseas before the turn of the century. In 1950, January 1, 1950, this was Burroughs job status overseas. Only 264 employees were working in foreign production on January 1, 1950, and total oversea personnel was 1,923. In the postwar period, most of the world, as you will recall, had very little dollar exchange. It was one of the reasons for the Marshall plan. Exports from the United States were severely handicapped by licenses and quotas.

At that time we created a new plant in Scotland and transferred completely one major product for world production. We deliberately picked a time when we were going into production on some new products in the United States, so we generated an additional 1,000 jobs in the United States at the same time we were transferring this major product abroad.

Then Burroughs United States bought from Burroughs Britain, for dollars, the calculators that we wanted, and by agreement we established our own quid pro quo program. We had our own internal Marshall plan, so to speak. We created our own exchange and were given credit for it, so that in turn Burroughs Britain could then buy

from Burroughs United States with dollars, fabricated parts covering a whole range of products. These were then assembled and, because sterling was available in what was then called soft currency areas, we were able to penetrate the world market to a much greater extent, and our international revenue started to multiply rapidly.

Later for the same reasons, money reasons, a plant was activated in France to reduce restrictions. It gave us easier access to the 14 countries involved in the European Payments Union, and subsequently additional plants both in Britain and France have been necessary.

Now here is the end of the story. Our oversea personnel has grown since 1950 from 1,923 to approximately 10,000, and jobs in the United States have increased from 11,937 to 29,169.

We believe that exporting some work from the United States was necessary to create an effective corporate format of operation and is actually importing jobs for the United States.

Stating it differently, we are creating jobs there and we are creating jobs here as the result of the moves.

Now has it paid off? Let's look at the U.S. balance of payments. In that same period from 1950 through 1961, the Burroughs Corp. has made a contribution in export surplus alone of $190.9 million. Dividends returned were $35,430,000, or a total contribution to the balance of payments in that short period of time of $225 million. This would have been impossible had we not been able to operate freely under existing law, and, when necessary, make the periodic investments essential for expansion.

While we are on the point of expansion, may I say that a reinvestment privilege never should be restricted to any one area of the world, because we need to expand and to penetrate the market where the competition is the greatest. You asked about the Common Market. It is tough and it is getting tougher, and we need to invest in it.

Senator McCARTHY. Thank you, sir.

Mr. EPPERT. May I just make one other comment?

Senator McCARTHY. Yes.

Mr. EPPERT. Then I am through. It pertains to the Common Market.

This committee will very shortly be receiving H.R. 11970, the trade bill. One of the things that we will have to do is to negotiate against an external tariff of the Common Market. They are computing external tariffs by averaging existing tariffs.

Now that sounds very simple at first blush, but there is a problem. Let us say that in West Germany they have low tariffs and they are a great importing territory. And then there is a very small country that has high tariffs, but imports very little.

When we put all those countries together and make an arithmetical average the result is a higher tariff, and we may be sending exports into some territories at a higher tariff than we are now subjected to.

But the important point I want to make is this. We will have to deal not on a product-by-product basis with the Common Market but on categories of products, and also negotiate against an external tariff for the entire bloc. At the same time this proposed tax legislation doesn't permit American business, without punitive tax action, to cover the Common Market with one facility. It just doesn't make sense.

Senator McCarthy. If I could ask you a question that requires a sweeping judgment: What would be your opinion as to whether or not what we do on taxes in this particular area might be more important than whatever good might come out of the tariff provision proposals that are now being considered?

There is no revision being considered. I am talking about the authority being asked for and the way in which that authority might be effectively used to reduce tariff values in the immediate future.

Mr. Eppert. I think we must have a tax program which is absolutely compatible with all-out promotion of American business in the world market or, as we move toward freer trade, Mr. Chairman, we are in trouble.

Senator McCarthy. It would be hard to choose really between the two.

Mr. Eppert. The two are irrevocably locked together. As a matter of fact, the trade bill and a tax bill together constitute a new foreign economic policy, and both can have and will have either a very favorable or a very negative effect on our balance of payments. I repeat what we said in the formal statement. The final answer, the ultimate answer to a balance of payments, and the only permanent answer, must be through an excess of exports over imports.

Senator McCarthy. May I ask you another question. If you had to make the hard choice between not having a tariff revision and not having this tax revision, or having the tariff revision plus the tax revision provided by or recommended by the administration, what would your choice be?

Mr. Eppert. I will answer that very bluntly. If this tax proposal in its present form were enacted, and I say this as a free trader at heart, Mr. Chairman, if this tax bill went through as it is, I think we should back up and take a good, sharp look and maybe see how high we can build our tariff fences, and, of course, that would mean the end of economic leadership by the United States in the free world.

Senator McCarthy. Thank you.

Mr. Sumerwell of the Clark Equipment Co.

STATEMENT OF ROBERT F. SUMERWELL, TAX MANAGER, CLARK EQUIPMENT CO.

Mr. Sumerwell. Mr. Chairman and members of the committee, my name is Robert F. Sumerwell. I am tax manager for Clark Equipment Co., of Michigan, a manufacturer of industrial materials handling equipment, construction machinery, highway trailers, and heavy-duty transmission, axles, and torque converters.

Mr. Walter E. Schirmer, executive vice president of our company, appeared before you on April 24, 1962, and testified to the adverse results of the foreign income provisions of H.R. 10650 on our company and its efforts to export and carry on foreign commerce. The proposed amendments to section 13 of H.R. 10650 do not eliminate our objections to H.R. 10650. In fact, those amendments add new complexities and pitfalls.

The proposed new Treasury Department amendments to section 13 contain numerous instances where the Treasury Department will have delegated to it the power and authority to legislate not by an act of

Congress, but by departmental regulation on such vitally important tax matters as—

(*a*) Source of income;

(*b*) What constitutes earnings and profits;

(*c*) When is a foreign corporation avoiding foreign taxes in the opinion of the Secretary or his delegate regardless of the application of the foreign company's own tax laws?

It is claimed that these amendments clearly permit foreign manufacturing subsidiaries to reinvest earnings in foreign countries free of U.S. taxes. This is not so as a practical matter. If each foreign manufacturing company with earnings must make the new investment, can you visualize the long string of corporations that will result? The German company will invest in the English company; the English company will invest in the Brazilian company; the Brazilian company will invest in India, and so forth. What a complicated patchwork quilt of corporations will result. As a practical matter, how will this be done if there are foreign partners who wish to withdraw dividends rather than make further investment in new countries or businesses?

Clark has made a $10 million investment in a transmission plant in Brazil using its share of earnings derived principally from European operations. This investment was made by Clark's base company and no U.S. earnings were used for this purpose. Under these proposed Treasury amendments Clark could not and would not have made this investment.

If it is good business for foreign manufacturing subsidiaries to be able to make new investments, why is it bad business to use a foreign-base company to make the investments? Clark's experience has shown clearly that without this corporate vehicle it could not have developed its foreign manufacturing facilities as has been done and its U.S. earnings, exports, and employment would have been considerably less. Clark has not invested in foreign countries to reduce U.S. taxes but to increase the sale of Clark products and the income of the U.S. company and its U.S. shareholders.

The proposed amendments to section 13 infer that there is something bad for a U.S. corporation to control a foreign corporation and to use it in any way to increase foreign business even though the fees, profit margins, and so forth, paid by the controlled foreign corporation may be the same as it receives from arm's-length customers. This is completely unnecessary because section 482 in the present code gives the Internal Revenue Service ample authority to make certain that intercompany profits and charges between a U.S. corporation and a foreign corporation are reasonable and fair.

This Treasury Department proposal completely ignores a basic principle in the economy of free nations that goods are distributed by a system of wholesalers, manufacturers agents, marketing outlets, sales companies, warehousemen, and other distribution media. A foreign-base company owned by a U.S. company can be an integral part of this distribution system. If it is not a sham company, then it is just as important and useful to the world economy as is a controlled foreign manufacturing company.

The proposed amendments to section 13 will permit a branch of a controlled foreign manufacturing company to be considered as a subsidiary corporation for determining if its income is foreign-base com-

pany sales income subject to full U.S. tax. This will give the Treasury authority to determine when the Dutch sales branch and the Swiss sales branch of a French manufacturing company controlled by a U.S. company are earning base company sales income subject to the full U.S. tax, despite the fact that the operation of these branches is carried on under the tax laws of these foreign countries and the branches are paying taxes required to be paid under those foreign tax laws.

If Clark were to find that the Common Market required consolidation of European manufacture into one or two factories with distribution through sales branches in the principal European cities, under these provisions, at the sole discretion of the Secretary or his delegate, Clark could be taxed by the United States on 100 percent of the income of these foreign sales branches. The Treasury proposes that it be the judge, prosecutor, and jury to determine the U.S. tax results of foreign sales branches of controlled foreign manufacturing companies.

Under U.S. tax law, income from services performed outside the United States by a nonresident is not subject to U.S. taxes. Now the Treasury claims this is wrong, if the company performing the services outside the United States is controlled by a U.S. company. Under this proposal, it won't be just a question of where the services are performed, but of mere stock ownership.

Clark has a foreign-base company that has license agreements with foreign manufacturing affiliates and subsidiaries. The license fees are earned by the base company foreign personnel performing management and engineering services overseas. The rate of service fee charged is the same or very similar for both related and unrelated foreign companies. Should there be a U.S. tax penalty for the service income received from a related company as opposed to that received from an unrelated company? Apparently the Treasury Department believes that no U.S. company should have any business dealings with a controlled or related company without paying full U.S. tax, regardless whether the income is fair and equitable, for the services rendered.

It would appear from the statements of the Treasury Department as expressed in the proposed amendments to section 13 that Clark and other U.S. companies have organized foreign-base companies primarily to evade U. S taxes rather than to carry on foreign sales and service operations staffed with skilled engineering, accounting, and management personnel. It would appear from the Treasury position that Clark has built up a distribution chain of 180 dealers in 80 free world countries for the promotion, sales, and service of Clark products, the establishment of engineering and sales offices in Belgium and in 7 other foreign countries complete with skilled personnel merely to avoid U.S. taxes. This is not true as the facts clearly show. Clark's U.S. export sales in 1961 were 400 percent greater than in 1955. Clark's U.S. employment was 600 people greater in 1961—an increase of 300 percent over 1955 directly due to this export businesss. Clark, United States, has received dividends from its foreign investments of approximately $600,000, a return of 30 percent on its foreign investments of only $2 million made from U.S. earnings. This $2 million investment was made since 1955. Additional dividends are planned for 1962.

Clark cannot export its lift trucks and construction machinery in any great volume because the selling price is too high but by developing foreign manufacturing facilities for Clark products we can and do export components, service parts, and can develop a demand for some models not manufactured overseas. None of the products manufactured at Clark factories in foreign countries have been imported into the United States for resale by Clark.

Our base company is the corporate vehicle that has made this possible. Without it, the foreign market for Clark products might still be near the level of 1955 and we would have few, if any, of the oversea manufacturing facilities. For certain we would not have the $10 million transmission plant in Brazil. The increase in U.S. earnings due to the greater exports generated by the activities of the base company, and dividends returned to the United States, resulted in U.S. taxes on foreign source income of $1 million in 1961 compared with only a quarter of a million in 1955.

The Secretary of the Treasury purports in his draft language to hit only at tax havens but he includes as tax havens any income of a controlled foreign company organized in a country with a tax rate less than the United States, even though earned through bona fide foreign business activities. If, in his efforts to reach tax havens, he would refer only to sham or paper corporations set up abroad to avoid U.S. taxes, then new and different types of legislation should be considered to accomplish this.

To pass legislation having such far-reaching implications and which will not accomplish an improvement in the U.S. balance-of-payments position, an increase in the U.S. tax revenues of any consequence, and will not stimulate the growth of the U.S. foreign investments, can have no other result than damage to U.S. economic interests.

I recommend that this committee reject the foreign income tax proposals of H.R. 10650 as ill conceived and ill advised.

Because this is the last day of testimony on H.R. 10650 and I am the last witness, I would like to comment on certain matters that have come to my attention today and during the last several days of hearings. I ask your permission to submit my written testimony for the record.

Senator McCarthy. Very well.

Mr. Sumerwell. It would appear from the Treasury Department position on this bill that Clark Equipment Co. has built up a distribution chain of 180 dealers in 80 world countries for the promotion, sales, and service of Clark products, the establishment of engineering and sales offices in Belgium and in seven other foreign countries complete with skilled personnel, merely to avoid U.S. taxes.

This is not true, as the facts clearly show. Clark's U.S. export sales in 1961 were 200 percent greater than in 1955. Its U.S. employment was 600 percent greater in 1961, an increase of 300 percent over 1955.

Clark United States received dividends from its foreign investments of over $600,000 in 1961, a 30-percent return on its U.S. dollar investment in foreign countries from U.S. earnings. Additional dividends are being considered for 1962.

Clark cannot export lift trucks and construction machinery in any great volume because their U.S. costs are too high, but by developing foreign manufacturing facilities for Clark products, Clark can and

does export components, service parts and develops a demand for some models not manufactured overseas. None of these Clark products manufactured at Clark foreign factories has been imported back to the United States for resale.

Our base company is the corporate vehicle that has made this possible. Without it, the foreign markets for Clark products would still be near the level of 1955, in our opinion.

For certain, Clark would not have made a $10 million investment in a transmission plant in Brazil without the use of this base company.

The increase in U.S. earnings due to the greater exports generated by the activities of this base company and the dividends returned to the United States have resulted in payment of U.S. taxes in the amount of over $1 million in 1961, compared with a quarter of a million dollars in 1955 on similar foreign source income.

This program of investment overseas, far from being detrimental to our U.S. investment program, has produced profits for the parent company, both from the sale of components never sold overseas plus finished machines and service parts. This has provided increased funds in the parent company which have been invested in U.S. facilities and working capital.

During the period 1955–61 the parent company invested over $40 million in the United States in facilities and working capital but in the same period invested only $2 million of its U.S. earnings in its base company overseas and in its Canadian manufacturing company.

All further investments in foreign operations have been out of foreign earnings and debt not guaranteed by the parent.

I have called these facts to your attention because they illustrate clearly the usefulness and beneficial results to the United States of a base-company operation. Clark has increased U.S. revenue, increased U.S. balance of payments, and increased U.S. employment.

Clark could not have done this without its base company, and the only taxes it has reduced has been those of the foreign countries in which it has operated.

In just 5 years the Clark tax return to the U.S. Government has far exceeded the initial dollar investment in the foreign operations and dividends have just begun to flow to the United States.

Clark is not a unique company in this foreign business and in this type of an operation. Its experience is the experience of many U.S. corporations. A company like ours has been referred to as a "tax haven" corporation, and "tax havens" have been accused of avoiding U.S. taxes. What is a "tax haven"?

Mr. Dillon tried to define it as some kind of a transaction but that is wrong. The term "tax haven" has for the years since it first came into use referred to a corporation organized under the laws of certain foreign countries where the tax rates are low, and only income from the sales and services in those countries is taxed by those countries; that is, the taxation of "territorial" income only.

This definition of a "tax haven" is still the correct one, although the term is now being applied by the Treasury Department indiscrimately to good, substantial, foreign business operations, such as ours, as well as to the sham or paper corporations without business substance.

This has led to great confusion. Subsidiary tax havens, carrying on bona fide foreign business operations reduce foreign taxes but do not reduce U.S. taxes; but, in fact, they increase them.

The Secretary of the Treasury in his draft language attacked tax havens and has included as tax havens any controlled company organized in a country with a tax rate less than the United States, even though that company carried on bona fide foreign business activities.

If he would have directed his proposals to sham or paper corporations, they would have made good business sense and good sense for the United States.

The mere fact that a foreign base company has only its name on the door in its country of incorporation should not be damaging, provided it carries on substantial business activities from some other foreign address.

This is actually no different than going to the State of Delaware to organize a Delaware corporation without any plans to open an office in Delaware other than the statutory one required, or, if I may, a "name place" office.

Section 13, as now drafted, as well as the amendments so far proposed, will be very harmful to U.S. exports, jobs and balance of payments.

This also applies to the alternative proposal recently discussed by members of the Treasury Department with a very few members of industry.

I refer specifically to the "escape hatch" proposal which provides a sliding scale for required distribution of foreign earnings to the U.S. parent based upon the effective rate of foreign taxes paid.

All of the good, sound objections to section 13 and its Treasury Department amendment proposal apply to this proposal as well. There are also several other objections:

1. This escape hatch proposal recognizes the principle of taxing corporate earnings to shareholders before distribution. This is deplorable.

2. It will hurt the reinvestment of earnings in less developed countries where corporate tax rates are generally less than in Europe and in the United States. This is exactly contrary to the general administration policy of increasing investments in less-developed countries.

3. It is also incomplete in its form to the extent that we cannot anticipate now all the technical problems that would arise, but we can see one that would present a tremendous problem. It is the computation of whether the escape hatch applies in any year, and the computation of the effective foreign tax rates by U.S. standards.

4. This proposal is bad because it will not apply uniformly to all foreign corporations but will benefit those with long-established foreign operations and drastically hurt new and developing businesses desiring to reinvest their foreign earnings overseas, particularly in less-developed countries.

This proposal is poor legislation and, in my opinion, should never become a part of the U.S. tax law.

This morning we have heard the witness, Mr. Stanley Ruttenberg, representing the AFL–CIO. He stated that the testimony of Mr. Dillon on this bill, particularly the balance-of-payments data in his exhibit 3, had never been refuted by any witness. With this I disagree, and respectfully refer you to the testimony of Senator Javits on May 3, 1962.

It may be found on page 3886 of volume 9, or part 9, as it is called, of the hearings.

On that page Senator Javits is quoted as saying:

> Now, Mr. Chairman, instead of going into the details on the assumptions made by the Treasury and its well-known exhibit 3, I would like permission to have inserted as part of my testimony a memorandum prepared by my staff in which those assumptions are very sharply questioned, and, of course, I will make copies available to all members.

I also refer you to testimony submitted for the record as of June 20, 1962, by Mr. Von Berg of the Pfaudler Permutit Co., who discussed the flow of U.S. dollars and the benefit to the United States derived from foreign investments.

I would like to comment on the loss-of-job claims by Mr. Ruttenberg. I refer you to my own testimony of today and that of many other business representatives during these hearings which show that our companies have increased U.S. employment and not reduced it, and, at the same time, have also increased the U.S. balance of payments.

Mr. Ruttenberg and the Treasury witness, Mr. Dillon, claim that any foreign sales corporation is a sham.

I don't know what they really mean by that, but I wonder if they mean that all distribution organizations are shams. If so, what about our whole economy and that of the rest of the free world which is dependent upon the use of wholesalers, sales companies, marketing companies, et cetera, to distribute products?

Perhaps they mean that shams are only those foreign sales corporations controlled by a U.S. corporation.

It would appear that there is some type of a tax crime committed when a U.S. company does business with a controlled foreign company, even though the share of the profits involved in the intercompany pricing is fair and equitable.

Taxes are costs, nothing more and nothing less, just as labor and overhead are costs.

Management does not make decisions for tax reasons alone, but makes them as they affect the company's earnings and ability to sell its products.

Decisions are made to get the best possible results for the corporate shareholders, who are the ones to whom the management has to answer on the profitability of the company's operations.

No company moves abroad or invests abroad unless it is the only way it can carry on its business. It does not move abroad for tax purposes alone.

I was extremely interested and surprised to hear the statement today of Mr. Ruttenberg's and I quote:

> * * * and then I think we must also consider that if the U.S. company does lose business to a foreign company operated by, or whose ownership is not American, that no great harm is done to the United States by this.

And to quote further:

> So that it seems to me that no great harm is done to the U.S. companies if the business is lost to a foreign corporation * * *.

I do not believe any legislation is needed affecting the taxation of foreign income. Proper application of section 482, together with the new reporting requirements, will permit the Internal Revenue Service to reach sham tax haven companies and tax their profits for the United States.

Foreign tax haven businesses that carry on legitimate, proper foreign business activities can continue to operate beneficially for the

United States, subject to review by the Internal Revenue Service under section 482, that the profits received by the U.S. parent from intercompany transactions are fair.

I would like to read into the record one sentence from the code at this time because I think that it is the answer to the "sham" operation problem. Section 482 contains just one sentence:

> In any case of two or more organizations, trades, or businesses, whether or not incorporated, whether or not organized in the United States, and whether or not affiliated, owned, or controlled directly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations, trades, or businesses.

There are two leading cases in section 482. Oine is Jesse Hall, Sr., 32 Tax Court 390 (1959), affirmed in the Court of Appeals in 1961. In this case, Jesse Hall, a U.S. citizen, had to pay U.S. taxes on profits he had tried to transfer to a Venezuelan company to avoid such taxes. Hall wanted to pay tax on only 10 percent of the profits in the United States and put 90 percent of the profits in the Venezuela company. The court said that he must pay tax on 70 percent, because that was what was earned in the United States.

Another leading case is *Asiatic Petroleum Co.* v. *the Commissioner*, 79 Federal 2d District 234, certiorari denied by the Supreme Court, 296 U.S. 645.

These cases clearly show that transactions between a U.S. corporation and its related foreign subsidiaries must be at "arm's length" to avoid the application of section 482.

Therefore, I cannot see why legislation is needed when the Treasury Department and the Internal Revenue Service have the statute and cases to support their positive action now.

If this bill, H.R. 10650, as proposed, becomes law, I believe that this committee and Congress as a whole will see a great demand for more and more foreign aid to replace the resulting reduction in private U.S. foreign investment.

Likewise, I firmly believe that more U.S. dollars will be exported for foreign investment than now is the case in order to partially replace the foreign earnings drained out of the foreign capital market to pay U.S. taxes.

I am certain that in my own company we will find it necessary to use some U.S. earnings for foreign investment if this proposal becomes law. This we have not done up to now, except for the original $2 million of equity capital put in our foreign corporations.

To conclude my testimony, I would like to quote for the record from the lead editorial of today's issue of the Wall Street Journal:

> If the administration had deliberately set out to design a piece of legislation that would defeat its purpose, it could hardly improve on the proposed tax change for earnings of foreign subsidiaries of American companies.

Thank you, Mr. Chairman.

Senator McCarthy. Thank you, Mr. Sumerwell.

This terminates the hearings on this tax legislation for this year.

The committee will meet in executive session on Wednesday next, July the 11th, to begin marking up the bill.

(By direction of the chairman, the following is made a part of the record:)

STATEMENT SUBMITTED BY H. PETER SOMERS ON BEHALF OF THE PHILADELPHIA NATIONAL BANK AND PHILADELPHIA INTERNATIONAL INVESTMENT CORP. ON REVISION OF H.R. 10650 PROPOSED BY THE SECRETARY OF THE TREASURY

The Philadelphia National Bank (PNB) is a national bank chartered in 1864 under an act of Congress. The Philadelphia International Investment Corp. (PIIC), a wholly owned subsidiary of PNB, is a so-called Edge Act company. It was organized in 1960 as a financing corporation under section 25(a) of the Federal Reserve Act, commonly known as the Edge Act, and is subject to the supervision and control of the Board of Governors of the Federal Reserve System.

Under the applicable law the business of Edge Act companies, including that of their foreign subsidiaries, is restricted to foreign financial operations, except for such activities in the United States as may be incidental to the conduct of their foreign business. These foreign financial operations may include loans to foreign governments, to foreign governmental agencies, and to foreign private business enterprises conducting their operations in various parts of the free world outside the United States. In actual practice, PUC's financing activities have been confined to loans made to private foreign manufacturing enterprises.

When the objectives of the pending legislation on foreign income taxation were first announced in the press release of the Ways and Means Committee, dated February 1, 1962, there was considerable concern that the income derived from the active conduct of a foreign financing business by a foreign affiliate of an Edge Act company might inadvertently be lumped with tax haven income. Such a result not only would have been clearly contrary to the specific policy of the Edge Act to encourage foreign financing operations, but it would also have gone beyond the stated objectives of the proposed legislation. These related to the artificial diversion of income from U.S. sources and the accumulation of passive investment income abroad, but they did not include interference with the active conduct of a foreign business.

The House version of H.R. 10650 specifically recognized the special status of foreign banking and financing affiliates, such as Edge Act companies. Thus, under section 952(e)(5) there is expressly excluded from the definition of foreign base company income—

"(A) the income of any corporation described in section 552(b) (relating to exception for banks and exempt corporations), or

"(B) the income of any foreign corporation if 50 percent or more of the fair market value of its outstanding stock is owned directly or indirectly by a domestic corporation which is either organized under section 25(a) of the Federal Reserve Act (12 U.S.C., secs. 611–631), or has an agreement or understanding with the Board of Governors of the Federal Reserve System under section 25 of the Federal Reserve Act (12 U.S.C., secs. 601–604), if all of the stock (except qualifying shares) of the domestic corporation is owned by a national or State bank which is a member of the Federal Reserve System."

The revised version of section 13 of H.R. 10650 recently proposed by the Secretary of the Treasury omits the foregoing exclusion of foreign Edge Act affiliates from the base company income provisions. However, this omission is not the result of any disagreement with the policy decision underlying the exclusion. On the contrary, the Treasury evidently intended to broaden its scope in order to exempt from the tax haven penalties other foreign income derived from active business operations. Thus, item 3 in the Treasury's explanatory comments under "Major Changes From Section 13 of H.R. 10650" reads as follows:

"3. Dividends, interest, rents, and royalties derived in connection with active business operations with unrelated persons are removed from coverage as foreign base company income. This change would remove the objection that section 13 treats certain types of operating income as 'passive' income in non-tax-haven situations. *Thus, companies engaged in the active business with unrelated persons of banking, financing*, shipping insurance, and leasing of property, *would not be covered by the foreign base company income provisions.*" [Emphasis supplied.]

If the italicized language were fully implemented by the statutory provisions actually proposed, it would be entirely consistent with the effect of section

952(e)(5) of the House version of H.R. 10650 and would meet with our wholehearted support and approval.

An examination of the proposed new statutory language, however, reveals that it produces, unlike section 952(e)(5) of the House version, only a partial exemption of foreign Edge Act affiliates from the foreign base company income provisions. The basic difficulty is that while foreign base company income generally includes all types of personal holding company income, the exclusion in the Treasury's draft is confined to dividends, interest, rents, and royalties. Thus, personal holding company income other than dividends, interest, rents, and royalties, as, for example, gain from the sale of securities, would, contrary to the Treasury's stated objective, remain subject to the foreign base company income provisions. Section 952(e)(5) of the House version, on the other hand, excludes all income of active foreign banking and financing operations from foreign base company income, without any suggestion of differentiating between various types of income.

The usual and regular income derived by a foreign Edge Act affiliate from its financing business would, of course, be interest, and such interest would not be foreign base company income either under section 952(e)(5) of the House version or under the new proposals. But if the Edge Act affiliates should, for example, realize a capital gain from the sale of debentures that have appreciated because of declining interest rates, such gain would be personal holding company income under section 543(a)(2).

It would be foreign personal holding company income under section 553 and foreign base company income under proposed new sections 954 and 952. As a result, the gain would be currently taxable as a dividend to the domestic Edge Act company under the Treasury's proposals, whereas it is not so taxable under section 952(e)(5) of H.R. 10650 as passed by the House. Like results might follow if the foreign Edge Act affiliate should sell at a gain an equity interest forced upon it as a result of a downgrading of its creditor status in connection with an insolvency or similar reorganization. Or the Edge Act affiliate might realize a gain from the sale of a stock warrant or similar equity interest acquired by it in the course of a financing deal. This possibility is a very real one, for in making loans in relatively underdeveloped areas the actual interest rate rarely is adequate compensation for the risks involved, so that the grant of a loan can be justified only by the simultaneous acquisition of a potentially valuable equity position in the form of a stock warrant or convertibility feature which may ultimately involve the realization of gain. The imposition of a current dividend tax on any such gain would, of course, discourage the extension of credit in underdeveloped, relatively high-risk areas, thus frustrating our national policy in this regard.

Moreover, under the Treasury draft the foreign Edge Act affiliate would have a powerful incentive to seek the conversion of currently taxable gain into nontaxable ordinary interest income—a novel twist to an old problem which might ultimately lead to equally artificial arrangements as those devised in the course of the more conventional attempts to convert ordinary income into capital gain.

Finally, the Treasury draft, in its present form, would discriminate against foreign business operations in the banking and financing fields, as compared, for example, with foreign shipping operations. Thus, if a foreign Edge Act affiliate were to sell an interest-producing debenture at a gain, it might be currently taxed. On the other hand, if a foreign shipping business were to sell a rent-producing ship at a gain, it would not be currently taxed. No doubt, it was not intended to draw any such distinction.

In brief, the provisions of section 952(e)(5) of the House version of H.R. 10650 evidently were omitted from the Treasury discussion draft only because it was thought that their substance was contained in the exclusion of dividends, interest, rent, and royalties from foreign base company income. This, as we have seen, is not the case. In order to cure this apparent oversight and avoid any unintended change of substance, the exclusion of the income of foreign Edge Act affiliates under section 952(e)(5) should be added in substantially its present form to the Treasury discussion draft, assuming the basic approach of that draft is adopted.

STATEMENT SUBMITTED BY MR. JOHN A. MIGUEL, JR. IN BEHALF OF THE INTERNATIONAL TRADE CLUB OF CHICAGO CONCERNING FOREIGN TAX PROVISIONS OF H.R. 10650

The International Trade Club of Chicago opposes the foreign income provisions of H.R. 10650 for the reasons stated below, and therefore urges defeat of the bill.

1. The "abuses" of present tax deferral privileges are not as widespread or as significant as the Treasury Department contends. We concede some abuses do exist, but we believe present tax laws provide adequate authority for the correction and control of the abuses of which the Treasury complains.

2. The ability to accumulate earnings in companies located in lower tax countries outside the United States enables U.S. companies to develop capital to be invested elsewhere. Undoubtedly much of this capital will be invested in the underdeveloped countries which the U.S. Government is anxious to assist. If this source of capital is throttled, it will be necessary to export capital from the United States in order to carry on this function.

3. Historically it has been proven that American investments abroad significantly increase our exports—beginning with machine tools and continuing on to parts and other products produced by the U.S. parent. These increased exports create more jobs and more wages in America. The proposed bill would deter American investment abroad and thus have an adverse effect on exports.

4. Normally U.S. investments abroad are only undertaken when the company cannot compete in the foreign market by exporting. Since there is a sizable risk involved, no company undertakes to establish a manufacturing operation in another country unless it feels this is the best manner in which to enter the particular market. Thus these investments do not replace production from American factories. Moreover, if the U.S. company is discouraged from making such investments, its foreign competitor being attracted by the same market conditions will act. Thus the U.S. company will not only lose the trade but also the profit from such investment that will eventually return to the United States.

5. In many instances tariffs make it impossible to import large varieties of goods into a country without paying prohibitive duties. In these countries American companies cannot compete by importing from the United States. Instead, our companies must organize their own operations in these countries.

6. The overall effect of oversea investments on the balance of payments situation is favorable. In 1960 the total dollars flowing into the United States from foreign manufacturing subsidiaries was $2.3 billion, whereas the total outflow from the United States to foreign subsidiaries was $1.0 billion, a net gain to the United States of $1.3 billion.

7. Tax considerations are a very important factor in U.S. business competing in foreign markets. Competitors from other countries utilize the tax reduction features of the lower tax countries. If U.S. business is denied the reduced taxes of these countries, it will be forced to forgo these business opportunities. This would obviously have a detrimental effect on the economy of this country.

The contentions of the Treasury Department that present tax laws provide a "loophole" for U.S. companies operating abroad are untrue. Our tax laws have never taxed income earned outside of the United States by citizens (corporations or individuals) of other countries. This legislation would severely discriminate against bona fide American enterprise abroad.

9. The proposed legislation constitutes an attempt to impose the authority of the U.S. Government on activities of a corporate citizen of another country when those activities are carried on entirely outside of the United States. The only basis for "jurisdiction" is to be the "control" owned (not exercised) by the U.S. shareholder. A serious question of the constitutionality of such an action exists. In addition, our foreign relations with the countries whose citizens would be affected would be adversely affected by such an attempt.

10. American private investment abroad is an important factor in our foreign policy. In recent years our Government has repeatedly emphasized the need for private capital abroad and encouraged American companies to go abroad. Restrictions of this type could cause serious regression in this program and would constitute a bad faith on the part of the United States for those companies who have aided their Government in its attempt to raise the economic levels of the world and are now to be penalized for doing so.

ROCKWELL MANUFACTURING CO.,
Pittsburgh, Pa., June 20, 1962.

In re amendments to House bill 10650 proposed by the Secretary of the Treasury.

Hon. HARRY F. BYRD,
Chairman Finance Committee,
Old Senate Office Building,
Washington, D.C.

DEAR SENATOR BYRD: Much of the testimony and written statements submitted to the Committee on Finance criticizing House bill 10650 is equally applicable to House bill 10650 as amended by proposed language submitted by the Secretary of the Treasury. Little could be gained by our reiterating some of these cogent comments and criticisms. We would like to make one or two observations, however, in an effort to orient this bill in its proper perspective.

The justification for House bill 10650 was to (1) correct unfavorable balance-of-payment problems; (2) establish tax neutrality; and (3) correct misuse of foreign corporations by diverting income to the foreign corporations in an effort to avoid U.S. taxes.

The myth surrounding the balance-of-payment problem and so-called tax neutrality, I believe, has been effectively exposed as evidenced by the testimony and written statements which are part of the record of the hearings on House bill 10650. See for example statement submitted by Standard Oil Co. (N.J.) beginning on page 3232 of part VII of the hearings.

It would seem the only remaining justification for legislation involving the foreign tax field would be if the present Internal Revenue Code is inadequate to correct so-called abuses of foreign corporations. The Treasury Department's approach to this problem is to create artificial distinctions, based on different types of business activities, between U.S. taxpayers owning investments in foreign corporations and taxpayers owning investments in domestic corporations, resulting in a dual tax standard in such concepts as capital gains treatment, standards for allocation of income, and concepts of unreasonable accumulation of earnings; and, in the final sweep, to legislate a division of the world economy by geographic locations of countries.

The Treasury's proposed amendments have attempted to eliminate some of the penal and vindictive features of House bill 10650, but even as rewritten, House bill 10650 still would not distinguish between legitimate and illegitimate foreign business operations. The "protective" language of proposed section 954(b)(4) is unclear and leaves the U.S. taxpayer foreign investor with no guidelines to determine whether or not he is subject to section 13.

It would seem, as a practical matter, that the only way a U.S. taxpayer would abuse the use of a foreign corporation would be either by improper allocation of income between it and the foreign corporation or by accumulating income in the foreign corporation in amounts beyond its normal business need. These abuses could possibly arise because of transactions described in proposed section 954(d) and they could possibly arise from other types of transactions not described in paragraph (d). They do not necessarily arise, however, because of transactions described in paragraph (d).

We sincerely believe the philosophies underlying sections 482 and 531 of the Internal Revenue Code are adequate to attack any abuse of the use of foreign corporations. To the extent these sections may not technically cover foreign corporations, any legislative language should nevertheless be drafted in conformity with these sections.

This bill is so complicated and introduces so many new concepts in our tax structure that it will be impossible for business to invest and operate in foreign markets with any realistic degree of freedom.

Very truly yours,

JEROME A. EARLEY,
Manager, Tax Planning.

SUPPLEMENTARY STATEMENT OF HARDWICK STIRES ON BEHALF OF REGISTERED FOREIGN INVESTMENT COMPANIES

(Mr. Stires appeared as a witness. His testimony appears on p. 3534 of the hearings)

This statement is submitted for the record of the Finance Committee's hearings on H.R. 10650, and is intended to supplement my statement to the committee of May 1, 1962, dealing with the new tax treatment for shareholders of foreign investment companies proposed by section 15 of the bill. Its submission is prompted by Secretary Dillon's report to the committee of May 31, 1962, recommending certain amendments to section 15.

The original statement was submitted on behalf of 13 foreign investment companies registered with the Securities and Exchange Commission under the Investment Company Act of 1940; it appears at page 3534 of the hearings.[1] In it we urged the committee, in considering the bill before it, to take into account the fact that these foreign-registered companies had been formed in response to the call of previous administrations for a vehicle making the foreign investment incentives of existing tax law available to large groups of private U.S. investors. Such private investment abroad, we pointed out, was expected to strengthen the economies of the free world nations and to reduce the need for aid programs by our Government. Accordingly, we questioned the wisdom of the sharp change in Government policy embodied in the bill.

In the event, however, that the committee decided that the proposed change was in the national interest, we suggested certain technical and substantive amendments to section 15 and certain clarifying statements to be made in reporting the bill to the Senate.

I am pleased to say that Secretary Dillion's proposals adopt substantially all of the statutory changes we recommended. The staffs of the Treasury Department and the joint committee have shown the utmost courtesy and cooperation in reviewing these changes with our representatives, and we greatly appreciate the consideration they have given to our suggestions.

With respect to the few suggestions we made which have not been incorporated in the revised draft proposed by the Treasury, we believe there are only three points of sufficient significance to require further consideration. These three matters, which we believe should be provided for in the statute, are discussed in the attached addendum.

In our statement of May 1, 1962, we also recommended that the report of the committee, which would accompany the bill, contain language to clarify two major matters. The Secretary's May 31 report presents only a proposed revised statute and, accordingly, does not set forth recommended language for the committee report. In view of their importance to the companies, and in order that they may be borne in mind in the preparation of the report, we here review the two suggestions we previously made:

1. *Domestication.*—We pointed out that one of the purposes of section 15 of H.R. 10650 was to provide for registered foreign investment companies and their shareholders tax treatment substantially identical with that of U.S. regulated investment companies and their shareholders. For this reason, some of the existing registered foreign investment companies may wish to reorganize as domestic regulated investment companies, bringing themselves and their shareholders within the system of taxation governing domestic companies under subchapter M of the code. Domestication would of course involve a reorganization requiring an advance ruling under section 367. Accordingly, it was proposed that the committee's report contain a sentence concerning the issuance of such rulings, as follows:

"Since the purpose of the new section 1247 is to provide tax treatment for registered foreign investment companies and their shareholders substantially similar to that applicable to domestic regulated investment companies and their shareholders, it is believed that the companies should be encouraged to become domestic corporations and that favorable rulings should be issued to them by the Commissioner of Internal Revenue pursuant to section 367 to permit the companies to become domesticated."

Since the shares of these companies are publicly held, their activities are closely regulated by the Securities and Exchange Commission, and in domesticating they would be subjecting themselves and their shareholders to taxation under the regulated investment company provisions of the code, it seems clear

[1] Hearings before the Committee on Finance, U.S. Senate, 87th Cong., 2d sess., on H.R. 10650 (hereinafter "hearings"), pt. 8.

that their reorganizing to make themselves U.S. taxpayers could not be with the purpose of avoiding Federal income taxes. Rather, it may serve to simplify the administrative procedures, for the companies, the shareholders, and the Treasury Department as well, involved in collecting substantially the same taxes from the shareholders. We believe the committee report should state, therefore, that the committee expects that those companies wishing to domesticate in order to produce this simplication will be allowed to do so.

2. *Reliance upon experts in determining income from foreign distributions.*—Registered foreign investment companies electing to qualify under proposed section 1247 must distribute 90 percent of their taxable income currently to their shareholders. Certain of the companies may find it difficult to ascertain with precision the amount of their taxable income, as determined by the standards of the Internal Revenue Code, from distributions received on stocks of foreign corporations, particularly distributions from foreign mining companies. Accordingly, we asked that the committee report include a statement that such a company would not be disqualified for failure to distribute 90 percent of its taxable income if in calculating such income it relied in good faith upon estimates and opinions of the independent certified public accountants and other experts which are also used in its financial statements filed with the Securities and Exchange Commission. The language suggested for this purpose in the committee report was as follows:

"It is recognized that registered foreign investment companies may experience difficulties in ascertaining the extent to which distributions which they receive on investments in stocks of other foreign corporations represent income to them under the standards of the Internal Revenue Code, particularly with respect to distributions from foreign mining companies. The bill provides that the company will not be disqualified under section 1247 if its failure to distribute 90 percent of its income is due to reasonable cause and not due to willful neglect. If, in determining its income, the company relies in good faith upon estimates and opinions of independent certified public accountants or other experts which are also used for purposes of its financial statements filed with the Securities and Exchange Commission under the Investment Company Act of 1940, such reliance would constitute reasonable cause for this purpose."

ADDENDUM

1. The corporations in which a foreign investment company owns securities may participate in mergers, recapitalizations and other transactions that would qualify as tax-free reorganizations if carried out by U.S. companies. For example, foreign investment company A may own 1 percent of the stock of foreign business corporation B which is merged into foreign business corporation C in a statutory merger. Pursuant to the merger the investment company receives shares of C in exchange for its B shares. If B and C were domestic corporations, this exchange would, of course, be tax free to A under section 354 of the code; but since B and C are foreign corporations A would realize capital gain or loss unless a ruling under section 367 is obtained.

The registered foreign investment companies confine their security purchases to minority holdings;[1] they do not control when or how such transactions by their portfolio corporations are initiated or carried out. It seems obvious that if they are required to exchange securities in such a transaction, it cannot be "in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax." For this reason it was originally suggested that the statute provide in section 1247(a)(1)(B) that a foreign investment company's capital gains be determined without the application of section 367.[2] Such a provision would spare the Treasury Department the administrative burden of ruling upon situations where the section seemingly serves no purpose.

If, however, the Treasury should consider it essential to retain the right to pass upon reorganizations involving the portfolio securities of registered foreign investment companies we urge that the committee make clear in its report that it recognizes such companies as having the right to obtain rulings under section 367 in determining their capital gains. Secretary Dillon has already told the committee in his May 10 statement that the Treasury would view sympathetically applications for rulings under the section, but the context suggests that what he may have had in mind were reorganizations involving controlled, rather

[1] See hearings, p. 3549.
[2] Hearings, p. 3539.

than portfolio, corporations.[3] We believe the policy should clearly extend to transactions in portfolio investments, if the statute does not eliminate the necessity for rulings under section 367.

2. Paragraph (3) of proposed new section 312(1) provides for reducing a foreign investment company's earnings and profits in connection with distributions in partial liquidation or redemption made after December 31, 1962. The earnings and profits account of such a company should clearly also be reduced as the result of partial liquidations and redemptions made on or prior to that date as well. The present language of the new rule, however, might possibly be construed as denying any credit at all for distributions prior to 1963. We originally suggested that the proposed new rule be made applicable to distributions both before and after December 31, 1962.[4] If this is not done, it seems essential to make clear in the committee report that the earnings and profits account should be reduced for the earlier distributions in accordance with present section 312(e) of the code.

3. Virtually all shareholders of registered foreign companies are expected to qualify under proposed section 1247, and thus avoid the new rule in section 1246 for gain on sale of their shares. For a shareholder in a nonregistered company, however, or a shareholder who inadvertently disqualifies himself, proposed section 1246(a)(3) poses a serious problem. If such a person sells or redeems his shares, he may face the burden of demonstrating the exact amount of his company's earnings and profits (and his ratable share thereof), on pain of having all of the gain he realizes taxed at ordinary income rates. For this reason it was suggested that the statute be modified to make it clear that the taxpayer could establish the maximum, as well as the actual, earnings and profits that measured the ordinary income portion of his gain.[5] It was also suggested that the committee report indicate that the taxpayer could establish and delimit maximum possible earnings and profits by showing the portion of his gain that represented his prorata share of unrealized appreciation in the company's assets.

STATEMENT OF WILLIAM G. VONBERG IN BEHALF OF PFAUDLER PERMUTIT INC., ROCHESTER, N.Y.

My name is William G. vonBerg and I am the corporate controller of Pfaudler Permutit Inc., Rochester, N.Y.

On May 2, 1962, I appeared before this committee to present my views with respect to the foreign income provisions of H.R. 10650, specifically sections 6, 11, 13, and 20.

Since that date, certain changes to the bill have been suggested by the Treasury Department, some of which are helpful in alleviating the inequities and administrative monstrosities incorporated in the legislation as originally proposed.

The most objectional section of H.R. 10650 for companies doing business abroad is section 13. Little if any improvement has been made as a result of the changes to this provision suggested by the Treasury Department.

I refer to the objectives of the Treasury Department in supporting H.R. 10650. These have been stated often and at length, and have been reported by the press as follows:

1. To improve the deteriorating balance of payments position of the United States.

2. To close existing tax loopholes by eliminating the use of tax haven subsidiaries.

3. To establish tax neutrality on the income of American oversea operations conducted through branches as opposed to foreign subsidiaries.

Masses of statistical data have been presented, both by Government and industry, to support their respective positions. Confusing as the issue has become, the objective evidence clearly points to the conclusion that our unfavorable balance-of-payments position has not been the result of American investment abroad. Indeed, our balance-of-payments situation would have been

---

[3] Hearings, pt. 10, p. 4256.

[4] Hearings, p. 3540.

[5] This could be accomplished by inserting "actual or maximum" between "the" and "amount" in line 11 on p. 149 of the bill. See hearings, p. 3538.

significantly worse, had it not been for the repatriation to the United States of income earned abroad from such foreign investments. Attached, as schedule A, is a chart showing a comparison of dollar investment abroad by U.S. companies and the resulting inflow of income. Schedule B, attached, shows our company's experience with foreign investment and the income we have received therefrom. Investment and the return of income run in sequence. Discourage or cut off the former, and the latter will soon dry to a trickle. This will not remedy our unfavorable balance of payments.

With reference to the closing of tax loopholes, no reputable businessman will question the point. Reams have been written by Treasury officials on the "deferral privilege," the "unreasonable accumulation of earnings abroad," and the "avoidance of U.S. income taxes," with no precise definition of the meaning of these terms. The propriety of the use of such slanted language by high governmental officials may be seriously questioned. Nothing, however, has been said about the business enterprises which have been established in foreign countries by U.S. companies for legitimate, reasonable business purposes.

Many American corporations, ours included, have established marketing subsidiaries abroad for the purpose of enabling them to compete with local businesses on an equitable basis. It is true that some American companies do business abroad through branch operations. Most U.S. companies, however, have found that this method of operation is both cumbersome and expensive. To operate through a branch, a U.S. company must first qualify itself to do business in accordance with the laws and tax regulations of that particular locality. Having done so, the U.S. company must then subject its entire operation to the scrutiny of local legal and tax authorities, must comply with local accounting practices, and must attempt to make an allocation of its business in each jurisdiction in order to determine the amount of income earned in each, which is then subject to taxation by each. Such an arbitrary allocation can readily result in a sum total of taxable segments in excess of 100 percent of total taxable income. Believe it or not, the sum of the parts can exceed the whole.

Let me explain my conception of legitimate, reasonable purposes for the establishment of a foreign subsidiary, with the following example. Marketing subsidiaries have been established abroad by some firms for the purpose of distributing the products of two or more manufacturing organizations which produce similar products. Consider the detriment to a business enterprise that would permit more than one marketing agency to distribute its products to customers in a single market area. In our particular case, we are engaged in designing, engineering, and manufacturing custom-built producer goods. To have several sets of representatives calling on the same customer, offering different specifications for equipment to produce the same end result, would be ridiculous. To attempt to service such specialized products through several sets of servicemen would be equally impractical. Hence, we have been and will continue to operate strategically located subsidiary companies abroad for the purpose of contacting customers, distributing our products, and furnishing adequate after-sales service for these products.

Yet, under current Treasury definition, this type of operation is classified as a "tax haven," and H.R. 10650 proposes to tax the U.S. parent company on the total earnings of this corporation even though these earnings are not available for distribution. The net result will be either : (1) the extent of the foreign company's operations will be curtailed, thereby inviting increased local competition, or (2) the parent company will pay the tax out of its own working funds, thereby reducing its potential expansion.

The first result would be quite inconsistent with the position taken by the administration in proposing new tariff legislation, the objective of which is to promote expansion of American foreign trade. The alternative second result would be quite inconsistent with the objectives of the administration toward accelerating the growth rate of domestic industry. It is difficult, if not impossible, to foresee, under these alternatives, an expanded rate of domestic capital investment or the creation of more jobs for American workmen.

The Treasury has referred to tax neutrality and has taken the position that there should be a removal of the differences in tax impact on domestic corpora-

tions doing business abroad through branches versus subsidiary corporations. I suggest that this is an illogical comparison, and it infers that the only factor involved in the decision by an American company considering operating overseas is the impact of taxes on its earnings. I suggest that a more logical comparison is between U.S. corporations doing business abroad and their local competitors. British oversea trade corporations and foreign corporations controlled by Canadians, for example, would have a decided advantage over their U.S. competitors in foreign countries. Is this the way to promote American expansion abroad?

Indicative of the arbitrary and ambiguous provisions of this bill is the proposal to classify countries as being either "developed" or "undeveloped." No criteria for making this distinction are established, but such definition is to be by Executive proclamation. By inference, it is the Treasury Department which will exercise such discretion. The Department of State, for world political reasons, may have an interest in this determination, as may the Department of Commerce. Considering the different objectives of these three agencies, the resulting decisions are interesting to contemplate.

Added to the risks incumbent upon the hapless American industrialist who is wrestling with the decision whether or not to make an investment abroad with shareholders' money is a new one. He must carefully weigh the impact on this investment of the rules which apply to undeveloped nations as against developed nations. He must then attempt to forecast the economic development of the country in which he invests, for in the not unlikely event that its economic classification is changed by Executive decree, the tax burden—and hence the return—on his investment will be quite different.

Another factor which must be considered by American business abroad is the impact of local import duties. It is very clear that industry within the Common Market countries is already providing increasingly severe competition to American industry within that trading area. Furthermore, their greatly strengthened position inside the Common Market is enabling the industries of these countries to offer even more aggressive competition to American exports in other areas. Japanese industrialists also are eagerly eyeing those markets in which American industry has enjoyed a predominant position. American industry is already burdened in the international competitive struggle by plant and facilities less modern and less efficient than those of its European and Japanese rivals. Most of their facilities have been rebuilt during the reconstruction period following World War II. American industry pays the highest wages in the world. Only by improving its technical ability and by discovering new and better products—both the result of heavy investment in research—can it hope to remain competitive in the world marketplace. This necessary goal will not be reached by imposing on American business the discriminatory and punitive tax provisions of section 13 of this bill.

In summary, I strongly urge the elimination of section 13 in its entirety. This most onerous provision of H.R. 10650 will not help correct our unfavorable balance of payments, it will not promote American expansion abroad, it will not foster an accelerated growth rate of domestic industry, and it will not create additional jobs for American workmen.

On the other hand, in spite of high sounding objectives, it will discourage American expansion abroad, it will place U.S. oversea enterprises at an unfair competitive disadvantage with local industry and with the subsidiaries of other foreign countries, it will tend to squeeze the United States into economic isolationism, and it will contribute ultimately to a reduction of the standard of living of the United States.

The Treasury Department, under existing laws and regulations, has ample authority to correct the "abuses" which it claims are being perpetrated by American businessmen. U.S. corporations are currently required to submit detailed information on their oversea operations. By examination of this data, the Treasury Department can readily determine any violation or unjustifiable "tax avoidance" through foreign subsidiaries and tax such earnings through a reallocation of income as provided under section 482. Similarly, alleged abuses arising through the use of "tax haven" companies can be eliminated.

Therefore, for the reasons I have stated, I urge the elimination of section 13 in its entirety from this legislation.

SCHEDULE A

Dollar inflow and outflow to direct investment companies abroad, 1950–61

[Millions of dollars]

Year	Direct investment outflow	Dividends and interest inflow	Net inflow	Year	Direct investment outflow	Dividends and interest inflow	Net inflow
1950	621	1,294	673	1957	2,482	2,249	(233)
1951	528	1,492	964	1958	1,181	2,140	959
1952	850	1,419	569	1959	1,372	2,206	831
1953	751	1,442	721	1960	1,694	2,348	654
1954	664	1,725	1,061	1961	1,681	2,637	956
1955	779	1,912	1,133				
1956	1,859	2,120	261	Total	14,432	22,984	8,552

NOTE.—(1) Data from Department of Commerce. (2) Covers all areas and all activities, branches, and subsidiaries. (3) Unremitted branch earnings are included in both outflow and inflow columns.

SCHEDULE B

Dollar inflow and outflow to direct investment abroad, Pfaudler Permutit, Inc., 10 years, Jan. 1, 1952, to Dec. 31, 1961

[In thousands of dollars]

	Amount invested abroad	Amount of income received in United States (before U.S. income taxes)
Western Europe	40	2,385
Far East	154	1,364
Western Hemisphere (outside United States)	1,088	450
Total	1,282	4,199

NEW YORK, N.Y., *June 15, 1962.*

Re H.R. 10650, foreign income provisions.

Hon. HARRY F. BYRD,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D.C.

DEAR SENATOR BYRD: In connection with the supplemental hearings to be held relating to the foreign income provisions of H.R. 10650, we desire to file this statement with the Senate Finance Committee, in order to call to its attention the following two points:

(1) Section 15 would add to the code sections 1246 and 1247 under which, in general, U.S. shareholders of foreign investment companies would be subject to ordinary income tax upon gain realized from the sale or redemption of their stock therein. A foreign investment company is defined in section 1246(b)(2) as a foreign corporation engaged primarily in the business of investing, reinvesting or trading in securities within the meaning of section 3(a)(1) of the Investment Company Act of 1940 (15 U.S.C. sec. 80a–1 et seq.). Under the draft of proposed Treasury amendments dated May 31, 1962, certain specific exemptions applicable under the Investment Company Act would also be made applicable for purposes of section 15.

The Investment Company Act of 1940 was enacted for the principal purpose of protecting small investors, primarily by requiring full disclosure concerning such companies. In furtherance of that purpose, the definition of the term "securities" under the Investment Company Act is very broad and includes many things not commonly thought of as securities, such as short-term promissory notes. In recognition of the broad scope of the statutory coverage, Congress provided not only the specific exemptions which would be picked up by the draft of Treasury amendments, but also a general power in the SEC, under section 6(c) of the act, to exempt any company from the provisions of the act if coverage of such company would not be in furtherance of the purposes thereof.

We question the wisdom of automatically applying the standards of the Investment Company Act of 1940, promulgated for an entirely different purpose, to section 15 of H.R. 10650. If that is to be done, however, we suggest that some additional exemptions are needed. Specifically, we have in mind a foreign corporation which is engaged primarily in the business of making short-term loans to various foreign enterprises. Such loans are evidenced by short-term promissory notes. Such a corporation essentially is engaged in a finance or lending business, and not in an investment business as that term is generally understood. Nevertheless, because of the broad provisions of the Investment Company Act of 1940 in relation to securities, such a corporation technically might be held to be covered thereby and, therefore, by section 15.

For Federal income tax purposes, short-term promissory notes are not generally considered securities. Under the provisions of subchapter C of the code, for instance, a mere promissory note having a maturity of less than 5 years is not considered a security. It seems to us that a corporation whose principal business is the making of short-term loans against such notes should not be subject to section 15. Accordingly, we suggest that from the definition of "foreign investment company" there should be excluded the following: "* * * a corporation engaged primarily in the business of lending money in return for obligations not issued in registered form or with exchange coupons attached and having a maturity of less than 5 years."

(2) We had previously filed with the staff of the joint committee certain comments with respect to the applicability of H.R. 10650 to foreign subsidiaries of so-called Edge Act companies, that is, companies organized as wholly owned subsidiaries of Federal Reserve Banks under section 25(a) of the Federal Reserve Act (12 U.S.C. sections 611–631). Under H.R. 10650, as passed by the House, such subsidiaries of Edge Act companies were specifically exempted from the application of the "foreign base company income" provisions, but were subject to the general rules respecting investment of earnings in "qualified property", that is, property used in a "qualified business". We had been troubled by the ambiguity in the definition of a "qualified business" which might be construed as requiring that the business must be carried on entirely outside the United States, and had suggested appropriate clarification of that language.

Under the new approach taken in the draft of proposed Treasury amendments dated May 31, 1962, many of the prior problems applicable to foreign subsidiaries of Edge Act companies appear to be satisfactorily resolved. If, however, the Senate Finance Committee desires to preserve the general approach of the House bill insofar as section 13 is concerned, we urge, on the basis of material previously furnished to the staff of the joint committee, that it be made clear that a "qualified business" need not be conducted entirely outside the United States.

Very truly yours,

CRAVATH, SWAINE & MOORE.

STATEMENTS OF COMMENTS BY COMMITTEE ON FEDERAL TAXATION OF THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS ON AMENDMENTS PROPOSED BY THE TREASURY DEPARTMENT ON MAY 10, 1962, TO SECTIONS 13, 15, 16, AND 20 OF H.R. 10650

SECTION 13

CONTROLLED FOREIGN CORPORATIONS

SUMMARY

TAX HAVEN LEGISLATION SHOULD NOT BE ENACTED

Complexities of legislation preclude enactment

Notwithstanding the latest amendments proposed by the Treasury, the Committee on Federal Taxation of the American Institute of Certified Public Accountants recommends that no legislation be enacted in this session of Congress to change the tax treatment of foreign business income. The committee believes that the complexity of legislation in this area precludes any action at this late time.

A review of the legislative history of the proposed legislation clearly demonstrates this complexity and the need for extreme caution in enacting legislation which would introduce into the tax structure new and perhaps unwise concepts.

President Kennedy first proposed legislation changing the tax treatment of foreign income in his message on taxation of April 20, 1961. Treasury Secretary Dillon later amplified the President's proposals on May 3, 1961, at hearings conducted by the House Ways and Means Committee. No legislative language was offered by the Treasury at that time. On July 28, 1961, the Treasury finally released a draft bill of proposed "tax haven" legislation. This draft actually amended the original proposals advanced by the President and later amplified by the Secretary of the Treasury. On January 31, 1962, the Treasury released still another tentative draft bill regarding "tax haven" legislation. This revision, changing the direction of earlier Treasury proposals, was submitted to the House Ways and Means Committee for consideration. The very next day, February 1, 1962, the House Ways and Means Committee rejected the Treasury's proposals and announced its own version of proposed "tax haven" legislation. These proposals, which differed from those recommended by the Treasury, were actively considered for the next few weeks. Then, on February 27, the course of the legislation was changed again when the House committee rewrote the foreign provisions. Finally, on March 12, after making still additional changes, the Ways and Means Committee approved the measures and ordered them favorably reported.

The foreign provisions of H.R. 10650 were not changed by the House which passed it on March 29, 1962. This chronology brings us up to the latest amendments to the foreign provisions which were advanced by Treasury Secretary Dillon on May 10, 1962.

The several proposals, and the frequent revisions of the foreign provisions, would indicate that any legislation to change the tax treatment of foreign income requires detailed investigation of all the possible ramifications and that if any legislation is to be enacted at all, it should be accomplished without pressure. It seems reasonable to us that no acceptable legislation can be enacted in this session of Congress.

Latest Treasury amendments

With respect to the amendments proposed by the Secretary of the Treasury on May 10, 1962, to section 13 of H.R. 10650, we believe that it corrects, in part, some of the problems presented in prior Treasury drafts; but these proposals are still too arbitrary and present far too drastic a solution for correcting "tax haven" abuses. Moreover, we are concerned over the wide latitude which would be given to the Secretary of the Treasury in prescribing rules which are properly a legislative responsibility. There are some 17 instances in section 13 as proposed which would give the Secretary or his delegate authority to prescribe regulations.

The new Treasury proposals would still impose unreasonable and unnecessary restrictions on American-controlled business operating abroad, penalize normal, legitimate sales transactions by reason of the definition of "foreign base company income" and create burdensome and costly accounting and administrative problems.

For the most part our previous comments ("Prepared Testimony and Statement of Comments" presented to the Committee on Finance April 3 and 10, 1962) concerning sections 13, 15, 16, and 20 as passed by the House, are still applicable. While the Treasury Department draft proposes to eliminate some of the major difficulties, we believe that they have inserted additional problems which will be commented on in the succeeding pages.

Our comments are presented in terms of—

A. Accounting and administrative problems.
B. Detailed technical comments in brief.
C. Conceptual and economic objections.

A. ACCOUNTING AND ADMINISTRATIVE PROBLEMS

1. General

The basic approach of attempting to define and segregate certain transactions as "tax haven" transactions creates compliance and administrative burdens of unwarranted magnitude and, in some cases, requirements which would be impossible to fulfill.

As explained by the Treasury, the basic approach taken in section 13 is to segregate certain classes of transactions and subject the income therefrom to special tax treatment.

While seemingly attractive in theory, in practice this would involve reviewing all transactions in order to determine those which are responsive to section 13. Accounting systems would have to be installed to insure that every transaction of every "foreign controlled corporation" is classified and recorded as transactions which are outside the ambit of section 13 and those which fall within the several categories taxable or possibly taxable under section 13.

The new accounting systems will form part of accounting records in foreign languages, foreign currencies, and in accordance with foreign accounting principles. Moreover, they must be designed to provide figures of income in U.S. dollars computed in accordance with U.S. tax accounting rules. It is clear that the burdens and cost of compliance would be great.

Paralleling this burden on the American taxpayer is a similar audit burden which would have to be assumed by the Internal Revenue Service.

2. Section 951—Amounts included in gross income of U.S. shareholders

The existence of a "controlled foreign corporation" may not be known by a U.S. shareholder. It may be difficult or impossible to obtain the needed information; qualified personnel may not be available to develop the information; it would be costly to develop the information and problems would be presented regarding the deductibility of these costs.

(*a*) *Uncertainty of existence of foreign controlled corporation.*—A minority shareholder owning 10 percent or more of the stock of a foreign corporation may not in some instances know whether there are other U.S. shareholders. Without the knowledge that he is a stockholder in a "controlled foreign corporation," he will not be in a position to attempt to make timely arrangements for the maintenance of the complex accounting records necessary for him to comply with the law.

(*b*) *Ability to obtain information.*—Even if the minority shareholder is aware that he is a shareholder in a "controlled foreign corporation," he may not be in a position to secure the necessary information to comply with section 13 because the "controlled foreign corporation" may refuse to furnish the in-

formation for what it may consider fully justifiable reasons other than the cost of compliance.

(*c*) *Need for qualified personnel.*—Gathering the information from the foreign corporation may not be possible by the personnel of the foreign corporation. Even in circumstances where the foreign corporation's personnel may be willing to supply the information, language barriers, lack of training, and so forth, may make obtaining the information in this way next to impossible. In many cases the only alternative open to the U.S. shareholders would be to send to the foreign country a team of accountants, assuming availability of personnel with the necessary qualifications, in order to gather the required information.

(*d*) *Treatment of costs incurred by U.S. shareholders to obtain information.*—Even if the U.S. shareholder can arrange for the foreign corporation to provide the requisite information at the expense of the shareholder, it would seem necessary to provide that such expenditure would be a proper deduction against U.S.-source income and not operate in reduction of foreign-source income with a possible resultant loss of foreign tax credit.

3. Section 952—Subpart F income defined

U.S. tax and accounting principles would be superimposed on foreign accounting methods. This would create difficult and perhaps invsolvable problems.

Earnings and profits.—This section, among other things, requires the determination of earnings and profits of each controlled foreign corporation for each year commencing after 1962. Proposed section 962 indicates that guidelines are to be provided by regulation for the computation of earnings and profits according to rules substantially similar to those applicable to domestic corporations.

We have previously stated our concern in this regard, but the new Treasury draft indicates the need for continued emphasis on the problems which may be anticipated.

Section 13 concerns itself with adjusted basis of certain U.S. property and earnings and profits of these foreign corporations. These determinations would be made under specific U.S. tax accounting rules. It should be obvious, however, that a foreign corporation will continue to keep its records applying the principles of accounting employed in the foreign country and complying with local laws and usage. Thus, the proposed provisions would make it necessary to maintain a duplicate system of recordkeeping. It is likely that in many cases the required information will be unavailable and that the foreign corporations will not be in a position to make appropriate determinations at the behest of the U.S. shareholder when there is a foreign minority interest. Accordingly, the U.S. shareholder would be put in the undesirable position of having to use his best judgment in reporting income and investment figures from available data, in addition, will be required to maintain auxiliary accounting records which may not be accurate under U.S. standards. He is entitled to protection from resulting tax penalties.

It is our opinion that U.S. tax and accounting systems should not be superimposed on foreign systems, and that generally accepted accounting practices employed in the foreign country be accepted for determination of U.S. tax under any proposed tax haven legislation.

In any event, while guidelines are to be provided by regulations for computation of earnings and profits, we believe administrative guidelines should not be substituted for statutory language. Unless regulations furnishing the guidelines are issued promptly after enactment—should that take place—considerable confusion and inconsistency would result. This emphasizes the need for coverage in the statute.

4. Section 954—Foreign base company income

New accounting records which would add substantially to the cost of operations would be required to develop necessary information regarding foreign base company income.

Additional accounting records would be required as a result of at least the following six factors:

(*a*) To determine in respect of each controlled foreign corporation the increase or decrease year by year in qualified investments in less developed country corporations for the purpose of ascertaining what dividends and interest may be excluded in arriving at foreign base company income.

(*b*) To determine in respect of each controlled foreign corporation year by year whether foreign base company income is less than 20 percent or more than 80 percent of gross income.

(*c*) To determine what income, if any, received by each controlled foreign corporation does not have the effect of substantial reduction in income taxes or taxes of a similar nature.

(*d*) To determine what personal property has been bought from or sold to related persons or has been bought or sold on behalf of related persons.

(*e*) To determine separately the sales income of branches of controlled foreign corporations in cases where such branches operate outside the country of incorporation. (This is because sec. 954(d)(2) would treat such branches as separate corporations.) It would be quite impracticable to make this determination where branches exist, for example, in some of the less developed countries.

(*f*) To determine what service income has been received from related persons outside the country of incorporation of the controlled foreign corporation.

5. *Section 954(b)(3)—Foreign base company income—Special rule*

> Because of the complexity of the provision under section 13, a de minimis rule with respect to taxable income should be incorporated in any legislation in this area.

It is proposed that no part of the gross income of the taxable year shall be treated as foreign base company income, if such income is less than 20 percent of gross income. This is a de minimis rule to exclude from the operation of the proposed provision marginal cases of potential applicability. It would appear appropriate, in addition to that provision, to establish a de minimis rule with respect to the amount of taxable income. For example, if a U.S. shareholder would be required to report taxable income of, say $10,000 or less, the proposed provision should not be applicable.

6. *Section 594(b)(4)—Foreign corporation not availed of to reduce taxes*

> The method of excluding from the proposed provisions those foreign corporations not availed of to reduce taxes will not accomplish the desired results.

Proposed section 954(b)(4) would exclude from the operation of the proposed provisions controlled foreign corporations, providing that it is established to the satisfaction of the Secretary or his delegate that the creation or organization of the controlled foreign corporation does not have the effect of substantial reduction of taxes. The standards given to the Secretary or his delegate to determine the applicability of these exclusions are so inadequate as to create a real possibility that the Secretary or his delegate will leave the decision to the courts. In order to make this provision meaningful, reasonable standards should be set out in the statutory language which will have the effect of encouraging the Secretary or his delegate to invoke the exclusion under appropriate circumstances.

7. *Section 954(b)(5)—Deductions to be taken into account*

> Taxable income, which is normally defined by legislative enactment, is left to administrative fiat. Substantial uncertainty is created by leaving material determinations to regulations yet to be issued.

It is unique and quite inappropriate in tax legislation to leave the determination of taxable income to regulations. Particularly objectionable is section 954(b)(5) which states in effect that deductions from foreign base company income will be allowable only to the extent of regulations to be prescribed. The only standard given for such regulations is that they take into account deductions (including taxes) properly allocable to foreign base company income, etc. The wide latitude given to the Secretary or his delegate has the effect of transferring legislative responsibilities to the administrative agency.

In any event, since the taxpayer would not be able to compute taxable income without such regulations, the legislation should not become operative prior to the issuance of final regulations under these provisions.

B. DETAILED TECHNICAL COMMENTS IN BRIEF

Following are 17 specific comments, questions, or observations regarding the latest Treasury draft of proposed tax haven legislation. For the most part, the comments suggest clarification of the intricate provisions of the proposed legislation.

Section	*Comment*
	1
951(a)(2)(B)	Subpart F income is taxed to the shareholders of a controlled foreign corporation on the last day of the taxable year. A reduction in the amount includable in taxable income is provided for dividends received by shareholders with respect to their stockholdings. Section 16 (proposed sec. 1248) provides that certain gains on the sale of stock in certain foreign corporations will be treated as dividend income. The question presented is whether a reduction in the subpart F income, as otherwise determined, will be allowed where a shareholder in a controlled foreign corporation disposes of his stock during the year and reflects such disposition in gross income.
	2
952(d)	It should be made clear that the reduction in earnings and profits here described includes increase in a deficit.
	3
954(b)(1)	The exclusions for reinvestments should not be confined to investments in corporations. Direct investment by the controlled corporation should be excluded, including investment through a partnership or joint venture.
	4
954(b)(4)	Standards for qualification under this exception should be clarified. For example, which corporation's taxes are substantially reduced? If reduced, against what standard is this reduction? Are these taxes reduced as against operation as a U.S. branch? Are they reduced as against another foreign jurisdiction in which the foreign-controlled corporation is operating or could operate? Further, it should be made clear whether this exception is confined to the creation or organization of new corporations or whether it includes the operation of existing corporations.
	5
954(b)(5)	It should be made clear whether the deductions include income taxes attributable to this income, including income taxes which are only payable on profits when distributed.
	6
954(c)(3)(A)	It should be made clear whether this excludes dividends, interest, rents and royalties received on temporary investments of funds not currently needed by a controlled corporation engaged in active business.
	7
954(d)(2)	It should be made clear how a branch has "substantially the same effect" as a corporation. Any branch could be considered to have the same effect as a corporation in some degree. It should be noted that treating branches as corporations in particular circumstances could result in the construction of a "great grandson" corporation with the consequent loss of a deemed paid foreign tax credit. Also, in particular circumstances, this provision could result in the loss of the protection of the 20-percent rule set forth in 954(b)(3).

Section	Comment
	8
954(e)	This section is so broad that it could encompass any kind of services for related subsidiaries including even administrative or accounting services. Also, it is not clear whether under this provision the Secretary would be estopped from creating service profits where in fact the services may have been performed on a break-even or nominal-profit basis.
	9
955(a)(2)	It should be made clear that earnings and profits in the year of disposition are decreased by the losses on disposition.
	10
955(b)(1)	Direct investment by the controlled corporation should be a qualified investment. The proposal could result in forcing the creation of "great grandson" corporations or less than 50 percent owned "grandson" corporations with consequent foreign tax credit loss. Further, the result is that even if the controlled foreign corporation is in an underdeveloped country, it cannot advantageously invest in that country except through a separate corporation. The provision appears to require that new stock be issued every year to cover qualified investment. If a capital contribution were considered to be an investment in stock, necessity for issuance of stock could be avoided.
	11
955(b)(3)	Where this results in refunds of tax paid, the question of interest on such refunds should be clarified.
	12
956(a)(1)	The question as to whether this would result in a dividend after income taxes (including taxes on distributed income, which taxes have not actually been paid) should be clarified.
	13
956(b)(1)	If beneficial interests in trust and partnership interests are to be included as "U.S. property," it should be so stated.
	14
957(c)(2)	The broader standard of section 931 should be used if income can be deferred by a U.S. corporation (i.e., a sec. 931 corporation). There would seem justification for deferral by a corporation organized in possessions of the United States.
	15
962	Will a foreign corporation be allowed to liquidate its foreign subsidiary tax free (i.e., as if sec. 332 applied) with or without a sec. 367 ruling?
	16
1249	Gain on the sale or exchange of patents, copyrights and similar property to a foreign corporation by a U.S. person which controls the foreign corporation will give rise to ordinary income. It is not clear what the effect will be of transfers of such patents, copyrights, etc., as a contribution to capital of such foreign corporations. Reference is made to IRC, ch. 5.

Section	Comment
	17
1249(a)	If this section and the language of "2" of the "General Description" and "1" of the "Major Changes" eliminate the possibility of a favorable sec. 367 ruling upon the transfer of patents abroad, this should be clarified. Sec. 1249(a) alone does not preclude a tax-free exchange under sec. 351 because the latter deals with the recognition of gain, not the nature of the gain.

C. CONCEPTUAL AND ECONOMIC OBJECTIONS

Certain conceptual and economic objections were set forth in considerable detail in our previous presentations. They are so fundamental, however, that we consider it useful to reiterate them in summary in this statement. The amendments proposed by the Treasury have not materially vitiated these objections, although, in some cases, they indicate recognition of and attempts to soften them.

1. Foreign commerce will be discouraged and U.S. exports reduced

The proposed legislation does not limit itself to tax abuses, but affects all business operations abroad, including long-established legitimate enterprises which under no circumstances could be classified as tax abuses. This broad attack can only lead to discouragement of U.S. private investment abroad with serious consequences to the U.S. economy.

The latest Treasury draft of tax haven legislation would still consider the income from normal legitimate sales transactions as "bad" income. A domestic corporation would have to recognize foreign base company income from selling activities anywhere in the world even if the sales represent goods manufactured or produced solely outside the United States. No provision is provided for reinvestment of income from such sales either in developed or underdeveloped countries of the world. This is entirely too arbitrary. A domestic corporation could mitigate the severity of this rule by incorporating a subsidiary in each of the foreign countries of the world where they may currently or subsequently make sales. It seems undesirable to enact legislation which would impose burdens on domestic corporations operating in legitimate worldwide activities, and which emphasize mere form rather than substance.

2. Entirely new and unwise concepts are proposed by disregarding the separate entity of foreign subsidiaries

It has been said that the corporate entity can be ignored where it is found to be a sham. The proposed legislation, in effect, adopts an entirely new concept because it ignores the corporate entity whether or not it is a sham and imputes to a U.S. shareholder income earned by a presumed "controlled" corporation whether or not it can or does distribute such income to its shareholders.

We believe it an unwise and regressive step in U.S. tax policy to disregard legitimacy of the corporate entity recognized under the present U.S. tax system. Adoption of this new principle with respect to foreign corporations would be discriminatory since it is not generally applicable to all corporations.

3. U.S. businesses would be hampered in competition with other countries' nationals in markets foreign to both

Most, if not all, of the economically advanced countries competing with American business in world markets afford positive tax incentives to their corporations and subsidiaries operating and trading abroad; for example, the United Kingdom oversea trade concept and the Holland (100 percent) and Belgium (80 percent) tax reductions for oversea income remittances. New burdens would be placed on American-owned foreign subsidiaries which will put them at a serious competitive disadvantage with foreign-owned competition, and may cause our enterprises to lose their share of world markets. The United States would be adopting economic isolation.

4. Arbitrary distinctions between developed and underdeveloped countries will discourage American business investments abroad

The proposed legislation provides different tax results as to developed and underdeveloped countries. This is an inequitable approach since in many cases

a business may operate across many national boundaries for sound management, business and economic reasons unrelated to tax considerations, but rather to stimulate growth in all countries in which it operates. To draw arbitrary distinctions between acceptable and unacceptable investments, country by country, for U.S. tax reasons is basically unsound.

The proposed amendments would eliminate the problem of investment in a country subsequently declared developed; however, it does not resolve the problem of business operating across international boundaries.'

5. The spirit and intent of 21 bilateral tax conventions would be violated

For the past 40 years the U.S. fiscal authorities have negotiated tax conventions with foreign governments for avoidance of double taxation. To date 21 such treaties have been ratified and approved by the Senate of the United States after careful deliberation, public hearings, and recommendations by its Committee on Foreign Relations. All of these tax treaties have recognized that a corporation is a legal and separate entity and that such corporations have a recognized standing where a legitimate business purpose is served by its form of organization. In imputing income to a corporate shareholder for U.S. income tax purposes the proposed legislation does violence to the sanctity of the corporate entity and by so doing violates the spirit and intent of these tax conventions.

SECTION 15. FOREIGN INVESTMENT COMPANIES

I. SECTION 1246(A)(3)—A PROPOSED DE MINIMIS RULE

A de minimis rule should be incorporated into the statutory language to relieve small shareholders of the necessity of making the required determination of earnings and profits.

Substantial practical and administrative problems will be encountered in the determination of the amount of ordinary income resulting from the sale of stock in controlled foreign investment companies as a result of the requirement for determination of earnings and profits of such company. It would be appropriate to relieve taxpayers of this burden where the result will not do injustice to the principles of taxation which motivate these provisions. A policy of this nature would also relieve administrative enforcement in areas where only nominal additional taxes might be in issue.

We suggest that consideration be given to the adoption of a de minimis principle in which gain from the sale of stock in controlled foreign investment companies of under, say, $1,000 (per taxpayer) would be excluded from the provisions of this section.

2. Taxpayer to establish earnings and profits

> It will frequently be impossible for a taxpayer to establish the amount of the accumulated earnings and profits of the foreign investment company and the ratable share thereof for the period during which the taxpayer held stock in the company.

Proposed section 1246 provides that when an investor sells his stock in a foreign investment company (which either is registered in the United States or principally owned in the United States) the portion of his gain attributable to accumulated earnings and profits of the foreign investment company after 1962 will be taxable as ordinary income.

The burden is placed upon the taxpayer to establish the amount of accumulated earnings and profits for the period that he held the stock in the foreign investment company. However, the term "earnings and profits" is not defined in the Internal Revenue Code and while it is indicated that the U.S. tax rules will apply, substantial difficulties will be realized by U.S. shareholders in making such determinations. The foreign corporation obviously cannot be forced to respect the rule, and it is equally obvious that individual shareholders will not be in a position to respect the rule because of lack of the required information.

Moreover, no provisions are included in the statutory language for determination of earnings and profits within accounting periods of the foreign corporation. Accordingly, it will be impossible under any circumstances to determine the earnings and profits for any sale of stock during a reporting year of a foreign-controlled corporation unless such corporation determines its earnings and profits on a daily basis; this would not be practicable. For this reason, provisions should

be incorporated in the statutory language permitting a determination of earnings and profits for interim reporting periods, possibly by allocating the income for the year on a daily basis.

SECTION 16. GAIN FROM CERTAIN SALES OR EXCHANGES OF STOCK IN CERTAIN FOREIGN CORPORATIONS

TAXPAYER TO ESTABLISH EARNINGS AND PROFITS

It is impracticable and unnecessary to place the burden of determination of earnings and profits of a foreign corporation on the taxpayer.

Proposed section 1248 would tax as ordinary income gain on the sale or exchange of stock in certain foreign corporations to the extent of earnings and profits after December 31, 1962. Again, the basic objection to be noted with respect to this provision is the complexity of the determination of earnings and profits and the probable inability to make the determination. It should be noted that the gain on sale or exchange of the stock is in no way related to the existence or nonexistence of earnings and profits, and the utilization of the proposed standard to determine whether the gain should be taxed at ordinary income or capital gains rates seems to be without foundation. Accordingly, it can be anticipated that any gains subsequently realized on the sale of stock will be primarily as a result of the earnings as determined under foreign accounting principles and reported to shareholders, and the prospect of future earnings. It would seem appropriate to relate the taxability of the gain to the reported income and not resort to complicated determinations such as earnings and profits which have no relationship to the gain recognized.

SECTION 20. INFORMATION WITH RESPECT TO CERTAIN FOREIGN ENTITIES

The following comments were made in our previous statements presented to the Committee on Finance. They are equally applicable to the latest Treasury draft and are restated for emphasis.

1. *Section 6038—Information to be furnished by individuals, domestic corporations, etc.*

   Very broad powers would be granted to the Secretary or his delegate regarding information to be furnished with respect to certain foreign corporations. Moreover, the penalty for failure to comply is severe in relation to information requirements.

The Secretary or his delegate would have the right under this proposal to require a taxpayer to furnish "any other information which is similar or related in nature to that specified." This new elements seems unnecessary in view of the full disclosure which is required under present law and which may be prescribed by regulations. Because of the severe penalties (through reductions of foreign tax credits otherwise allowable) which would be imposed in the case of failure to comply with all the requirements with respect to any "foreign corporation," all additional information required should be specified by statute if it is to be required at all.

Present law and the proposed law impose penalties without regard to any intended avoidance of tax and thus may be considered punitive. A wholly inadvertent failure to accurately and completely furnish the required information could result in a penalty. Where there is no willful failure to furnish the information no penalty should attach. Civil penalties could be related to the tax avoided. The arbitrary reductions in tax credits called for by any failure on the part of the U.S. person are beyond the needs of enforcement.

2. *Civil penalty for failure to file return*

   A civil penalty would be imposed for failure to file a return under section 6046 regardless of whether failure to file was due to "willful neglect." Under present law, section 7203, sufficient penalty is imposed for willful failure to file a return.

An additional penalty should not be imposed because of other penalties already in the code. Should section 6046 be amended as proposed, many shareholders could unknowingly fail to comply with the reporting requirements. This would be a very severe and unwarranted penalty.

SVERDRUP & PARCEL & ASSOCIATES, INC.,
St. Louis, Mo., June 21, 1962.

Hon. STUART SYMINGTON,
Senate Office Building, Washington, D.C.

DEAR STU: The House recently passed an act (H.R. 10650) to amend the Internal Revenue Code of 1954. Some of its provisions are intended to tax American stockholders of foreign corporations.

The bill presently is pending before the Senate Committee on Finance. Recently, Secretary of the Treasury Dillon appeared before that committee and proposed amendments to the House bill which are very disturbing. The House bill would tax American stockholders and require them to report currently as income (even though not paid to them) income which is known as personal holding company income, such as dividends, interest, and other income from investments. Mr. Dillon's proposal would tax them on a current income basis (even though not paid) not only the income just referred to, but also income "derived in connection with the performance of furnishing of technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial, or like services."

Having in mind the President's announced desire to have American foreign business expand, the fact that foreign governments actually subsidize engineering companies in their effort to enlarge business in other countries, and the fact that Russia has been active in supplying technicians and their services to undeveloped countries, Mr. Dillon's proposal seems singularly contradictory and unwise. Obviously, it not only would handicap American engineers and architects in their present efforts to compete abroad, but it would destroy any incentive to engage in such activities. The risks involved in working in foreign countries already are sufficient to deter the more prudent engineer or architect from entering that field. To add to this the burden of being required to pay tax on money not received, and which in fact may never be received, seems so unrealistic that I feel called upon to direct specific attention to it. I have no doubt that if the Senate, as a body, becomes aware of this provision, suitable action will result. However, I also have the feeling that tax legislation is so technical that if special attention is not directed to a provision like this, it can easily escape notice.

I am informed that the American Institute of Certified Public Accountants has made representations to the effect that all of the proposed amendments to the code which have for their purpose a desire to reach so-called tax haven income are unnecessary for the reason that the existing code contains provisions which give the Internal Revenue Service all the power it needs to correct any abuse that might exist in this field. I refer to section 482 which permits the Internal Revenue Service to reallocate income if it is found that corporations (foreign as well as domestic) are being used to avoid the payment of their just share of taxes. If that be true, the proposed legislation on this subject (which I am informed is exceedingly complex) is unnecessary and would merely add to the difficulties of the taxpayer in understanding and the Government in administering an already complex law.

I am informed that all businesses engaged in foreign operations are most disturbed by the pending legislation and are making strong representations about the destructive effect it will have on them and therefore I am addressing myself only to the effect the law would have on our professional activities.

With kind regards,

Sincerely,

L. J. SVERDRUP.

STATEMENT OF ROBERT H. TUCKER, MINNESOTA MINING & MANUFACTURING CO., ST. PAUL, MINN., WITH RESPECT TO AMENDMENTS TO SECTIONS 13, 15, 16, AND 20 OF H.R. 10650 PROPOSED BY THE SECRETARY OF THE TREASURY ON MAY 10, 1962

On June 8, 1961, Minnesota Mining & Manufacturing Co. (3–M Co.) appeared before the House Ways and Means Committee in opposition to the proposal to tax U.S. corporations on the undistributed profits of foreign subsidiaries.

On May 2, 1962, 3–M Co. appeared before this committee and voiced its opposition to H.R. 10650, particularly to those sections relating to the taxation of foreign operations.

On date of May 10, 1962, the Secretary of the Treasury, in his testimony before this committee, proposed certain changes in sections 13, 15, 16, and 20 of the bill.

Under date of May 31, 1962, the Treasury Department submitted in draft form the changes in the bill which had been recommended by the Secretary.

The proposed changes in the bill have been carefully restudied, and we herewith respectfully submit this statement in our continuing opposition to H.R. 10650. While we are opposed to this bill on broad principles, in this statement we confine ourselves to comments upon section 13 thereof.

MAJOR CHANGES IN SECTION 13

Section 13 as rewritten in the Treasury draft of May 31, 1962, is almost a complete rewrite of the former section 13. It is interesting to note how drastically the specifics of section 13 have been changed after but a few weeks of committee hearings. Among the major changes in the new draft which would affect determination of income, which under this bill would be taxable to a U.S. shareholder owning at least 10 percent of a "controlled foreign corporation," are the following:

1. Elimination of provision for taxing income from U.S. patents, etc., to U.S. shareholders on current basis and substitution of provision for taxing the sale of U.S. patents, etc., to "controlled foreign corporations."
2. Elimination of provision restricting the use of earnings by operating companies, except that such earnings cannot be invested in certain U.S. property.
3. Includes certain service income derived from related parties by a "controlled foreign corporation" as "foreign base company income."

These important changes materially affect the income the U.S. shareholder must report and on which he would be required to pay tax. It is submitted that yet another draft could be prepared within a similar short period of time which would call for taxing U.S. shareholders of a "controlled foreign corporation" on yet quite a different basis. Such material changes must come about only after a most careful and detailed analysis and study.

It would seem the changes were not only inescapable, but continued change will be inevitable, because the bill is an attempt to cover in one law all situations for all kinds of businesses operating in all countries of the world upon an indefinite and elusive basis for assessing the income to the U.S. shareholder. Today the calculation of tax on foreign subsidiary income received by a U.S. shareholder is not simple, but is at least possible to determine. Why? Because the basis is sound. The shareholder is taxed only when he receives income. And it seems to us that this very lack of a solid basis for determining income is the real source of most of the difficulties in enacting this bill into law. We cite, for example, the provisions of section 13 covering "foreign base company income," which provide in the event a "controlled foreign corporation" finds at yearend its "foreign base company income" exceeds 20 percent of its total income, then its U.S. shareholders are subject to U.S. tax for their pro rata portion of such income whether or not distributed.

ADMINISTRATIVE INTERPRETATIONS

The bill would appear to be next to impossible administratively. The vagueness of the entire bill and the power and authority which is left to the Secretary to be prescribed by regulation (17 such references are contained in section 13) warrants the position that the bill itself should not be enacted until these details have received full study. If enacted, business can anticipate a long period of uncertainty during which no company would know how best to operate, what unknown or unforeseen tax liabilities it might be creating for itself, or what ultimate tax liabilities (including penalties) might be imposed upon it.

In the new draft section 954(b)(4) reads as follows:

"EXCEPTION FOR FOREIGN CORPORATION NOT AVAILED OF TO REDUCE TAXES.—For purposes of subsection (a), foreign base company income does not include any item of income received by a controlled foreign corporation if it is established to the satisfaction of the Secretary or his delegate with respect to such item that the creation or organization of the controlled foreign corporation receiving such item under the laws of the foreign country in which it is incorporated does not have the effect of substantial reduction of income, war profits, excess profits, or similar taxes."

The foregoing exception recognizes that in attacking "tax haven" operations, which term has never been defined, normal business operations will become subject to the punitive provisions imposed on "foreign base company income." Relief is intended here consistent with the aim of this bill. But what does the above wording mean? How will it be administered? Business is provided with

no yardsticks, no standards. The question is raised—should not other taxes such as "turnover" taxes (used broadly by foreign countries) be given consideration in such determination?

RECORDKEEPING-REPORTING

Compliance with section 13 and section 20 will require voluminous additional recordkeeping and reporting. The income of each foreign subsidiary will have to be analyzed to determine if any part of such income must be considered "foreign base company income." These figures would require exhaustive examination of each transaction during the year to determine the source of all income.

FOREIGN BASE SALES COMPANY INCOME

Particularly referring to the 3M Co. foreign operations, which incidentally were established in 1951, we are currently operating in Western Europe through 10 "controlled foreign corporations." Many of these operating subsidiaries are in Common Market countries and it is little less than amazing the remarkable progress which has been made in the Common Market toward genuine economic union in these countries. It would be our hope that one day we will be able to operate with far fewer subsidiaries than is possible today. This would reduce our cost of doing business by simplifying our organization and administrative problems. However, under our interpretation of the applicable provisions of section 13, our French subsidiary (for example) could not purchase goods manufactured by our German subsidiary and sell such goods outside of France (if such outside sales exceeded 20 percent of the French company's income) without subjecting such income to taxation to 3M Co. as a stockholder, even though this income was not received by the parent. In the foregoing multicountry example, all transactions are entirely without the United States. The question is raised: Is it the business of the United States to police such transactions? The enactment of this provision could well lead to a multiplicity of unnatural and uneconomic corporate locations, organizations, and operations. U.S. foreign subsidiaries would thus be put at a competitive disadvantage. It would be expected that foreign competitors will not be compelled to operate under any such handicap as would be imposed by the United States under this section. If, in the foregoing example, the governments of the foreign countries involved do not question the transaction (which would come under the surveillance of section 482 of the United States Code, had the source of the goods been United States), under what rationale, on the example cited, should the U.S. taxing authorities impute income to the U.S. shareholder?

PATENTS

The new draft of section 13 relating to sale of patents, inventions, designs, etc., to "controlled foreign corporations," denies capital gain treatment to such sale, and taxes the gain therefrom as ordinary income. This treatment is imposed whether or not the sale or exchange of the patent, etc., was for adequate consideration and reasonable value. There seems little justification for thus discriminating against such a transaction, as compared with a similar domestic transaction.

EFFECT OF BILL ON FOREIGN GOVERNMENTS

Some consideration must be given to the possible action and reaction of foreign governments to H.R. 10650. It would seem likely that we could anticipate an increase in the foreign tax rates to equal the U.S. rate, as foreign governments will feel that if the corporation is to be subjected immediately to a U.S. tax, it might as well levy the tax itself and put the money in its treasury. In addition, it would seem if the United States by indirection interferes in the internal affairs of other governments in their relation with corporations existing under their laws, we may expect to find some kind of discriminatory counteraction taken by them.

CONCLUSION

It is our considered judgment that the enactment of the bill as now proposed would create administrative nightmares, would displace the judgment of management in plant location and methods of operation, and would antagonize for-

eign governments with ultimate loss to the U.S. Government in revenues and the balance of payments. Finally, the present unstable situation of both domestic and foreign business suggests caution in adding more uncertainties by changing the long-established rules.

REPUBLIC OF PANAMA, *June 19, 1962.*

Senator HARRY F. BYRD,
Chairman, Senate Finance Committee,
Washington, D.C.

DEAR SENATOR BYRD: Reference is respectfully made to H.R. 10650 now before the Senate Finance Committee which seeks to amend the Internal Revenue Code of 1954.

Now that your committee has decided to reopen hearings on that section of the bill which directly affects U.S. foreign trade, as well as extremely vital areas of the economy of Panama and Latin America, the Colon Free Zone Managers' Association deems it prudent to submit to the members of your committee, for purpose of review and record some of the efforts which have been undertaken from this country to preclude the possibility of harmful or unjust treatment to Panama, being unwittingly meted out by the Congress of the United States.

The Colon Free Zone Managers' Association is an organization representing the vast majority of the firms established and operating within the free zone, an autonomous agency of the Republic of Panama, and counts among its members a great number of U.S.-owned corporations. The free zone is an international trade area contiguous to territory under the jurisdiction of the United States, and an excellent example of joint Panama-United States planning.

We are fully aware of the aims the U.S. Treasury Department wishes to pursue in seeking this type of legislation. However, we are doubtful that the overall adverse effects which would ensue from enactment of the measure, in its present form, on Panama, in particular, and in general on United States-Latin American relations, have been given due consideration. Unless modified, H.R. 10650 could very well destroy the incentive for U.S. business to operate effectively and competitively overseas, and at the same time could seriously hamper the operation of the Alliance for Progress program.

This latter fact alone should give pause to the actions now being contemplated against foreign based business operations. Since the introduction of this tax measure in the House of Representatives last year, intense anxiety has arisen in the Republic of Panama, both at governmental and private levels. Diplomatic exchanges have occurred between Panama and Washington on the subject, and various sectors of the Panamanian community have made representations to the U.S. Congress and the Senate Finance Committee, itself, on the subject.

The accompanying material [1]—presidential messages, cables, resolutions, declarations and feature articles—graphically portrays the ill effects that could overcome the Republic of Panama by enactment of H.R. 10650. This batch of material also focuses attention on how the law will penalize U.S. business operations in Latin America, instead of furthering the program of business expansion so much to be desired. Furthermore, it points up the prevalent thinking in this region that, if enacted, certain provisions of the law would defeat the announced objectives of the Alliance for Progress which has been proposed by the U.S. Government.

It is also a well known fact that foreign trade and investments contribute favorably to the balance of payments and domestic employment. Therefore, we take the view that provisions of the new law should be so drafted as not to impose inequities upon U.S.-controlled foreign corporations which function legitimately in areas of international trade competition. If we are placed in the position of being unable to compete on a neutral and equal tax basis with the fast-developing industries of other countries, it will represent a severe curtailment of U.S. foreign economic opportunities, prestige, and a loss of trade balances far in excess of the revenue gains now contemplated.

Indications are that a postponement of action on the bill is being considered until next year. May we invite your attention to the fact that failure to adopt some action on this measure now will tend to militate against the establishment

---

[1] The accompanying material was made a part of the committee files.

of new business in Latin America where most American manufacturers and investors will take an attitude of "wait and see what will happen next year." As you are aware these are crucial moments in Latin America and 1 year of indecision could prove very costly to the entire hemisphere.

Very respectfully yours,

COLON FREE ZONE MANAGERS' ASSOCIATION,
HERBERT TOLEDANO, *President.*

ALTMAN, LEVENFELD & KANTER,
Chicago, June 11, 1962.

Senator HARRY F. BYRD,
Senate Office Building,
Washington, D.C.

DEAR SIR: On March 23, 1962, I wrote Mrs. Springer regarding the proposed revision of section 6038 under H.R. 10650 furnishing her a copy of an article of mine appearing in the February 1962 Journal of Taxation on the subject of the proposed expansion of the reporting requirements on foreign corporate operations.

With the scheduling of additional public hearings in June with respect to new proposals of the Treasury regarding the foreign provisions of the revenue bill of 1962, I would like to call to the attention of the members of your committee as part of these public hearings the substance of my preceding letter together with the article enclosed and the further point noted below.

In the previous letter I emphasized that the proposed revision of section 6038 would unreasonably expand the scope of foreign operations with respect to which reporting would be required by reason of application of the so-called attribution or constructive ownership rules of section 318, Internal Revenue Code of 1954.

The article above referred to includes several examples of how these rules would work and the inherent difficulty in complying with the rules in numerous circumstances where persons subject to the obligation to file might not even be aware of the obligation to do so and where they are unable to obtain the requisite information to be furnished.

A further comment which I have not noted previously I believe should be called to the attention of your committee. The number of parties between or among whom the transactions required to be reported on must be detailed under the present statutory provision is broader than finally adopted in the Treasury's regulations. Nevertheless, the proposed statute would extend to the same scope as the present statute instead of conforming to the narrower scope of the present regulations. This inconsistency seems completely unwarranted.

Under the present statute, reporting is required with respect to the transactions (1) between the foreign corporation and the domestic parent, (2) between any of the domestic company's foreign subsidiary operations, and (3) between such subsidiary operations and any shareholder of the domestic corporation owning at the time of the transaction 10 percent or more of the value of any class of stock outstanding of the domestic corporation. The present Treasury regulations, however, as a result of taxpayer comment on the originally proposed regulations, restrict reporting to transactions between the controlled foreign corporation or foreign subsidiary on the one hand and the domestic parent or any holder of the requisite stock interest in the domestic parent on the other.

The proposed statute would require reporting based on essentially three categories of relationship comparable to those in the present statute expanded to conform to the different approach of the present statute to encompass reporting by all U.S. persons and not only domestic corporations controlling foreign corporate operations, with the one change that in the third category of reporting it is to be with respect to transactions between certain shareholders of a foreign corporation and the foreign corporation instead of specified shareholders in the domestic corporation and the foreign corporation. Specifically, the proposed section 6038 would require reporting as to transactions (1) between the foreign corporation and the U.S. person in control of the foreign corporation. (2) between the foreign corporation and any other (foreign or domestic) corporation which the U.S. person controls, and (3) between the foreign corporation and any U.S. person owning at the time of the transaction 10 percent or more of the value of any class of stock outstanding of the foreign corporation.

It seems to me that this approach should be carefully considered by your committee so that the new statute, if adopted, will not, in effect, represent an adoption of a broader scope of reporting than exists under present Treasury regulations unless such is clearly intended. The Treasury apparently recognized the practical problems involved in this broader scope of reporting and voluntarily restricted the present statutory requirement of the second category. Congress should not impune this action of the Treasury and thereby preclude the Treasury from adopting regulations which are manageable and workable should this new provision be adopted.

I respectfully request that, if possible, you have this letter, together with my earlier letter[1] and accompanying enclosure brought to the attention of the members of your committee and included in the public hearings pertaining to this subject.

Very truly yours,

BURTON W. KANTER.

STATEMENT BY MR. CHAD F. CALHOUN, VICE PRESIDENT, KAISER INDUSTRIES CORP., WASHINGTON, D.C.

JUNE 29, 1962.

Hon. HARRY FLOOD BYRD,
Chairman, Senate Finance Committee,
Washington, D.C.

DEAR SENATOR BYRD: As I have heretofore advised you, a representative of Kaiser Industries Corp. and its principal associated corporations, Kaiser Steel Corp., Kaiser Aluminum & Chemical Corp., Willys Motors, Inc., and Permanente Cement Co., will not appear before your committee to testify with respect to the amendments submitted by the Treasury Department with respect to certain sections of H.R. 10650, as scheduled for July 3, 1962. However, in lieu of such appearance I respectfully request that the statements contained herein be made a part of the record of the hearings of the Senate Finance Committee.

DISTRIBUTIONS OF FOREIGN PERSONAL HOLDING COMPANY INCOME—SECTION 7 OF H.R. 10650

The draft submitted by the Treasury Department does not propose any amendment to section 7 of H.R. 10650. However, the amendments proposed with respect to the definition of subpart F income, to specifically define, by section 954(c), the foreign personal holding company income to be taken into account as subpart F income indicate that the amendments made by section 7 are no longer appropriate if these amendments are adopted.

Section 954(c) (3) of the draft bill excludes from subpart F income dividends, interests, rents, and royalties which are derived in the active conduct of a trade or business from unrelated persons. Section 954(c) (4) excludes such items of income under specified circumstances even though such items are received from related persons.

These provisions demonstrate that it is not necessary to tax personal foreign holding company income items, per se, in order to accomplish the purposes of the draft bill. It is also recognition of the fact that a foreign corporation may have gross income from such items in excess of 20 percent and not violate the principles of the draft bill.

If section 7 is not deleted from H.R. 10650, it will result in the taxation of individuals with respect to exactly the type of income which is to be excluded from the application of section 13. Not only would such income be subject to tax, but it would be subject to tax to every shareholder—not only those holding 10 percent or more of the corporation's stock.

It is our understanding that the amendments contained in section 7 by H.R. 10650 were for the purpose of equating the existing provisions with respect to the taxation of foreign personal holding companies to the amendments proposed in section 13 of H.R. 10650. (See p. 13. report of the Committee on Ways and Means.) If the Treasury changes in section 13 are accepted, section 7 of H.R. 10650 will no longer equate taxation, and, therefore, the amendment would not serve its avowed purpose.

Moreover, section 7 is not required for that purpose in any event, since foreign personal holding company income would, under section 13 of H.R. 10650, be taxed

---

[1] Previous letter made a part of the official committee file on H.R. 10650.

to shareholders holding 10 percent or more of the stock of foreign personal holding companies and with more onerous results.

The reduction of the percentage in the definition of foreign personal holding companies from 60 percent to 20 percent for a purpose unrelated to proposed revisions contained in section 13 of H.R. 10650 is completely without justification. This percentage, and the 80-percent test contained in the domestic personal holding company definition, were adopted at what were thought to be sufficiently low levels to discourage "incorporated pocketbooks" and at sufficiently high levels so as not to penalize and interfere with the operations of corporations engaged in the active conduct of a business. This premise is recognized by the Treasury Department in its proposed amendments to H.R. 10650, and apparently the 60-percent limitation has been regarded as effective for this purpose since 1937 when the foreign personal holding company provisions first became a part of our revenue system.

The reduction of the percentage in the definition will have the effect of treating many substantial operating companies as personal holding companies. It may, in fact, result in the taxation of corporations, the stock of which is widely held and traded on stock exchanges, as foreign personal holding companies. These results are not reasonable.

In the event the Senate Finance Committee adopts the provisions of section 13 of H.R. 10650, in almost every case a foreign personal holding company, as presently defined by the 1954 Code, will be a controlled foreign corporation, and its U.S. shareholders owning more than 10 percent of its stock would be taxed on their pro rata share of subpart F income from personal holding company sources, as well as other sources.

If the Senate Finance Committee adopts the provisions of section 13 of the draft bill, the U.S. shareholders of a corporation having personal holding company income, as defined by section 954(c)(3) and (4) will be taxed whether or not the shareholdings of the corporation meet the definition of a foreign personal holding company. If the corporation is, in fact, a foreign personal holding company, as presently defined by the 1954 code, its shareholders will be taxed currently with respect to all of its income without any amendment.

In our judgment, the amendments of section 552 of the 1954 code contained in section 7 of H.R. 10650 are unnecessary and unjustified, if the proposals of the draft bill are not adopted, and more unnecessary and unjustified if the provisions are adopted.

DETERMINATION OF "PRO RATA SHARE OF SUBPART F INCOME"—SECTION 951(A)(2)

Section 951(a)(1)(A)(i) requires that a U.S. shareholder of a controlled foreign coporation include in gross income his pro rata share of such corporation's subpart F income for the appropriate taxable year. The amount to be so included is defined in section 951(a)(2).

The pro rata share to be included in gross income by the shareholder is the amount of the corporation's subpart F income attributable to such shareholder by reference to his ownership on the last day of the corporation's year of the corporation's stock. If the corporation was not a controlled corporation for the full year, the amount described in the preceding sentence is to be reduced by the amount attributable to the period of the year during which the corporation was not a controlled foreign corporation. Subsection (B) of section 852(a)(2) provides for a further reduction of the includible income by "the amount of any distribution received by any other U.S. person during such year as a dividend with respect to such stock."

The limitation of this latter reduction to "distributions to U.S. persons" produces what we believe to be an unintended result and a result which is unjustifiable under any circumstances where persons other than "U.S. persons" are shareholders of the controlled foreign corporation and receive a distribution from such corporation.

To illustrate this point, assume that under the draft bill a corporation is a controlled foreign corporation during the entire calendar year 1963 and that it has subpart F income of $100. A owns 25 percent of the stock of such corporation which he sells to B on July 1, 1963, and B continues to own such stock until the end of the calendar year 1963. On June 30, 1963, the corporation distributed $50 as a dividend to its shareholders on that day. No further distributions are made by the corporation during the calendar year 1963. Under section 952(a)(2)(A), there would be included in B's income for the calendar year 25 percent of $100 or $25, reduced under the provisions of section 952(a)(2)(B) by $12.50, which was the amount distributed to A, provided, however,

that A was a U.S. person. If A were not a U.S. person, B would receive no reduction under subsection (B) and, therefore, would be chargeable with $25 gross income even though he could never receive more than $12.50, since that would be all the corporation had left to distribute to him. Under such circumstances his taxes on the income could be larger than the amount received.

This undue penalty is not alleviated by any of the provisions in the draft bill. It would be corrected if section 952(a)(2)(B) were amended to delete the term "United States" so that that provision would then read as follows:

"(B) the amount of any distribution received by any other person during such year as a dividend with respect to such stock."

We believe this suggestion is entirely consistent with the general philosophy of the draft bill. It would result in taxing to U.S. persons undistributed subpart F income for the taxable year, which is the object of the provision.

FOREIGN BASE COMPANY SALES INCOME—SECTION 954(d)(1)

The draft of statutory language submitted by the Treasury Department omits the limited deferral right which was contained in H.R. 10650 for earnings of foreign subsidiary corporations engaged in trading activities.

Many U.S. corporations maintain large staffs in centrally located foreign countries, the purpose of which is to conduct sales activities with respect to goods produced by these corporations and their subsidiaries. Experience has shown that these selling activities can be much more effective if located close enough to the customers to permit frequent personal and telephone communication. Because of differences in languages, customs, and time differentials it is not practical to conduct large-scale export sales operations in Europe, South America, and Asia from sales offices located in the United States. It is also impractical to open branch offices of the U.S. parent corporation in these foreign countries.

Consequently, most U.S. corporations conducting extensive export sales activities have found it necessary to set up foreign subsidiary corporations to handle foreign sales activities. Under the usual practice, the foreign subsidiaries either purchase the products and resell them or operate on a commission basis. In either case, the income received by the foreign corporation is only that income which is properly attributable to its sales activity and therefore is income actually earned outside of the United States.

Income attributable to the manufacture or other processing of such goods in the United States is properly included in the income of the U.S. corporation and is accordingly subject to tax by the United States.

In recognition of possible distortions of income between controlled organizations, the revenue acts for many years have conferred upon the Commissioner of Internal Revenue authority to allocate income and other items affecting the tax liabiliities of members of a controlled group between such organizations in order clearly to reflect income or to prevent tax evasion. The present provision of the law is section 482 of the 1954 code. It and its counterparts in other revenue acts have been used to prevent an improper attribution of income actually earned in the United States to foreign sources so as to evade our Federal taxes.

Section 6 of H.R. 10650 contains amendments to section 482 of the 1954 code which are intended to make this provision more effective and to lessen the burden of administering its provisions. Although we think the effect of section 6, if enacted, may result in substituting irrational formulas for sound judgment, we are not opposing its enactment. If enacted, it may make more stringent the rules with respect to the allocation of income to sales subsidiaries and aid the Internal Revenue Service in the enforcement of such rules.

Many corporations handle income from these sales activities much in the same way as income from their foreign manufacturing operation. Part of the funds, after payment of any applicable foreign taxes, are returned to the U.S. parent in the form of dividends and a part reinvested in foreign countries in operations which will increase the export sales and other earnings of the U.S. parent corporation.

The Treasury, however, proposes to tax to the U.S. parent corporation on a current basis the income earned by the foreign sales subsidiary regardless of whether this income has been repatriated to the United States. This is done by classifying sales income as "foreign base company income" under section 954 of the Treasury draft. Despite the fact that this sales income results from the active conduct of a trade or business and that section 482 prevents any unreasonable allocation of such income to the foreign activity, the Treasury has unfairly taken the position that foreign sales activity is a "tax haven" operation

in the same manner as the passive receipt of foreign personal holding company income.

There has been a great deal of testimony before the Senate Finance Committee and the House Ways and Means Committee pointing out that the elimination of the deferral of income legitimately attributable to foreign sales entities will have the effect of diminishing U.S. exports and thus contributing to a reduction of the balance of payments to the United States. Certainly, the enactment of any provision which would tend to diminish the competitiveness of the U.S. manufacturer in world markets and to discourage the incentive to export goods manufactured in the United States would be detrimental to the interests of the United States. If profit properly attributable to export sales were deferred until such profit was actually repatriated to the United States through payment of dividends or other distributions, there is an incentive to increase export sales. Treating such income as so-called tax haven income may well have the effect to encourage U.S. manufacturers to diminish their export sales efforts in favor of manufacturing abroad or through utilization of other sales organizations, which would further diminish the return of moneys to the United States.

Export sales of goods manufactured in the United States contribute very substantially to the flow of moneys to the United States. The portion of any gross income from export sales which is properly attributable to the foreign sales activity under the provisions of section 482 of the 1954 code is very small in comparison to the gross volume of income.

We propose that section 954(d)(1)(A) of the Treasury draft be amended by the addition of the words "outside the United States and" immediately before the first complete word in the fourth line of subparagraph (A). The effect of this amendment would be to eliminate income from the conduct of foreign sales activity on behalf of U.S. produced goods from the category of "tax haven" income. As indicated above, there is sufficient protection to the United States in section 482 to prevent any unreasonable attribution of income to the foreign sales subsidiaries and the Internal Revenue Service will have at its disposal all pertinent records of the manufacturing costs and profits attributable to the operations performed in this country, as well as with respect to the foreign subsidiaries.

We believe that the suggestion contained above that there be deferral of income realized from U.S. export sales will best serve the interests of this country. However, your committee may wish to consider a more limited deferral which would at least provide some of the advantages to our economy which we sincerely believe result from such deferral. We therefore suggest, as a possible alternate, that all income realized by a controlled foreign corporation through export sales of goods produced in the United States be excluded from subpart F income to the extent that such income is (a) used in the business of such controlled foreign corporation, or (b) invested in "qualified investments in less developed country corporations" as that term is defined in section 955(b) of the draft bill.

FOREIGN BASE COMPANY SERVICES INCOME—SECTION 954(e)

The draft of statutory language prepared by the Treasury Department and submitted to the Senate Finance Committee contains in section 954 a new category of so-called tax haven income, that of "foreign base company services income."

In his testimony before the Senate Finance Committee on May 10, 1962, the Secretary of the Treasury stated:

"Thus, the omission under H.R. 10650 of income received by tax haven companies from related parties for rendering managerial, technical, and other services outside the country of their incorporation should be corrected since this is a significant form of tax haven income."

It was expected from this testimony that the Treasury intended to cover as tax haven income certain managerial and technical assistance fees from related companies which in many respects resemble the foreign personal holding company income proposed to be currently taxed. It was our understanding, as well as many others, that this provision would be inserted to close a loophole which might result if royalty income from related companies (a form of personal holding company income) was converted to fees for technical assistance and managerial services.

The language proposed by the Treasury in section 954(e) goes substantially beyond this concept. "Foreign base company services income" is defined to include income not only from technical or managerial services performed for a

related company but also "engineering, architectural, scientific, skilled, industrial, commercial, or like services" where these services are furnished in connection with business activities carried on by the related company outside the country of incorporation of the corporation furnishing the service. (It should be noted that, contrary to the Secretary's testimony, the draft bill can be construed to cover activities of the controlled foreign corporation within the country in which it is incorporated.) This language is so broad that it could conceivably cover manufacturing or mining operations (as "industrial services") carried out wholly within the foreign country where a foreign corporation is created in situations where the output is sold to other related corporations for further processing or distribution. It could also cover shipping operations (as commercial services"), even though the Secretary of the Treasury in his testimony on May 11 specifically stated that the Treasury did not want to include such companies under section 13 of the bill. It would also be contrary to the intent of the Secretary indicated in the explanation to the Treasury draft on page 2 where he stated, "* * * Thus non-tax-haven profits, such as those of a manufacturing operation, would not be taxed under section 13 unless they were invested in certain U.S. property."

We suggest that the broad sweep of this provision is perhaps unintended and that this should be corrected by the addition of wording at the end of subsection (e) similar to the following:

"*Provided*, That the term 'foreign base company services income' does not include income derived from manufacturing, processing, mining or extraction of natural resources, engineering, architectural, scientific, or construction activities carried on by the controlled foreign corporation within the country under the laws of which such controlled foreign corporation is created or organized or income derived from ships engaged in foreign commerce."

INVESTMENT OF EARNINGS IN UNITED STATES PROPERTY—SECTION 965

Section 956 of the Treasury-prepared draft is a new section which embodies certain of the principles contained in H.R. 10650.

The purpose of this section is to treat as earnings of the U.S. shareholders property or funds which are returned to the United States much in the manner of a de facto dividend from the controlled foreign corporation in order to avoid U.S. tax which would be imposed if the return of the property or funds were actually in the form of a dividend.

We are in accord with the basic philosophy behind this section.

However, we believe that the scope of the language is so broad that the result will be that certain bona fide transactions will be reached that were not intended to fall within the purview of the bill.

One problem arises in situations where a controlled foreign corporation has already obligated itself to acquire and hold certain U.S. property other than that for which an exception is given under section 956(b)(2). It would be unfair to subject these transactions to taxation at this date. We suggest that this problem could be alleviated by the insertion of the following words in subparagraph (b)(1) after the words "December 31, 1962":

"(other than property a controlled foreign corporation obligated itself to acquire before March 12, 1962, pursuant to a transaction conducted at arm's length)."

The date March 12, 1962, has been suggested as that is the date H.R. 10650 was introduced. No taxpayer conducting business before that date could have been aware of the detailed provisions of the proposed new legislation. Moreover, a date subsequent to March 12, 1962, such as the effective date of the act, might be more fair since some taxpayers may have entered into transactions after March 12, 1962, while unaware of the impact of the proposed law.

With respect to the exception contained in subsection (b)(2)(C) of section 956, we also believe that limiting this exception to sales of property is unduly restrictive. We suggest that there be included after the word "sale" in the second and sixth lines of subparagraph (C) the words "processing or manufacturing." Obligations incurred in connection with either of these types of transactions, within the limits provided in subparagraph (C), have equally legitimate purposes as in the case of sales.

In addition, it would be desirable to have the committee report on this section include a statement such as the following:

"The term 'ordinary and necessary' in section 956(b)(2)(C) includes investment in obligations of U.S. persons which might reasonably be required of the controlled foreign corporation if the transaction involving the sale or processing of property had occurred at arm's length between unrelated persons. For example, such investment might be required by the commercial necessities of the

trading relationship between them or for the purpose of enabling the controlled foreign corporation or the U.S. person to finance the construction of facilities for producing or processing the property which is the subject of the trading relationship."

BLOCKED FOREIGN INCOME—SECTION 962(B)

This section provides, in general, that, under regulations prescribed by the Secretary or his delegate, no part of earnings and profits of a controlled foreign corporation shall be included in earnings and profits for the purposes of sections 952, 955, and 956, if it is established to the satisfaction of the Secretary or his delegate that such part could not have been distributed to U.S. shareholders because of currency or other restrictions or limitations imposed under the laws of any foreign country.

This change is suggested by the Treasury Department to meet the objections that shareholders might otherwise be taxed on constructive distributions under circumstances in which there could not be an actual distribution of money or other property. The addition of this provision removes substantial inequities which would otherwise exist under the proposed legislation. However, we believe that consistent with the principle of this section the principle should be extended in order to avoid substantial detriments to U.S. shareholders in similar circumstances.

One such circumstance is the situation which has been recognized by the Internal Revenue Service in Mim. 6475, 1950-C.B. 50, as amended by subsequent rulings of the Internal Revenue Service, and we believe that similar recognition should be given here.

We therefore believe that section 962(b) of the draft bill should be amended to insert in the seventh line after the word "corporation," the words "without substantial loss."

A closely related problem to that of blocked currency arises in situations where a controlled foreign corporation was already committed on March 12, 1962, to a retention of its earnings and profits, or a part thereof, to meet its obligations under bona fide indebtedness. An existing corporation which falls within the definition of a controlled foreign corporation may well have entered into an agreement pursuant to which it has obligated itself to use its earnings for the purpose of retiring indebtedness and is, therefore, unable to pay dividends to its shareholders. It would be grossly inequitable to tax the shareholders of the controlled foreign corporation with respect to income which is not available for the payment of dividends because of such agreement, and provisions of prior Revenue Acts presenting similar problems have recognized this inequity.

Specifically, the provisions with respect to the taxation of personal holding company income to the shareholders of both foreign personal holding companies and domestic personal holding companies recognize this inequity. The definition of undistributed personal holding company income, as set forth in section 545 of the 1954 code, provides an adjustment as a deduction from taxable income.

"* * * amounts used or irrevocably set aside to pay or to retire indebtedness of any kind incurred before January 1, 1934, if such amounts are reasonable with reference to the size and terms of such indebtedness."

In order to correct the inequities which might otherwise result, we suggest that there be added to section 962 a new provision which would provide as follows:

"Payment of indebtedness incurred prior to March 12, 1962. No part of the earnings and profits of a controlled foreign corporation for any taxable year used or irrevocably set aside to pay or retire indebtedness of any kind incurred before March 12, 1962, shall be included in earnings and profits for purposes of sections 952, 955, and 956, if such amounts are reasonable with reference to the size and terms of such indebtedness."

Again, we have suggested the date of March 12, 1962, inasmuch as that is the date H.R. 10650 was introduced in the House of Representatives. However, some later date may be more equitable inasmuch as taxpayers may have incurred such indebtedness without knowledge of the detailed proposals of H.R. 10650 as it may be amended.

LIMITATION WITH RESPECT TO SUBPART F INCOME—SECTION 952(C)

Pursuant to the provisions of section 951, a U.S. person is to be taxed upon his share of the sum of the items enumerated in section 951(a)(1)(A). The general concept of this section is that the U.S. person is regarded as having

realized such items of income directly and, therefore, such items should be included in the U.S. person's income tax returns.

It is incongruous that such income should be regarded as the income of a U.S. person when it exists and yet not give such U.S. person the benefits which he would have were such income to be realized directly by such U.S. person. Specifically, 952(c) provides a limitation with respect to the inclusion of subpart F income of any controlled foreign corporation in the tax returns of a U.S. person. This limitation, however, is in general that the subpart F income of any taxable year shall not exceed the earnings and profits of such year reduced by prior deficits.

We recognize that this and certain related provisions of the Treasury draft are much more equitable than the general application of section 13 of H.R. 10650. However, we do not believe that they produce the equities which are demanded in the circumstances.

The effect of 952(c) is to give a U.S. person credit for losses realized by a controlled foreign corporation on a deferred basis in the event that that corporation has income in the future. If a U.S. person is to be taxed with respect to current income, reason demands that such person should also be permitted to include in the computation of taxable income for any year any losses realized by such controlled foreign corporation attributable to activities which would be productive of subpart F income.

Similarly, there is no provision whereby U.S. shareholders who are individuals may claim a credit with respect to foreign taxes which have been paid by the controlled foreign corporation. It is true that section 954(b)(5) permits a deduction for taxes allocable to foreign base company income in arriving at the amount of such foreign base company income. However, such a deduction is not necessarily equivalent to a tax credit with respect to such foreign taxes. Had the individual U.S. shareholder carried on the activity directly, he could be permitted to claim such a credit. It is inconsistent with the concept of taxing him directly with respect to such income of the foreign controlled corporation to deny him a credit for the foreign taxes paid.

Respectfully submitted.

CHAD F. CALBOUN,
Vice President, Kaiser Industries Corp.

STATEMENT BY WILLIAM D. VAUGHN, PRESIDENT, OVERSEAS MANAGEMENT SERVICES, INC.

The proposed amendment to section 13 of H.R. 10650 purportedly improves the original version of this bill as a result of "numerous meetings with persons interested in the bill". The piecemeal modifications do rectify certain obvious inequities such as the threat to Puerto Rico's entire development program, which is based upon special tax considerations. They do, however, create other inequities to which I am sure many witnesses will point. And as before, almost all witnesses will oppose the whole concept of immediate U.S. taxation of business activities outside the United States.

One of the principal reasons for this opposition is the fact that U.S. companies must compete with non-U.S. companies which do have the very type of tax advantage the U.S. Department of the Treasury is trying to eliminate with this bill. My knowledge of business operations in Panama and the Colon Free Zone where my firm maintains operations substantiates this point. The difference of opinion with respect to how foreign companies utilize these facilities is exemplified in a comparison of statements of the Secretary of the Treasury and information which has been made available to my organization by local Panamanian management of the Colon Free Zone and by non-U.S. companies utilizing the Colon Free Zone.

Secretary of the Treasury Dillon, according to the record of the hearings on this bill before the Senate Finance Committee on May 10, 1962 (p. 4261) stated:

"We feel that this should not cause any real problem because although a few foreign companies do make use of tax havens, this very widespread use of tax havens is essentially an American phenomenon. If American companies could not use them, they would just be put on a more or less equivalent basis with most of their foreign competitors."

Mr. Dillon reiterated (p. 4274): "But foreign countries don't use tax havens to anywhere near the extent that we do."

And again (p. 4320) he stated: "The reason for that is that practically all foreign countries except Germany have a measure of exchange control. They simply do not permit their companies except in exceptional cases to use tax havens."

It is evident that Mr. Dillon feels that U.S. companies would not suffer in future competition with non-U.S. producers utilizing the facilities and the opportunities at present made available to U.S. companies, but which, if this bill is passed, would no longer be available. While it is true that any given foreign country does not use tax haven procedures to the extent that this country does, it is a matter of record in the Colon Free Zone that large foreign corporations do use Panama corporations for tax deferral purposes.

To take two specific examples: (1) A British manufacturing company making automotive component parts has a Panamanian corporation which operates its own warehouse with its own resident management, and this British company does not receive its dividends until declared by the Panamanian corporation. The British Government does not tax the earnings of the Panama company until such time as these dividends are received by the parent company. Undoubtedly, the British tax authorities recognize this procedure and permit it on a negotiated basis. This company would not be interested in this situation if it were not certain to be advantageous. and the British Government is evidently endeavoring to be of assistance. (2) The Colon Free Zone advises us that a group of Japanese manufacturers is well along in its plan to establish warehousing facilities in Panama, and Japanese law, we are advised, permits the creation of foreign corporations and does not tax the earnings of these corporations until such time as the profits are returned.

During the past 20 years the position of the United States as the major exporter of consumer and capital products to Latin America has altered drastically to the disadvantage of the U.S. manufacturer. In spite of the overall increase in consumption in Latin America, the U.S. share of the market in real terms has been conisderably reduced.

During the first few years after the end of World War II, the United States produced almost all goods and services imported in Latin America. As the economies of Western Europe and Japan recovered, product competition revived, and of course the U.S. share in the Latin American market was reduced. In the early and middle 1950's, the U.S. share of the market was further reduced because Western European countries, unlike the United States, provided the means to permit their manufacturers to offer Latin American buyers long-term credit arrangements.

For approximately the past 5 years, U.S. manufacturers have maintained their competitive advantage in Latin America because of superior products and the relative short length of time between the placing of an order and the delivery of goods. Generally speaking, Western European and Japanese manufacturers were unable to fill orders from stock, and the mass production facilities and geographical location of American manufacturers offered them a significant advantage. Most South American countries, during the latter part of the 1950's, required importers to deposit at least the amount equal to the delivery price of the goods ordered with central banks at the time an order was placed. With the high interest rates in South America, frequently in excess of 1¼ percent per month, the American time advantage became very important. The ability to deliver in 4 weeks, as opposed to 8 to 12 weeks, generally offset the price advantage of competitors in the market.

Many American manufacturers increased this advantage after 1951 by establishing warehouses in the Colon Free Zone. This facilitated direct shipments from Panama and enabled Latin American buyers to place smaller orders. During the late 1950's and early 1960's, European manufacturers also began to utilize Colon Free Zone facilities, generally through subsidiary corporations. During the past year, Japanese manufacturers, also recognizing the advantage of use of the Colon Free Zone, have begun to invest in Colon Free Zone facilities and also in what may be called permanent inventories.

At this time, therefore, the manufacturers of all countries utilizing the Colon Free Zone are more or less on an equal competitive basis. Each company which utilizes a subsidiary corporation to operate in the Colon Free Zone is generally able to offer the same freight time; each is able to accept smaller orders because of its maintenance of stocks of goods in the Colon Free Zone warehouses; and each is entitled to deferral of income tax until the profits are returned to the parent corporation.

At a time when Western European and Japanese manufactuers are taking every available opportunity to increase their investments in Colon Free Zone operations, and when a group of Japanese manufacturers are in the process of establishing a bank in Panama to finance further credits to Latin American buyers, the U.S. Government proposes to eliminate this operating equality by subjecting the profits of U.S. corporations in the Colon Free Zone to immediate taxation of income, thereby reducing the ability of American corporations to meet the ever-increasing competition for the Latin American market.

At a time when it is important to the United States to meet foreign competition in every way possible and to improve the position of the United States in the international financial world, it is submitted that the discrimination inherent in H.R. 10650 as passed by the House of Representatives against the marketing of American products is unwise from a national point of view and unfair from the point of view of the companies which have investments in the Colon Free Zone.

Mr. Dillon, in his testimony during the hearings on this bill as reported on page 4320, stated: "It is only in the case of the United States where the situation (tax havens) is at the moment more or less out of control."

As pointed out, undoubtedly both the British and Japanese Governments recognize the activities of corporations engaged in business in Panama. These companies have been given an opportunity to take advantage of a specific situation to gain a specific objective. Both of these countries certainly wish to increase their distribution in Latin America. Both are in a position to use the Colon Free Zone most advantageously for redistribution of their goods into this market.

If this situation is out of control in the case of the United States, it is probably because the U.S. Department of the Treasury has never adequately enforced a reasonable tax position within existing laws, nor can a U.S. company get any ruling from the U.S. Department of the Treasury on a proposed method of operation, even to meet specific situations.

To write comprehensive control legislation for this particular area of international trade without creating substantial inequities in relation to certain countries, certain industries, and certain companies is virtually impossible. The result of trying to write in specific exemptions creates a polyglot of piecemeal situations which unfortunately, when it is done, will in all probability result in discrimination against the corporations or industries who are least prepared to argue their case. As a rule, these will be the medium size to small companies who are not in a position to protest effectively against this proposed legislation. As a result, the large companies, or those most active in the international field, will have the opportunity and the incentive to restructure and revise their operations to take advantage of the specific exceptions which will be written in. The small company, which needs the opportunity the most, will be the most injured party.

It is submitted that the most logical course of action would be to utilize existing legislation to eliminate abuses or tax havens. First of all, a course of action by the Department of the Treasury should be undertaken to define properly the so-called tax haven corporation—a definition which it has been conspicuously unwilling to make. It is hoped that the Senate Committee on Finance will appreciate the difficulty of being asked to write legislation on a subject ill defined as "tax haven" without requiring the proponents of such legislation to define their terminology.

P. R. Mallory & Co., Inc.,
Indianapolis, Ind., June 28, 1962.

Subject: Revenue bill of 1962 (H.R. 10650).

Hon. Harry F. Byrd,
Old Senate Office Building,
Washington, D.C.

Dear Senator Byrd: Under date of April 13, 1962, I wrote you expressing the views of our company with respect to certain of the provisions of the proposed revenue bill of 1962 (H.R. 10650). In respect of the discussion of section 13(a), in indicating our position, we suggested that the higher taxes which would result to many companies operating abroad would make foreign investment less attractive. Since the date of my former letter, we have carefully examined our books and records relating to the various interests of our company in foreign subsidiaries and affiliates and, as a result of such review, it is our considered judgment that adoption of H.R. 10650 would result in additional taxation to

our company of approximately $50,000 per year. We believe that the impact of such additional tax on a company of our size is dramatic evidence that the concerns we expressed in our letter are valid. We feel that the adoption of H.R. 10650 would not be in the best interest of the economic strength of the United States or of its allies since we would take into account the impact of taxation on unremitted profits generated by a prospective investment in those countries where our foreign policy would otherwise encourage investment.

We would further like to suggest that while such additional tax which would be currently payable by our company to the U.S. Government would have the adverse effects noted, the real possibility exists that this additional tax dollar would not find its way into the U.S. Treasury. We are of the opinion that foreign countries might well increase their tax rate so as to result in their receiving these additional dollars rather than having the same paid to the United States.

In other respects, we would like to respectfully affirm our objections to H.R. 10650 as recited in our letter of April 13, 1962.

Very truly yours,

G. B. MALLORY.

STATEMENT OF ROBERT E. MARSHALL, VICE PRESIDENT, WORTHINGTON CORP., OF NEW YORK, IN CONNECTION WITH THE TREASURY DEPARTMENT'S PROPOSED AMENDMENTS TO H.R. 10650 RELATING TO TAXATION OF FOREIGN INCOME

In April, Mr. S. Riley Williams, a vice president of this company, testified before this committee in opposition to H.R. 10650 and the Treasury Department's then position. Our concern was and still is with the purpose to tax income earned abroad and not reduced to dollars in the United States—a form of taxation which we understand no other country imposes for a very good reason: through the centuries international trade has supported the economy of the great nations which have encouraged and not discouraged its growth.

The Treasury Department has now proposed a number of amendments to this bill. But these amendments do not really change the Treasury's fundamental position to tax income wherever earned abroad and never brought within the jurisdiction of the United States. This position stands upon the omnipotent power of government to tax its citizens. Whether government uses that power with conscience is the test which should be met.

The Treasury, with these proposed amendments, would tax the sale of capital—patents, copyrights, etc., as income. Would the Congress do the same thing with the imposition of taxes upon domestic transactions? These Treasury amendments would tax American citizens on the income of foreign companies because they engage in business in some country other than their country of incorporation. Would the Congress especially tax the income of, say, a New York corporation because it transacted business in some other State? These amendments would especially tax Americans even if a company they had an interest in used its profits to support a business in some less developed countries. Would the Congress vote to tax especially a New York corporation because it used its resources to engage in business in a commercially less developed State? We must evaluate the Treasury's position with today's and tomorrow's commercial life of the Common Market. The Treasury ignores the fact that we are now embarking upon a challenge to blend our economy with that of the Western World as we move forward to an integrated commercialism with our Western allies. Taxation based on geographic discrimination should not be a part of a forward looking tax structure.

Our great strength in the battle with communism is trade; our great hope of reversing the outflow of gold is trade. We have historically been a commercially adventurous country. But the trade of the United States will wither if American citizens are confined parochially to the borders of the United States.

The trade of the Western World will go on whatever tax measure is or is not voted by Congress. France, Western Germany, Great Britain, Japan, Italy, and the other knowing commercial-minded countries will participate in the great Western World trade now aborning because the trade will be there, but not—the Treasury Department proposes—the citizens of the United States.

If the Congress approves the foreign income tax provision of H.R. 10650, or some other version of it, it will be threatening the $20 billion of exports from the United States and the jobs of millions of Americans.

It is difficult enough for American owned or controlled foreign companies to compete with their foreign national competitors who have many inherent advantages. It may be impossible to successfully compete if we are saddled with the higher taxes Treasury proposes.

Foreign trade is one of the lucrative facets of American commercialism. We hope you will encourage that trade by striking from this bill the provisions which will discourage those who would engage in international business because of the tax this bill would levy on income, though never received.

STATEMENT OF HENRY F. ROOD IN BEHALF OF THE LINCOLN NATIONAL LIFE INSURANCE CO. ON THE DRAFT OF AMENDMENTS PROPOSED BY SECRETARY OF TREASURY TO FOREIGN INCOME PROVISIONS OF H.R. 10650

INTRODUCTION

The Lincoln National Life Insurance Co. is an Indiana corporation, organized in 1905, and doing business as a life insurance company. In addition, it is the owner of 100 percent of the stock of the Lincoln National Life Insurance Co. of New York which is organized, licensed to do business, and is doing business in the State of New York—the only State wherein the Indiana corporation does not do business as a life insurance company. In January 1957, the Lincoln National Life Insurance Co. (the Indiana corporation) acquired a controlling ownership of the stock of the Dominion Life Assurance Co., of Waterloo, Ontario, Canada; and presently owns 93.673 percent of the stock of such Canadian life insurance company.

The Dominion Life Assurance Co. had previously been licensed to do business as a life insurance company and had done business as a life insurance company not only in Canada, but also in several States of the United States. Since the 1957 acquisition by the Lincoln National Life Insurance Co., the Dominion Life Assurance Co. has operated virtually as an autonomous unit, and has expanded in its operations in the United States. It now does business in seven States and about 25 percent of its life insurance in force is on the lives of residents of the United States. As a result of its operations in the United States, the Dominion Life Assurance Co. is subject to the Internal Revenue Code of the United States, and—commencing with the tax year 1958—has filed income tax returns and paid U.S. Federal income tax in accordance with the Life Insurance Company Income Tax Act of 1959, as a "foreign life insurance company," pursuant to section 819 of the Internal Revenue Code.

STATEMENT OF PROBLEM

Since the Dominion Life Assurance Co. would be considered a "controlled foreign corporation" as such term is defined in proposed section 957,[1] there is a definite possibility of double taxation from its carrying on of a life insurance business in the United States. As a "controlled foreign corporation" under the Treasury's proposal, any increase in its earnings invested in U.S. property would be considered income to its parent even though the increase in such property resulted from an increase in liabilities or from U.S. income upon which it had paid a U.S. tax. It does not seem proper that an increase in U.S. property resulting from either cause should precipitate a tax upon the parent.

The Treasury's proposals recognize the harshness of H.R. 10650 in this area and would partially alleviate the situation by excluding from the definition of "U.S. property," in the case of an insurance company, "the amount of assets * * * equivalent to the unearned premiums on outstanding business with respect to contracts which are not described in section 953(a)(1)." Such exclusion would presumably be of considerable importance to a casualty insurer, but does not appear to be of significant assistance to the life insurer.

---

[1] Proposed section numbers as given in Draft of Amendments proposed by Secretary of Treasury.

Note, however, that the Treasury's proposed exclusion from "U.S. property" does not exclude an amount equivalent to the unearned premiums on contracts which are described in section 953(a)(1). Contracts which are described in section 953(a)(1) are those contracts insuring or reinsuring U.S. risks. It is not surprising that the Treasury prefers not to recognize such reserves, for the insurance and reinsurance of U.S. risks by a controlled foreign corporation has become a typical "tax dodge" of the type which the Treasury is properly attempting to prevent. However, the reason for not excluding an amount equivalent to the reserves on contracts insuring U.S. risks is absent when the controlled foreign corporation has paid a U.S. tax with respect to the profits derived therefrom. Indeed, proposed section 952(b) recognizes that it would be improper to impose upon the parent a tax based upon the U.S. income of a foreign subsidiary when that subsidiary is liable for a U.S. tax thereon, and excludes such U.S. income of the subsidiary from the parent's subpart F income.

Similarly, it seems inappropriate that an increase in the subsidiary's investments in "U.S. property" resultant from the subsidiary's having enjoyed a profit from its U.S. business should precipitate a tax upon its U.S. parent when the subsidiary has paid a U.S. tax with respect to its profits. It would seem that—with respect to its U.S. business—such a parent-subsidiary organization should be accorded the same tax treatment as though both were domestic corporations.

RECOMMENDATION

It is suggested that the Secretary's proposed section 956(b)(2) be amended by deleting subparagraph (E) thereof and adding the following:

"(E) the amount of assets of an insurance company equivalent to the sum of—

"(i) its unearned premiums and life insurance reserves on outstanding business with respect to contracts which are not described in section 953(a)(1); and

"(ii) its unearned premiums and life insurance reserves on outstanding business with respect to these contracts described in section 953(a)(1) the income from which is excluded from subpart F income by virtue of section 952(b).

Submitted by:

THE LINCOLN NATIONAL LIFE INSURANCE CO.,
HENRY F. ROOD, *Senior Vice President.*

STATEMENT OF THE NATIONAL AFFAIRS COMMITTEE, VIRGINIA STATE CHAMBER OF COMMERCE, TO SENATOR HARRY F. BYRD, CHAIRMAN, SENATE FINANCE COMMITTEE, REGARDING SECTIONS 13 AND 16, H.R. 10650, THE REVENUE ACT OF 1962, JULY 5, 1962

(This statement is intended to supplement the material we submitted on June 14, 1962, and represents our conclusions regarding the proposals with respect to foreign income in secs. 13 and 16 of H.R. 10650)

As we are sure you are aware, the radical changes in U.S. tax policy, the lack of precision and completeness in draftmanship, and the manifold complexities in application—all inherent in the foreign income provisions of H.R. 10650—make a concise critique extremely difficult. Witnesses and other spokesmen for the business community have already presented much excellent and persuasive material in opposition to the foreign income provisions of the bill. Accordingly, for the sake of brevity, we will not attempt a detailed discussion of all the shortcomings of the bill, as many have been adequately covered by others.

We want to say, first, that we recognize the absence of wide interest among the rank and file of voters in the foreign income provisions and that, therefore, the political aspects of these sections are not so sharply defined. However, the more we have thought about the President's and Secretary Dillon's proposals the more important they appear to be. Truly, some of them constitute changes in the most essential and fundamental concepts of our income tax system. Accordingly, we earnestly solicit your most careful consideration of all the facets of the subject.

Since Secretary Dillon has submitted a draft of statutory language that modifies the original H.R. 10650 approach to taxation of foreign income and embodies "technical improvements in the application and mechanics" of the bill, we shall direct our observations to the provisions of the revised draft.

First, we would like to point out that while the revised draft was described as "the more limited tax haven approach," the statutory language is not limited to the treatment of income that is commonly considered to be "tax haven" income. It attempts to reach much further in its application, as we shall later discuss.

SECTION 13. CONTROLLED FOREIGN CORPORATIONS

We are dismayed that the Treasury Department continues its campaign against foreign income in the face of practically unanimous opposition. Organized labor is the sole group to approve publicly the Treasury Department proposals. The opponents include not only the solid ranks of businessmen who would be directly affected, but also students—such as lawyers, accountants, and economists—who are intimately familiar with the principles and problems involved in the subject and who probably would stand to gain if the proposals were enacted into law.

General economic aspects

Whatever may be the ideological purpose of the proponents of section 13—and we realize there is much controversy about this point—one ostensible purpose is to diminish the outward flow of investment capital from the United States and assist in solving the problem of maintaining the country's gold reserves. Now we yield to no one in our concern over this vital matter. We are not among those who are ready to disavow the "cliches of the past," and we shudder at the prospect of national bankruptcy if the country's fiscal policies continue to be shaped in disregard of the immutable fact that ruin inevitably befalls the profligate.

On the other hand, we have the distinct feeling that the Treasury Department's approach cannot be sustained when all the economic facts are examined. For instance, the evidence submitted in the hearings establish beyond reasonable doubt that foreign investment by U.S. industry does not result in the "export" of U.S. jobs, nor does it damage our basic balance-of-payments position. In fact, just the opposite is true.

The record shows that investments and activities of U.S. business abroad have promoted the utilization and expansion of domestic facilities. Obviously, these do not result in reducing employment in the United States. On the contrary, our recent history is full of examples of increased demand for U.S. goods as a result of the cultivation of foreign markets and investment in facilities in foreign countries to fabricate or distribute goods manufactured here. Our country did not grow to its present eminence by staying out of foreign markets—we doubt that anyone would dispute that fact. And our success during this period in maintaining employment at a level much above the predictions of the proponents of Government controls should effectively dispose of the contention that jobs would be exported by the stimulation of foreign investment.

Insofar as the balance-of-payments problem is concerned, we believe the facts that have been presented to you will amply demonstrate how ineffective the tax proposals would be in curing the cancerous drain on our monetary system. Obviously, to the extent foreign investments were deferred, there would be a smaller balance of payments to be offset. But, just as surely the return flow of income from these investments would be smaller—and this effect would be cumulative for several years. Clearly, there are direct and much more effective methods of achieving a balance, or a surplus, of exports in relation to imports.

Competitive hurt to U.S. business

The Treasury Department gave way partly in face of the strong protests of U.S. business that section 13, as originally proposed, would put our industry at a stifling disadvantage in competing for foreign markets. Except for increases in U.S. property, the Treasury Department revision eliminated so-called operating foreign income from the taxable portion of income of controlled foreign corporations. However, the revised section 13 would continue, with limited exceptions, to subject the U.S. income tax undistributed income of these corporations that comprised dividends, interest, rents, royalties, and trading and service income. Thus, the Treasury Department would inhibit the use by U.S. business of international holding, trading, leasing, servicing, and licensing companies despite the fact that such enterprises owned by foreign interests operate at tax rates far below the U.S. corporate rate of 52 percent. We believe no one would deny that these types of international companies have effectively developed U.S. exports in competition with foreign products. Surely, it is inadvisable to put them at a competitive disadvantage by subjecting their income to U.S.

taxation, except to the extent that there is a diversion abroad of income that is properly attributable to the United States. As heretofore noted, any such diversion can be prevented by application of section 482.

The myth of tax equality

By use of such terms as "tax deferral," "tax neutrality," and "tax equality," the Treasury Department has obscured the fundamental issue raised in its proposal to tax certain income of controlled foreign corporations. In reality, the Treasury Department is attempting to tax income earned abroad before it is realized by a U.S. taxpayer. This is a complete departure from the rule existing since 1913 that the undistributed earnings of a corporation are not subject to U.S. tax, with the limited exception applicable to foreign personal holding company income.

The Treasury Department originally contended that equality of tax treatment required that practically all income of foreign subsidiaries operating overseas should—regardless of whether available to the U.S. parent—be subject to the same corporate income tax rates as the income of subsidiaries operating in the United States. It has now retreated from this position by eliminating foreign operating companies, but would subject to U.S. tax "passive" and "tax haven" income, in the form of dividends, interest, rents, and royalties, and certain sales and service income, earned by controlled foreign corporations.

The anomaly of the Treasury Department's present proposal is demonstrated when we consider the U.S. revenue consequences of taxing this income. If the income is subjected to foreign tax at rates comparable to U.S. rates, the operation of the foreign tax credit will result in the collection of no tax by the United States. However, if the income is earned in foreign countries with tax rates below those of the United States, then this country will currently collect tax thereon only to the extent not offset by the tax credit. Thus, the Treasury Department would discourage operations abroad resulting in income earned in low tax rate foreign countries. By what right and for what reason does the Treasury Department justify its attempt to control the places and methods of foreign operations of foreign corporations controlled by U.S. shareholders, particularly when the penalty imposed will not apply to U.S. shareholders of a foreign corporation controlled by foreigners? It is not a question of revenue; in fact, income earned in low tax countries would produce more U.S. tax when that income was distributed to U.S. shareholders. The truth is that the Treasury Department can advance no sound basis for this attempt to control the manner of earning income abroad.

A U.S. parent corporation does not realize income when its foreign subsidiary receives dividends, interest, rents, and royalties from other foreign corporations—whether or not they are related corporations—nor does it realize income when the subsidiary earns service fees or trading profits abroad in transactions with related corporations. The foreign subsidiary is not subject to U.S. tax because its income is not from sources within the United States. The situation of the foreign subsidiary is not comparable to that of a domestic subsidiary operating in the United States. The latter is taxed to finance Government expenditures which in various ways provide protection and other benefits to the corporation in the United States. The foreign subsidiary, with its earnings and operations abroad, receives few if any, of these benefits.

On analysis, therefore, the Treasury Department cannot support its charge of tax "inequality" between foreign and U.S. subsidiaries in the area of foreign income vis-a-vis U.S. income. The only condition that warrants any change is in the area of tax avoidance—which we are convinced is not widespread—resulting from arrangements and transactions between related U.S. and foreign corporations whereby income properly attributable to the U.S. parent is allocated abroad. It has been contended that avoidance results from improper pricing practices and unjustifiable passing of service fees and patent and know-how royalties between the domestic parent and a foreign subsidiary resulting in the taxation in a low tax rate foreign country of income properly allocable to the United States. As we have reiterated many times, such avoidance can be cured by a vigorous and intelligent application of section 482. It may well be that amendments to section 482 and in other limited areas would give the Commissioner a more effective, but still equitable, weapon to prevent tax avoidance with respect to foreign income. But no such provisions as are found in section 13 can be justified on the case that the Treasury Department has made to date; certainly the Treasury Department has not established a factual or economic basis for the radical changes proposed by section 13.

Constitutionality

There is probably no more important question than whether section 13 is valid and within the long-established principles of our Constitution. Naturally, we do not intend to present a legal brief, but we do believe that the constitutional aspects of the proposed legislation cannot be overemphasized. It goes without saying that the Congress should be very loath to enact legislation without a clear constitutional basis. Yet, we are firmly convinced that section 13 lacks sanction in the Constitution.

The 16th amendment authorizes the imposition of tax on "incomes, from whatever source derived." But, it certainly does not authorize the imposition of tax on one person measured by the income of another person. Under the foregoing language, it is abundantly clear that a person can be taxed on "income" and only on income that has been "derived," that is, received or accrued.

While the Treasury Department has published material purporting to rationalize section 13 with constitutional principles, it seems to us that the better view has been stated by those who disagree with the Treasury Department position.

We cannot comprehend the propriety of taxing a U.S. person on the income of a foreign corporation before the U.S. person has received the income (either actually or constructively). The courts have vigorously denied many such attempts—possibly the most notable of which is found in the case of *Eisner* v. *Macomber* (252 U.S. 189).

Actually, the taxation of unrealized corporate income is completely foreign to our firmly established legal principles, and we are convinced that the "imputing" of income under section 13 is without support in the 16th amendment.

In addition to the foregoing point—which we believe to be controlling without more—the singling out of certain type of income for taxation and the failure to allow all losses of controlled foreign corporations to their U.S. shareholders while taxing its profits to them, raise issues under the due process clause of the 5th amendment.

Status under tax treaties

In its income tax treaties with other countries, the United States has agreed that it will not tax the earning of corporations of those countries except to the extent allocable to permanent establishments in the United States. While the tax proposed by section 13 is not levied directly upon foreign corporations as such, taxation of its undistributed income by the United States at the shareholder level certainly violates the spirit of these commitments in our income tax treaties.

Other objections to section 13

In addition to the more fundamental defects discussed in preceding sections of this statement, there are many other features of section 13 that in and of themselves would normally warrant its rejection. We shall mention some of them briefly in the following paragraphs.

1. Legislative power is delegated by the Congress to the President and the Secretary of the Treasury. Simply by the exercise or nonexercise of powers granted them in section 13, the President and the Secretary can affect the amount of income tax payable by U.S. shareholders of controlled foreign corporations.

(*a*) The President is empowered from year to year to designate less developed countries and thus alter at will the income tax payable by U.S. shareholders of controlled foreign corporations.

(*b*) The determination of whether income is derived from certain sources outside the United States is to be made under regulations prescribed by the Secretary. Sections 861 and 862 make statutory provision for determining amounts of income from sources within and without the United States. Yet, as between certain foreign areas and the United States, section 13 would give the Secretary the power to override the express provisions of the Internal Revenue Code.

(*c*) The Secretary would have the power to determine the taxability of U.S. shareholders on undistributed foreign income of a controlled foreign corporation by deciding whether the creation of the foreign corporation receiving the income has the effect of substantially reducing income or similar taxes.

(*d*) The net amount of undistributed foreign income of a controlled foreign corporation which is taxable to U.S. shareholders is to be determined under regulations prescribed by the Secretary so as to take into account deductions properly allocable to the income. What guidelines will be used by the Secretary

in promulgating these regulations? For example, will they follow the pattern of the Internal Revenue Code as to allowable deductions in determining taxable income, bearing in mind that the books of foreign corporations must generally be kept in strict accordance with local rules? The standard set forth in section 13 seems wholly inadequate.

(*e*) Foreign income (other than from insurance) taxable to U.S. shareholders falls into three categories; namely, foreign personal holding company income, foreign sales income, and foreign service income. The Secretary is empowered to prescribe by regulation into which category a particular item of income falls and thus affect the tax consequences to U.S. shareholders.

(*f*) In order to exclude from the taxable income of U.S. shareholders earnings of a controlled foreign corporation which cannot be repatriated, the proposed section requires the Secretary to be satisfied that repatriation is prevented under the laws of a foreign country. Despite the wide latitude given the Secretary in interpreting the laws of a foreign country, the provision may well be too narrow when repatriation is not possible because of currency restrictions imposed by banking authorities and not under any specific law. In addition, the provision would disregard the reduced foreign income taxation on account of reserves set aside from earnings.

2. The provisions of section 13 are so complex and novel that it is difficult (and sometimes seemingly impossible) to interpret them. Administration of section 13 would require, among many others, the following determinations:

(*a*) Whether a foreign corporation is controlled at any time during a year.

(*b*) Whether a taxpayer owns directly or indirectly 10 percent of the voting power or total value of the shares of a controlled foreign corporation.

(*c*) The earnings and profits of several foreign corporations operating under different laws, in different countries and in different currencies.

(*d*) Source of income from transactions involving two or more countries (this would be extremely difficult to determine accurately).

(*e*) Whether fees are for services or for use of tangible or intangible property.

(*f*) Where goods are to be used, consumed, or disposed of.

(*g*) Where goods are manufactured, produced, or grown.

(*h*) Whether a branch outside the country of incorporation of a controlled foreign corporation is in effect a subsidiary of such corporation (we shall have to confess that this provision is practically incomprehensible to us).

(*i*) Whether a foreign corporation is a less developed country corporation which entails determining the source of its income and the type and location of all its assets.

(*j*) Whether certain obligations of a U.S. person to a controlled foreign corporation exceed an amount which would be ordinary and necessary to carry on the trade or business of either party if they were unrelated persons.

3. Particularly unreasonable among the provisions of section 13 are those which would tax to U.S. shareholders sales or service income of a controlled foreign corporation derived in connection with transactions between the corporation and a related corporation where the purchased property is produced outside of the country of incorporation of the controlled foreign corporation and is sold for use outside of such foreign country, or where the services are performed outside such foreign country.

Assume, for example, that a U.S. corporation desired to market its U.S.-produced goods in Europe through a selling organization under its control located in Europe. The logical step, particularly in view of the existence of the Common Market, would be the organization of a sales subsidiary under the law of one European country, say Switzerland, which would purchase from the U.S. parent and sell in the several European countries. However, income realized by the subsidiary from sales in countries other than that of its incorporation would be taxable to the U.S. company. Of course, this result could be avoided by organizing separate sales subsidiaries in each European country. But, country-by-country incorporation would be expensive and contrary to sound and efficient business methods. The only possible avoidance of U.S. income tax in the above operation would be through improper pricing methods between the U.S. parent and its sales subsidiary. This is subject to control through the application of section 482.

In the above example the U.S. corporation might find it necessary or advisable for competitive reasons to establish a manufacturing subsidiary in the Common Market, say Belgium, with selling operations handled by its Swiss sales subsidiary. Section 13 as proposed would cause the legitimate income of the Swiss

subsidiary from sales in countries other than Switzerland to be taxed to the U.S. parent. Where is the logic in this result? The income in question is earned outside of the United States and should be no concern of this country until realized by distribution to the parent.

The foregoing arguments against inclusion of sales income of the sales subsidiary in taxable income of the U.S. parent apply in like manner to service income that might be earned by the Swiss subsidiary. Suppose that the Swiss subsidiary employed personnel who rendered technical services to the Belgian manufacturing subsidiary. Legitimate income earned by the Swiss company for these services is no concern of the United States since it is earned outside the United States. If rendering of the services entailed use of technical know-how belonging to the U.S. parent, income properly attributable thereto could be reached by application of section 482.

A possible, and alarming, application of proposed section 954(d)(2) might come into play if the Belgian manufacturing subsidiary described above established a sales branch in Switzerland, rather than a sales subsidiary. This section, in language and purpose most difficult to understand, empowers the Secretary to determine whether the Swiss branch is in effect a subsidiary of the Belgian company. Upon such determination, income of the Belgian company from sales outside Switzerland, which in accordance with the laws of Belgium is allocable outside of Belgium and therefore not taxable in Belgium, would be taxable to the U.S. parent. This result is reached by a most novel process of deeming the Swiss branch a subsidiary of the Belgian subsidiary and then treating the income earned by the Swiss sales branch as foreign base company income taxable to the U.S. parent.

SECTION 16. GAIN FROM SALES OF EXCHANGES OF FOREIGN CORPORATION STOCK

The House Ways and Means Committee stated that the purpose of section 16 was to prevent deferred income from being realized at capital gain rates rather than ordinary income rates. The justification in logic and equity for ordinary income treatment of gain on disposition of foreign corporation stock escapes us. Stock of a foreign corporation certainly is a capital asset and represents an interest in a corporation which has earned its income outside of the United States, where it has not received the benefit of U.S. laws and expenditures. The fact that the corporate income earned abroad may have been subjected to tax rates lower than those of the United States should not convert gain on sale or liquidation of the foreign corporation from capital gain to ordinary income. It is probable that, as an adjunct of lower foreign tax rates, the foreign operations were subject to great financial risks through political and currency upheavals that are nonexistent in the United States. It is small comfort, indeed, to weather such risks and, upon realization of the fruits of investment in the United States, to be subjected to a tax commensurate with that payable if the business had been conducted in the United States.

The Treasury Department justifies the ordinary income proposal of section 16 as part of its plan for "equality" in the tax treatment of foreign and U.S. income. We have already dealt with the myth of this equality theory. However, if the Treasury Department is so concerned with equality, why does it not round out its proposal by calling for ordinary loss treatment on sale or liquidation of a foreign corporation.

In light of all the arguments against the proposed sections 13 and 16—and the absence of any persuasive arguments in their favor—we earnestly urge your committee to reject the proposals in their entirety.

(Whereupon, at 1 p.m., the committee adjourned, to meet in executive session on Wednesday, July 11, 1962.)